Statement before the United States House of Representatives
Committee on Ways and Means
Social Security Subcommittee
Hearing on Social Security's Finances

Andrew G. Biggs, Ph.D.

Resident Scholar

American Enterprise Institute

June 23, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Johnson, Ranking Member Becerra and Members of the Committee. Thank you for offering me the opportunity to testify with regard to Social Security's finances. My name is Andrew Biggs and I am a resident scholar at the American Enterprise Institute. The views I express today are my own and do not represent those of AEI or any other institution.

Elected officials and the American people face a daunting challenge. As the Congressional Budget Office has confirmed, over the next several decades the largest fiscal challenge facing the federal government is the aging of the population, which will drive up costs for Social Security, Medicare and Medicaid.[1] In an aging society, smaller numbers of working-age individuals must be sufficiently productive to support ever-increasing numbers of retirees. If society can sufficiently increase economic output it is possible to support larger populations of retirees without reducing the standard of living of working age Americans. In short, a strong and growing economy is the only way in which entitlement reform can avoid being a zero-sum game between young and old.

When smaller numbers of workers must support larger numbers of retirees, public policy should encourage individuals to do three things:

- First, work more, meaning more hours of the week and more weeks of the year;
- Second, save more, meaning higher participation in an employer-sponsored retirement plan and increased contribution levels; and
- Third, retire later, meaning putting off retirement from 62, when most Americans currently claim Social Security benefits, until a later age.

If we improve the incentives for Americans with regard to work, saving and retirement ages, we can boost the economy and increase our capacity to finance the Social Security program, alongside the even more daunting challenges of Medicare and Medicaid. This context should inform our view of whether to address Social Security's financing challenges through increased taxes or reduced benefits.

But let me begin with one area that is not in dispute: we should *not* reduce benefits for low earners who cannot save sufficient amounts for retirement on their own and who otherwise would fall into poverty in old age. Social Security's most important task is to prevent Americans from falling into poverty. A recent proposal for Social Security reform I authored as part of a Peterson Foundation initiative would guarantee a poverty-level income for all beneficiaries, regardless of earnings or labor force participation, increasing benefits for around one-third of all beneficiaries.[2]

In effect, the main policy disagreement is whether to raise taxes on middle and high earners in order to pay higher benefits to middle and high earners. I will argue that it is generally preferable to maintain current tax rates as much as possible, while achieving long-range solvency principally by extending work lives and slowing the growth of benefits for middle and higher earners.

A recent study by the RAND Corporation confirmed what economic theory and evidence already suggest: most individuals would react to lower Social Security benefits by saving more and/or delaying retirement.[3] Forty-seven percent of respondents told RAND they would definitely extend their work lives, with another 44 percent saying maybe. Likewise, 41 percent said they would save more prior to retirement with another 50 percent saying maybe. In both cases, around 1 in 10 said they would react to lower scheduled benefits by doing nothing and simply swallowing the benefit cut. These survey results correspond with research findings that Social Security tends to reduce private saving[4] and encourages earlier retirement.[5]

While we expect individuals to react to lower benefits by increasing their work and saving, how can we expect them to react to higher taxes? Put broadly, increased taxes generally mean that individuals will

- Work less, because the reward for working has been reduced;
- Save less, because they have less after-tax income with which to save and, through provision of more generous entitlement benefits, less reason to save; and
- Retire earlier, because the effective replacement rate paid by Social Security – that is, Social Security benefits relative to after-tax pre-retirement earnings – will rise.

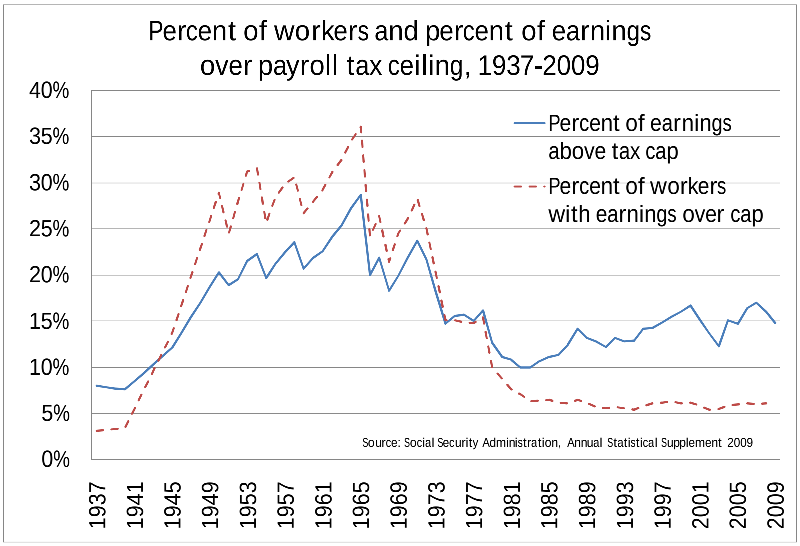
In other words, higher taxes work opposite to macro-level goals that a broad spectrum of analysts and policymakers generally would recognize. We may disagree regarding how large the effects of raising taxes might be and whether some policy goals are sufficiently important that the negative economic effects are a price worth paying. But we should not dispute the fact that increasing taxes to support entitlement programs imposes a cost on the economy's ability to support growing populations of retirees.

Since very few leaders on either side in Congress have discussed raising the payroll tax rate, I will focus on the most common proposal for raising Social Security taxes: lifting or eliminating the maximum taxable wage. Currently, individuals pay taxes and accrue benefits only on the first $106,800 in earnings. Many have proposed increasing this cap. Indeed, the Social Security Actuaries project that if the payroll tax ceiling were eliminated it would be sufficient to restore the program to solvency over 75 years, albeit not to the more exacting standard of "sustainable solvency."

It pays to begin with some history. In June 1934, President Franklin Roosevelt appointed the Committee on Economic Security to put flesh on the bones of Roosevelt's ideas for old age pensions. The Committee conferred and issued a report, which was the basis upon which Congress began work in formulating the Social Security program.[6] In that report, the Committee recommended that individuals with earnings above $3,000 (around three times the average wage) be *exempt* from Social Security taxes and not even participate in the program.[7] That is, the Committee recommended that Social Security contain *no* overt redistribution from high to low earners. The $3,000 figure also was not chosen to match any particular percentage of total earnings. Rather, it reflected an "esthetic logic," in the words of one Committee staffer, that "looked very good. It was $250 per month."[8]

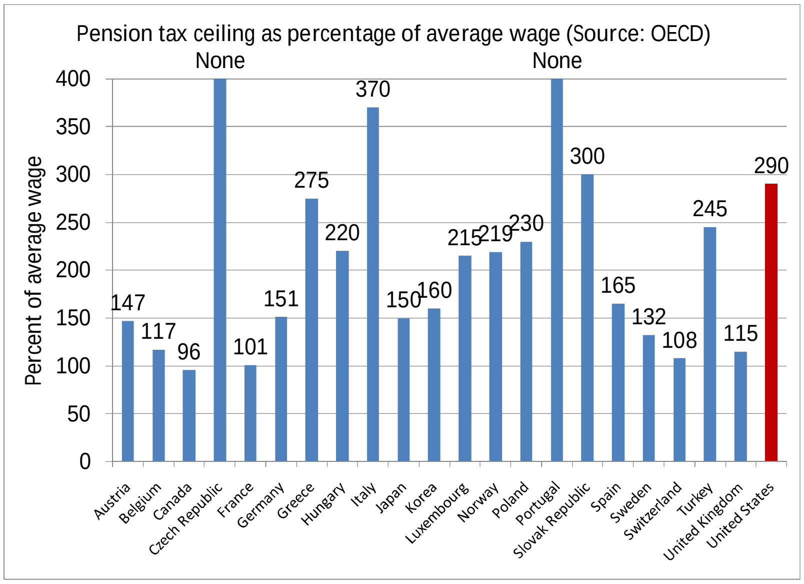
While the Committee's recommendation to exempt high earners was not adopted in the end, the eventual decision to base both taxes and benefits on earnings up to a given maximum reflected Roosevelt's intent that Social Security more closely resemble a mandatory individual saving program, with a modest supplement to low earners, than a welfare program transferring resources wholesale from rich to poor. Roosevelt went to great pains to distinguish Social Security from what was then called "relief" and is today termed "welfare."

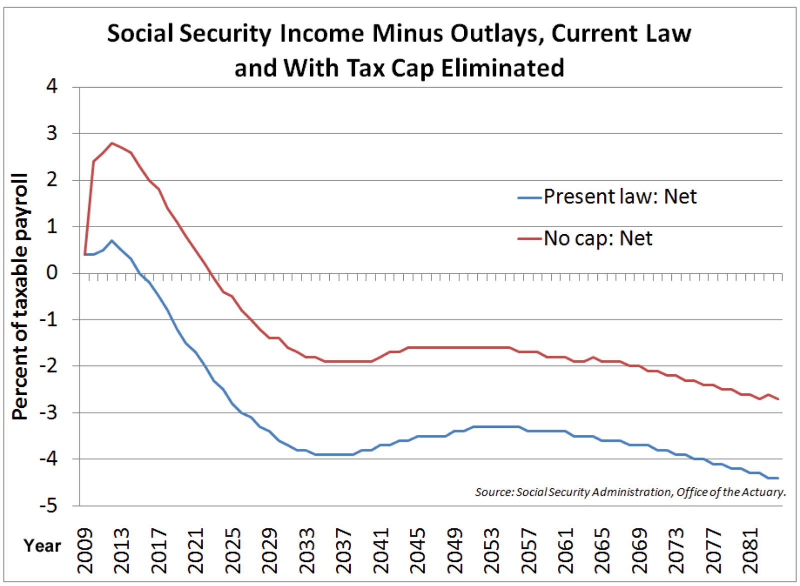
Over the years, the maximum taxable wage was increased many times. In the early years of the program such increases were often portrayed as being in the interests of middle and high wage workers, who would pay more and then receive more in retirement. This is more plausible than it may seem, as the implicit rate of return paid by Social Security in early decades was high. However, increases in the maximum taxable wage also often corresponded with general benefit increases to all beneficiaries, indicating that the need for additional revenue to expand the program was a motivating factor. More recently, the argument for an increased payroll tax ceiling has again been framed in terms of fairness, but in this case the question is how to distribute the burdens of higher taxes.



In that context, it is worth noting that the current payroll tax ceiling is not unusually low by historical standards. Through much of Social Security's history, a significantly greater share of total earnings escaped taxation and more workers had earnings above the payroll tax ceiling than today. As of 2009, 85.2 percent of total wages were subject to the payroll tax, leaving around 15 percent above the tax ceiling. From 1950 through 1970, however, an average of 22 percent of total earnings lay above the tax cap. Likewise, around 6 percent of current workers have earnings above the payroll tax ceiling, while from 1950-70 around 29 percent of workers had at least some earnings above the maximum taxable wage. The current payroll tax ceiling is not out of character with how Social Security has been financed over the last seven decades.

Social Security's payroll tax ceiling also is not unusually low relative to other developed countries. Across 22 OECD countries, pension taxes were on average applied up to 2.1 times the average wage. In the United States, the Social Security payroll tax is applied up to around 2.9 times the average wage, a significantly higher tax cap than in the U.K., Germany, Canada and other competing countries. On the benefit side, Social Security is also more progressive than the typical OECD program. Only a small number of countries, most of Anglo origin, have more progressive pension benefit structures than the U.S.[9] Broadly speaking, the U.S. Social Security program is smaller but more targeted than pension programs in other developed countries.





Lifting or eliminating the cap on taxable earnings could significantly increase revenues to Social Security, raising taxes by around $1.5 trillion over the first 10 years, according to data from the SSA Office of the Chief Actuary.[10] But to this policymakers should ask two important questions:

First, would those additional revenues be saved? Eliminating the payroll tax ceiling would reduce the rising cost burden on future taxpayers only if the near-term surpluses it generated were saved to cover benefits once the program went into deficit. By saved, I mean not simply credited to the Social Security trust fund, but saved in a sense that reduced overall budget deficits and added to national saving. If near-term surpluses were effectively spent, either through increased outlays or lower non-Social Security taxes, then on a straight cash basis eliminating the payroll tax ceiling fills only around 40 percent of annual Social Security deficits once they occur.

A trio of studies by well-respected economists concludes that Social Security surpluses since the 1980s have *not* translated into improved budget balances or reduced publicly-held government debt. The basic analytical technique is to ask how changes in the Social Security balance correlated with changes to the overall budget balance, after controlling for other factors. Professor Kent Smetters of the Wharton School, who wrote the first such study, concludes:

> There is no empirical evidence supporting the claim that trust fund assets have reduced the level of debt held by the public. In fact, the evidence suggests just the opposite: trust fund assets have probably increased the level of debt held by the public.[11]

Barry Bosworth and Gary Burtless of the Brookings Institution reached similar conclusions: for OECD countries, "Between 60 and 100 percent of the saving within pension funds is offset by reductions in government saving elsewhere in the public budget."[12] Likewise, research by John Shoven of Stanford and Sita Nataraj of Occidental College on all U.S. federal trust funds "suggest[s] a dollar-for-dollar offset of trust fund surplus with spending increases or tax cuts; the authors are able to reject the hypothesis that the full dollar of trust fund surplus is saved by the government."[13]

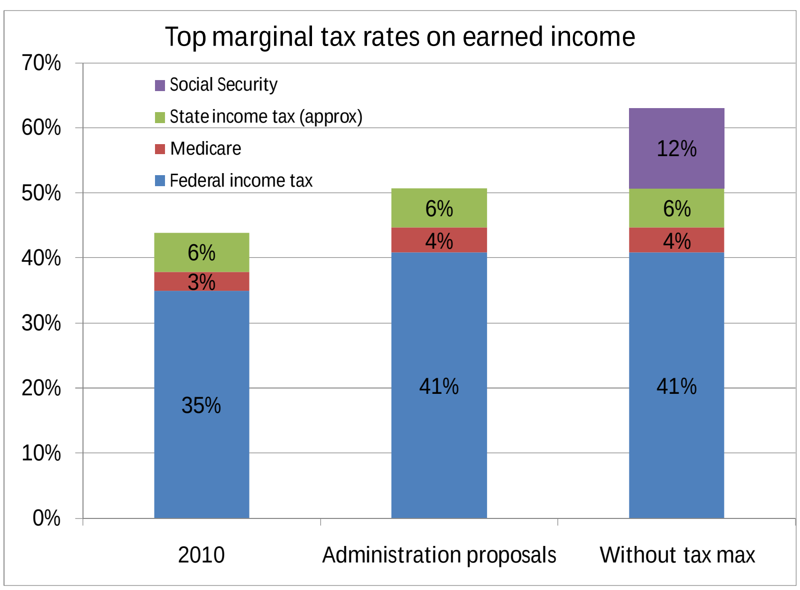
The Congressional Budget Office appears to have accepted these views, recently stating that

> trust fund balances convey little information about the extent to which the federal government has prepared for future financial burdens, and therefore ... trust funds have important legal meaning but little economic meaning.[14]

It would be ironic if Congress approved a strategy to fix Social Security that relied on trust funds that both economic research and the Congressional Budget Office have concluded don't effectively pre-fund future benefits.

This leads to a second question: how would higher tax rates affect work, the economy, and tax revenues? Higher Social Security taxes should be seen in the context of other tax increases that are already in the works. Currently, the top federal income tax rate is 35 percent. Adding in the 2.9 percent Medicare tax and a typical state income tax rate of around 6 percent, the all-in top marginal tax rate on earned income is around 44 percent. In some high-tax states it could be as high as 49 percent.

Under the Obama administration's plans, the top income tax rate will rise to 40.8 percent, due to an increase in the top rate to 39 percent and the restoration of the Pease provision phasing out itemized deductions for high earners. The Medicare tax rate on high earners is scheduled to rise to 3.8 percent as of 2013 as part of the recent health reform legislation.[15] Assuming, perhaps optimistically, that state income tax rates remain constant, the top marginal tax rate will rise under current plans to 51 percent, with a maximum in states such as Hawaii and Oregon of around 56 percent.



Now imagine that we eliminate the Social Security payroll tax ceiling. While only around 6 percent of earners have earnings above the tax max in a given year, about 24 percent of households would be affected by higher taxes over their lifetimes.[16] In years in which earnings exceeded the current taxable maximum, these individuals would pay an additional 12.4 percent tax on their wages. The total maximum marginal tax rate on earned income could reach 63 percent and even higher in certain states.[17] These tax increases, which would leave high earners essentially tapped out in terms of revenues, would be before we've addressed Medicare and Medicaid's multi-trillion dollar funding shortfalls.

Even if individuals did not alter their work behavior, increasing the Social Security maximum taxable wage would cause non-Social Security taxes to shrink. SSA's Office of the Chief Actuary projects that eliminating the payroll tax ceiling would reduce earnings subject to those increased taxes by around 6 percent, as employers lower wages to cover their own increased tax obligations.[18] These lost wages would no longer be subject to federal income taxes, Medicare taxes, or state income taxes. I estimate that the federal budget would lose slightly over 20 cents in non-Social Security revenues for each dollar of new Social Security taxes, a figure that appears consistent with Joint Tax Committee practices.[19] In addition, state governments would lose income tax revenues based on the reduced tax base.[20]

Many respected economists would go even further. Edward Prescott, the 2004 winner of the Nobel Prize in economics, points out that Americans on average work around 50 percent more hours than do working-age French, Italians or Germans. What drives this difference? Prescott explains: "It turns out the answer is not related to cultural differences or institutional factors like unemployment benefits; rather, marginal tax rates explain virtually all of this difference."[21] Back when Europeans were subject to around the same tax rates as Americans, they worked around the same number of hours. But, as my AEI colleague Alan Meltzer has pointed out, "From the 1970s to the 1990s, the effective tax rate on work increased by an average of 28 percent in Germany, France and Italy. Over that same period, work hours fell by an average of 22 percent in those three countries."[22]

Revenue losses increase quickly if taxable income falls in response to the new tax. For instance, if individuals reduced earnings above the ceiling by 5 percent in response to higher marginal tax rates, then non-Social Security revenue losses would rise from around 20 percent to about 38 percent of new Social Security revenues, which would themselves decline versus static projections.

This example may not overstate the case. Using relatively conservative assumptions regarding the responsiveness of taxable income to tax rates, Professors Jeffrey Liebman of Harvard University and Emmanuel Saez of the University of California, Berkeley estimated that 46 percent of the static increase in revenues due to eliminating the Social Security payroll tax ceiling would be offset due to employer changes in wages, offsets against other federal and state taxes and changes in labor force participation.[23] Using more aggressive behavioral assumptions, which nevertheless have some support in the tax literature, the net revenue gain would be zero.

In a future economy when smaller numbers of workers must support larger numbers of retirees, these are not outcomes policymakers should be comfortable with. Leaving aside the moral issue of taxing away over 60 percent of an additional dollar earned, countries such as Germany, France, Holland and Sweden – which have no such qualms about high taxes – have judged that as a matter of economic stewardship such high rates are counterproductive. We should bear the same factors in mind.

Lawmakers face a choice: policies that encourage more work and more saving, while retaining the safety net for the poor, versus policies that discourage work and saving. Our ability to care for those in need springs from the goods and services produced in the economy. If we punish workers who produce those goods and services, the goals of Social Security and other important federal programs will be more difficult to achieve.

---

[1] Congressional Budget Office. "Long Term Budget Outlook, 2010."

[2] Antos, Joseph, Andrew Biggs, Alex Brill, and Alan D. Viard. "Fiscal Solutions: A Balanced Plan for Fiscal Stability and Economic Growth." Peter G. Peterson Foundation. May 25, 2011.

[3] Delavande, Adeline and Rohwedder, Susann. "Individuals' Responses to Social Security Reform." (September 29, 2008). Michigan Retirement Research Center Research Paper No. WP 2008-182.

[4] For a review of the literature see Congressional Budget Office. "Social Security and Private Saving: A Review of the Empirical Evidence." July 1998.

[5] For instance, Burtless and Moffitt point out that large numbers of individuals retiring at age 62 did not occur prior to the availability of early Social Security benefits at that age. Burtless, Gary, and Robert A. Moffitt. 1984. "The Effect of Social Security Benefits on the Labor Supply of the Aged." In *Retirement and Economic Behavior,* ed. Henry J. Aaron and Gary Burtless, 135–71. Washington, DC: Brookings Institution.

[6] The Committee's report is available at http://www.ssa.gov/history/reports/ces/cesbasic.html. It is worth noting that the CES report, and the Social Security Act, contained many elements beside what we consider today to be "Social Security." These included unemployment benefits, need-based benefits for the elderly to be distributed by the states, and other policies.

[7] The Social Security program would be compulsory for individuals earning less than $3,000 per year (average earnings in 1935 were roughly $980). By comparison, the current average wage for Social Security purposes is slightly over $43,000 while the maximum taxable wage is $106,800. For individuals earning above $3,000, as well as for the self-employed, the Committee recommended the establishment of voluntary government-provided annuities.

[8] See Schieber, Sylvester J. and John B. Shoven. *The Real Deal: The History and Future of Social Security*. Yale University Press. 1999. P. 151.

[9] Source: OECD. *Pensions at a Glance 2007*.

[10] See http://www.ssa.gov/OACT/solvency/provisions/tables/table_run191.html. Following budgetary convention, 10-year tax revenues are in nominal dollars.

[11] Kent Smetters, "Is the Social Security Trust Fund Worth Anything." NBER Working Paper No. W9845, July 2003.

[12] Barry Bosworth and Gary Burtless. "Pension Reform and Saving." The Brookings Institution. January 5, 2004.

[13] Sita Nataraj, John B. Shoven. "Has the Unified Budget Undermined the Federal Government Trust Funds?" NBER Working Paper No. 10953. December 2004.

[14] Congressional Budget Office. "Effects of the Patient Protection and Affordable Care Act on the Federal Budget and the Balance in the Hospital Insurance Trust Fund." December 23, 2009.

[15] Alan Viard. "The Myth of a Return to Clinton-era Taxes." *The American*. September 15, 2010.

[16] Based on calculations for the 1990 birth cohort conducted using the Policy Simulation Group Social Security and pension models. For details on these models, see www.polsim.com.

[17] If policymakers opted to pay additional benefits based upon higher Social Security taxes, the additional tax rate net of new benefits would be around 6.6 percent of earnings, raising the top marginal rate to 57 percent. Under this option, eliminating the taxable maximum would not be sufficient to restore 75-year solvency because of the increased benefit costs.

[18] Author's calculations, based on Alice H. Wade and Chris Chaplain. "Estimated Long-Range OASDI Financial Effects of Eliminating the OASDI Contribution and Benefit Base." Memorandum. Social Security Administration, Office of the Chief Actuary. October 20, 2003.

[19] It is unclear how the CBO would score such a change, but it appears that the Joint Economic Committee would assume a 20 percent revenue offset for a change in the employer portion of the payroll tax. See Congressional Budget Office. "The Role of the 25 Percent Revenue Offset in Estimating the Budgetary Effects of Legislation."

January 13, 2009. Staff of the Joint Committee on Taxation. "Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation." February 2, 2005.

[20] This would have a minor positive effect on the federal budget, as state income tax payments are deductible from individual federal tax returns.

[21] Edward C. Prescott. "The Elasticity of Labor Supply and the Consequences for Tax Policy," Federal Reserve Bank of Minneapolis. February 2005.

[22] George P. Shultz, Michael J. Boskin, John F. Cogan, Allan Meltzer and John B. Taylor. "Principles for Economic Revival." *Wall Street Journal*. September 16, 2010.

[23] Liebman, Jeffrey and Emmanuel Saez. "Earnings Responses to Increases in Payroll Taxes." U-C Berkley Working Paper. September 2006