Statement before the Senate Finance Committee
On “Perspectives on Deficit Reduction: Social Security”

An Incremental Approach to Social Security Reform

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May 10, 2011

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, my name is Alex Brill, and I am a research fellow at the American Enterprise Institute. Thank you for the opportunity to appear before the Committee this morning to testify on Social Security and our country's deficit and debt challenges.

Chairman Baucus remarked at the opening of the first hearing in this series that "[a]ddressing our deficits and debts is an economic issue, a national security issue and a moral issue." He went on to say that "we have a moral obligation to leave this place better than we found it, but today, our fiscal challenges prevent us from meeting that responsibility."[1] I wholeheartedly agree and am greatly concerned by the willingness demonstrated by Congress to consistently deficit-finance federal government spending in excess of our economy's rate of growth. A broad spectrum of projections indicates that without substantive legislative action large deficits will continue for years to come, which means that we will become increasingly dependent on foreign lenders' willingness to lend and are imposing an ever-increasing burden on future generations who must service that debt.

Some policymakers and lawmakers will argue that Social Security is separate and distinct from our broader fiscal challenges. I disagree. I believe that immediately addressing the challenges facing the Social Security program offers an opportunity to improve our country's fiscal soundness, lift an undue burden from future generations, and strengthen our economy's long-run growth prospects—all objectives consistent with and complementary to the purpose of tackling our deficit and debt challenges. Congress, in addressing Social Security now, could take an important step toward achieving public policies that reflect the need of our country to live within its means.

A Manageable Approach to Reform

My testimony will focus on the long-range fiscal challenges our country faces. In this context, the Social Security program is a significant concern, and delaying action simply worsens the problem. In any near-term legislative agenda to address the deficit and debt, there is an opportunity to approach Social Security in the same manner in which deficit and debt reductions are likely to be achieved—incrementally.

[1] Max Baucus, "Hearing Statement of Senator Max Baucus Regarding Perspectives on Deficit Reduction: As Prepared for Delivery," April 13, 2011, http://finance.senate.gov/imo/media/doc/041311mb.pdf.

I am not advocating for fundamental reform or an overhaul of the Social Security program. Rather, I urge the Committee simply to take a first step. One sizeable step forward could do much toward delaying the trust fund depletion Social Security faces in the next quarter century. And it will open the way for further reasonable action on Social Security reform in the coming years. Much as our fiscal challenges generally cannot be ameliorated in a single vote and the budget cannot be balanced tomorrow, so too is Social Security not going to be fixed overnight. But Congress could this year pursue meaningful, incremental change to strengthen Social Security.

Social Security and the Economy

The social security program is the largest single program in the federal government. Including the retired, the disabled, and surviving spouses of deceased workers, over 54 million people, which equates to roughly one in every six U.S. residents, receive Social Security benefits.[2] About 90 percent of the elderly in the U.S. are receiving benefits.

Social Security outlays in FY2010 accounted for one-fifth of the federal budget, approximately $706 billion dollars or 4.8 percent of GDP.[3] Total income earned for the trust fund, payroll taxes, interest, and taxes on certain benefits was about $788 billion in FY2010, and about 158 million people will work in OASDI covered employment this year. Given the magnitude of the program, it should be no surprise that it has measurable consequences on our economy and our society.

Poverty. The program provides critical assistance to tens of millions of low-income retirees who depend on Social Security benefits. These benefits comprise the majority of income for 55 percent of beneficiaries age 65 or over; for 26 percent of elderly beneficiaries, Social Security benefits represent 90 percent or more of their income, while a full 15 percent of

[2] Social Security Administration (SSA), "Benefits Paid by Type of Beneficiary," www.ssa.gov/OACT/ProgData/icp.html.
[3] Congressional Budget Office (CBO), "CBO's 2010 Long-Term Projections for Social Security: Additional Information," www.cbo.gov/ftpdocs/119xx/doc11943/10-22-SocialSecurity_chartbook.pdf.

beneficiaries age 65 or over have no income outside of Social Security.[4] Social Security benefits keep more than 13 million elderly Americans out of poverty.[5]

Private Savings. Earning future Social Security benefits while working has been shown to depress an individual's decision to accumulate private savings. A wide range of estimates exist in the academic literature, but the Congressional Budget Office (CBO), in a study dedicated to this topic in 1998, concluded, "The best empirical estimates . . . indicate that each dollar of Social Security wealth reduces other assets between zero and 50 cents."[6] More recent research by Sudipto Banerjee at Ohio State University finds that Social Security crowds out 20–27 cents of private savings per dollar increase in Social Security wealth. Of particular importance is the finding that the crowd-out effect is near zero for median- and low-income workers but rises to 44 cents per dollar of Social Security wealth for households in the 90th percentile and near dollar-for-dollar for higher wealth households.[7]

Labor Market Participation. Academics have debated the magnitude of the labor market participation response to changes in Social Security benefits, but recent research has indicated that it may be significant. James Vere, in a recent article in *Labour Economics*, writes, "From a policy standpoint, the results [of my research] indicate that if concerns about fiscal solvency lead Congress to reduce Social Security benefits, older workers . . . are likely to compensate by increasing their participation in the labor force and working more hours."[8] Similarly, Giovanni Mastrobuoni, in an article in the *Journal of Public Economics*, finds a strong labor market participation response to the phased increase in the retirement age enacted in 1983.[9]

Uncertainty. An additional way that Social Security affects the economy is the economic burden posed by uncertainty over the program's future viability and potential policy changes. As

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[4] SSA, "Income of the Population 55 or Older, 2008," Table 9.B1, www.ssa.gov/policy/docs/statcomps/income_pop55/2008/sect09.html#table9.b1.Ibid.

[5] Paul N. Van de Water and Arloc Sherman, "Social Security Keeps 20 Million Americans Out of Poverty: A State-by-State Analysis," Center on Budget and Policy Priorities, August 11, 2010, www.cbpp.org/files/8-11-10socsec.pdf.

[6] CBO, "Social Security and Private Savings: A Review of the Empirical Evidence," July 1998.

[7] Sudipto Banerjee, "Does Social Security Affect Household Saving?" October 28, 2010, http://web.econ.ohio-state.edu/~sudipto/Research_files/Does%20Social%20Security%20Affect%20Household%20Saving_%20JMP_Banerjee.pdf. A similar finding for private pensions crowding out savings is reported by Gary Englehardt and Anil Kumar, "Pensions and Household Wealth Accumulation," *Journal of Human Resources* 46 (2011).

[8] James P. Vere, "Social Security and Elderly Labor Supply: Evidence from the Health Retirement Study," *Labour Economics*, 2011 (in press).

[9] Giovanni Mastrobuoni, "Labor Supply Effects of the Recent Social Security Benefit Cuts: Empirical Estimates Using Cohort Discontinuities," *Journal of Public Economics* 93 (December 2009).

then–CBO director Douglas Holtz-Eakin noted in testimony in 2005, "[T]here is uncertainty about the future of Social Security: what the program will look like and who will be affected by changes to it. The sooner that uncertainty is resolved or reduced, the better served will be current and future beneficiaries, who must make various decisions about their retirement. Phasing in changes to Social Security allows for gradual accommodation, giving people time to modify their expectations and to adjust their work and saving behavior."[10]

The Social Security Outlook

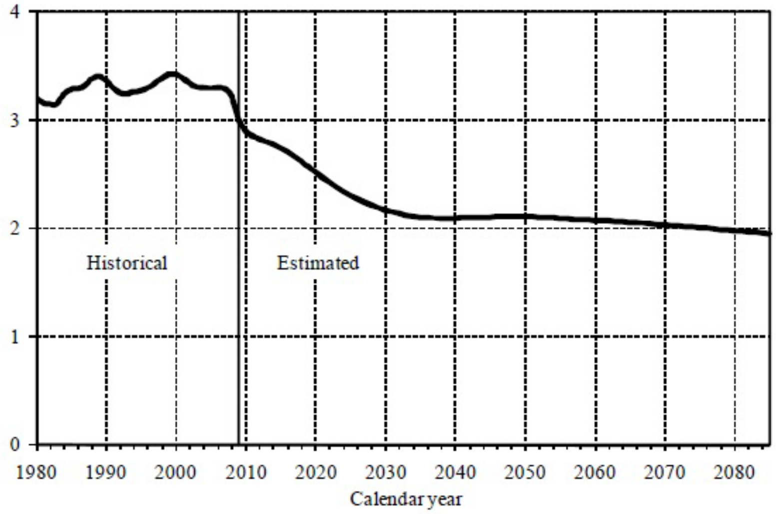
As many analysts and researchers have warned, lawmakers will be forced to change the Social Security program in coming years because it is on an unsustainable path. Future projected payroll taxes are insufficient to provide expected benefits. The Social Security Administration estimates that on the program's current course, trust fund assets will be exhausted in 2037, and benefits will have to be reduced by 22 percent.[11] CBO meanwhile predicts trust fund exhaustion in 2039 and a 21 percent reduction in scheduled benefits.[12] The Social Security Administration is expected to update their forecast in the 2011 OASDI Trustees Report later this month. While there is a degree of uncertainty with regard to the year in which the trust funds are exhausted, there is no plausible scenario in which the trust funds are not depleted in the coming decades.[13]

According to the CBO analysis, there is a 99 percent likelihood that scheduled outlays will exceed revenues in 2030 and a greater than 90 percent probability that scheduled benefits will exceed outlays in every decade through 2080.[14] The demographic changes underlying the financial outlook for Social Security have been well documented. Currently, there are approximately three workers per beneficiary, but that ratio will drop to two to one over time, as illustrated in Figure 1. As a result of this shift, the system is unsustainable in its current structure.

[10] Douglas Holtz-Eakin, "The Role of the Economy in the Outlook for Social Security," testimony before the House Committee on Ways and Means, Subcommittee on Social Security, June 21, 2005, www.cbo.gov/ftpdocs/64xx/doc6492/06-21-Prefunding.pdf.
[11] *2010 Annual Report of the Board of Trustees, Federal Old-Age and Survivors Insurance and Federal disability Insurance Trust Funds*, August 9, 2010, www.ssa.gov/oact/tr/2010/tr2010.pdf.
[12] CBO, "CBO's 2010 Long-Term Projections for Social Security: Additional Information."
[13] CBO simulates five hundred scenarios, and trust fund exhaustion dates range from 2031 to 2057 for 80 percent of the cases. (Ibid.)
[14] Ibid.

Figure 1

Number of Covered Workers Per OASDI Beneficiary



Source: 2010 Annual Report of the Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds

Incremental Change for Social Security

The current academic and think tank community debate over Social Security reform frequently reflects an unwavering commitment to a single-step, absolute fix to Social Security's future imbalance. Whether through proposals to increase taxes, adjust future benefits, or a combination of both, no major reform proposal attempts to solve less than the entire shortfall. While I admire those researchers who choose to "think big," as a practical matter I disagree with this approach. Free from the limitations imposed by trying to solve the whole problem, Congress has a number of incremental policy options available for consideration. There are several reasons to consider an incremental approach to Social Security.

First, such an approach is consistent with the broader deficit and debt debate currently going on in Washington. It is widely accepted that the federal budget, in its current form, is unsustainable. CBO called the long-term budget outlook "daunting," pointing out that we have "been recording the largest budget deficits, as a share of the economy, since the end of World War II."[15] However, while policymakers recognize the current fiscal imbalance, there is zero probability that legislation this year will balance the near-term and long-run budget. Our best hope is continued legislative vigilance aimed at fiscal stability. For example, President Obama's

[15] CBO, *The Long-Term Budget Outlook*, June 2010 (revised August 2010), www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf

recently announced “Framework for Shared Prosperity and Shared Fiscal Responsibility” sets “a goal of reducing our deficit by $4 trillion in 12 years or less.” While such an objective is sizable, it likely fails to even stabilize the debt-to-GDP ratio, according to the Committee for a Responsible Federal Budget.[16] The President’s proposal does not include any explicit Social Security reform proposals.

Second, while the probability that the Social Security trust fund will be unable to provide scheduled benefits in the coming decades, the precise exhaustion date is uncertain. Given the myriad of uncertainties involving life expectancy, labor force participation, wage growth, immigration, and other factors, it is possible, even likely, that any policy intended to “solve” the Social Security problem may, eventually, miss the mark. For example, the 1983 Amendments to Social Security were estimated at the time to create actuarial balance for the combined OASDI trust funds.[17] However, unanticipated economic and demographic changes have led to another forecast of trust fund insolvency.

And finally, an incremental approach is consistent with the political necessities of legislative compromise. While the political difficulty of addressing Social Security can be acute, policymakers from both parties have urged bipartisan cooperation and action. This kind of cooperation will be more feasible if smaller goals are set.

With this in mind, I would encourage the Committee to consider three incremental policies that would reduce the projected trust fund funding gap.

Three Options for Incremental Reform

1. Raise both the normal retirement age and the early retirement age. If implemented slowly over time, a policy that raises both the normal retirement age and the early eligibility age could both narrow the long-run financing gap and foster economic growth. As the President’s National Commission on Fiscal Responsibility and Reform points out in its December 2010 report, life expectancy has increased significantly since the Social Security program was established in 1935, making an upward adjustment of the retirement age an appropriate measure to address funding concerns, particularly since it is not outside the intent of the program as it was

[16] Committee for a Responsible Federal Budget, “Analyzing the President’s New Budget Framework,” April 21, 2011, http://crfb.org/sites/default/files/Analyzing_the_Presidents_New_Budget_Framework.pdf.
[17] John Svahn and Mary Ross, “Social Security Amendments of 1983: Legislative History and Summary of Provisions,” *Social Security Bulletin* 46, no. 7 (July 1983), www.ssa.gov/policy/docs/ssb/v46n7/v46n7p3.pdf.

originally established. The Fiscal Commission's recommendation to index the retirement age to gains in longevity could be one important incremental step to getting Social Security on the right track. This policy, which includes a hardship exemption for workers physically unable to work beyond the early eligibility age, eliminates almost one-third of the 75th-year financing gap.[18]

Raising the early eligibility age from 62 to 65, while only having a modest impact on the trust fund insolvency date by pushing it back about five years, would promote labor market participation and, as estimated by my colleague Andrew Biggs, would increase GDP by about 5 percent.[19] Such a change would, as a result of the overall economic growth effects, have a positive effect on the deficit.[20]

2. Modify the benefit formula to slow future benefit growth. The formula for determining a retiree's benefits is progressive. Social Security replaces 90 percent of the first $9,000 in average annual wages but replaces just 32 percent of the next $55,000 in average annual wages and only 15 percent of average annual wages from $64,000 to $107,000. The "bend points" at which this rate applies increase annually not with inflation but with average wage growth. Modifying the benefit formula to improve solvency has been advocated by the President's Fiscal Commission, the Bipartisan Policy Center's Debt Reduction Task Force, and a number of other groups. Modification could be achieved through a variety of reforms, including reducing the benefit formula's second and third rate, indexing the second and third bend points to inflation instead of wage growth (commonly known as progressive price indexing), or establishing a fourth bend point that reduces benefits for workers with high lifetime average incomes.

3. *Adopt a chain-weighted consumer price index for the annual Social Security cost of living adjustment (COLA).* Social Security benefits are adjusted annually to reflect changes in the cost of living or inflation. Under current law, inflation is measured by the consumer price index for urban wage workers (CPI-W). The President's Fiscal Commission as well as the Debt Reduction Task Force both recommended adopting an alternative measure of inflation, chain-weighted CPI-W, for adjusting Social Security payments that would reflect not only the change

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[18] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010, www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.
[19] Andrew Biggs, "The Case for Raising Social Security's Early Retirement Age," AEI *Retirement Policy Outlook*, October 2010.
[20] Biggs estimates that over the first ten years of raising the early eligibility age to 65 the federal budget deficit would decrease by 0.45 percent. (Ibid.)

in prices over time but also the shift in consumption as various products' relative prices change. Social Security Administration actuaries estimate that this change would, on average, reduce the COLA in most years, which would eliminate about one-sixth of the financing gap in the 75th year.

An Essential Stipulation: Protect the Poor

With any reform we consider, we must not forget the most vulnerable among us. Thus, Congress should also consider some of the options for strengthening benefits for low-income individuals. Such proposals were endorsed by President Bush's Commission to Strengthen Social Security as well as by President Obama's recent Fiscal Commission. For example, the Fiscal Commission proposed a minimum benefit of 125% of poverty for an individual with twenty-five years of work. While such a policy by itself would exacerbate the imbalance in Social Security trust fund financing modestly, if combined with any of the options outlined above, the program's financing could be enhanced while the benefits for low-income retirees could be increased.

A Final Thought: Social Security and Thrift

This Committee has enacted a variety of policies in the last decade to expand retirement savings through various defined contribution options. Such steps have strengthened our country's "retirement security" in many regards. While I believe that still more can be done to promote retirement savings, it should be recognized that expanding and improving IRAs, 401(k)s, and the like are a complement to, not a substitute for, addressing the need for Social Security reform itself.

But I would like to highlight a final matter that must also be addressed in order to ensure that future retirees have adequate incomes and that our country has sufficient savings to facilitate growth. That matter is the virtue of thrift. Beyond tax policy changes, cutbacks in various government programs, and overall strategies for deficit reduction, our country—citizens and policymakers alike—have drifted away from thrift as a virtue, and it is evident in both consumer finance (high personal debt burdens and low savings rates) and federal finance. Inaction with regard to Social Security's finances is, in one sense, a symptom of this trend. However, Congress in its efforts to reduce the deficit and the federal debt may have the opportunity to help reestablish thrift as a virtue, one that can result in a stronger, safer, and more prosperous country for future generations.

A broad range of policy change is required to achieve the goals of debt reduction, but with regard to Social Security, I believe that incremental reforms—if implemented soon—can begin to steer the trust funds toward sustainability and steer our country back toward thrift. As we do this, workers can begin to save more, our country can grow more, and we can begin to meet the challenge of ensuring that future generations are increasingly better off.