

SOCIAL SECURITY

Statement before the
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SOCIAL SECURITY REFORM

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify on achieving sustainable balance in Social Security. Since Social Security was first enacted, vast changes have occurred in the economy, life expectancy, health care, the physical demands of jobs, the labor force participation of women, and even the age at which one can be considered old. Yet, we often debate Social Security as if the type of system we want in 2080 should be determined by perceptions and measures of society's needs in 1930, or 150 years earlier. Much of my testimony will deal with our increasing inability to protect the young, the truly old, and the vulnerable when Social Security morphs into a middle-age retirement system.

The Social Security debate could and should be part of a larger one in which we engage our fellow citizens in figuring out how to take best advantage of new opportunities created by longer lives and better health. How can we spread the gains from this increased level of well-being and wealth to create a stronger nation with opportunity for all? And how should we share the costs?

Unfortunately, as now scheduled, the legacy we are about to leave our children is a government whose almost sole purpose is to finance our own consumption in retirement. We who are middle-aged or older come nowhere close to paying for the government transfers we are scheduled to receive, especially once health benefits are added in. More important, we plan to pay for them by shrinking almost to oblivion the rest of government that would serve our children and grandchildren.

The impact on the budget is especially large beginning around 2008 because that is when so many start moving from the working-age population into the retired population. Assume merely that Social Security, Medicare, and Medicaid continue on automatic pilot, that interest on the debt is paid, and that as a percentage of GDP existing levels of revenues are allowed to rise only moderately and defense expenditures decline only modestly. Then by about 2015 no revenues are left for anything else—not for justice or transportation or education, not for wage subsidies or education or environmental clean-up or community development, not for the IRS or national parks—not even to turn on the lights in the Capitol. The pressure on the budget is not awaiting some magical date like 2018 or beyond. Social Security and Medicare are already spending much more than the Social Security tax for Social Security and Medicare, and even this accounting does not include all the other programs for the retired and elderly in the budget. The pressure on programs for children and working families is being felt right now, and the fight over the fiscal 2006 budget makes this glaringly apparent.

Clearly, retaining a necessary share of the budget for our children and grandchildren means that we must pare the growth rate in elderly entitlement programs. Nonetheless, I believe that *it is possible under existing tax rates to build a Social Security system that would do a better job than the current one at removing poverty (measured by relative living standards) and serving the majority of the population when they are truly*

old. If we start with that type of base, then we can move onward to the other debates—those over how to increase private retirement saving, how many benefits should be provided to those who are middle-aged, and how much higher benefits need to be for those who are better off.

MEASURING LIFETIME BENEFITS

Looking at Social Security reform through an annual lens often distorts the impact of longer lives and more years of benefits on the costs of the system and the rate of benefit growth. A more comprehensive and more revealing approach, I believe, is to look at the lifetime package of benefits.

Define “lifetime benefits” as the value, at age 65, of Social Security and Medicare benefits as if they were sitting in a 401(k) account that would earn interest but be drawn upon over retirement. In today’s dollars, lifetime benefits for an average-income couple have risen from about \$195,000 in 1960 to \$710,000 today (\$439,000 in Social Security and \$271,000 in Medicare) to over \$1 million for a couple retiring in about 25 years (over \$1/2 million in both Social Security and Medicare—see figure 1). These numbers quickly reveal what is happening to the budget as a whole. We cannot provide a very large portion of American couples \$1/2 to \$1 million of benefits and simultaneously encourage them to drop out of the workforce for the last third of their adult lives without affecting dramatically the services that can be provided through the budget to our children and to working families.

THE SIMPLE ARITHMETIC DRIVING SOCIAL SECURITY REFORM

Despite the confusing aspects of trust fund accounting, rates of return, and financial measures of solvency, the arithmetic behind Social Security’s current problems is simple. Once the baby boomers starting hitting retirement, there is a scheduled drop in workers per beneficiary from more than 3-1 to less than 2-1. To simplify our arithmetic, let us assume that the drop is exactly from 3-1 to 2-1, and imagine that this drop were to occur instantaneously. Recall that Social Security is almost entirely a pay-as-you-go system, despite a slight and temporary buildup in trust funds that ultimately would pay for only around one-tenth of liabilities under current law. Now consider three workers, A, B, and C, who each transfer $\$3,333 \frac{1}{3}$ to pay \$10,000 of benefits to D (figure 2). All of a sudden C disappears, so only A and B must pay the benefits of D. A and B can continue to pay \$3,333 each. But then D would receive only \$6,666 in benefits. Thus, her benefits would fall by one-third. Or D can be held harmless, so that she still receives \$10,000. But then A and B would have to increase their payments to \$5,000 each. If we must hold at least one group harmless, then what is required is either a benefit cut of 33 percent or a tax rate increase of 50 percent.

A MIDDLE-AGE RETIREMENT SYSTEM SERVING THE VULNERABLE LESS EACH YEAR

Social Security's current dilemma centers almost entirely on the drop in scheduled workers per retiree—a labor force issue. Although more saving would be nice, whether in trust funds or retirement accounts, we are not going to save our way out of this problem. Consider some of the consequences of the current system.

The system has morphed into a middle-age retirement system.

- Close to one-third of the adult population is scheduled to be on Social Security within about 25 years. Including adults on other transfer programs, we are approaching the day when the majority of the adult population will depend upon transfers from others for a significant share of its support.
- People already retire on average for close to one-third of their adult lives.
- The average Social Security annuity for a man retiring at 62 lasts 17 years, for a woman 20 years, and for the longer living of a couple at least 25 years. The life numbers are even higher for those with above-average lifetime earnings because they have above-average life expectancies.
- When Social Security was young—for instance, in 1940 and 1950—the average worker retired at about age 68. To retire for an equivalent number of years on Social Security, a person would retire at age 74 today and age 78 in another 60 years (figure 3).

Almost every year a smaller share of Social Security benefits goes to the most vulnerable.

- By constantly increasing benefits to middle-age retirees, at least as defined by life expectancy, smaller and smaller shares of Social Security benefits are being devoted to the elderly (figure 4). If progressivity is defined by how well the vulnerable are served, the system is becoming less progressive every year.

The economy gets hit several ways, not just in terms of costs.

- Among the most important, but ignored, sides of the Social Security budget equation is the decline in growth of the labor force (figure 5), with its additional effect on slower growth in national income and revenues.
- When a person retires from the labor force at late middle age, national income declines. But the decline is borne mainly by other workers, not by the retiree. For instance, when a \$50,000-a-year worker retires a year earlier, national income declines by approximately \$50,000, but most of those costs are shifted onto other

workers as the retiree starts receiving about \$23,500 in Social Security and Medicare benefits (much more in the future) and pays about \$18,300 less in taxes (figure 6).

- Saving declines because people retire in what used to be their peak saving years. For instance, when a person retires for 20 years versus 15, he both saves for 5 years less and spends down his or society's saving for 5 years more.

THE OPPORTUNITY: INCREASING WORKSPANS WHILE PROTECTING THE VULNERABLE

Believe it or not, there is tremendous opportunity in all of this. People in their late 50s, 60s, and 70s have now become the largest underutilized pool of human resources in the economy. They represent to the labor force for the first half of the 21st century what women did for the last half of the 20th century. The labor demand, I believe, will be powerful, and it is mainly our institutions, public and private, that are blocking us from making full use of these valuable and talented people.

Keep in mind that this labor force story differs dramatically from that of the past 60 years. Two factors made the remarkable decline in labor force participation among older men possible: the entry of the baby boom population into the labor force and the increased labor force participation of women. The net effect over the post-World War II period was an adult employment rate that increased over almost all non-recession years (figure 7). What this tells me is that there is a demand for labor that very possibly would be met by this extraordinary pool of talented older workers if institutions adjusted to encourage it and let it happen.

We don't really know yet how all of this will play out. But if we remove the disincentives to work, increased labor force participation could make all sorts of budget decisions easier over the long run. Again, it is because increased labor will add both to national income and to revenues—thus lessening how drastically programs for the young AND the old have to be cut.

RE-ORIENTING BENEFITS TOWARD THE OLD

Restoring Social Security to an old-age, not a middle-age, retirement program can be done partly by increasing the retirement ages (including the early retirement age—else it is just an across-the-board benefit cut). A related move would be to backload benefits more to help those who are older. Whatever the level of lifetime benefit settled upon in a final reform package, actuarial adjustments can provide more benefits later and fewer earlier. These adjustments can take various forms: adjust benefits upward when Social Security predicts that average life expectancy has fallen below, say, 12 years (about age 74 in 2005 and indexed for life expectancy in later years) and downward in earlier ages; or provide a lower up-front benefit in exchange for post-retirement wage indexing.

A related adjustment would be to provide a better actuarial adjustment for working longer. Currently we subsidize people to retire early. While lifetime benefits are about the same for a worker retiring at, say, age 62 or 65 or 68, the worker who stays in the workforce contributes much more in the way of tax. A greater differential between earlier and later retirement would be appropriate both from a fairness and an efficiency standpoint.

These changes in retirement ages and in the lifecycle distribution of benefits have many positive effects. They progressively move benefits to later ages when people have less ability to work, lower income, and less help from a spouse to deal with impairments. Support in old age WAS the original purpose of the program. They put labor force incentives where they are most effective—in late middle age, including the 60s, when most people report being in fair, good, or excellent health. When cuts in benefit growth rates are required, they cause less hardship than almost any across-the-board benefit cut for two reasons: first, they are more likely to increase revenues, thus making it possible to afford a better benefit package, and second, they don't affect the benefits of the truly old as long as they adjust their work lives in line with the changes in the retirement ages.

I recognize that some people are concerned about groups with shorter-than-average life expectancies. But attempting to address their needs by granting many of us who are healthy a 20th and 21st and 22nd year of transfer support and tens, if not hundreds, of thousands of dollars in extra benefits for retiring early is a very bad form of trickle-down policy.

An increase in the retirement age can be combined with other provisions that help, rather than hurt, groups with shorter life expectancies. One way to do this is to provide a minimum benefit aimed at lower-income households and at reducing poverty rates (using a poverty standard adjusted for living standards or wage-indexed) among the elderly. With such a minimum benefit in place, any of the age-of-retirement adjustments can actually increase, rather than decrease, the relative share of benefits for groups with lower life expectancies, since their life expectancies are correlated with lower lifetime earnings. In fact, with a good minimum benefit, we can increase the income of low-income people and reduce poverty rates, even relative to current law.

One warning is in order here, however. Some minimum benefit packages end up more symbol than substance. For instance, they may not be indexed for wages, so don't cost much in the long run. Or they have so many years of work requirement that they don't help some groups of low-income people, especially women. We need Social Security and other agencies to provide estimates of the effectiveness of different alternatives if we want to provide a base of protection.

EVIDENCE ON ABILITY TO WORK

One question that often arises is whether Social Security needs to provide an increasing share of benefits every year to those further and further from date of expected death. Three pieces of evidence are provided here: (1) health trends among old and near-

old; (2) physical demands of jobs; and (3) the ability of people to work at similar ages in the years before early retirement options and other benefits were made available.

First, older Americans over age 55 seem to be reporting that their health has improved. Figure 8 reports the share of older adults reporting fair or poor health in two groups: those age 65–74 and those age 55–64 between 1982 and 2002. Even among those age 65–74, the fraction reporting fair or poor health is less than one-quarter. The fraction actually reporting poor health is much smaller still. The rest report being in good or excellent health.

Similarly, among those age 55 to 59, the share with work limitations has declined from 27.1 percent in 1971 to 19.5 percent in 2002 (figure 9). Note that a work limitation does not mean inability to work but, rather, a limitation to do certain types of jobs. In any case, the trend moves in the same direction: as years pass, fewer people of a given age have been reporting work limitations.

Survey results such as those just reported, of course, involve qualitative data. We need to check alternative evidence. A second approach is to try to find trends in physical limitations of jobs using a similar measure over the years. One source, shown in figure 10, indicates that the share of U.S. workers in physically demanding jobs has declined from over 20 percent in 1950 to about 8 percent in 1996.

Finally, let us compare the labor force participation of males with a similar life expectancy from 1940, when Social Security first paid benefits, until 2001. In figure 11, we see that about 86 percent of men with about 16 years of life expectancy participated in the labor force in 1940. That figure remained high until the late 1960s, a few years after men with a similar life expectancy became eligible for early retirement benefit and after Medicare benefits were enacted into law. After those enactments, labor force participation began a very rapid descent to less than 35 percent. It is now beginning to rise slowly—one more piece of evidence that demand for labor is shifting to older workers.

Comment:

It is hard to believe that as the physical demands of jobs have declined, people have become that much less capable of working. It is more likely that the higher levels of benefits in Social Security and Medicare, increasingly available for more and more years before expected death, have been the major factors driving the drop in labor force participation.

CHANGING THE DEFAULT

Under current policy, federal government spending grows automatically, by default, faster than tax revenues as the population ages and health costs soar. These defaults threaten the economy with large, unsustainable deficits. More important, they deny to each generation the opportunity to orient government toward meeting current needs and its own preferences for services. Only by changing the budget's auto-pilot

programming can we gain the flexibility needed to continually improve government policies and services.

Rudolph L. Penner (also a senior fellow at the Urban Institute and a former director of the Congressional Budget Office) and I have come to believe that there is no way to get the budget in order without addressing the issue of these defaults. Budget-irresponsible defaults apply to many programs of government, but the largest are linked to Social Security and Medicare. As currently structured, these programs are designed to rise forever in cost faster than national income and revenues—an impossible scenario. In Social Security, the problem is caused by the combination of more years of retirement support over time and wage indexing for annual benefits.

Regardless of what Social Security reform is undertaken, some rule should be adopted that would put the program back into balance over the long term when, for instance, the trustees report for three consecutive years that the program is likely to be in long-run deficit. This trigger should force the system's automatic features to move responsibly back toward budgetary balance.

With the trigger pulled, two of many options at that point strike me as particularly simple and easy to implement. First, the early and normal retirement ages could be automatically increased two months faster per year than under current law for everyone younger than, say, 57 in the year the trigger is pulled. Second, in those years, the benefit formula could be indexed to the lower of price or wage growth in a way that allows average real benefits to increase but more slowly than wages.¹ This approach could be supplemented by a new special minimum benefit indexed to wage growth. Other approaches to this option can also be devised to reduce the growth rate of benefits more for high earners than for low earners.²

Of these two options, I prefer increasing the retirement ages since that allows more revenues for the system and, consequently, higher lifetime benefits for the same tax rate. Other benefit reductions, as noted, hit the oldest beneficiaries with their greater needs as well as everyone else. For similar reasons, among the “progressive price indexing” options, I prefer creating a wage-indexed minimum benefit since that is more likely to protect the more vulnerable, including survivors, than is a form of progressive price indexing that continues to spend larger shares of revenue on increasing benefits for succeeding generations of those with well-above-median lifetime earnings. But, regardless, the system must be redesigned so that, when on automatic pilot, the default option leads to a responsible and sustainable budget.

There is, of course, no reason to believe that such automatic changes will alone lead to a socially optimum Social Security system. For instance, they do not deal with the

¹ Technically, the so-called bend points in the benefit formula could be indexed to the lower of wage or price growth. This approach to price indexing differs from some recent proposals that ratchet down future benefits derived from the current benefit formula by the difference between the rate of growth of wages and prices.

² The term “progressive price indexing” has sometimes been applied to this effort, but there are many ways to change the growth rate differentially for workers with different levels of lifetime earnings.

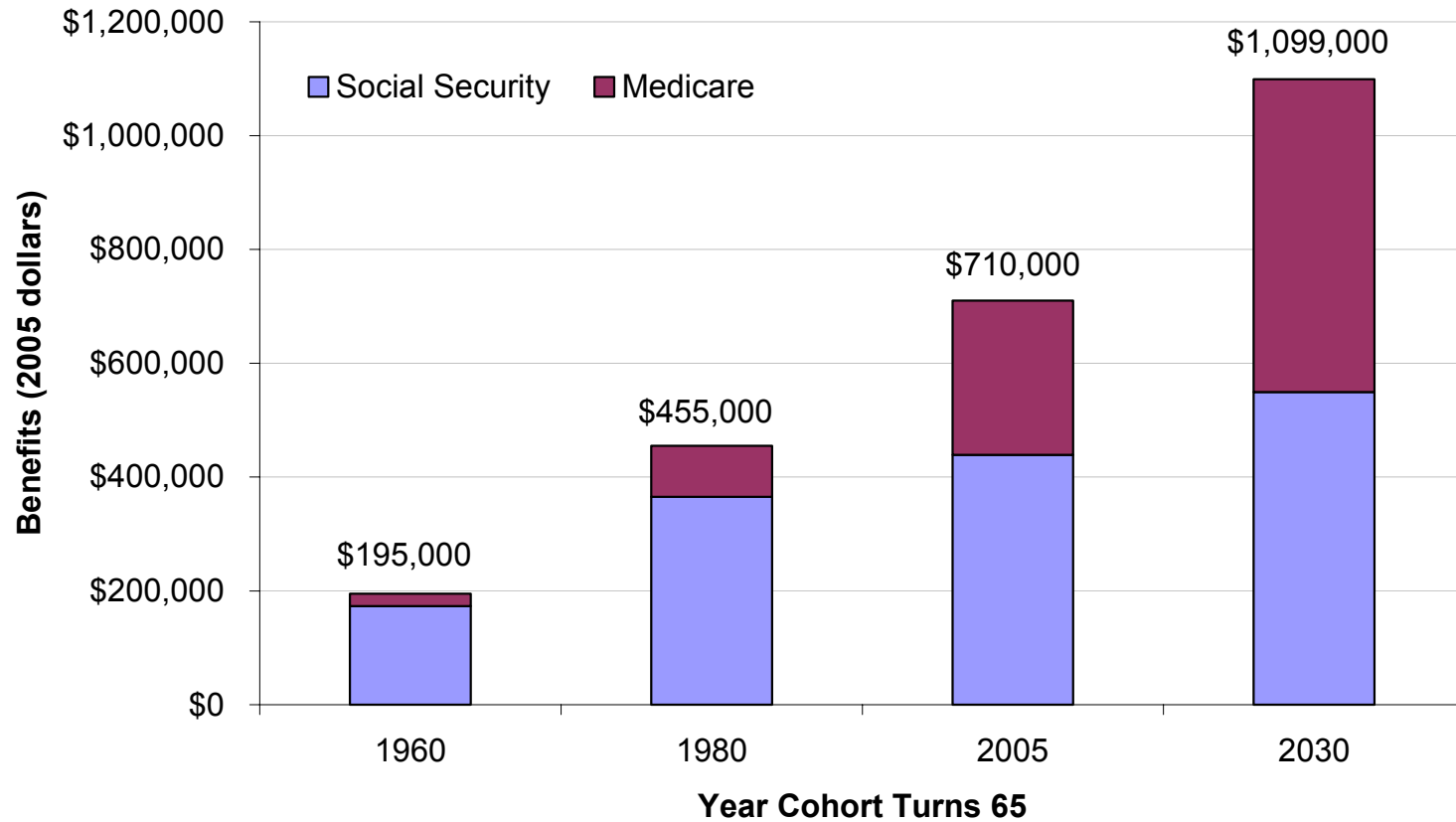
discrimination in current law against single heads of households. The point of changing the defaults is, rather, to migrate from a system in which the Congress has little choice but to enact painful benefit cuts to one in which Congress has the opportunity to provide more generous benefits from time to time—that is, to play tax Santa Claus rather than Scrooge sometimes, as politics requires.

By creating a system in which the budget automatically becomes ever more responsive and responsible to future taxpayers and beneficiaries, the door is also open to spending more now on programs for people who aren't elderly—especially children—and on public investments. Or Congress might use the freed-up resources to make Social Security benefits more generous to those with low average lifetime earnings or to provide more cash to lower-income elderly to help pay for medical payments. And, of course, Congress can always choose to raise taxes to provide a higher benefit growth rate in each year, though remaining responsible means making each year's decision to increase benefit levels independent of the next year's.

CONCLUSION

We can and should fix a Social Security system that favors middle-age retirement and that continually reduces both the shares of Social Security resources for the truly elderly and the share of total revenues remaining for programs for children and working families. A reformed system can easily reduce poverty rates (adjusted for life expectancy), while providing many others among the truly old a lifetime benefit as good, or better, than most generations have received in the past.

Figure 1
Social Security and Expected* Medicare Benefits for Average-Wage, Two-Earner Couple (\$36.6K each)



* Expected rather than realized benefits. Notes: The “high” and “average” wage profiles are those hypothetical profiles routinely employed by the Social Security Administration in its analyses. Lifetime amounts, rounded to the nearest thousand, are discounted to present value at age 65 using a 2 percent real interest rate and adjusted for mortality. Projections based on intermediate assumptions of the 2005 OASDI and HI/SMI Trustees Reports. Includes Medicare Part D. Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2005.

Figure 2

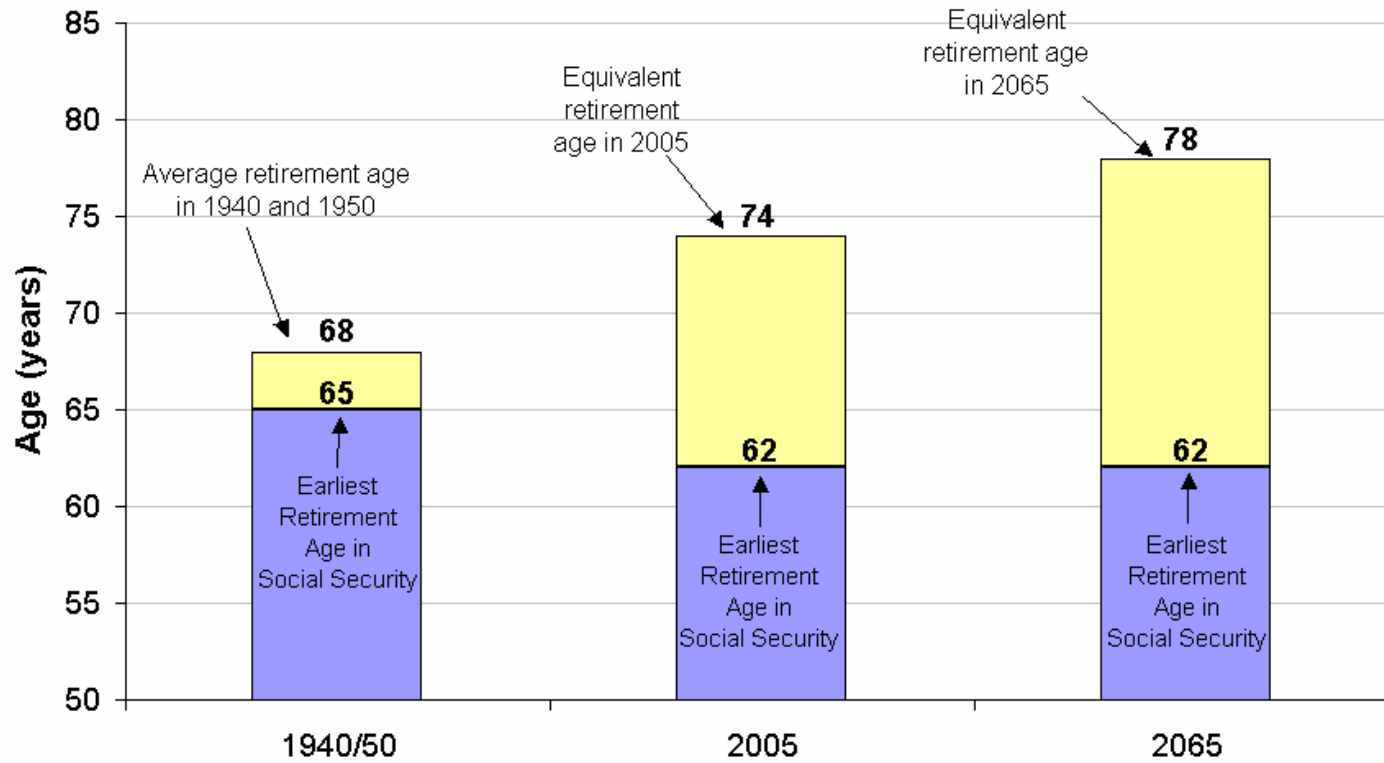
Simple Example			
Effect of a Drop in Workers to Beneficiaries From 3-to-1 To 2-to-1			
Taxes Paid By Taxpayers			Benefits per Beneficiary
A	B	C	D
Pre-Baby Boomer Retirement			
\$3,333	\$3,333	\$3,333	\$10,000
Post-Baby Boomer Retirement - Hold Taxpayers Harmless			
\$3,333	\$3,333	\$0	\$6,666 (33 percent reduction in annual benefits)
Post-Baby Boomer Retirement - Hold Beneficiaries Harmless			
\$5,000 (50 percent increase in tax rates)	\$5,000 (50 percent increase in tax rates)	\$0	\$10,000

Source: C. Eugene Steuerle, "The Simple Arithmetic Driving Social Security Reform." *Economic Perspective Column*, Tax Analysts. April 20, 1998. Available online at <http://www.urban.org/url.cfm?ID=1000085>.

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Figure 3

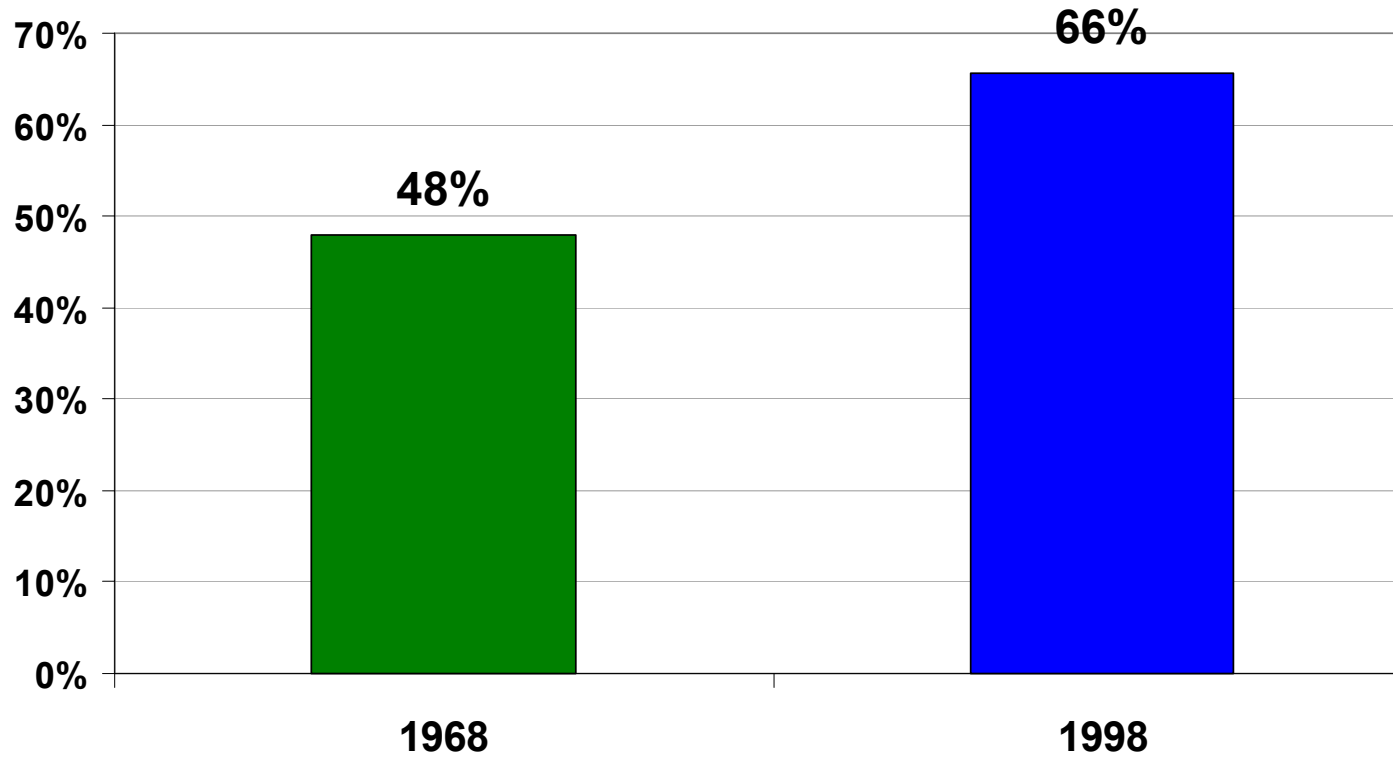
Retirement Age and Life Expectancy, 1940/50, 2005 and 2065



Source: The Urban Institute, 2005. Based on data from the Social Security Administration, Birth Cohort Tables, 2005.

Figure 4

Proportion of Men's Social Security Benefits Going to Men With More Than 10 Years Remaining Life Expectancy



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the Social Security Administration's 2001 Annual Statistical Supplement, Table 5A.1.

Figure 5

Labor Force Projections

Annual Growth Rate (% over Period)		
2000-10	2010-20	2020-30
1.08	0.38	0.38

Note: Projections assume no change in patterns of retirement by age and sex.

Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the US Bureaus of Census and Labor Statistics.

Figure 6

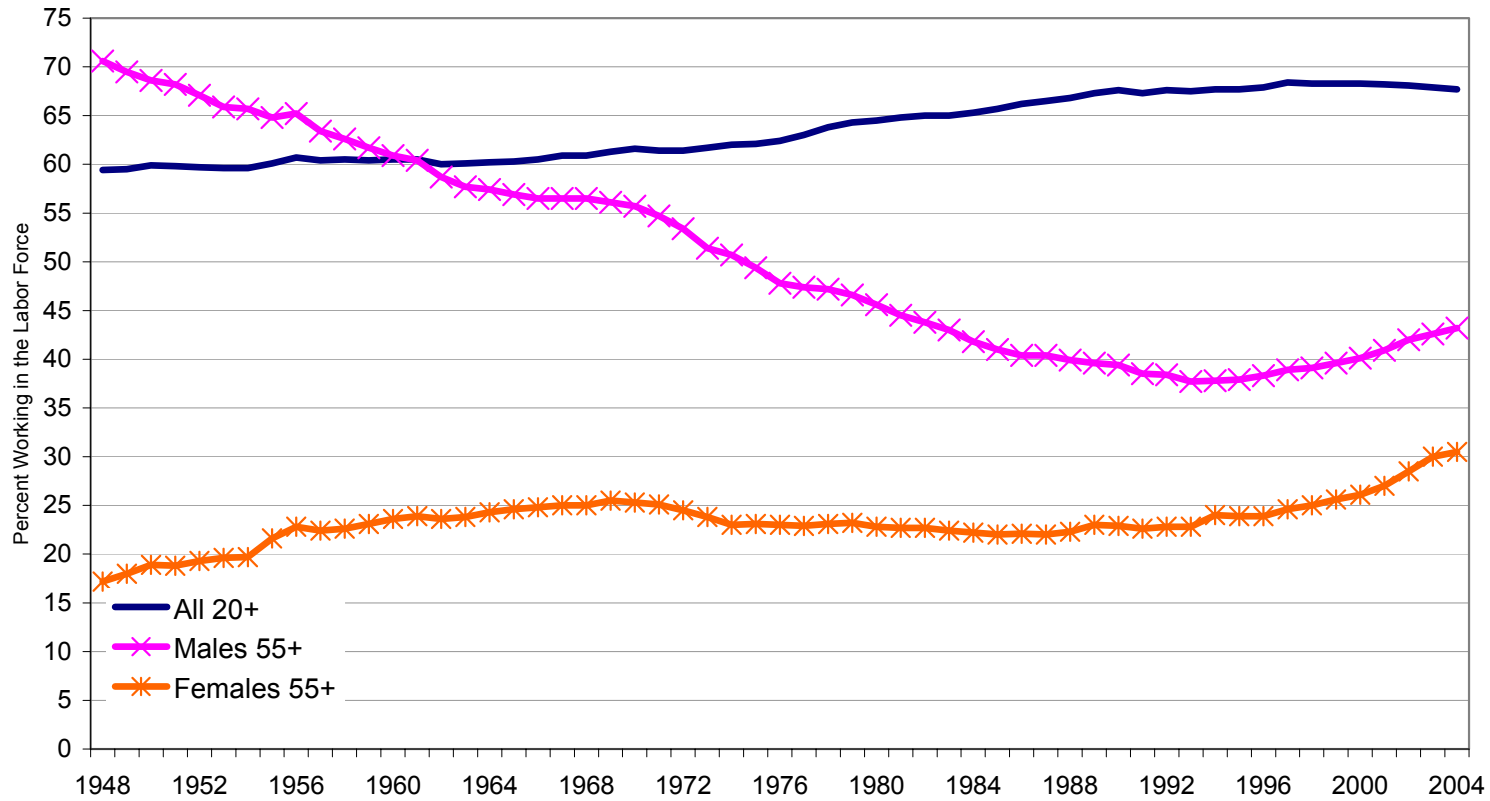
For a worker who earns \$50,000...

Increases in Resources Transferred from Others	
Social Security Benefits	\$18,500
Medicare Benefits	\$5,000
	<hr/>
Total 1	\$23,500
Decrease in Resources Transferred to Others	
Social Security Taxes	-\$7,700
Federal Income Taxes	-\$6,600
Other Taxes (Including State and Local)	-\$4,000
	<hr/>
Total 2	-\$18,300
Net Change in Transfers Received (Total 1 - Total 2)	\$41,800
	<hr/>
Addendum: Additional decline in retiree's after-tax earnings otherwise available to meet current and future needs	\$31,700
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Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

Figure 7

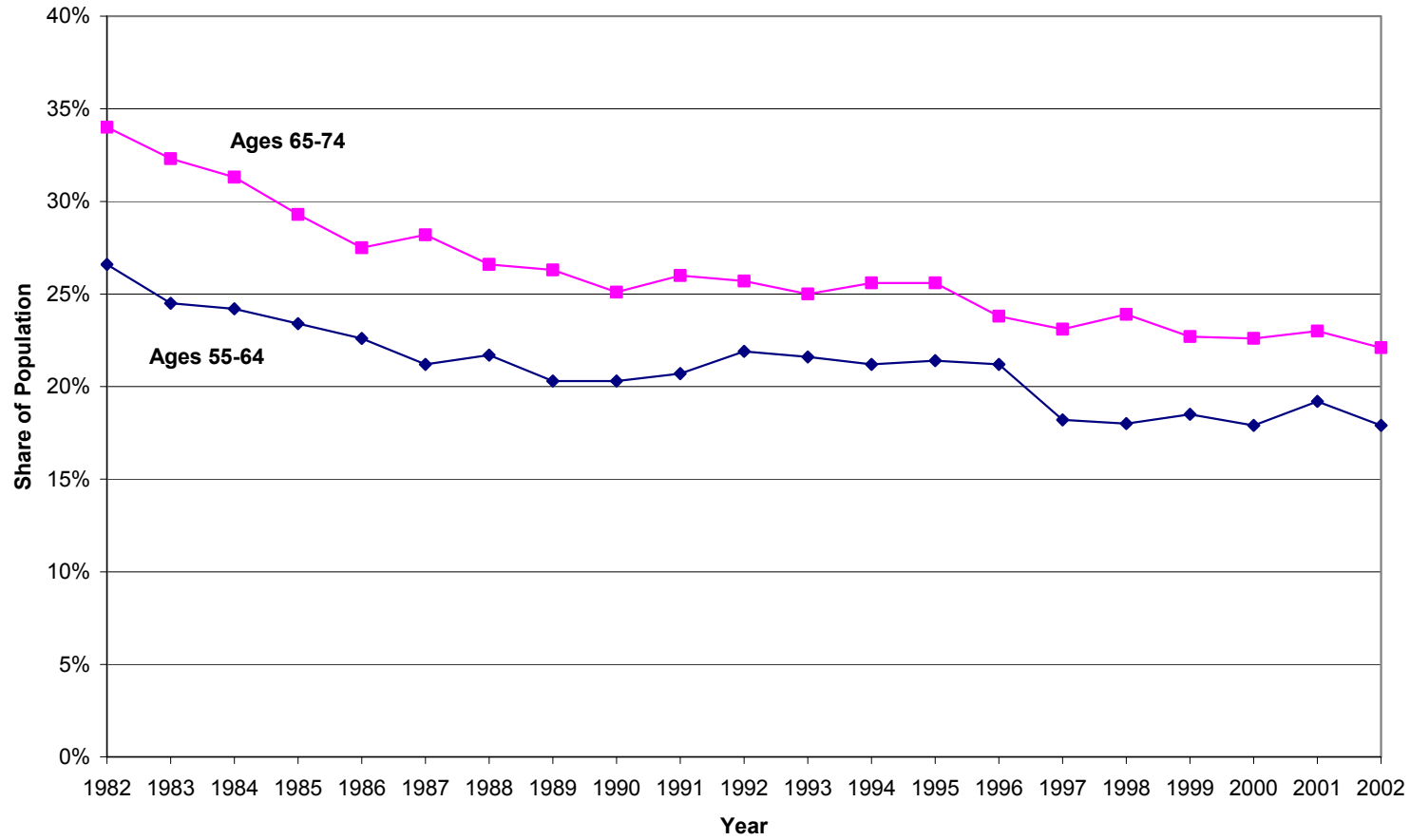
Labor Force Participation Rates: Males and Females Aged 55+ vs. the Adult Population, 1948-2004



Source: U.S. Bureau of Labor Statistics, 2005.

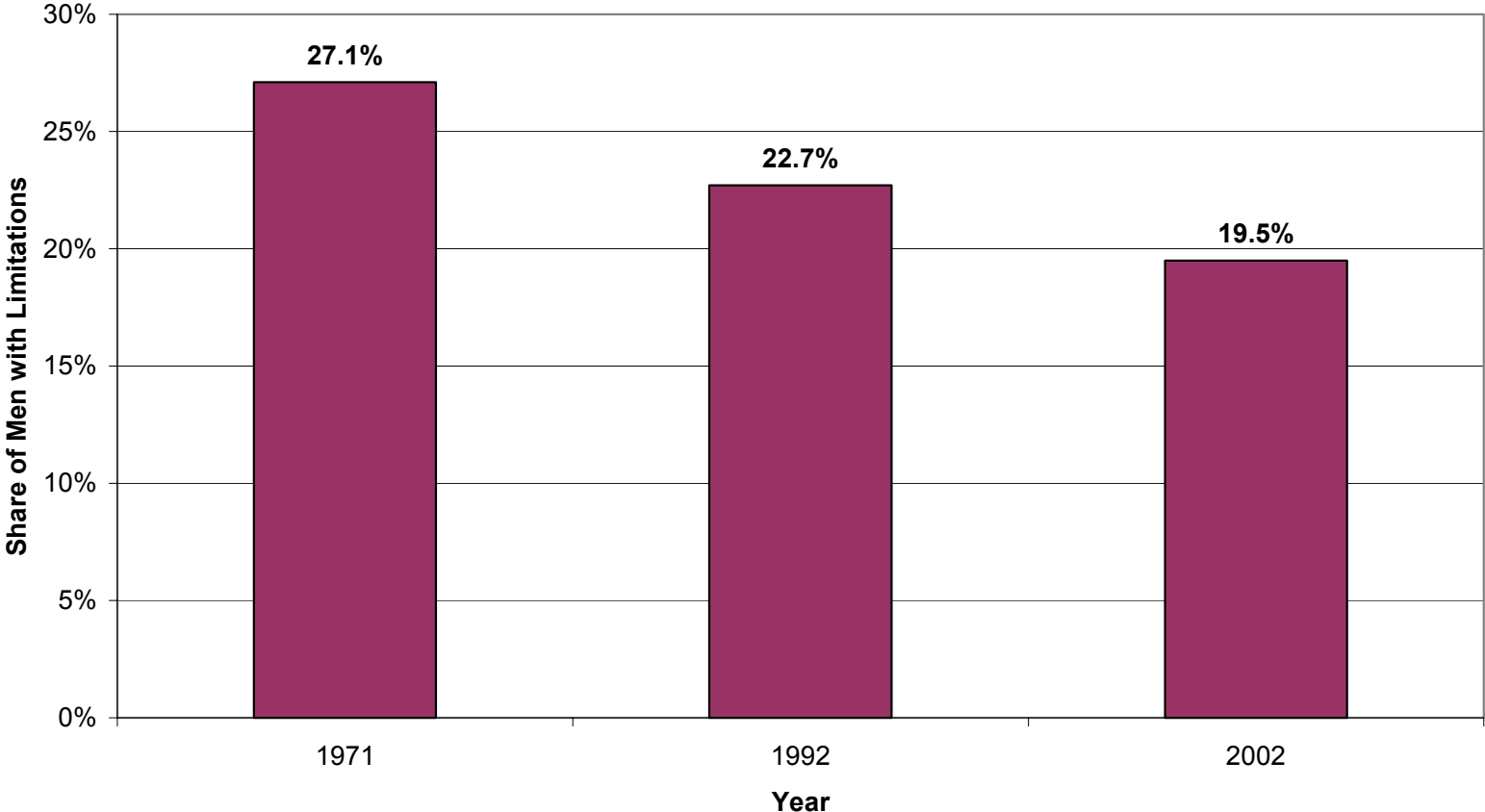
Figure 8

Share of Older Adults Reporting Fair or Poor Health, 1982-2002



Source: National Center for Health Statistics (2004).

Figure 9
Share of Men Ages 55-59 with Work Limitation, 1971, 1992, 2002



Source: Richard Johnson and C. Eugene Steuerle, "Promoting Work at Older Ages: The Role of Hybrid Pension Plans in an Aging Population." Pension Research Council Working Paper 2003-26. Available online at http://www.urban.org/UploadedPDF/410932_promoting_work.pdf. Estimates from the National Longitudinal Survey of Older Men and the Health and Retirement Study.

Figure 10

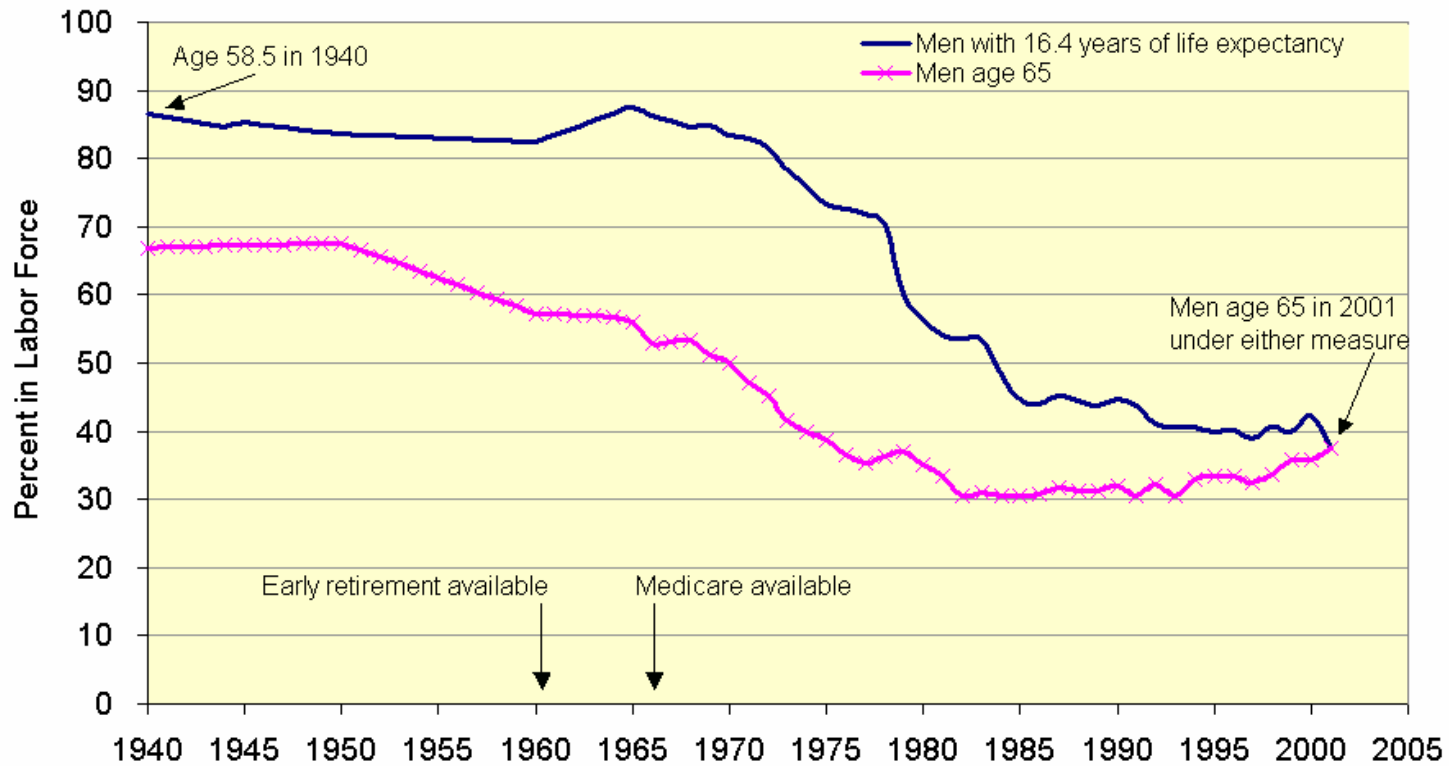
Figure 9. Share of U.S. Workers in Physically Demanding Jobs



Source: C. Eugene Steuerle, Christopher Spiro, and Richard Johnson. "Can Americans Work Longer?" *Straight Talk on Social Security*, No. 5, The Urban Institute, August 15, 1999. Based on the U.S. Department of Labor, *Dictionary of Occupational Titles* (1977) and the U.S. Bureau of the Census Current Population Survey, 1971, 1981, 1991 and 1997. Data points for 1950 and 1960 are taken from the U.S. Social Security Administration study *Increasing the Retirement Age: Effect on Older Workers in Physically Demanding Occupations or Ill Health*, 1986.

Figure 11

Male Labor Force Participation Rates, 1940-2001



Source: C. Eugene Steuerle, Adam Carasso and Meghan Bishop, The Urban Institute, 2002. Based on data from the U.S. Social Security Administration, the Bureau of Labor Statistics, and the U.S. Census of Population.