RESTORING SOLVENCY AND IMPROVING EQUITY IN SOCIAL SECURITY: BENEFIT OPTIONS

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to testify on alternative ways to restore solvency and undertake benefit reforms in Social Security. My understanding is that you have already held testimony on financing challenges and revenue options and today want to focus on benefit options. As for revenue options beyond the scope of this hearing, I refer you to the testimony I made before the National Commission on Fiscal Responsibility and Reform, although I must note here that too little attention is given to the ways that benefit options within Social Security can be designed to have a very positive impact on revenues, including income tax revenues.

In my testimony I will concentrate on four types of benefit reforms. These include restricting automatic growth in benefits where needs are least, adjusting benefits so they both encourage employment and are concentrated more in older ages, removing many sources of inequity and inefficiency in the system that penalize beneficiaries ranging from low-income abandoned mothers to faithful spouses, and reforming private pensions so they better protect the majority of workers who today end up with little in the way of private retirement benefits. Basic principles of public finance imply that each of these four arenas should be reformed even if there were no budget imbalances in Social Security or in the wider federal budget so we can better direct our societal resources.

Before proceeding, I must repeat a dream I have laid out before this Committee in the past. In this dream, researchers from the National Institutes of Health come in to the Committee room and proclaim that they have found an expensive cure for cancer. The audience is thrilled at the possibilities, but behind the podium the members are sweating and commiserating among themselves. At last, I figure out why they are concerned: better health means longer lives and more health costs, so Social Security and Medicare will be even more out of balance.

The point of recounting this dream is simple. To develop a 21st-century government and promote a strong future economy, we must deal with many problems: inadequate educational attainment, crime, unemployment, youth being raised without fathers, too much borrowing from abroad, and so forth. Longer lives and better health are not among them. These blessings and societal gains have been converted into budgetary problems by the way we have designed our social insurance systems to spend ever-larger portions of our national income on needs that are marginally less important.

Social Security and the Modern Economy

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, the percentage of women left on their own to both raise children and work, the age at which one can be considered old, the consumption levels of the elderly relative to the nonelderly, and poverty levels of children relative to the old—to mention only some factors. Yet we often debate Social Security as if the type of system we want in 2080 should be determined by perceptions and measures of needs of a society in 1930.

As a consequence, our programs of elderly support contain a benefit structure that needs substantial reform, even if there were no solvency issue. The current Social Security system

- provides $555,000 worth of benefits ($905,000 if one adds in Medicare) to the newly retiring average-wage couple in 2010, rising toward $700,000 ($1.2 million) for couples in their mid-40s today, even while programs for their children are scheduled to be cut;
- has morphed into a middle-age retirement system, with typical couples soon receiving close to three decades of benefits, while individuals retire on average at least a decade longer than they did when the system was first established;
- despite doing a good job in reducing poverty in its early years, has made only modest progress recently despite spending hundreds of billions of dollars more;
- keeps expanding years of support and benefits most for higher-income workers;
- discourages work among older Americans at the very time they have become among the most underused source of human capital in the economy;
- threatens the well-being of the truly elderly by encouraging them to spend their retirement income too soon; and
- denies equal justice in a whole variety of ways by discriminating against
    - the working single head of household,
    - couples where both spouse works, especially if their earnings are approximately equal;
    - the long-term worker,
    - the worker who stays married;
    - the divorced person married less than ten years,
    - the divorced person with a living former spouse,
    - married couples of a similar age;
    - the divorcee, widow, or widower who remarries someone with lower earnings than the former spouse, and
    - the parent who doesn’t delay child-bearing until his 40s or beyond.

None of these features, I assure you, derives from adherence to any principle—liberal or conservative—but simply from design flaws and failures to adjust with the evolution of the modern economy and family. In fact, many of these features would be illegal if put into private benefit plans.

What is worse is that these deficiencies would continue for decades if not centuries under many proposed Social Security reforms. If we can’t deal with them now when Social Security must be reformed, then when can we deal with them?

In the remainder of my testimony, I will concentrate on four types of benefit reforms built around traditional principles of progressivity, equal justice, efficiency, and individual equity. These reforms would

(1) restrict growth in benefits and growth in years of support, with primary effects on higher-income households, when the system is out of balance;

(2) increase labor supply and enhance revenues along with benefit reform;

(3) improve the equity and efficiency of the current system, regardless of size; and

(4) enhance Social Security with more adequate private pension benefits for tens of millions.

Lifetime Benefits

In examining these reforms, it is best to start with the package of benefits received by the elderly within Social Security or, more broadly, within Social Security and Medicare. Such an approach allows us to consider trade-offs not made obvious when decisions about annual benefits, retirement age, indexing of benefits, premium cost for Medicare, and other features are considered separately.

With the exception of the World War II period, programs for the elderly have been absorbing ever-higher shares of national income and of the budget for almost seven decades. Define "lifetime benefits" as the value, at age 65, of Social Security and Medicare benefits as if the necessary monies were sitting in a 401(k) account that would earn interest but be drawn upon over retirement years. In today's dollars, lifetime benefits for an average-income couple have risen from about $297,000 in 1960 to $906,000 today ($555,000 in Social Security and $351,000 in Medicare). See figure 1. Add in the backup insurance most of us have if we go into a nursing home for any extended period, and the total approaches $1 million per couple. Over the next two decades, the benefits grow by about $225,000, or an average of more than $10,000 a year.[1]

We cannot provide a very large portion of the population these million-dollar packages 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, both to them when they are truly old and to children and working families.

Limit Growth for the Less Needy Elderly When the System Is Out of Balance

Under current policy, federal government spending grows automatically, by default faster than national income and tax revenues, as the population ages and health costs soar. These defaults are threatening 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.

Beginning in 2004, Rudolph G. Penner (also an Institute fellow at the Urban Institute and a former director of the Congressional Budget Office) and I started publishing suggestions about the use of triggers to deal with various budget issues. Within Social Security, or within Social Security and Medicare together, such triggers could be used to put these programs back into balance, say, whenever the trustees report for three consecutive years that the program is likely to be in long-run deficit. With the trigger pulled, here are some options that could be considered:

[1] C. Eugene Steuerle and Stephanie Rennane, "Social Security and Medicare Taxes and Benefits Over a Lifetime" (Washington, DC: The Urban Institute, 2011), http://www.urban.org/url.cfm?ID=412281.

- Cap expected lifetime benefits for a couple at, say, $1 million in Social Security and Medicare, or, say, $700,000 in Social Security.
- Gradually adjust the retirement age or ages so they provide a fixed, rather than continually growing, number of years of support.
- Index growth in benefits more slowly for higher-income workers.

For those who believe that Social Security, or Social Security and Medicare, will come somehow back into balance in the future, one advantage of triggers over other reforms is they only get pulled when that optimistic view is wrong.

Triggers also allow gains from efforts, say, to increase labor supply to translate to higher benefits since, if successful, they will reduce imbalances and the need to pull the triggers as much. In that way, the risk that the system will go back out of balance is reduced. With triggers, we are less likely to overshoot or undershoot the amount of reform needed.

The first option would start with the richest beneficiaries and give them choices on how their million dollar–plus—but not growing—benefit package would be allocated. They could decide, for instance, to receive fewer years of support or a lower level of benefit in their 60s. If the insurance value of Medicare is folded into the reform, over time they might also be offered less expensive options as a way of saving money. Unlike most of Medicare today, the richest beneficiaries would then share in the saving generated by choosing lower-cost options—a potentially crucial requirement for ever getting real health reform. This broader reform also folds in choices on premium costs in Medicare with the cash payments in Social Security—issues that ideally should be considered together.

Capping lifetime benefits, over time, is sufficient by itself to restore long-term balance to Social Security or Social Security and Medicare, although some other intermediate adjustments may be needed because of how swiftly the baby boomers are retiring. Although there are some technical aspects in deciding exactly how to perform the calculations (e.g., what interest rate to provide to beneficiaries for delayed benefits), the proposal has the great advantage of being both intuitively understandable and revealing of how expensive our elderly and near-elderly programs have become.

Benefits could be raised beyond $700,000 or $1 million, or whatever maximum amount is determined, but the actions would be done on a discretionary rather than automatic basis—thus competing with other priorities such as education, welfare, and defense.

The second and third options don't cut benefits relative to where they are now. They simply ask future retirees to forgo higher levels of benefits while these entitlement programs are out of balance and while many other groups are being asked to bear in the burden of dealing with our national debt.

Look at the lifetime benefit table. In the midst of the current debt crisis, with potential benefit cuts and tax increases for many workers and children, Congress still passively increases lifetime Social Security and Medicare benefits for every year's cohort between 2010 and 2030 by about $10,000 annually. Indeed, Congress this year essentially "voted" to grant significantly higher benefits to retirees in 2012 than 2011 and to retirees in 2013 than 2012.

Adjusting the retirement age and indexing benefit growth are fairly progressive ways of making benefit adjustments; combined with the various minimum benefit proposals I suggest below, they would be more progressive yet. For the most part, they ask the most of higher-income recipients, who are expected only to accept restrained growth relative to current recipients. The retirement age proposal, in turn, allows benefits to be concentrated more in old age and was discussed earlier as a way to cap growth in benefits. In the next section, I reexamine that option and related options to increase labor force participation.

Encourage Greater Labor Force Participation

Social Security's current fiscal dilemma centers almost entirely on labor force issues—the drop in scheduled workers per retiree. At the same time, the extraordinary expansion in years of support has morphed the system into a middle-age retirement system that threatens the well-being of the older elderly. Consider some of the consequences of the current system:

- Close to a third of the adult population is scheduled to be on Social Security within about 20 years.
- People already retire on average for close to a third of their adult lives.
- For a couple retiring today at age 62, benefits are expected to last about 27 years—rising to close to three decades for those who are middle aged today.
- 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 75 today and age 80 in another 60 years (figure 2)—rather than 63 to 64, the age at which the average worker retires today.
- 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 3).
- 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 spends both five fewer years saving and five more years spending down his or society's savings.

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 underused pool of human resources in the economy. For the labor force, they represent for the first half of the 21st century what women did for the last half of the 20th century. I believe the labor demand for these workers will grow over time, and it is mainly our institutions, public and private, that are blocking us from fully using these valuable and talented people.

Three types of reform can help address these issues:

- Increase the early and normal retirement ages (perhaps combined into a simpler "earliest age of retirement, with actuarial adjustments for later retirement").
- Backload benefits more to older ages.

- Provide simpler options for people to purchase the higher Social Security annuity already available to them in theory, but currently made difficult to obtain for those considering partial retirement, set-aside of other funds, or partial receipt of Social Security.

Again, we should undertake these benefit reforms even if the system was in balance and all the saving was devoted back to Social Security. Increasing the retirement age would allow us to devote greater resources to the truly old. Increasing the early retirement age, interestingly, does little for Social Security balances because of actuarial adjustments, but it could help significantly increase tax collections, including the income tax.

By encouraging work, these proposals also become revenue raisers. At any given tax rate, they provide for higher lifetime benefits because of the additional revenues, while annual benefits are raised quite substantially because those higher lifetime benefits are concentrated on fewer years.

For all these reasons, an increase in the retirement ages (including the early retirement age, else it is just an across-the-board benefit cut) causes the least hardship of almost any benefit cut.

I recognize that some people are concerned about lower-income groups with shorter than expected life expectancies. But attempting to address their needs by granting the many healthy among us a 20th, and 21st, and 22nd year of transfer support and tens, if not hundreds, of thousands of dollars in extra benefits is a very bad form of trickle-down policy. As discussed below, an increase in the retirement age can be combined with other provisions that help, rather than hurt, these lower-income groups.

Whatever the level of lifetime benefit that is settled upon in a final reform package, actuarial adjustments can provide more benefits later and fewer earlier. These adjustments can take various forms, such as an increase in annual benefits at the point that Social Security predicts that average life expectancy has fallen below, say, 12 years (about age 74 in 2005) and a decrease in earlier ages. Another would be to wage-index benefits after retirement, offset by lower up-front payments in the early years. This type of "back loading" has all the right effects. It progressively moves benefits to later ages when people have less ability to work, lower income, and less help from a spouse to deal with impairments. It puts 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.

In this context, I should mention my mixed feelings about the proposal to amend the cost-of-living adjustment (COLA). I think there is a good case for basing any COLA on what we may believe to be the most appropriate index of price changes. However, within Social Security, a COLA adjustment downward front-loads benefits even more. That is, it might cut back on benefits in a second year of retirement by less than 1/3 of 1 percent, but by close to 10 percent near the end of one's life. If such an adjustment is made, it is more important than ever to offset such front-loading with a more back-loaded package of benefits. By the way, this is yet another example of the problem with deciding on annual benefits first, rather than on the lifetime benefit package first, which then can be allocated in the fairest and most effective way thereafter.

Finally, I also suggest that we can provide vast simplification in the earnings test and the delayed retirement credit. These technical provisions are extremely confusing and lead individuals mistakenly to believe that the decisions to retire, to take Social Security benefits, or to purchase a higher level annuity are somehow are all tied together. In point of fact, I have suggested that it is possible to design an annuity option within Social Security that would not cost any more than current law, would closely replicate options hidden within the actuarial adjustments already provided by Social Security, and would effectively give people a ready way to get greater annuity protection in old age.[2]

Improve the Equity and Efficiency of the Existing System

Various other reforms should be part of any Social Security package. Simply put, the current system is designed poorly for the needs of the modern family and economy. Today, ever-increasing Social Security benefits have had relative weak effects on protecting the poor and on the very old *for the additional dollars spent*. The current system spends a lot more every year with only modest marginal effects on reducing poverty and near poverty.

Social Security also consistently violates notions of equal justice by taxing more or paying less to those who are equally situated. Many of these inequities also have extremely perverse anti-work and inefficiency aspects. The major causes of many of these problems are provisions that initially were meant to help some of those who might be vulnerable, but in fact were poorly targeted. In particular, the Social Security spousal and survivor benefit—unlike that in U.S. private pensions and public pensions in most countries around the world—provides "free" transfers whose generosity increases the richer the person one marries. This benefit is free in the sense that no additional contribution is required.

In a private pension system, many of these forms of discrimination would be declared illegal. There, standards of fairness require that spousal and survivor benefits normally should be actuarially determined through higher contributions or lower initial worker benefits. Social Security's particular design structure is largely built around a decades-old stereotypical (but never very accurate) view of the two-parent family with only one worker. As a result, the current system

- discriminates against working single heads of household (disproportionately lower-income minorities), who often receive substantially fewer benefits than others who pay fewer taxes and raise fewer children—the *anti–welfare reform effect*;
- discriminates against two-earner couples, who can receive substantially fewer lifetime benefits than one-earner couples who have the same income and pay no more in tax—the *anti–working spouse effect*;
- discriminates against longer-term workers by providing substantially higher benefits to the person who works 30 years at $40,000 than the person working 40 years at $30,000—the *anti–long-term-worker effect*;
- provides multiple spousal and survivor benefits at no additional cost for the worker with multiple marriages lasting more than 10 years, while simultaneously granting no share of a worker's benefits whatsoever to spouses married to that worker for less than 10 years—the *divorce roulette wheel effect*;

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[2] C. Eugene Steuerle, "How Social Security Can Costlessly Offset Declines in Private Pension Protection" (Washington, DC: The Urban Institute, 2010), http://www.urban.org/url.cfm?ID=901355.

- rewards divorced partners more when their former partner dies than when he lives—the *Agatha Christie effect*;
- penalizes some divorcees, widows, and widowers who marry someone who earns less than their former spouse—the *marriage penalty effect*;
- provides more lifetime benefits to couples with large age gaps between partners—the *trophy spouse effect*;
- penalizes many widowers and widows if they marry someone with lower earnings than their former spouse (the *marriage penalty effect*); and
- provides extra children's benefits to the parent, normally male, who has children later in life—the *Hollywood effect*.

At times, these differences can be huge, ranging from tens to hundreds of thousands of dollars in lifetime benefits. Figure 4, for instance, shows the difference in annual benefits alone for a low-income single parent who contributes taxes versus the benefits for a high-income spouse for whom no additional taxes are paid by either spouse. Put another way, everyone has to pay into Social Security to support spousal and survivor benefits, but only spouses and survivors can then draw money out of this part of the system.

Once again, reforming these parts of Social Security make sense regardless of its eventual size. Here are some suggestions on how it might be done:

- Provide a well-designed, wage-indexed minimum benefit to serve the low-income worker.
- Either ensure that the minimum benefit is graduated so it gives a decent benefit to those with fewer years of work history or include some minimum creditable years of contribution at a minimum earnings level for those who have supported their children.
- Determine additional family benefits for middle- and upper-income individuals in an actuarially neutral manner, requiring that survivors benefits be covered out of each worker's benefit.
- To move toward this fairer system, cap the level of existing free spousal and survivor benefits—those not paid for through actuarial adjustment.
- Count all years of work in any Social Security benefit formula.

With this combination of reforms, tomorrow's Social Security system can provide higher levels of benefits than today's for a significant share of those with lower lifetime earnings. These progressive reforms would reduce poverty and near-poverty rates (using a poverty standard adjusted for living standards or wage indexed) among the elderly.

At the Urban Institute, my colleague, Melissa Favreault, has done a lot of work (in which I have sometimes participated) on minimum benefits. This research demonstrates that at least two groups of individuals have low lifetime earnings: those with low annual earnings and those with limited years of work history. Included in this latter group are many people, primarily women, who spend significant amounts of time raising children but are poorly targeted by today's spousal and survivor benefits.

These types of adjustments can more than compensate for any losses for lower-income groups in lifetime benefits stemming from other reforms—such as increases in retirement ages.

Movement toward actuarial neutrality, in turn, would apply private pension standards to middle- and upper-income households and make sure that their benefits are shared more equitably. Different forms of benefit sharing or earnings sharing could be tried, while capping family benefits being paid for by many ineligible for them helps in the transition to this newer, fairer system. Similarly, divorced persons would be extended the types of equity rules that apply in the private pension system.

As for the proposal to count all years in determining level of benefit, no one would think to deny some people their employer's 401(k) contributions because they worked more than 35 years. There is no legitimate reason in Social Security that all years of work should not be counted. Redistribution can always be made to low-earning workers through the rate structure of the benefit formula or a minimum benefit. This change would have an additional work incentive effect as well; under current law, many years of work result only in a pure additional tax, with no additional benefit generated.

Reform Private Pension Policy

Today most middle-class retirees—not just the poor—depend primarily upon government in their retirement. Over two-thirds of those approaching retirement have less in accumulated wealth in all forms—retirement plans, housing, and saving accounts—than the value of their Social Security and Medicare benefits. Put another way, only a few households have accumulations of private assets that approach the nearly $1 million lifetime value of Social Security and Medicare for average-wage couples.

Most households, therefore, need substantially more in the way of private retirement support than they currently receive. Enacting private pension reform along with Social Security reform could significantly enhance our ability as a society to care well for our older population.

Among the proposals worthy of consideration are ones that would

- provide additional incentives for private pension and retirement plans that provide a minimum contribution level for each worker; and
- provide additional disincentives for those plans that do not provide such a minimum.

Among the incentives that can be considered are enhanced savers' credit and removal of complicated discrimination rules for plans providing such a minimum. Among the disincentives would be a lower or unindexed level of maximum contribution for plans not meeting the new standards.

These types of proposals are closely related to those recently adopted by Great Britain when it undertook its own combined Social Security and private pension reform.

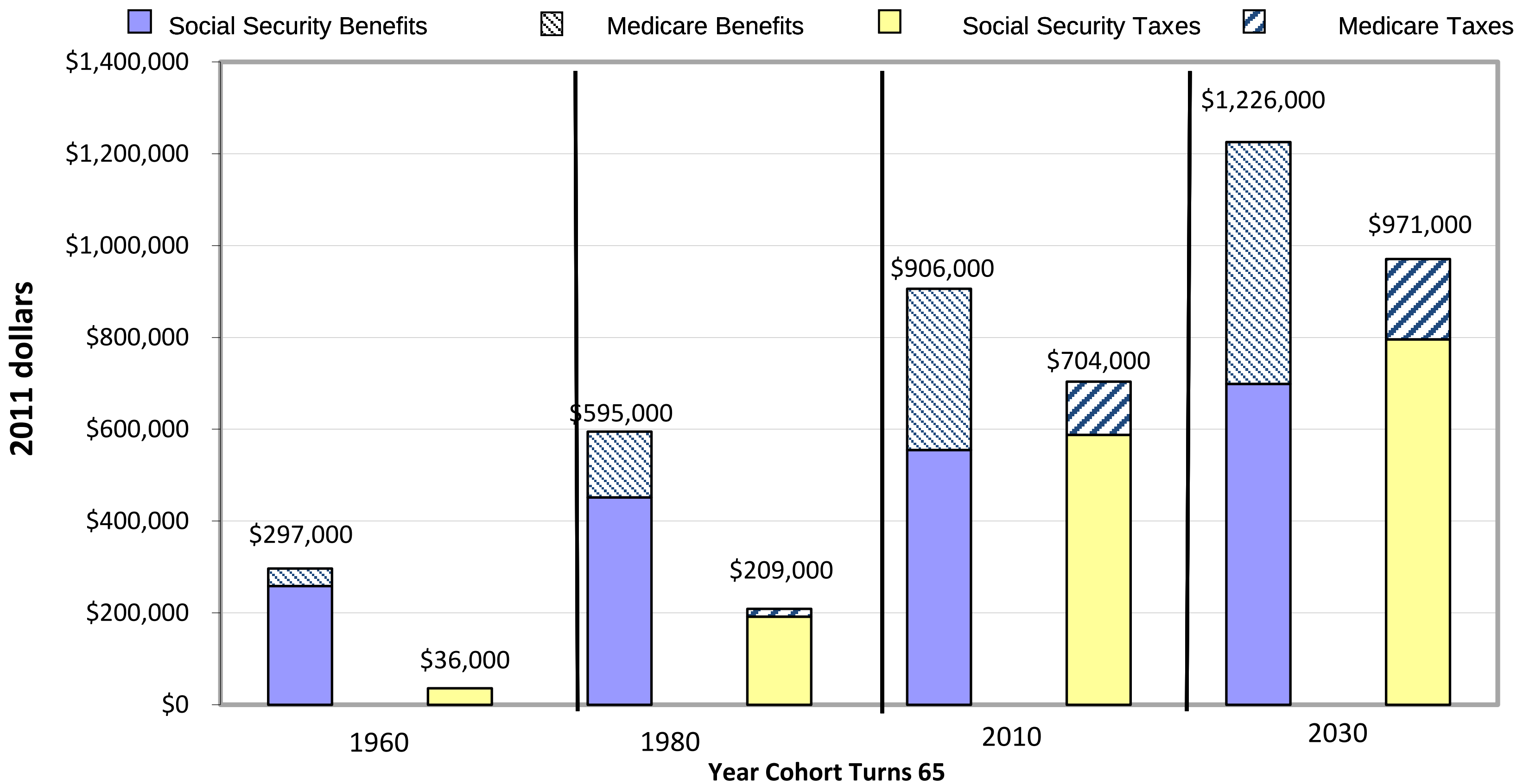
Private pension reform is a complicated subject which requires attention unto itself. Pamela Perun and I put forward some suggestions on how to put together the types of reforms noted here,[3] but my broader point is that protections in old age could be significantly enhanced if Social Security reform would be combined with an effort to increase the percentage of workers who go into retirement with some decent retirement saving.

Conclusion

Reform of the Social Security benefit structure should proceed based on such principles as progressivity, equal justice, efficiency, and individual equity. Focus needs to extend far beyond the narrow debate over solvency. Four types of reforms especially should be considered: limits on growth in benefits for less needy groups when the system is out of balance, incentives for greater labor force participation, removal of many inequities and inefficiencies that derive from many of today's poorly designed and targeted provisions, and enhancement of Social Security with a Great-Britain–like private pension reform that would provide far greater protection to many more workers.

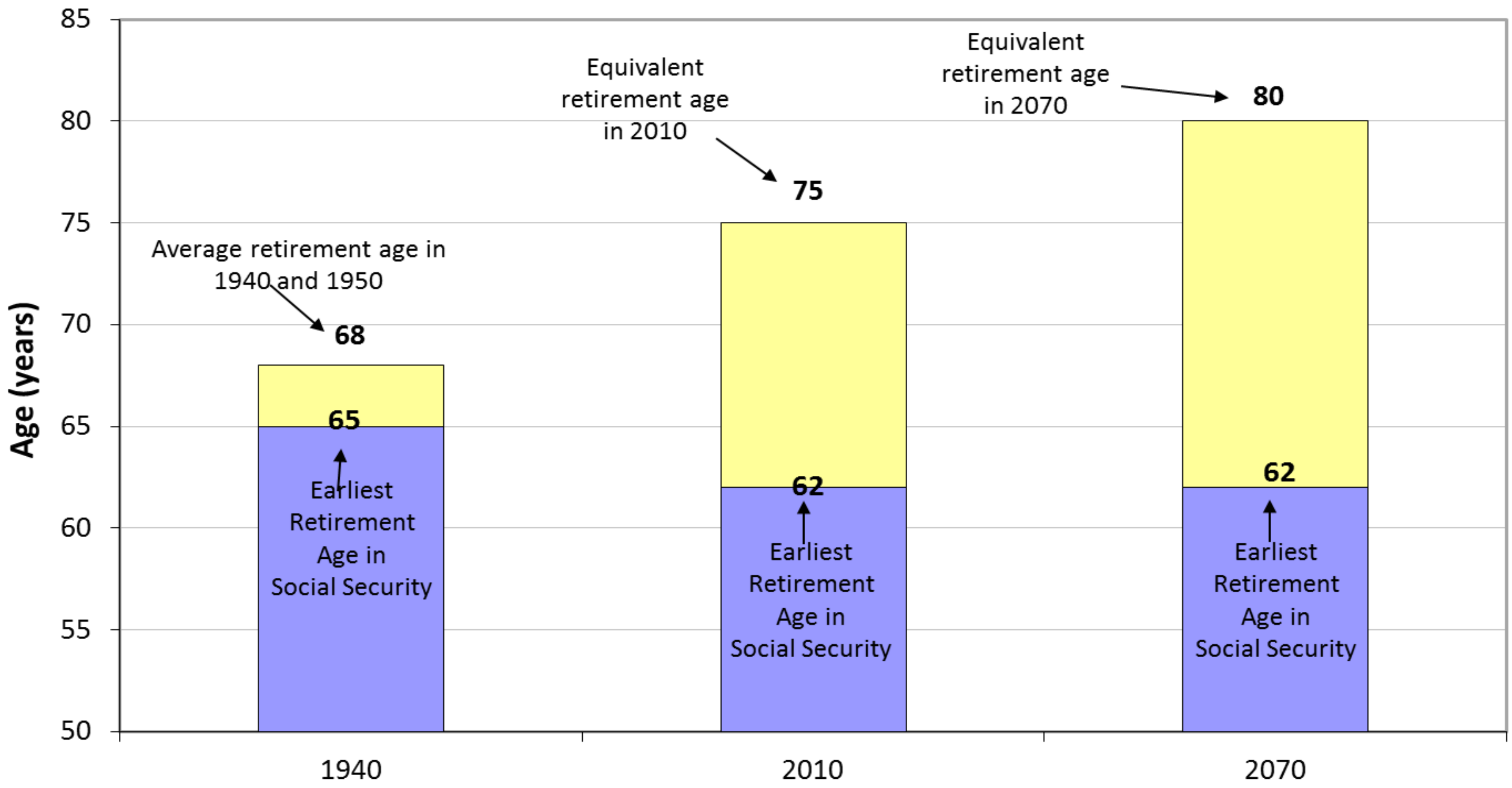
[3] For additional information, see Pamela Perun and C. Eugene Steuerle, "Why Not a 'Super Simple' Saving Plan for the United States?" (Washington, DC: The Urban Institute, 2008), http://www.urban.org/url.cfm?ID=411676.

Figure 1. Social Security and Expected* Medicare Benefits and Taxes for Average-Wage, Two-Earner Couple ($43.5k each)



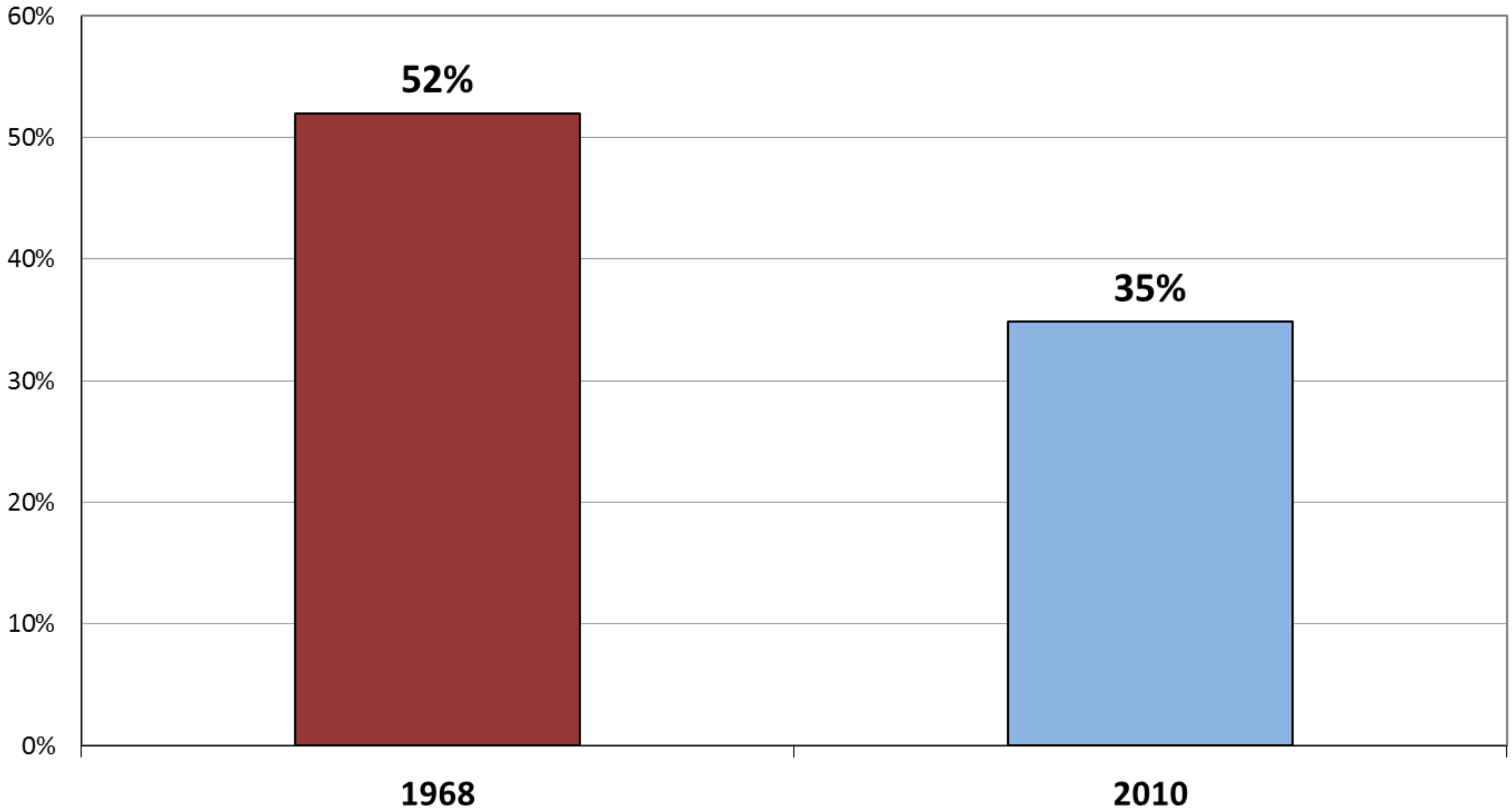
Source: C. Eugene Steuerle, 2010. Based on earlier work with Adam Carasso.
Notes: Expected rather than realized benefits. Lifetime Social Security benefits are $259,000 from 1960, $452,000 from 1980, $555,000 from 2010, and $699,000 from 2030. The “average” wage profiles are those hypothetical profiles used by the Social Security Administration in its analyses. Lifetime amounts are rounded and 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 2010 OASDI and HI/SMI Trustees Reports. Includes Medicare Part D.

Figure 2. Age of Retirement if Number of Years of Benefits Remain Constant



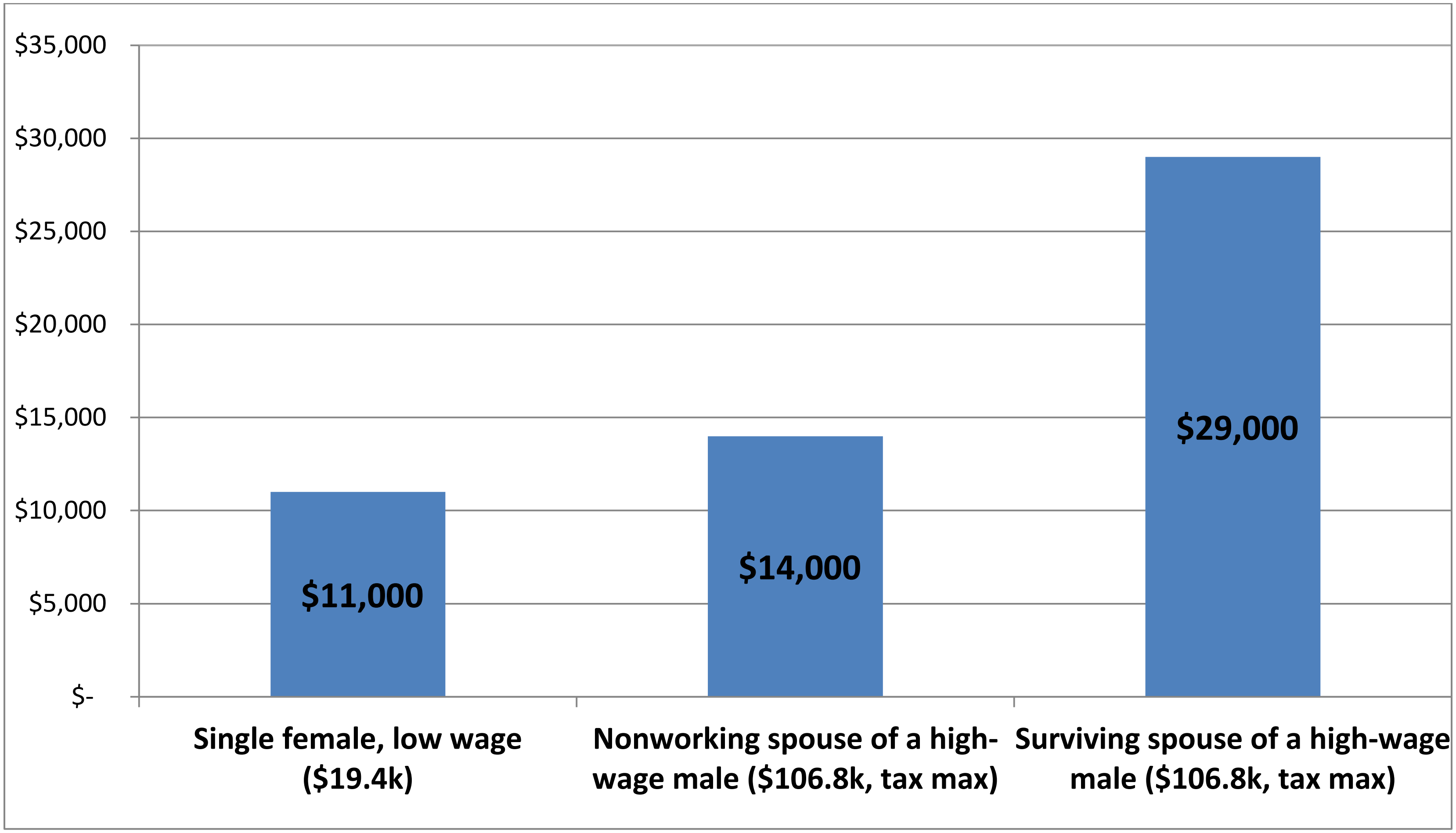
Source: Stephanie Rennane and C. Eugene Steuerle, The Urban Institute, 2010. Based on data from the Social Security Administration, birth cohort tables.

Figure 3. Proportion of Men's Social Security Benefits Going to Men With Less Than 10 Years Remaining Life Expectancy



Source: Stephanie Rennane and C. Eugene Steuerle, The Urban Institute, 2010. Based on data from the Social Security Administration's 2009 Annual Statistical Supplement.

Figure 4. Discrimination against Single Heads of Household by Annual Social Security Benefits



Source: Stephanie Rennane and C. Eugene Steuerle, The Urban Institute, 2011.
Note: Low wage is 45 percent of the average Social Security wage.