

MAJOR ISSUES IN SOCIAL SECURITY REFORM

Statement before the President's Commission to Strengthen Social Security

October 18, 2001

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Chairman Parsons, Chairman Moynihan, and Members of the Commission:

It is a privilege for me to be here with you today. I see many friends and colleagues here, and I would like to thank you for your personal support in this very difficult period. I also applaud your efforts to engage the difficult task of helping the nation redefine its priorities. And make no mistake about it. It is this broader task of redefining national priorities to which you have been called in the context of dealing with Social Security — the largest single demand upon the federal budget.

Sorting Out Priorities and the Role of Social Security

For approximately the past half-century, spending on the elderly has been the highest expenditure priority of the federal government. As that spending has grown from 10 percent of non-interest domestic spending to about one-half, it did much good. Under most projections, however, it would grow to 80 percent or more of non-interest domestic spending almost regardless of the size of any tax increases or cuts now being contemplated. As it has continued to require growing shares of federal taxes, Social Security has steadily been pushing aside other domestic spending, whether measured as shares of the budget or of gross domestic product.

Today a new demand has been placed on both public and private budgets — the need to combat terrorism through new, not-yet-fully-understood, defense and internal security measures. But public expenses are only the tip of the iceberg. Shifting domestic priorities initially means more job losses as workers are transferred. In the economic slowdown, hundreds of thousands of workers have already been idled and hundreds of billions of dollars in output lost. Meanwhile, private sector output will be transformed by new architectural requirements, revamping of the transportation system, and the handling of chemicals, energy supplies, and biological research.

Unmet shifts in other demands are also not going to reverse themselves. For far too long, the nation has failed to insure an adult presence for each child throughout most of the day — a task not easily met when the federal budget spends six times more on each elderly person than on each child. And in the elderly budget itself, the needs of single heads of household and of the oldest of the old are increasingly being ignored so as to provide retirement support to healthy middle-age Americans.

Thus, while the terrorism threat is being newly engaged, the requirement for flexible budgets that respond to current needs is not new. Every fiscal crisis in the nation's history reflects nothing more than the simple need to be able to find resources to meet new priorities. In this context, the principal problem of Social Security is not that historically it has failed to do a good job in protecting the elderly on average, but that at the margin it grows independently either of the needs of the nation as a whole or of the elderly themselves.

The new national sense of urgency cannot be ignored. Let's be candid. We all know that in politics the goal is to claim to do something for someone without ever admitting the costs. Identify winners, not losers. Typically, expenditure increases and tax cuts come at a pretended cost of nothing to anyone. In the Social Security debate, some claim that larger shares of the national pie for elderly programs should never be admitted to channel resources away from other

priorities. Meanwhile, others argue just as naively that if we just shift around a bit of money to individual accounts, then no one loses. In truth, if we transfer less resources to others, then of course we can get a higher “return” of our own money. But so what?

In a period when there is a call for new national sacrifices, when lives have been lost and more will be lost, when the needs of the unemployed are large, and when businesses face failure and bankruptcy, this type of rhetoric gets us nowhere. The fundamental issue, I repeat, is how can the nation shift priorities to meet its most important needs now and down the road.

If the greatest failure of Social Security is its tendency to build in growth independently of changes in the needs of society, the commission's practical task is to leave some level of resources free to apply in the future to new emergencies and needs. This can be done in part by indexing benefit growth so that it fits within available revenues from workers, as has been done recently by Sweden. One method I understand the Commission is considering is to index growth in benefits of future retirees by prices, rather than wages. While better than nothing in the short run, a preferable method would be to determine an affordable rate of growth in lifetime rather than annual benefits, while encouraging later retirement so that workers are more likely to have increased annual benefits in true old age.

Retirement Age and Poverty Issues

The message that this Commission sends at this point about Social Security reform is far more important than the particular proposals it suggests. Nonetheless, shifting resources to meet greater needs requires attention to two other matters that up to now have been given short shrift: the scheduled depression-size decline in the adult employment rate, and the “poor” job that Social Security does with additional resources to reduce the poverty rate.

Scheduled Declines in the Adult Employment Rate

In my view, the employment incentives within Social Security seriously threaten economic growth in the future and economic recovery from recession. They could undermine any other successful reform aimed merely at the structure of annual benefits, with or without individual accounts. The primary problem is that Social Security now encourages most individuals to retire in late middle age when the nation needs their talents. About one-quarter of a century of support is now provided to the longer living spouse of a typical couple who retire.

When a person leaves the work force to go on Social Security, he affects far more than Social Security benefit payments. For instance, a couple might not only begin to receive \$15,000 in Social Security payments, but when they stop working, they also might reduce national income and output by \$50,000 and pay \$15,000 less in income, Social Security, and other taxes. Put another way, when a person works longer, she reduces the immediate demand on government, increases her support of Social Security and other government efforts, and adds to her own savings. Your mandate as a Commission could be interpreted narrowly to look mainly at each individual’s Social Security benefit structure, but in fact the affordability of Social Security to society is affected as much, if not more, by the income that she produces and all the taxes (not just Social Security taxes) that she pays.

Over the postwar period, the trend toward more and more years in retirement — whether through longer lives or earlier retirement — was more than offset by the increase in female labor force participation, allowing for continual growth in the adult employment rate (the percentage of adults who are employed). But that era is over. The danger we now face is twofold. First, once the early baby boomers hit their 60s, the adult employment rate could fall precipitously. In the recent past, we considered increases in the unemployment rate of 4/10 of 1 percent a red flag signaling possible recession. Barring reforms to encourage employment among those in their 60s and early 70s — now the largest group of potential employees in the nation — we could see an equivalent recessionary hit from the labor force every year for more than two decades running.

Second, Social Security employment incentives could dampen the ability of the economy to recover from a downturn or recession. In the post World War II period, a downturn meant shifts in demands for labor that eventually would be met by the redeployment of idle resources and increases in labor force participation (particularly among women). But recessions now and in the future potentially involve a much larger contingent of more permanent drop-outs from the labor force among the near elderly and no large source of females to be drawn into the labor force. Thus, even a reformed Social Security could prolong and exacerbate any economic downturn if the employment incentives associated with retirement ages and the structure of lifetime benefits aren't part of that reform.

If this Commission wishes to increase future economic resources as a way to help pay for future benefits, in fact, its surest two methods are, first, to adjust the early retirement age and, second, to reconfigure lifetime benefits so that more are received later in retirement rather than earlier. These measures would increase the supply of labor. Although I also favor attempts to increase saving for retirement, their ultimate effects on national saving and increased future economic resources are less predictable. The plain truth is that government doesn't know how to ensure an increase in saving because any government action can be offset easily by other private actions. Thus, while trying to improve saving is worthwhile, *relying* upon it to solve what is essentially a labor market problem is risky.

I recognize that the retirement age is highly sensitive politically. In good faith, however, can we build Social Security reform on the presumption that a sixteenth or twentieth or twenty-fifth year in retirement is a more important national priority than finding the labor resources to staff our military, redesign our buildings, institute new security precautions, provide new opportunities to the newly unemployed, and pay for this transformation? Or to meet the needs of our children? I think not.

I would like to suggest a way to cut the Gordian knot over retirement age. I believe the Commission should redefine retirement age policy by setting an earliest retirement age and increasing it gradually so that the system stays within budgetary balance taking into account such factors as growth in life expectancy and, as in a recent Swedish reform, changes in other demographic factors such as fertility rates. (A reduction in the growth rate of expected lifetime benefits can also be part of this balancing act, but retirement age adjustments require less net benefit reduction because they produce more tax revenue.) There should be no "normal

retirement age." Instead, there should be a systematic actuarial adjustment in benefits for those who work any period beyond the earliest retirement age. This upward actuarial adjustment should be larger than currently provided since the later retiree contributes more to Social Security and to other tax collections and, through additional earnings, is less likely to require other government assistance throughout retirement. Whether actuarial adjustment is mandated for those who continue to work, as is now done between early and normal retirement ages, or voluntary, as is now done after the normal retirement age, is of less importance. Either way, I suggest putting a greater share of whatever lifetime benefits are provided to each individual toward that period when she is truly old (e.g., when life expectancies are ten years or less). This last step would remove the current incentive to retire at an income level that proves inadequate for the very large portion of individuals likely to live twenty, twenty-five, thirty, or more years in retirement.

My suggested version of retirement age reform symbolically does not sound as harsh as increases in the normal retirement age. Over the next few decades it merely moves the earliest retirement age up toward what is now slated to be a "normal" retirement age. It also allows any reform package to provide significantly higher annual benefits both because it will generate higher Social Security tax receipts and because affordable lifetime benefits will be spread over fewer years.

Meeting the Needs of the Elderly Poor

For many reasons, the current Social Security system does an increasingly inadequate job of directing new resources to the needs of the elderly poor, even though the initial *raison d'être* for the program was concern over the poverty situation among the elderly.

Among its primary defects is that Social Security discriminates against single heads of household who work, pay taxes, raise children, and yet get lower benefits than some individuals who do none of these. Under the current Social Security structure, very large spousal and survivor benefits are independent of any additional contributions and do nothing for single heads of household. Because the numbers of single heads of household have grown significantly, the projected reduction in elderly poverty is very modest relative to the scheduled increase in benefit payments of hundreds of billions of dollars.

This Commission is also considering reform in the form of individual accounts. While I am quite comfortable with that type of reform as a matter of good budget policy (by paying for retirement promises up front) and private pension policy (by improving coverage), this tack *by itself* imposes risk that cannot be undertaken or understood well by those with low incomes. In the case of annuitized pensions, unsubsidized but mandated individual accounts also imply a lower-than-average rate of return for lower-income individuals with shorter life expectancies.

Hence, I strongly urge this Commission to pay particular attention to the needs of the poorer among the elderly. Set up a decent minimum benefit that insures that the bottom one-third or so of the income distribution is better off no matter what happens to any individual account or private pension policy. Let this minimum be indexed over time by wages even if other benefits grow more slowly. Adjust spousal and widow and widower payments so that they

do not discriminate so much against single heads of household (or against couples with more equal distributions of earnings among themselves). To deal with poverty among widows and widowers, some of this adjustment should be in the form of reduced benefits up front to pay for higher benefits when one spouse dies.

A minimum benefit is also one of the surest ways to insure that lower-income women and minorities fare well in any reform. I simply don't believe that you can solve all these problems — removal of a net addition to risk to low-income individuals from reform, a fairer allocation of what now is spent on spousal and widow and widower benefits, and an insured improvement of the status of lower-income women and minorities through a means-tested approach. Means-testing additionally involves all sorts of enforcement problems and saving disincentives.

Conclusion

As the nation faces years of adjusting its public and private budgets to meet the long-term threat of terrorism, it must address its other societal choices with candor. Promising something for nothing or exempting large portions of the population from sacrifice is not in keeping with the spirit that now unites the nation. Social Security's current dilemma is that it is inflexible in meeting national priorities, whether they be combating terrorism or addressing the needs of children and the oldest and poorest among the elderly themselves.

Whatever reform you undertake, I urge you not to dodge the problems associated with a retirement age policy that suggests that a 15th, 20th, or 25th year in supported middle-age retirement is the nation's highest priority, that threatens economic growth by scheduling large declines in adult employment rates, and that induces many to retire when their income may become inadequate decades after they retire. At the same time, I also urge you to increase resources for the poorest of the elderly. Our system has the resources to provide a basic benefit for everyone at above a poverty level, and that should be the first goal of any reform.