TESTIMONY ON PROGRESSIVE INDEXING
before the Senate Finance Committee
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Mr. Chairman and Committee Members:

Thank you for the opportunity to present my proposal for reforming Social Security called "Progressive Indexing". As explained below, progressive indexing is a fair and workable approach to returning the Social Security system to solvency. In my view, the Congressional debate needs to focus first on solvency, and only then on personal accounts. Solvency is the "spinach" that needs to be eaten before we get to the "dessert" of personal accounts.

It bears emphasis that progressive indexing can address the solvency issue without additional reforms. It would close the long-term deficit of Social Security by over 70%—from a present value of $3.8 trillion to roughly $1.1 trillion. Progressive indexing of Social Security benefits would not begin until 2012, in order to preserve the scheduled benefits of current retirees and those nearing retirement.

Progressive indexing can also be combined with other types of benefit reforms such as moving back the retirement age, or it can be combined with revenue raisers such as increasing the wage base subject to payroll taxes. In addition, progressive indexing can be combined with personal accounts – either carve-outs such as 2% per year from the 12.4% payroll tax, or add-on accounts such as enhancements to Individual Retirement Accounts (IRAs).

This testimony will begin by explaining how progressive indexing works, next it will rebut the key arguments against progressive indexing, and then it will describe how progressive indexing might be combined with other approaches to Social Security reform.

I. Progressive Indexing

After workers retire and begin to receive Social Security benefits, these benefits are increased each year by cost of living adjustments (COLAs) – reflecting increases in consumer prices each year. This is called price indexing. By contrast, when the initial Social Security benefits of workers are set at the time of their retirement, their average career earnings are adjusted upward by the rate at which American wages have increased during their careers. This is called wage indexing.

Progressive indexing means the continuation of wage indexing for all workers retiring in 2012 and later years whose career earnings average $25,000 per year or less (indexed to wages over time). All these low-wage workers would receive the Social Security benefits they are presently scheduled to receive under present law (scheduled benefits). Most of these low-wage workers do not have sources of retirement income other than Social Security – for example, 401(k) plans or IRAs. As mentioned previously, progressive indexing would also maintain current schedules for Social Security benefits for all retirees and all those retiring before 2012.

The initial benefits of all workers with career earnings above $113,000 per year in 2012 (the maximum wage base subject to FICA taxes in that year) would be increased by price indexing – the rise in prices during their working careers. These workers are relatively well off; most receive retirement income from 401(k) plans and IRAs in addition to Social Security benefits. The initial benefits of workers above $25,000 per year and lower than $113,000 per year in average career earnings would be increased by a proportional mix of wage and price indexing. For example, a worker with career earnings in the middle of the range would have his or her Social Security benefits adjusted upward approximately 50% by wage indexing and 50% by price indexing.

Progressive indexing is illustrated by the chart in Appendix A. The continuous line shows the path of Social Security benefit growth under wage indexing, which would apply to workers with average career earnings of $25,000 per year and below. The

hyphenated line shows the path of Social Security benefit growth under price indexing, which would apply to workers with average career earnings of $113,000 per year and above. The dotted line shows the path of Social Security benefit growth under a blend of half-wage indexing and half-price indexing, which would apply to workers with career earnings in the middle of this range.

II. Arguments Against Progressive Indexing

There are several arguments that have been made against progressive indexing. In my view, none of these arguments is well founded.

A. "Too Favorable" for Low-Wage Workers

Progressive indexing has been criticized as "too favorable" for low-wage workers because it provides them with faster growth of Social Security benefits than middle or high earners. For this purpose, low-wage workers mean workers with $25,000 per year or less in average career earnings; these workers constitute roughly 30% of all workers in the United States.

As mentioned above, these low-wage workers have minimal participation in IRAs and 401(k)s; they depend almost entirely on Social Security for retirement income. By contrast, most middle and high earners participate in these private retirement programs, which are heavily subsidized under the federal tax code. In 2004, for example, the tax subsidies for IRAs were approximately $55 billion. Thus, from the perspective of overall government support of retirement income, progressive indexing of Social Security benefits is needed to bring about even-handed treatment of all wage groups.

B. "Benefit Cut" for Middle Earners

Progressive indexing has been criticized as imposing a "benefit cut" for middle-wage workers because their Social Security benefits would grow more slowly under progressive indexing than under the current schedule. While their

benefit growth will be slower, this should not be considered a “benefit cut” for two reasons. First, according to the United States Supreme Court, future retirees have no legal entitlement to the current schedule of Social Security benefits. (Under progressive indexing, all Social Security benefits are preserved for any worker already in retirement or retiring before 2012).

Second, more practically, the purchasing power of the Social Security benefits received by the middle earner under progressive indexing will still increase over time. For example, under the current schedule, a scaled middle earner retiring at age 65 in 2005 would receive approximately $14,400 per year in initial Social Security benefits. Under progressive indexing, a scaled middle earner retiring at age 65 in 2055 would receive approximately $17,400 per year in initial Social Security benefits, as compared to $21,770 per year under the current schedule (all figures expressed in constant 2004 dollars). Thus, although the yearly benefits for middle earners would grow more slowly under progressive indexing than under the current schedule, the purchasing power of their benefits would increase by over 20% from 2005 to 2055 (from $14,400 to $17,400 in constant 2004 dollars).

C. <u>Lose “Political Support” of High Earners</u>

Progressive indexing has been criticized for reducing the Social Security benefits of high earners to the point where the Social Security benefits of all wage groups are the same. While progressive indexing would produce a flat benefit if it continued beyond 2100 that is neither necessary nor contemplated. Progressive indexing as modeled stops at 2079; it can be stopped before 2079 in order to retain a larger differential in Social Security benefits among wage groups.

Moreover, some of these critics of progressive indexing are inconsistent in their political analysis of high-wage workers. On the one hand, these critics express fears that high-wage workers will no longer “politically support” Social

Security if the benefits of these workers grow more slowly than scheduled. On the other hand, these same critics often advocate increased payroll taxes for high-wage workers with minimal extra Social Security benefits for them. In my view, the political support of high-wage workers will depend on what they receive in Social Security benefits relative to what they contribute in payroll taxes.

D. Relationship Between Wages and Prices

Wages have grown on average 1.1% per year faster than prices during the twentieth century in the United States. Critics of progressive indexing have pointed out that the historic relationship between wage and price growth may change over the next 75 years in the United States. On one hand, wages might grow faster than prices by more than 1.1% per year, or the gap between wage and price growth might narrow over time.

This is a reasonable criticism, which should be addressed by careful legislative draftsmanship. For example, instead of using price indexing, Congress could define the indexing applicable to the calculation of the initial benefits of high wage workers as annual wage growth minus 1.1% per year.

III. Combinations with Progressive Indexing

Progressive indexing can be implemented alone or combined with other approaches to Social Security reform. Set forth below are a few examples of such combinations.

A. Combined with Normal Retirement Age

As mentioned above, it would be feasible to stop progressive indexing at a date before 2079 (i.e., return to wage indexing only for years after that date) in order to retain larger differences in Social Security benefits among various groups of earners. In that scenario, it might make sense to move back normal retirement age (NRA) after the year when progressive indexing is stopped in order to continue moving the Social Security system toward the goal of permanent solvency.

For example, if progressive indexing of Social Security were stopped in 2061, it would be feasible to move back NRA gradually to age 68 ½ from 2061 to 2079 (at a rate of one month in NRA for every calendar year during this 18-year period). Although changes in NRA may not be popular among voters, they may be politically acceptable if instituted in distant time periods.

B. Combined with Carve-out Accounts

Since progressive indexing would slow the growth of Social Security benefits for some workers, it could be combined with a personal retirement account (PRA) involving a voluntary allocation of a modest portion – such as 2% – of 12.4% in payroll taxes. Any worker who made such an allocation to a PRA would have to accept a lower traditional Social Security benefits since he or she would be paying in lower amounts to the traditional system. The PRA would be presumptively invested in a low-cost balanced account, comprised 60% of an equity index fund and 40% of a bond index fund, which would have a good chance of earning higher returns than the Social Security system over 30 to 35 years – the entire careers of these workers.

Critics have pointed out that carve-out PRAs would not improve the solvency of the Social Security system and would increase government borrowing. As illustrated by the chart in Appendix B, however, a combination of progressive indexing and a carve-out PRA with a 2% allocation (limited to $3,000 per year with the limit indexed to prices) would make Social Security solvent by the end of the standard 75-year period used to measure the system's solvency. No government borrowing would be needed until 2030 and such borrowing would be completed before 2079. Moreover, the government borrowing needed to finance this combination would be $2 trillion lower than the government borrowing needed to finance the current Social Security system over the next 75 years.

C. Combined with Add-on Accounts

For those who oppose carve-out PRAs, progressive indexing could be combined with various forms of add-on accounts in a legislative package. Again, add-on accounts themselves will not make Social Security solvent and would increase the budget deficit. However, a combination of progressive indexing with modest expenditures for add-on accounts could be designed to substantially improve the solvency of Social Security.

In my view, the most efficient way to pursue add-on accounts is to enhance the existing structure of IRAs, rather than to create an entirely new set of accounts. One possibility would be to transform the low-income tax credit for IRA contributions into a partially refundable tax credit. This would make the tax credit effective for families with incomes below $40,000 per year, who often do not pay federal income taxes. Another possibility would be to remove the income ceiling from the Roth IRA, which currently starts to phase out for families with incomes over $120,000 per year. The removal of the income ceiling would be a political quid pro quo for high wage earners with the slowest growth Social Security benefits under progressive indexing.

D. Combined with Raising Payroll Tax Base

For those who insist on increasing the payroll tax base, this can be combined with progressive indexing (and perhaps a new type of personal account). In my view, it would be unfair to raise the payroll tax base from $90,000 to $150,000 or $200,000 per year. This would impose a huge tax increase on workers in these brackets, while not touching most of the earnings of the workers with very high wages. A fairer approach, based on the Medicare model, would be to impose a 2.9% payroll tax on earnings above $90,000 per year without an earnings limit.

If such a 2.9% incremental tax above the current maximum earnings base were implemented, what would be the Social Security benefits associated with this 2.9% incremental payroll tax? To maintain the framework of social insurance, Congress would

have to grant substantial benefits for that incremental tax. On the other hand, there might be a public outcry against very large monthly checks from Social Security to millionaires. A possible compromise would be to allow 2% of the 2.9% incremental tax to be invested in a PRA, while dedicating 0.9% to increasing the solvency of Social Security.

Conclusion

Progressive indexing provides a fair and workable foundation for legislative efforts aimed at improving the solvency of Social Security system. Progressive indexing is flexible with regard to the date it is implemented and the date it is stopped. Moreover, progressive indexing can be combined with various forms of political “sweeteners” to make a viable legislative package.

I would be happy to answer any questions that any Senator might have about progressive indexing. Thank you again for the opportunity to testify on this very important subject.