AMERICAN ACADEMY *of* ACTUARIES

Testimony of
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Committee on Ways and Means
United State House of Representatives

Hearing on
Protecting and Strengthening Social Security

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Protecting and Strengthening Social Security

Chairman McCrery, Congressman Levin, and distinguished committee members: thank you for the opportunity to testify on the impact of longevity on Social Security's finances and ways to encourage work at older ages. My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. We are the non-partisan professional organization representing all actuaries in the U.S. and do not endorse or propose legislation. Instead, we analyze the potential effects of legislation and evaluate its advantages and disadvantages relative to current law.

The Demographic Challenges for Social Security: As you noted in your announcement for this hearing, there are major demographic challenges for Social Security: the retirement of the baby boomer generation and longer life spans. Chart I, at the end of this testimony, graphs Social Security's annual income and outgo. It shows that outgo increases rapidly for 20 or so years starting in 2008, when the baby boomers are first eligible for (old-age) retirement benefits. Outgo, as a percentage of covered payroll continues to increase thereafter, even though the baby boomers are retired, due to projected increases in our longevity. The problems do not get easier. The difference between Social Security's outgo and income will continue to widen, unless we reduce benefits, increase taxes, and/or raise the normal retirement age (NRA).

Raising Social Security's Retirement Ages: You have asked us to discuss the options for raising Social Security's retirement ages. Retirement age is at the heart of the issue of balancing the Social Security system by defining the appropriate cultural expectations between the period of work and retirement life. More extensive information on the effects of increasing retirement ages on workers, employers, and Social Security can be found on the Academy's website (http://www.actuary.org/socsec/background.htm). At this hearing, you expressed a particular interest in how raising the retirement age would affect Social Security benefits and retirement ages.

Current Rules Increasing the Normal Retirement Age (NRA): Between 2000 and 2005, Social Security's normal retirement age (the age at which there is no reduction for early retirement) increased from age 65 to age 66. Although this change has already affected the benefits of people born after 1937 who retired early, there has been little negative feedback. That may be because:

(1) Congress made this change in 1983, many years before it affected anyone's retirement benefit.

(2) Congress only applied the change to people under age 45 at enactment, thus giving workers many years to prepare for it. The change did not affect people who were closer to retirement, who would have had less ability to change their retirement plans.

(3) Congress phased the increase in NRA to age 66 gradually over the six years from 2000 to 2005 so there would be no reduction in initial benefits compared to people who retired the year before. For example, raising the normal retirement age from 65 to age 65 and two months in the year 2000, reduced benefits for people retiring at age 62 by about 1 percent. As wages probably increased by more than 1 percent over their last year of work, a retiree's benefit is likely to be larger than the initial benefit of a similarly situated person who retired in the prior year.

(4) We are not only living longer, we are healthier at older ages, as shown by lower levels of impairment.[1]

[1] See Chronic disability trends in elderly US populations: 1982 - 1994 by Manton, Corder, & Stallard. In 1982, 14.1 percent of elderly between 65 and 74 were IADL (Instrumental Activities of Daily Living) or ADL-impaired or institutionalized. In 1994 this decreased to 11.5 percent. For ages 75 to 84, it dropped from 31.9 percent to 26.9 percent.

(5) Fewer jobs are physically demanding, now.
(6) More people are interested in staying active both mentally and physically, and jobs help to promote that.
(7) Many recent retirees may not even have realized it happened.

The 1983 Social Security reform also increased the normal retirement age from age 66 to age 67, but it won't start affecting people's benefits until 2017. It affects people born after 1954, and will be fully phased in at age 67 for people born after 1959. Thus, all these gradual changes in the NRA (from age 65 to age 67) affect people born after 1959, so their benefits will have been reduced by about 13 percent. However, because each generation is living longer, we really only decreased the value of lifetime benefits by around 5 percent.[2] In other words, if we don't increase the NRA, then we are de facto increasing Social Security lifetime benefits, because future generations will receive benefits for more years. If we do gradually raise the NRA, we can keep total lifetime benefits about the same (or the same relative to payroll taxes paid).

Proposals to Increase NRA: One possible reform option would eliminate the hiatus in the increase in the NRA to age 67. Instead of waiting until 2017 to start increasing the NRA again, it could start next year. The Social Security actuaries have determined this change would eliminate only about 7 percent of Social Security's 75-year shortfall, because it only affects people born between 1944 and 1959 and only by a small amount.

Another option found in the 1996 Social Security Advisory Council Report would, in addition to the last suggestion, very gradually increase the NRA by one month every two years so that the NRA would reach age 68 in 2035 for workers born in 1973. Age 70 would be reached in 2083, but that would only affect people not yet born (i.e., for people born in 2021). This proposal increases the NRA only one-fourth as fast as the recent increases in NRA, and it eliminates about 36 percent of Social Security's shortfall.

Raising the NRA could eliminate the shortfall if it were done fast enough. The current increases in the NRA of two months per year create benefit cuts that are very similar to those created by price indexing the basic benefit formula, which would eliminate the shortfall. Thus, continuing the increases in the NRA by two months per year to an NRA higher than 67 would substantially reduce Social Security's shortfall.

Disability Retirees Not Affected:[3] Raising the NRA is different from a straight-forward benefit cut in one aspect. It does not affect disability benefit amounts, whereas decreases in the benefit formula do affect the disabled because the same formula is used to determine both old age and disability benefits. Because disability benefits are not cut when the NRA is increased, more people in their 60s may apply for and receive disability benefits, and the Social Security actuaries have reflected that in their pricing of the proposals that affect retirement ages.

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[2] Based on Table V.A.4, males age 65 in 2022 will live 8.4 percent longer than males age 65 in 2000, so the 13.3 reduction in benefits is offset by an 8.4 percent increase in years receiving the benefit.

[3] Certain other survivors are not affected by an increase in NRA, as noted in my earlier testimony on the subject of Increasing the Retirement Age, at http://www.actuary.org/pdf/socialsecurity/ss_future.pdf (page 2).

Early Retirees Are Affected: The above proposals do not change the earliest eligibility age (EEA) for retirement benefits under Social Security. Workers could still retire at age 62 and receive Social Security benefits. However, if the earliest retirement age stays at age 62, then those benefits become much smaller. For example, if we raise the NRA to age 70, then the age 62 retiree will have retired 8 years earlier than the NRA, which means their benefits will be only 55 percent of the benefits they would have received at the NRA. This issue of inadequate benefits is also important for surviving spouses, because a couple's total benefit can drop by one-third on the death of a spouse. One way to discourage these early retirements might be to require the spouse to sign off on early retirement decisions (acknowledging the reduction in benefits due to early commencement), but that would complicate administration (e.g., if separated spouses cannot be found or if they disagree on the appropriate retirement age).

This issue is important for workers in physically demanding jobs. Should Social Security continue to pay these benefits at an early age (even though they would be smaller), even though it can encourage people to retire too early, or should we increase the earliest eligibility age for Social Security benefits? This issue also affects employers who provide these jobs. If they need to retire workers in physically demanding jobs early, then they will find that they need to provide adequate pensions at those ages, which emphasizes the importance of a strong voluntary defined benefits retirement system to provide supplemental benefits until Social Security benefits are available.

Proposals to Increase the Earliest Eligibility Age: To avoid inadequate early retirement benefits, some proposals also gradually increase the earliest eligibility age for retirement benefits from age 62 to age 65. Social Security's actuaries noted that this would eliminate an additional 10 percent of the Social Security shortfall.[4] This change in EEA doesn't help Social Security much over the long run, because the system is designed so that a person's total lifetime benefits have approximately the same value regardless of the age that one elects to commence benefits. The effect on Social Security is that a small amount of cash outlays would be delayed, which would help the unified budget a small amount, but the following year their benefits would be paid and their benefits would be slightly larger than they would have been had people been able to retire earlier. In addition, raising the EEA might encourage more unhealthy workers (especially those in physically demanding jobs) to apply for disability benefits, which are larger than early retirement benefits.

Encouraging Work at Older Ages: While raising the EEA only reduces Social Security's shortfall by 10 percent, it can have a large effect on when people retire, since a person's retirement date is very much a financial decision.[5] Raising the EEA can encourage people to work longer, and not retire until they can get their Social Security pension. Chart II, at the end of this testimony, shows that retirement ages quickly shifted to age 62 after Social Security allowed benefits at that age for men in 1961 (enacted in 1956 for women). However, in the past 20 years, workers have started retiring later due to:

(1) Government policy encouraging work (e.g., mandated employer-based pension accruals after age 65, higher Social Security earnings limit before NRA, no earnings limit after NRA, increased NRA, increased credits from Social Security for working beyond NRA, training programs under Older Americans Act, etc.);

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4 Per the 1994 – 1996 Social Security Advisory Council Report Appendix III, items D1c and D2a.

5 In addition, people retire due to a desire for leisure, or due to the inability to work or find work, or due to the desire to retire after a spouse retires.

(2) Employers converting their defined benefit plans to 401(k) arrangements, which will provide smaller incomes for most people and require employees to retain investment and longevity risks;
(3) Employers cutting back on their post-retirement medical plans so that many more employees wait until they can receive Medicare at age 65; and
(4) Employers compensating workers more to retain them in certain industries due to labor shortages, particularly now that baby boomers are starting to retire and the numbers of new workers may not be enough to replace the retiring workers.

Increasing both the Normal and Earliest Eligibility Ages: Increasing Social Security's earliest eligibility age to 65 in tandem with the increase in the NRA to age 70 by 2083 (described earlier) would eliminate about 46 percent of the shortfall.

Solvency and Sustainability of Social Security: So far we have only discussed raising retirement ages. Another option would be to increase contributions. Increasing contributions by 1.92 percent of covered earnings would eliminate 100 percent of the shortfall and make the system *solvent* over the next 75-year period. However, if this is the only change, we might be back here in 20 years with a large deficit again, due in part to our continually increasing life spans. The same is true if we immediately cut all benefits by 13 percent to achieve 100 percent solvency. In fact, this is one reason why the 1983 fix did not last. It made the system solvent for the 75-year period ending in 2058 (1983 + 75).[6] Now the 75-year period includes many more *deficit* years, in which outgo is more than income due to our longer life spans. Thus, as long as we continue to live longer, we will need very slow and gradual increases in retirement ages (or small and continual increases in taxes or reductions in benefits). If we don't want Social Security to continually go out of balance, then we need to not only make it solvent, but also make it sustainable. The accepted test for sustainability is that trust fund ratios in the final years of the 75-year period be level or increasing.

Predictability: There is another reason that could bring us back to the table in future years, even if we have a solution that is estimated to be sustainable under intermediate projections. We may live longer than assumed under the intermediate projections, have fewer children, have higher inflation, or be less productive. In fact, these last two concerns become more relevant now that we are discussing price indexation (or progressive price indexation) of the initial benefit at retirement.

Indexation of Initial Retirement Benefits: Under price indexation, if real wages increase less than projected under the intermediate assumptions, Social Security will receive less payroll taxes. Benefit outgo could increase more than wage income if real wages were negative like they were in the 1970s. Thus, under price indexation, the pessimistic projection of trust fund assets could still go to zero just when the economy is in bad shape, and benefits would have to be cut and/or taxes raised again. On the other hand, if real wages increase more than expected under the intermediate assumptions, payroll taxes would be more than expected, but benefits (only increasing with price inflation) would fall further and further behind wages. This would make the optimistic projection of the trust fund assets increase much faster than expected. If it actually happened, we would find we had cut benefits more than needed and/or increased taxes more than needed. In summary, price indexation would increase the spread between the optimistic and pessimistic forecasts. Social Security's finances would be more volatile.

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[6] Another reason is that some assumptions did not fare as well, such as real wage growth and mortality, and this will be discussed later.

Wage indexation reduces that problem, because when wages go up more than expected, benefits do too (although with a lag).

Automatic Adjustments: Because it is impossible to predict the economy or the future demographics of the system, Congress might want to consider slightly modifying Social Security so that it automatically handles unexpected changes in the economy or the demographics of the nation. For example, indexing the initial retirement benefits to *wages* would make the system less volatile to unexpected changes in wages.

That's not to say that we should not use *price indexation*. We could use it (or something similar, such as increasing initial retirement benefits by wage growth less 1 percent) if we wanted to gradually decrease benefits, but it only makes sense to use it until benefits are at the desired level. If price indexation is not turned off, benefits eventually fall below contributions, at which point, Social Security would have surpluses thereafter. Some note that this gives us the option to reduce payroll taxes at that point in time. We could also decide now whether to return to wage indexation or reduce taxes at that date (although it should be noted that if we do not ever return to wage indexation, then benefits eventually become inconsequential in comparison to wages). Similarly, we could try *progressive price indexation*, if we wanted to move to a Social Security system that provides level benefits (i.e., the same benefit for everyone as in the United Kingdom's tier I benefit) instead of the individually equitable benefits under today's system. Under a current proposal for progressive price indexation, benefits would become the same amount for middle and upper income workers in 75 years assuming real wages grow by 1.1 percent per year (or 65 years assuming real wages grow at 1.3 percent per year).

We could also automatically respond to unexpected changes in life spans. That would decrease the large spread between the optimistic and pessimistic projections.

Life Spans: There is much disagreement on whether life spans will increase faster or slower than the intermediate projections in the trustees' reports.[7] Past improvement in life spans suggest that we could fully index the system to keep it in balance by increasing the normal retirement age very gradually (by one month every two years, which reduces the increase in benefits by only ¼ percent per year). This would be less than one-fourth of the reductions in benefits under price indexation. If life spans increase more, then we would eventually have to cut benefits more or raise taxes more. If life spans increase less than expected, then benefits will have been cut too much (or taxes raised too much). A solution would be to index benefits, payroll taxes, or the NRA to life spans. Some call this longevity indexation. If life spans increase faster or slower than expected, Congress could create rules that automatically make an adjustment (within parameters set by Congress on how fast the changes could occur and how soon they could be applied[8]). These adjustments would be based on historical improvements in life spans and not depend on the person doing the calculations. If the Social Security system is indexed by longevity, then the optimistic and pessimistic projections would not be so far apart.

[7] Olshansky, S.J., Passaro, D., Hershow, R., Layden, J., Carnes, BA., Brody, J., Hayflick, L., Butler, RN., Allison, DB., Ludwig, DS. 2005. A Possible Decline in Life Expectancy in the United States in the 21st Century. New England Journal of Medicine 352:1103-1110

[8] For example, we might not want benefits, taxes, or retirement ages to be constantly changed up and down, so some smoothing mechanism could be employed. In addition, Congress might not want to change benefits or retirement ages for people close to retirement.

Which of those three choices (indexing benefits, taxes, or NRA) would make the most sense? In order to analyze this, it helps to look at the extremes. In the distant future, when people are living to age 150 (for example), will it make sense to still have the retirement age at 67 so that we are retired for 80 years (twice as long as our working lifetimes) and our pensions are tiny, or our contributions huge (to maintain the same level of benefits)? Or will it make more sense to have a later retirement age and not have to continually cut benefits and/or raise taxes so much? While raising the normal retirement age appears to be a more logical solution, we would still have to address the issue of unhealthy people who are not quite eligible for Social Security disability benefits and workers in physically demanding jobs. Gradually relaxing Social Security's disability tests as is done currently at older ages[9] already addresses this concern to some extent. A flexible employer-sponsored defined benefit system, which can provide pension benefits tailored to the individual aspects of each company's workforce also can be of great help.

These longevity indexation provisions could help prevent Social Security from getting out of actuarial balance in the future, relieving Congress from having to address Social Security issues every 20 years. While it might not put Social Security on autopilot forever, it would be an improvement on current rules. In addition, if Congress ever felt uncomfortable with benefits being cut too much (or taxes going up too fast) by the automatic rules, they could revise them. In fact, they could give themselves an automatic standing order to vote on changes, with preferential rules requiring a vote.

Additional Issues to Address

In addition to the issues discussed above, you asked that we discus ways to encourage people to work at older ages.

Consistent Laws: If Congress wants to encourage work at later ages, you may want to consider having consistent rules so that workers think of age 67 as the "*normal*" retirement age. For example, Medicare still uses age 65, and employer pension plans are not allowed[10] to use a normal retirement age later than age 65. During these economically difficult times for employers, it might be valuable for Congress to consider allowing, and possibly encouraging, employers to have a normal retirement age in their pension plans that was consistent with Social Security. For example, Congress could provide employers flexibility in meeting the administratively complex accrual rules, if the plan sponsor increases the NRA gradually for employees who were accruing benefits. The new benefit accruals would ensure that employees' benefits were not being reduced, without having to test them each month.

This would not mean that employees had to work until age 67 to get their employer pension. Just as with Social Security, most employers allow employees to retire and commence pensions earlier. In fact, most employers allow early retirement at age 55. It would just allow employers to keep their NRA consistent with Social Security's NRA, and thus keep their pension plan costs from spiraling up as we live longer.

[9] Per Social Security regulation Sec. 404.1563

[10] See Internal Revenue Code Sec. 411(a)(8), which defines the maximum NRA as age 65 and 5 years of service, Sec. 401(a)(9) which defines a maximum distribution starting age of 70 1/2 for owners, and Sec. 401(a)(14) which sets the latest commencement date rules (age 65 and 10 years of service).

Conversions to Cash Balance Plans and Elimination of Early Retirement Subsidies: A new kind of defined benefit pension plan, called a cash balance plan, also encourages workers to retire later. Some history may be needed to explain it. Many employer pension plans added subsidized early retirement benefits in the 1970s and 1980s when the labor supply was high. It helped workers retire at younger ages when the baby boomers (and many women) were looking for work. However, now the tide has turned and labor is not as plentiful, so employers may not want to encourage early retirement; they may need to retain their employees. Employers can eliminate their early retirement subsidies or they can convert their traditional pension plan to a cash balance plan. Cash balance plans promise workers an account with a guaranteed rate of return. They are easier for employees to understand and provide better benefits for young and mobile workers, but they can also decrease the growth in future accruals for older, long-service employees. After 20 years of their existence, the law is still not clear for these plans, and court cases have further complicated their prospects. Employers need Congress to clarify the law so that they can design their pension plans in an acceptable way that won't subject them to expensive litigation.

Phased Retirement: Employers are developing other ways to retain their employees, such as phased retirement programs; however, such programs face legal obstacles because an IRS regulation[11] requires that retirement plans be exclusively for (full) retirement. The Internal Revenue Service is to be commended for proposing a rule allowing employers to pay partial pensions when employees are phasing gradually into retirement. However, there is concern about the incredible complexity in the proposed rule as discussed in our letter to the IRS on this subject. Congress might consider clarifying the law, so employers can have phased retirement programs without having to constantly monitor an employee's hours and adjust their pension amount for ups and downs in hours worked.

Other Dangers to Employer Sponsorship of Retirement Plans: There are suggestions to reform the federal tax system to a consumption based tax, or provide equivalent tax advantages to all savings through such vehicles as Lifetime Savings Accounts (LSAs), or provide tax advantages to annuities purchased with non-pension funds. If there are no incentives for employers to surmount the enormous complexity and cost of providing pension plans to their workforces, they will surely face no alternative but to terminate their pension plans. This would be unfortunate not only for the retirement security of the nation's workers, but also for employers who use these plans to help with workforce management issues, and for the country, which benefits from the large pool of pension savings that are efficiently invested in the economy. In addition, employer-sponsored pension plans help reduce our reliance on Social Security and help provide diversification of retirement risks over the three legs of the retirement stool (government retirement systems, employer-sponsored pension plans, and individual savings). If any of these proposals are acted upon, it is important to examine and debate how they would affect national retirement security, and consider ways to encourage employers to provide pensions for their employees.

Summary: The demographic challenges for Social Security brought about by the baby boomers' upcoming retirements and our longer life spans can be solved through various gradual indexation methods. These include indexation of contributions, benefits, or the NRA to life spans and anti-volatility mechanisms to automatically adjust them if longevity improves faster or slower in the past. This indexation could reduce Social Security's vulnerability to future changes that we can't predict. Then Social Security would be less likely to go out of balance and Congress would be less likely to be

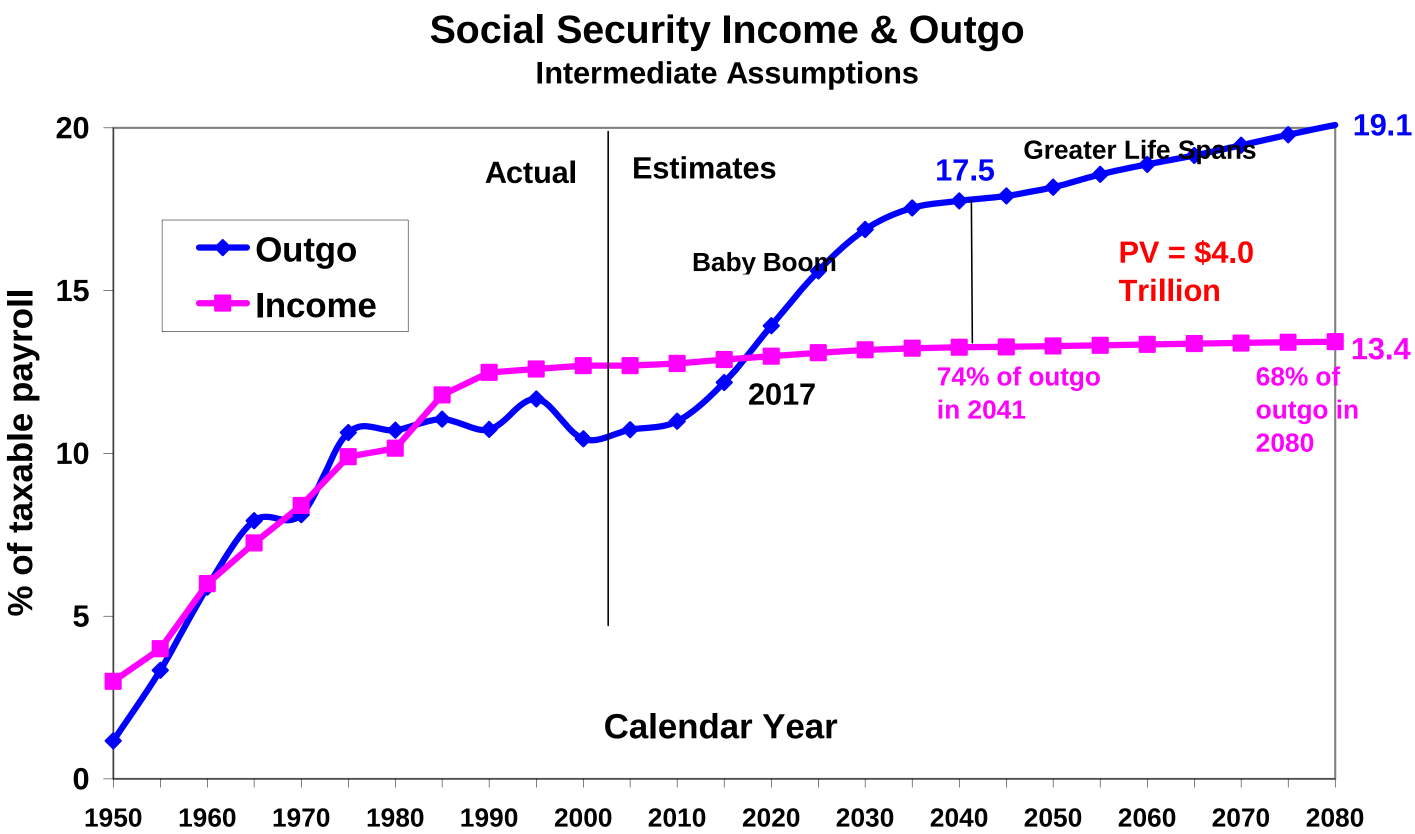
[11] IRS regulation Sec. 1.401-1(b)(1)(i)

called on to address these difficult issues. It would also help workers feel more assured that they would get their benefits from Social Security.

In addition, preserving and providing flexibility to the employer-based pension system could help us encourage more work at older ages. It also could help us avoid having to pay the larger Social Security benefits prevalent in other countries. Hopefully, Congress will continue to encourage employers to provide these pension plans, and not discourage them, as might happen with some recent proposals.

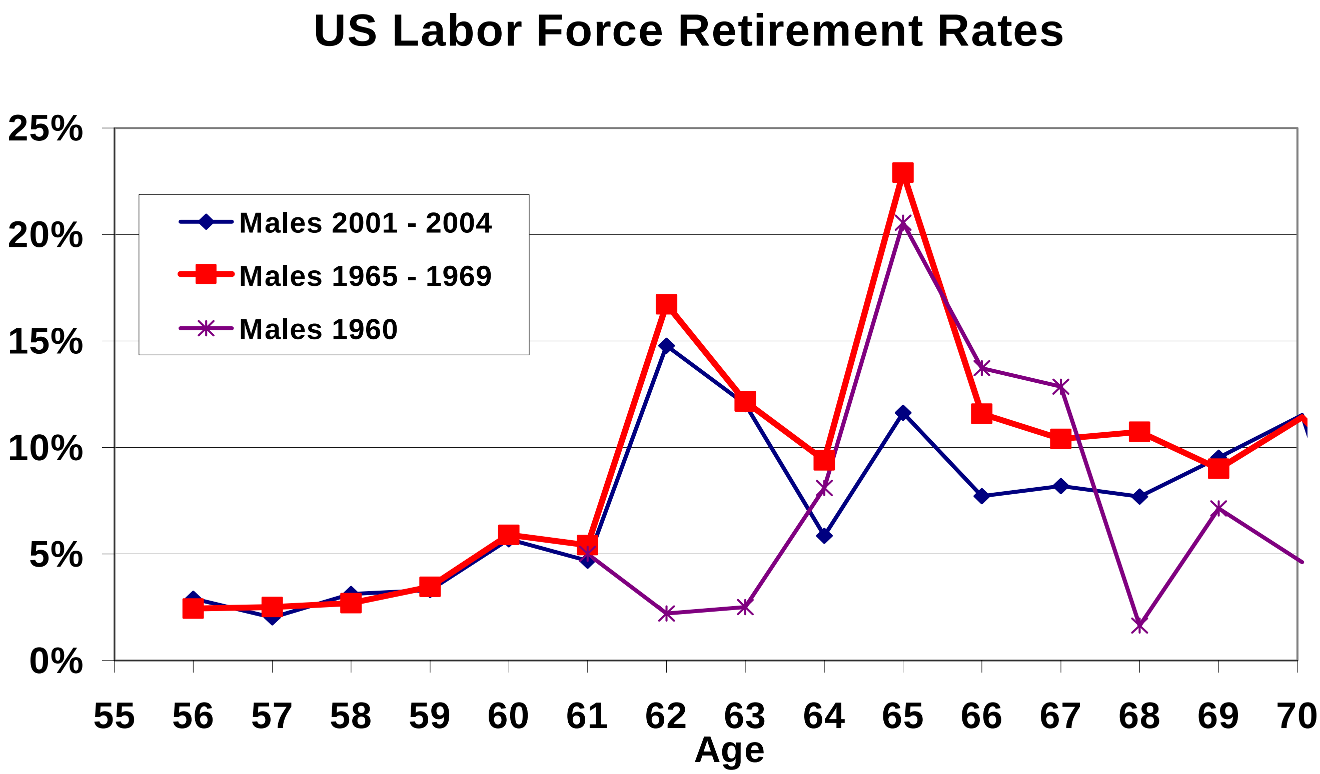
The Academy appreciates the opportunity to testify before this committee.

Chart I



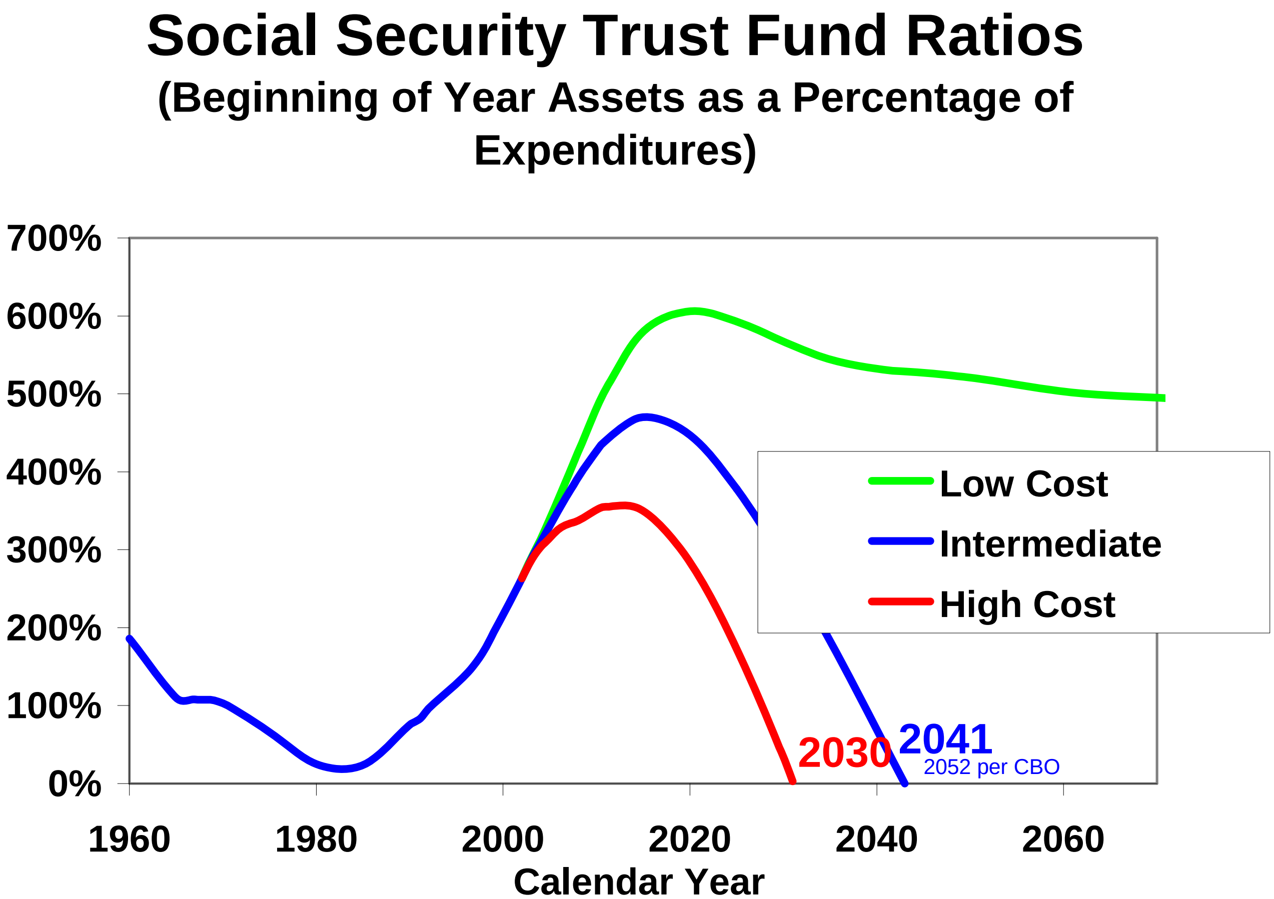
2005 Trustees Report Table IV.B1 using Intermediate Assumptions

Chart II



Highest retirement rate in 1960s was at age 65, in 1990s it was at age 62 (the eligibility ages for Social Security & Medicare, respectively). Also note many older males returning to work in 2001 - 2004.
Retirement Rate = Labor Force % in next year/ Labor Force % in current year.
Source: Unpublished data from BLS Consumer Population Survey

Chart III



Social Security Trust Fund Ratios
(Beginning of Year Assets as a Percentage of Expenditures)
700%
600%
500%
400%
300%
200%
100%
0%
1960
1980
2000
2020
2040
2060
Calendar Year
Low Cost
Intermediate
High Cost
2030
2041
2052 per CBO