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Committee on Ways and Means
U.S. House of Representatives
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Questions for the Record
July 8, 2011 Hearing
Answers of Charles Blahous

1. How do we keep the benefit structure simple in a way that is fair but also helps boost job and economic growth over time?

Significant problems with the current Social Security benefit structure are that it is opaque and offers uncertain returns on taxpaying work. Workers are encouraged to believe that their payroll taxes are generating "earned benefits" while at the same time the Social Security system is aggressively redistributing income -- from younger generations to older ones, from high- to low-wage workers, from single earners to married couples, and in various other ways. Further complicating matters is the fundamental imbalance between aggregate scheduled benefits and the amount that can be financed from current-law taxes, with workers and employers not yet knowing how this shortfall will be resolved. None of this is conducive to facilitating economic growth.

I will begin my answer by describing optional approaches from a purely theoretical perspective before offering suggestions that might have more practical utility. In a theoretical sense, the simplest benefit structure might be one in which current broad trends of income distribution are made transparent. The current 12.4% payroll tax could be divided into three parts of roughly equal size. Roughly one-third of the tax would earn no benefits whatsoever, representing the proportion of worker taxes redistributed to older generations under current law. Another third could provide benefits equal to that portion of the tax times a Treasury bond interest rate, and could be financed either through the traditional Trust Fund or through a personal account (either is possible, as this portion would involve no direct income redistribution). The last third could provide a redistributive, safety-net benefit, offering above-market returns for low-earners and zero returns for maximum-wage earners. Such a hypothetical system would be distributionally very similar to our current one but would be much more transparent in its presentation.

Some Social Security reformers have suggested simplifying the system by splitting the benefit and tax structures instead into two components: one that provides an equal safety-net benefit to all participants, the other component being a savings account in which benefit levels are solely a function of individual contributions (i.e., there is no income redistribution). These proposals are also intended to roughly replicate the current system's progressivity, clarifying work incentives and fostering economic growth by facilitating saving. One example of this approach is the Schieber-Weaver proposal of the 1994-96 Social Security Advisory Council. Andrew Biggs of AEI has offered proposals that are conceptually similar.

Such fundamental reforms might be more than can be agreed to at this time on a bipartisan basis. But as a general rule, job creation and economic growth will be facilitated to the extent that the growth of costs facing workers and employers is constrained. This can theoretically be accomplished either by changing the benefit formula to grow more slowly than wage inflation, or by advance-funding a portion of future benefits through savings accounts, or by some combination of the two. If legislation is enacted soon, benefits can continue to grow more rapidly than price inflation for workers at all wage levels and in all birth cohorts, with or without changing the current system's financing mechanism.

Policy makers face a difficult choice between designing the benefit formula to optimize labor force participation or to offer greater income protections to low-wage individuals. The more progressive the benefit formula, the lower the incremental returns to workers on their tax contributions (to a first approximation). One possible way to minimize this dilemma is to redesign the benefit formula to offer benefits based on each individual year of work rather than on a career average. This would offset some of the income redistribution in the current system that takes from steady low-wage workers and gives to intermittent high-wage workers.

2. What are the options for changing the Actuarial Reduction Factors or Delayed Retirement Credits? How can we reward workers who work longer and encourage others to do the same?

The current ARF reduces annual benefits by 20% if an individual claims three years before Normal Retirement Age (NRA). The DRC increases benefits by 8% for each year (up to three) that an individual claims after NRA. If these figures were increased to 25% and 10% respectively, they might more closely reflect the extent to which individuals who delay claims and remain in the workforce continue to contribute payroll taxes, and thus act as an improved work incentive.

Some analysts have suggested that the DRC might be more attractive to individual workers if they had the option of taking it as a considerable lump sum, instead of only as an incremental addition to monthly benefit levels.

One potentially attractive way to better reward work would be to redesign Social Security's benefit formula so that it applies to each individual year of earnings rather than to a career average. Under current law, it is generally true that the longer one works, the more one's "career average earnings" rises, and the lower one's incremental returns under Social Security's progressive benefit formula. But if the formula were redesigned to accrue benefits based on each additional year of contributions (while still remaining just as progressive), incremental returns would not drop in this way and work incentives would be preserved.

Other policies worth considering to improve work incentives are to restrain the future growth of the non-working spouse benefit, and to provide some payroll tax relief for seniors who have already contributed payroll taxes for 45 years or more.

3. Under current law, Social Security benefits may be reduced for State and local public workers who receive a pension from work not covered by Social Security. This benefit offset is known as the Windfall Elimination Provision. Would your idea to apply the benefit formula to individual years of earnings have the additional effect of reducing the need for the windfall elimination provision, since years without earnings would not be included in the benefit calculation?

Yes, this would be an additional advantage of such reform.

4. In your testimony, you discussed raising the retirement age, can you tell us more about the approaches you support and how you think we should address the problem of those who may be physically unable to delay their retirement?

I would recommend that physical incapacity in middle age be dealt with through Social Security's disability program, which is better designed for that purpose. The Old-Age and Survivors program is not designed to deal with variable individual physical incapacity, but rather to define a broadly-applicable concept of "old age" that is appropriate for most individuals in the society that it serves.

By any measure, Americans are living much longer than when Social Security was first established. Period life expectancy at birth has grown by over fourteen years for both men and women, whereas period life expectancy at age 65 has grown on average by more than six years.

Due to subsequent relaxations in benefit eligibility requirements, however, Americans are claiming Social Security's "old-age" benefits at younger ages than at Social Security's inception. The primary reason for this is the establishment of Early Eligibility Age (EEA), now 62. The establishment of EEA in combination with assorted benefit increases since the program's creation together mean that Americans generally now claim benefits earlier, receive higher annual payments (even in a relative sense), and live substantially longer. This is not sustainable within current tax rates.

If the EEA and NRA were each gradually increased by three years from their current levels, the age of earliest claim would again be where it was at Social Security's inception. From that point, policy makers could then decide how much of longevity gains to date should be reflected in further changes to the eligibility ages.

5. Due to limited time, you were unable to provide your comments on the chained CPI as an alternative to the current COLA calculation index. What are your views on the chained CPI?

I believe that the selection of an inflation index should be based on our best estimate of overall inflation as opposed to distributional goals for benefits. The chained CPI has an advantage over the current CPI-W and CPI-U in that it accounts for upper-level substitution bias – that is, consumer purchasing substitutions across spending categories as prices rise – whereas the other two measures do not.

The statutory intent of inflation-indexation is to adjust for value relative to general price inflation faced by consumers. If it is judged that Social Security benefits are too low, either generally or with respect to specific populations, the appropriate means for handling this is by adjusting the benefit formula and collecting additional taxes as necessary. By contrast, it would contort the purpose of CPI-indexation to achieve these goals through the continued use of an index that overstates general price inflation.

I would most strongly recommend against the adoption of CPI-E (the new experimental index for the elderly) to index Social Security benefits. Many Social Security beneficiaries are not elderly; it would make no policy sense to use CPI-E to index benefits for dependent children or for the young disabled. It would also add undesirable complexity and confusion for one index to be used for some beneficiaries and another for others, which would require changes in the applicable index as individuals move between beneficiary categories (for example, when a disabled beneficiary converts to retirement benefits).

6. In your testimony you supported slowing the growth of benefits for middle and higher income beneficiaries. What is the best way to do this?

The most precise way of targeting the benefit effects of such a change is to directly change the numbers in the benefit formula to produce the desired results. Many proposals would gradually reduce the formula's 32% and 15% bend point factors over a period of some decades until the preferred formula is reached. I have in the past developed proposals that would establish a new bend point at 175% of the first current-law bend point, and gradually reduce the 32% and 15% bend point factors above that point (while retaining the full 90% and 32% factors below it). Proposals from Simpson-Bowles, Liebman-MacGuineas-Samwick and Kolbe-Boyd have all included similar provisions, but with differences in the individual formulas.

The "right" place to set a new bend point, and the "right" eventual modifications to the 32% and 15% factors are a function of several considerations, most especially the degree to which a comprehensive proposal relies upon such changes to attain financial sustainability.

Whatever ultimate formula is decided upon, I would recommend that it be phased in as rapidly as is practicable. The vast majority of cost growth relative to the tax base under current law would occur by 2035, such that any changes postponed until after then will reduce benefits for future generations without doing much to ameliorate the projected peak level of worker tax burdens. Ideally, the new formula would be fully phased in by 2040, and no later than 2050.

An alternative approach to prescribed bend point factor changes is known as progressive indexing. Under this approach, automatic adjustments are made to the upper bend point factors so that benefits for low-wage workers grow with wage inflation, maximum-wage worker benefits grow with price inflation, and others in between receive benefits that are determined by a sliding-scale formula that blends the two.

7. In your testimony you encourage acting sooner rather than later to give beneficiaries time to plan. What are the differences between the challenges Social Security is facing today versus the challenges it faced in 1983? What are the consequences of waiting until the system faces insolvency as it did in 1983?

The long-range (75-year) Social Security shortfall is already larger than the one addressed by the 1983 reforms, and is now measured at 2.22% of taxable payroll over the next 75 years under current methods. This however understates the substantial degree to which today's long-range deficit is larger, because the trustees' actuarial methods were changed in the 1988 trustees' report. If calculated by 1983 methods, today's long-range deficit is already more than 50% larger in relative terms.

There are critical differences, however, with respect to both the immediacy of the problem and the consequences of delay. In 1983, legislators faced an immediate solvency crisis in that Social Security's trust funds were on the verge of depletion within months. This is not the case today, but in another sense the need for action is even more urgent; in the early 1980s, the ratio of taxpaying workers to collecting beneficiaries was relatively stable, such that temporary delays in resolving the system's shortfall could be patched over with short-term measures and without untenable opportunity costs. Today, however, each year of delay means that millions of additional baby boomers will be on the rolls, with legislators powerfully reluctant to change their benefits.

For a time yet to come, delay in resolving Social Security's shortfall is likely to mean that the eventual solution relies more heavily on tax increases. If benefit reductions for those in or on the verge of retirement are to be avoided, and if future real declines in benefit levels are also to be avoided, legislative action must occur within the next few years to avoid a substantial tax increase. Moreover, after these next few years the size of tax increases required to avoid these adverse benefit effects will grow substantially larger.

After a certain point, however, the likely effect of further delay is that Social Security cannot survive as a self-financing program. In that scenario, benefit payments would eventually lose certain protections that they enjoy under the current financing structure. By the early 2030s, for example, even the short-term actions required to sustain self-financing would need to improve <u>annual</u> system operations by over 3% of taxable payroll, a level of immediately-felt austerity several times larger than the short-term effects of the 1983 reforms. Once this point is reached, and it is impossible to know exactly when that will be, it is highly unlikely that Social Security finances can be corrected in a way that preserves the program's historic financing structure.