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Thank you, Chairman Johnson, Ranking Member Becerra, and all of the members of the subcommittee. It is an honor to appear before you today to discuss options for adjusting the growth of Social Security benefits. My written testimony will begin with some benefit basics before proceeding to general policy considerations, then to the pros and cons of specific options and finally to some subjective recommendations offered in the final section of this testimony entitled, "Suggested Rules of Thumb." Although I serve as a Research Fellow for the Hoover Institution and as a Public Trustee for Social Security, none of the opinions that I express in this testimony should be interpreted as representing the views of the Hoover Institution or of my fellow Social Security Trustees.

Basics of Social Security Benefits

The current retirement benefit calculation can be thought of simply as occurring in four steps. The first step is to credit each worker for his or her history of taxable wages. The system tracks the wages of each individual worker subject to the Social Security payroll tax each year. A formula is applied to adjust wage levels from earlier years into their wage-equivalents in more recent years. The worker's top 35 years of earnings are thus determined and averaged. This results in a single number representing average earnings over a worker's career.

Note that because each worker's lifetime earnings are consolidated into a single number, certain distinctions are lost: a high-wage earner with 20 years of work may look, at the end of this calculation, no different than a lower-wage earner with 35 years of work. This has inevitable implications for the level of precision with which protections for the poor can be targeted.

Also notable is that this method often produces "average earnings" figures that are lower than many casual observers expect. Many workers have "zero earnings" years (work interruptions) that bring down the career average. Moreover, any earnings above the taxable wage cap are not counted. By this method, then, fewer than 20% of workers have "average earnings" of $70,000 or above. Accordingly, a benefit change affecting workers with "average earnings" of $70,000

and up would actually affect *fewer* workers than if the $106,800 cap on taxable wages were raised (which would affect roughly 20% of all workers at some point during their careers).

The second step is to apply a progressive benefit formula, converting each worker's taxable wage history into a benefit. Perhaps the easiest way to think about this formula is that it operates somewhat analogously to our system of income tax brackets. There is a 90% bracket, a 32% bracket, and a 15% bracket. These brackets render the distribution of benefits progressive. The 90% bracket delivers high returns on a worker's first dollars of earnings, while the 15% bracket delivers much lower returns on a high-wage worker's last dollars of earnings.

Also like income tax brackets, the borders (known as "bend points") between the factors in the benefit formula are indexed to grow automatically each year. Unlike tax brackets, however, Social Security bend points grow with the Average Wage Index (AWI). Because wages nationally tend to grow faster than prices over time, this formula causes initial benefits to grow in real terms. That is to say, later retiree cohorts are provided benefits with greater purchasing power than are earlier ones. This contributes significantly to program cost growth.

The third step is to adjust the benefit for when it is claimed. If benefits are claimed at the Normal Retirement Age (NRA: now 66, rising in the future to 67), the full benefit is paid. If an individual claims earlier (the earliest eligibility age is 62), an actuarial reduction in the annual benefit is made because it is expected to be paid for more years. A Delayed Retirement Credit (DRC) also increases annual benefits (for up to three years) for benefit claims after the NRA.

The fourth step is to adjust benefits, after an individual begins to receive them, annually for price inflation. A Cost-of-Living-Adjustment (COLA) is provided each year based on annual growth in the Consumer Price Index (CPI-W).

The benefit formula just described pertains to benefits for a retired worker. Social Security also provides for a number of other benefits as well, including disability benefits, spousal benefits, and benefits for widows, widowers and survivor children. Although there are differences in the methods of computing benefits for these respective populations, they all hinge in some fashion on the basic retirement benefit formula. Thus, unless provision is made to the contrary, changes to the basic benefit formula will have spillover effects on other forms of Social Security benefits.

Summary of Social Security Benefit Computation Steps

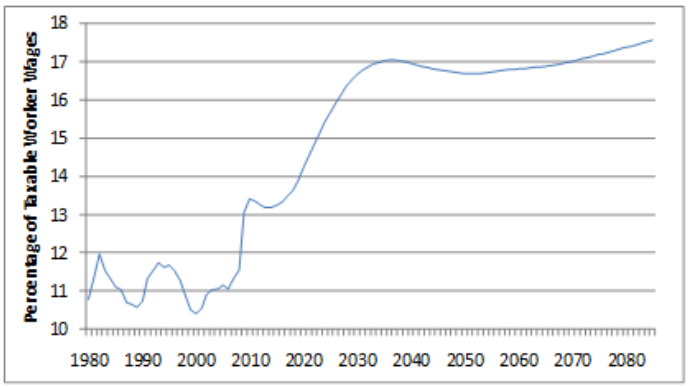
1) Compute the worker's average taxable wages;
2) Convert this wage history into a benefit amount using a progressive formula;
3) Adjust the initial benefit level for age of claim (lower if claimed before Normal Retirement Age, higher if claimed later);
4) After benefit payments begin, annually adjust via a COLA based on CPI growth.

Why Consider Slowing the Rate of Social Security Benefit Growth?

Whether to slow the rate of growth in Social Security benefits is a critical societal value judgment on which informed, well-intentioned individuals can and do disagree. Below I will describe basic elements of the case for slowing the rate of benefit growth.

A critical part of this case is that absent a slowing of benefit growth, younger workers will be subject to Social Security tax burdens far greater than tolerated by any previous generation. This can be seen on the following graph, which shows projected annual Social Security costs as a percentage of the program's tax base. Under current schedules, cost rates would rise rapidly from roughly 11 and a half percent -- their level in 2008 just before the Baby Boomers began to retire -- to more than 17 percent by the mid-2030s. This would mean that the total cost of paying Social Security benefits would exceed one out of every six taxable dollars that workers earn.

Figure 1: Social Security Costs as a % of Workers' Taxable Wages
(Past and 2011 Trustees' Projections)



The following equation may be helpful in understanding why Social Security costs are projected to grow so dramatically:

(Per-capita benefits as a % of worker wages)

_____ = (Worker cost burden, as a % of wages)

(Ratio of workers to beneficiaries)

As noted earlier, the current benefit formula attempts to hold constant the numerator on the left side of this equation, by indexing initial benefits to rise fully as fast as wages (AWI).

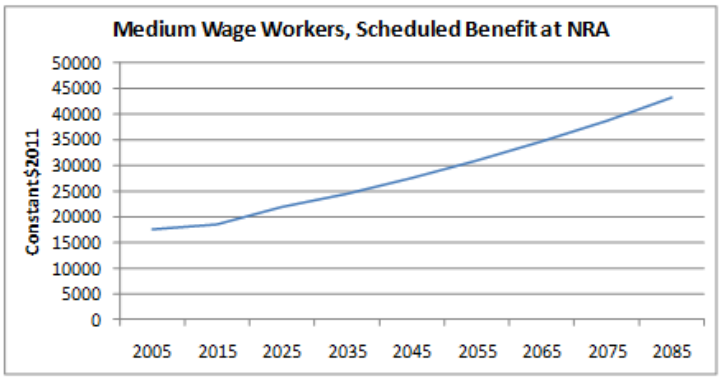
Consequently, if the ratio of workers to beneficiaries sharply declines – which is happening as the Baby Boomers retire -- worker cost burdens must rise substantially. In effect, the current benefit formula implements a value judgment that as we live longer, healthier lives, we should face markedly higher tax burdens when working so that we can be paid retirement benefits, for a longer period of time, that keep pace with general wage increases.

This is not the only value judgment that could be made. An opposing value judgment would be that longer, healthier lives should instead translate into longer periods of taxpaying productivity, enabling a *reduction* in annual tax burdens on workers and employers. Or alternatively, gains in longevity and health could be proportionally split between taxpayers and beneficiaries. Concern about the value judgment inherent in the current formula, specifically the rising tax burdens that would result under it, was expressed by a consultant panel hired by the Congressional Research Service when Congress was considering its adoption in the 1970s:

> This panel gravely doubts the fairness and wisdom of now promising benefits at such a level that we must commit our sons and daughters to a higher tax rate than we ourselves are willing to pay.[1]

A further element of the case for restraining benefit growth is that these substantially higher tax burdens would be imposed to greatly *increase* the future purchasing power of beneficiaries. If instead we act soon to slow benefit growth, benefits needn't be reduced from current levels.

Figure 2: Growth of Initial Benefit Payments Relative to Inflation



[1] www.ssa.gov/history/reports/hsiao/hsiaoChapter1.PDF, p. 8.

With our nation's operative demographics, a benefit schedule that grows with wages cannot be sustainably afforded within a stable tax rate. Initial benefit payments, however, *can* continue to grow more rapidly than inflation, provided that legislative action is taken relatively soon. This is why many experts urge prompt action to recalibrate the growth of the Social Security benefit formula, to prevent undesirable effects such as a marked growth in tax burdens or the risk of future real benefit declines.

There is of course a case for the current benefit formula, which is based on the concept of *replacement rates*. Simplifying, a "replacement rate" is the ratio of post-retirement income to pre-retirement earnings, and is often an important basis for retirement planning. The current formula attempts to maintain constant "replacement rates" for similarly situated workers retiring at the NRA over time. There are many reasons, however, why this approach may not be the most appropriate basis for Social Security benefits.

One is that maintaining constant replacement rates does not produce consistent net treatment across generations. With our demographics, as noted, maintaining constant replacement rates subjects later generations to higher cost rates. As a result, later generations would -- even under wage-indexing -- receive a declining percentage of their contributions back as retirement income.

Another problem is that each generation's Social Security benefits are paid from the contributions of younger generations without creating a net addition to the pool of saving available to finance total retirement income. Accordingly, rising cost rates under wage-indexing result in less income being available to later generations to build retirement saving *outside* of Social Security. To maintain constant replacement rates for *total* retirement income requires attention instead to the amount of national saving dedicated to financing retirement benefits. Such saving is more likely to be induced under a policy in which income transfers under Social Security grow more slowly than under current law.

Specific Benefit Options

There are a number of possible ways to establish a more affordable growth rate for Social Security benefits. Among them:

Eligibility age changes. In 2003, the Congressional Budget Office[2] estimated that 55% of projected Social Security cost growth was attributable to population aging, the remaining 45% to

[2] "The Future Growth of Social Security," http://www.cbo.gov/ftpdocs/43xx/doc4380/07-01-SocSecAging.pdf. The calculation references growth through 2075; the percentage attributable to aging is higher through 2035.

the growth in per-capita benefits. Because the decline in the ratio of workers to beneficiaries is the single biggest contributor to Social Security's cost growth, adjusting eligibility ages addresses the financing shortfall's most direct cause. Slowing the growth in the number of years over which individuals receive benefits is further attractive to many reformers because doing so reduces financial pressure to raise taxes or to lower annual benefit levels.

For a worker with a given wage history, a number of factors combine to determine the benefit she can receive at a given age, including: the NRA (now 66, later rising to 67), the Early Eligibility Age (EEA; now 62), the actuarial adjustments for early/delayed retirement, and the basic benefit formula itself. Various benefit increases enacted over the years, as well as the establishment of the early retirement option, mean that workers now can and do claim retirement benefits earlier than when Social Security was first established.

Even if both the EEA and the NRA rose by a further three years beyond current law (to 65/70, respectively), retirees could still claim relatively higher benefits at age 65 than they could at Social Security's inception. Few existing reform proposals raise eligibility ages even this much, meaning that they do not truly begin to adjust for longevity gains since then. Therefore, despite misperceptions to the contrary, most proposals now on the table would not oblige workers to delay retirement relative to FDR's original vision.

Early/delayed benefits: In addition to changing the eligibility ages themselves, many proposals would increase the actuarial reduction factor (ARF) for early benefit claims as well as the delayed retirement credit (DRC) for later claims. The current ARF and DRC are calculated to hold constant one's expected benefits if one lives an average lifetime, i.e.: providing lower annual benefits for earlier claims and higher benefits for later claims. The individual who claims the DRC, however, will likely have worked longer and paid more in payroll taxes than the person who accepts the ARF. Because the ARF/DRC hold total expected benefits constant, therefore, someone who continues to pay payroll taxes often receives no additional benefits for doing so. Increasing the ARF/DRC could increase the incremental benefits returned by the system for each additional year of taxpaying work while also improving system finances. Offering the DRC with a lump sum option might also make delayed claims more attractive to some workers.

Slowing benefit growth for higher-income workers: Many proposals improve program finances by slowing benefit growth for higher-income workers. The logic of this is straightforward: the scheduled rate of growth cannot be afforded for everyone without a substantial increase in taxes. Meanwhile, there is a bipartisan desire to protect benefit growth for low-income workers as much as possible. Heeding these two imperatives necessitates slower benefit growth on the high-income end. Unfortunately, Social Security repairs have already been delayed to the point where, if a large tax increase is to be avoided, the rate of benefit growth must be changed for the clear majority of workers. If reforms are still further delayed, more low-income people will be adversely affected. Fortunately, benefits need not yet decline relative to inflation for anyone.

There are two basic approaches to slowing the rate of benefit growth for higher-income workers. The first family of plans relies on variations of "progressive indexing." In these plans, benefits on the highest end would grow with price inflation, while on the lower end (often the bottom 30 percent) they would grow more rapidly with wage growth. Everyone else would be somewhere in between. The second family of plans by contrast doesn't change the indexing method by which benefits grow. These plans surgically alter the numbers in the benefit formula so as to target benefit changes on the upper-income end. While the first approach offers a clearer growth-rate rationale, the second allows reformers to more precisely target the desired amount and timing of savings, as well as the distribution of changes among worker income levels.

Work incentives; AIME reform: One of the larger problems with the current benefit formula is the way that it handles two competing objectives: on the one hand to produce a single number for one's lifetime wages, and on the other to progressively distribute benefits. The combined effects can produce inequities and undesirable incentives. The longer one works and one's "average earnings" rises, the worse one's returns on taxes paid. These adverse effects are particularly pronounced once one reaches the maximum of 35 earnings years. Research by Andrew Biggs of AEI has shown that the rate of benefit return on working seniors' payroll taxes is nearly a negative 50 percent. Put another way, individuals who delay retirement receive only a few pennies in extra benefits for each dollar of extra taxes they pay into the program. Also, because the benefit formula cannot distinguish a steady low-wage worker from an intermittent high-wage worker, returns can be the same for each, undercutting the efficiency of anti-poverty protections. This can cause inequities with respect to populations moving in and out of Social Security coverage, such as state/local workers and immigrants.

One possible reform is to apply the progressive benefit formula to *each* year of wages rather than to one's lifetime average. This would strengthen work incentives, especially for seniors contemplating retirement. This would reap dividends not only for Social Security but for the broader budget and for the economy as a whole. It would also target a higher fraction of system resources on steady, lower-wage earners, reducing benefit growth for intermittent workers.

CPI/COLA Reform: Many have suggested reforming the Consumer Price Index used to calculate annual COLAs, basing them instead upon the chained C-CPI-U. This is projected to reduce the growth in future COLAs by an average of 0.3 percentage points per year. The basis of this recommendation is that the current CPI-W (and CPI-U) likely overstate price inflation by failing to adequately incorporate purchasing substitutions as such inflation occurs.

Because the objective of the annual COLA calculation is to adjust for inflation it seems a straightforward reform to use the most accurate measure of inflation available, whatever it might be. In the Social Security context, however, switching to C-CPI-U is not without controversy.

Some have suggested shifting instead to CPI-E, an experimental index used to measure seniors' buying patterns. This change would (based on historical experience) increase Social Security costs. There are a number of issues with the CPI-E, which like CPI-U and CPI-W fails to fully account for purchase substitutions. This flaw is especially problematic for CPI-E because health care purchases are both more prevalent among the senior population and are a prime area for such substitutions. Many are rightly concerned about the adequacy of benefits among the oldest seniors, but benefit distributional goals are probably better addressed via changes to the benefit formula rather than via a formulaic, compounding overstatement of general inflation.

Non-working spousal benefits: The current non-working spouse benefit is 50% of the household primary worker's benefit. Many have expressed concern that the current design of the benefit creates both work disincentives and distributional inequities. A spouse of a high-wage earner can for example receive, despite having made no payroll tax contributions, a higher benefit than received by a minimum-wage earner based on a full career paying Social Security taxes. Some have therefore suggested capping or slowing the growth of the non-working spouse benefit.

Minimum benefits: Some have also suggested increasing the benefits received by lower-income beneficiaries to increase Social Security's protections against poverty. Under current law these protections will already strengthen over time due to the wage-indexation of the Social Security benefit formula. Reformers who wish to further strengthen benefits for the poor sometimes suggest increasing the formula's "bend point factors" on the low end, or establishing new provisions to guarantee a minimum benefit of 100% or more of the poverty level, the precise percentage often being a function of total years worked.

I share the goal of increasing these protections against poverty and have worked to develop many such provisions. One caveat I would sound is that Social Security's labor disincentives are already substantial and that they could be significantly further worsened by collapsing the benefits of higher-wage and lower-wage workers too closely together. I have found as a general rule that a "minimum benefit" best meets the dual goals of protecting work incentives and of reaching those in need if it phases upward as an individual's total number of work years rises from about 25-40. Under this approach, the SSI program would need to remain a critical protection against old-age poverty for individuals with few years of taxpaying earnings.

Suggested Rules of Thumb

To assist in condensing this compendium of technical information into more useful advice, I offer the following subjective rules of thumb.

1) *Act soon.* The balance of benefit and tax changes in balancing Social Security's books is a critical societal value judgment. But regardless of the balance chosen, the earlier the solution is enacted, the more equitable it can be. The longer that action is delayed, the more that changes will be concentrated upon a smaller number of birth cohorts, increasing adverse effects on vulnerable populations within those cohorts.

2) *Yes, slow the growth of benefits.* As to the threshold question of whether benefit growth should be slowed at all, my subjective recommendation would be "yes." To do otherwise would subject younger generations to tax burdens far higher than previous generations have ever tolerated. In no sense has the current benefit formula been "paid for" by workers or anyone else, as it well exceeds the program's total tax revenue (see Figure 1). If the rate of growth is adjusted now, real benefits can continue to rise (see Figure 2). If instead the current formula is left in place, there is the real risk of future benefit *declines* if voters rebel against the taxes required to sustain current-law payment schedules.

3) *Recognize demographic realities*. America's population is aging rapidly as the Baby Boomers leave the ranks of the workforce and enter the retirement rolls. Accordingly, something has to give. Either taxes will rise markedly, annual benefits be significantly adjusted, or the duration of benefit payments must grow more slowly. We are currently in a situation where a typical beneficiary claims benefits three years earlier than under FDR's vision but lives six years longer. We would need to raise Social Security's early and normal retirement ages substantially (i.e., by at least three years) just to get back to the starting point, let alone to adjust for longevity gains since the program's inception.

4) *Phase in changes as rapidly as palatable before 2035.* The vast majority of projected program cost growth will have taken place under current law by 2035. Annual costs will rise dramatically to 17 percent of worker wages by then, a level they won't permanently exceed until the 2070s. Benefit changes that occur only after 2035 will thus do very little to address the looming tax burdens facing younger workers.

5) *Repair flawed work incentives.* The current system is practically designed to drive seniors and secondary earners out of the ranks of those seeking employment, as this was deemed desirable in 1935. We now have the opposite need, as future economic growth is jeopardized by the permanent withdrawal of millions of skilled Baby Boomers from the workforce. The penalty for early retirement benefit claims should be increased; the reward for delayed claims also increased (and perhaps a lump sum option offered to make it more attractive). The benefit formula should be redesigned to offer robust additional benefits for *each* year of further work by seniors, rather than offering worse returns with each year of work as does the current formula.

6) *Protect the vulnerable by constraining benefit growth for higher-income workers.* The faster that benefits grow on the higher-income end, the less there will be left over for those most at risk of old-age poverty, at least within a given level of tax revenue. It is both financially and politically inefficient to have higher tax burdens driven in large part by benefit growth above and beyond inflation for upper-income workers. Take care, however, when making the benefit formula more progressive so as not to further undermine labor participation incentives.

7) *Maintain the contribution-benefit link; don't means-test.* There is an important conceptual distinction between a more progressive benefit formula and a true means-test. The former requires no new administrative capabilities of the Social Security Administration and it does not penalize individuals for the retirement saving they do outside of Social Security. Also, do not sever the vital link between contributions and benefits that distinguishes Social Security from welfare. Continue to credit all worker contributions toward benefits, and resist the temptation to bail out the program with other unrelated revenues such as estate taxes, "legacy surcharges," or other general revenues.

8) *Maintain the link between retirement/disability benefits.* There is sometimes a temptation to decouple the retirement and disability benefit formulas, to hold the disabled harmless from any changes affecting retirees. The fact that the disability benefit formula is based on the retirement formula, however, is important to prevent "gaming" of the system and to provide for a smooth transition once a disabled individual reaches retirement age.

9) *Avoid unnecessary complexity.* It is important to remember that not every part of the Social Security benefit system can do everything. There is sometimes a temptation to resist a change in the eligibility age, in the CPI, or in another part of Social Security because of what is perceived as an undesirable distributional effect. I recommend instead that distributional goals be pursued through the benefit formula rather than asking the retirement age or the CPI to do that work. Don't set up multiple eligibility ages for different professions or income levels, for example, in an effort to protect the physically incapacitated. Deal with those issues through the disability program and just have the retirement age do what it's intended to do: establish the definition of "old age" for the general case. Don't choose the CPI index, for another example, based on desired benefit levels for 85-year-olds. Instead, just choose the best measure of economy-wide inflation. If we want benefits for 85-year-olds to be higher, we can deal with that separately in the benefit formula. In pursuing progressivity, we should focus on the *total* progressivity of the system rather than asking *every* subcomponent of the system to be progressive, from the payroll tax to the retirement age to the CPI. We can make the system as progressive as desired through the benefit formula, without creating unnecessary confusion and complexity in these other parts of Social Security. Social Security has flaws and faces many challenges, but let us retain the virtue wherein certain parts of it are still relatively easy for Americans to understand and to plan around.

Conclusion

I trust that this information is useful and I would be pleased to answer any questions that the subcommittee may have.