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Testimony of

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Good morning, Mr. Chairman and Members of the Subcommittee. Thank you for the opportunity to testify. It is a privilege to appear before the Subcommittee. When Social Security started in 1935, it was assumed that each generation would be larger than the previous one, leading to manageable costs on individual workers. Nobel Laureate Paul Samuelson wrote, "The beauty about social insurance is that it is actuarially unsound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in…" However, demographics have changed from what we expected when the program was designed. Life expectancies have increased while birth rates have declined, leading to a workforce that will grow more slowly than the retired population, and a continuation in the decline of the worker to beneficiary ratio.

The first of the seventy-eight million Baby Boomers will retire in 2008. Many of them will spend as much as a third of their adult life in retirement. Over the next half century, the number of Social Security beneficiaries will more than double, while the number of covered workers will increase by only 22 percent.[1] Thus, the basic underlying premise of the intergenerational, pay-as-you-go, transfer system has been turned upside down.

Table 1: Life Expectancy for Males and Females at Different Ages

	At Birth		At Age 65	
	Male	**Female**	**Male**	**Female**
Actual				
1940	61.4	65.7	11.9	13.4
1950	65.6	71.1	12.8	15.1
1960	66.7	73.2	12.9	15.9
1970	67.2	74.9	13.1	17.1
1980	69.9	77.5	14.0	18.4
1990	71.8	78.9	15.1	19.1
2000	74.0	79.4	15.9	19.0
Projected				
2010	75.4	80.0	16.6	19.2
2025	77.0	81.2	17.5	20.0
2050	79.4	83.2	18.9	21.4
2075	81.3	84.9	20.2	22.7

Source: Social Security Administration

[1] According to the Social Security Administration, between 2005 and 2055, beneficiaries will grow from 47 million to 98 million, while covered workers will grow from 158 million to 194 million.

In many ways Social Security reform is a numbers game – we have to decide what revenues to increase and what benefits to reduce. We have to decide the timing of these changes. And we have to decide who will be affected and who will be protected – the more some are protected, the more others will have to be affected.

But when it comes to dealing with the demographic and labor force challenges, there are some sensible policies that have dynamic, positive effects beyond just their effect on Social Security solvency. Let me be clear, I am not advocating that there are any free lunches out there – there are not. Social Security reform will require tough choices and they should be made sooner rather than later. But smart choices will help ease the transitions.

When Social Security began, workers on average were not expected to live to the retirement age of 65 while now they are expected to live decades beyond that. Though the retirement age is moving (at glacial speed) towards age 67, this change alone will not be close to enough to return the ratio of retired years to working years to what it once was. Supporting retirees for roughly a third of their adult life in retirement would require far greater levels of Social Security taxes than we have been willing to contribute.

Changes to Social Security

A sensible place to start is building adjustment into the Social Security system that reflect these demographic changes. Longevity indexing is one such adjustment. Under longevity indexing, benefit levels would be adjusted based on projected increases in life expectancy. As life expectancies continued to grow, the amount of the annual benefits would be lowered to balance out that benefits would be collected over a longer period of time. If life expectancy increases slowed down, the adjustments would slow correspondingly. Benefits would still increase from one cohort to the next due to the wage indexing of benefits. But whereas now each subsequent cohort gets a "raise" from wage indexing *and* longer life expectancies, that double-bump up would be reduced. A number of reform proposals have included longevity indexing in one form or another as one of their components. This reform is not untried; versions of it have been used in Italy and Sweden.

Longevity indexing can be done in a number of ways. One option is to reduce the initial benefit based on life expectancy. Another is to modify the 90, 32, and 15 PIA formula factors to reflect life expectancy expectations or by some pre-set amount. Generally, proposals would rely on the Social Security Administration's projections for life expectancy and adjustments would be made on a regular basis. Most proposals would exempt disability and some other auxiliary benefits from the adjustments.

This change is similar to increasing the retirement age, but has the advantage that it would allow more choice about when participants retire, which offers a desirable level of flexibility. Furthermore, while increasing the retirement age (both early and normal) is a sensible policy, many politicians strongly oppose it. Thus, longevity indexing offers a policy with similar benefits but less political baggage. A second advantage is that the changes would be made automatically, thereby removing the need for Congress to continually make the tough choice of when to adjust benefits. Congress could always alter the adjustments, but automatic indexation would do much of the heavy lifting.

Another option is something I would call "Progressive Longevity Indexing". Generally, longevity indexing is based on a single, unisex, life expectancy projection. However, one could use more detailed life expectancy projections, broken apart by economic group. This approach is easily justified by the fact that high-income individuals are living increasingly longer than those with lower incomes. Thus, the effects of growing income inequality are exacerbated by the growing inequalities in life spans. Progressive longevity indexing, which would allow benefits to be adjusted by life expectancy expectations for specific income groups, would undo some of the disproportionate gains going to the better-off. Like longevity indexing, the changes would do nothing to make cohorts worse off than those that came before them on a lifetime basis.

Labor Force Incentives

An alternative or additional approach to adjusting benefits to reflect longer life expectancies is to find ways to encourage workers to remain in the workforce for longer, thereby increasing the revenues they pay into the Social Security system and decreasing the time period over which they collect benefits. The positive benefits of such policies clearly go beyond their effects on the Social Security system. The labor force is projected to grow far more slowly in the future than it has in the past. This is true even accounting for higher levels of immigration. The higher economic contributions from keeping people engaged in productive work for longer would be significant.

One option would be to tie full retirement benefits to a set number of years of work rather than a set retirement age. For instance, workers could be entitled to full benefits after 40 years of contributions, which would allow somebody who began working full-time at the age of 20 and worked straight through, to retire at 60, while those who may have spent more time in school or out of the workforce, would receive full benefits at a later age.

People would still be able to retire earlier, but their benefits would be reduced accordingly, reflecting their fewer years of contributions. This policy would undo some of the bias against workers who are in the workforce for years beyond those where they get full credit for their contributions.

Another option would be a late retirement bonus. It is reasonably well established that people prefer lump-sum payments to annuities even when the value of the annuity is higher.[2] Thus, there is an opportunity to incentivize people to stay in the workforce by offering a lump-sum payment as a reward. For instance, workers who remained in the workforce until the age of 70, or for 45 years or more, could be offered a small immediate payout upon retirement on top of their traditional benefit. By allowing workers to choose to take some of the larger benefit they would have accrued from their additional years of work in the form of an up-front payment, many would be motivated to work a bit longer. You could construct this lump-sum payment so that it would actually save money for the Social Security system but still serve to encourage workers to work longer.

Perhaps the most important change we can make on this front is developing more flexible workforce options for workers who want to remain in the workforce beyond the retirement age, but may not want the commitment or responsibility of a traditional, full-time job.

With good reason, the idea of gradual retirement and productive aging is becoming more popular. Many workers do not want to shift abruptly from a full-time work environment to full-time leisure. At the same time, they do want to scale back their time commitments and increase the flexibility of their jobs, to allow more leisure time, time with the family, flexibility to deal with health issues, etc. Similarly, many employers are realizing they are beginning to lose a significant segment of their talent pool. This loss of institutional knowledge will only grow as the Baby Boomers start to leave the workforce.

Finding new ways to allow for and encourage flexible work environments will be a key in both helping the solvency of the Social Security system and addressing the wider problem of labor market shortages. Currently, part-time and nonstandard workers receive,

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[2] Warner, John T. and Saul Pleeter, "The Personal Discount Rate: Evidence from Military Downsizing Programs." *American Economic Review*, vol. 91, no. 1, March 2001, p. 33-53. Atkins, Allen B. and Edward A. Dyl, "The Lotto Jackpot: The Lump Sum Versus the Annuity." Finan*cial Practice & Education* 1995. vol. 5, issue 2. p. 107-111.

on average, lower hourly wages than do their full-time counterparts.[3] Furthermore, only 14% of nonstandard workers receive healthcare benefits compared to 69% of traditional workers in the same jobs.[4] The discrepancies between part and full-time coverage for pensions is similar to that of healthcare.

Reducing the many biases that exist against part time work – both in terms of compensation and perception – will help to encourage workers to remain in the workforce well beyond when they might otherwise retire. For instance, allowing workers to begin collecting from their private pensions while participating in phased retirement would be one option to induce workers to remain in the workforce. There is a tremendous opportunity for advocates of flexible work from the AARP and the work-family community to work together on this issue. The solution does not lie in using mandates to force businesses to change, or using the over-utilized tool of tax credits to encourage them to so. Instead, the combination of the mass exodus we are about to experience from the labor pool and the many benefits of keeping talented workers active, provides a win-win option for businesses and individuals.

I would like to conclude by saying that I am encouraged by the choice of topic for today's hearing. Both longevity indexing and more flexible work conditions offer fair and sensible options to help the Social Security system. None of the choices we confront as the result of an aging society are simple. And the changes I have mentioned today will alone not be sufficient to fix Social Security. But they are an excellent place to start on implementing long-overdue reforms to help Social Security in that they offer one of the few silver linings in the Social Security debate since they would help both the Social Security system and the economy at large.

[3] New America Foundation's Work and Family Program: "Working Families' Catch-22: Inflexibility or Part-Time Penalty." April 2004.

[4] Ibid.