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

"What Workers Need to Know About Social Security as They Plan for Their Retirement"

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July 29, 2014

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

Mr. Chairman and Members of the Subcommittee: Thank you for inviting me to address the question of "What Workers Need to Know About Social Security as They Plan for Their Retirement."

I am a resident scholar at the American Enterprise Institute. Previously I served as the Principal Deputy Commissioner of the Social Security Administration, the Deputy Commissioner for Policy, and the Associate Commissioner for Retirement Policy. In 2005 I worked on Social Security policy on the staff of the White House National Economic Council, and in 2001 I was on the staff of President Bush's Commission to Strengthen Social Security. The views I express today are my own.

Much of what Americans need to know about Social Security is difficult to understand. Worse, much of what we think we know about the program turns out not to be true.

- The state of retirement security in the U.S. is substantially better than you think. While some studies claim that Americans face a "retirement crisis," these studies make a number of methodological choices that, in my view, are unsupportable. Other high-quality research, including projections from the Social Security Administration, show a much more positive view of Americans' retirement saving.
- However, Americans nevertheless face retirement risks. Social Security's financial status has worsened considerably in recent years. The insolvency of Social Security is by far the largest risk facing American retirees, but Congress has done nothing to address the issue.
- Social Security is needlessly complex, such that even many Americans on the verge of retirement have little idea what they will receive prior to receiving their first check. Many near-retirees significantly overestimate what they will receive from Social Security, while many underestimate their benefits. These errors complicate decisions on how much to save and when to retire.
- Social Security benefits themselves can vary considerably, even for households with the same career earnings and contributions to the program. This variability, which derives from facets of the benefit formula, undermines the social protections provided to low earners. A simpler benefit formula could provide more reliable benefits at comparable cost.
- The Social Security Statement mailed to workers each year systematically understates the benefits individuals are likely to receive in retirement by expressing future dollar amounts in a form – "wage-indexed dollars" – that is neither meaningful for retirement planning nor commonly used outside of the agency. For a younger worker, the Statement underestimates the inflation-adjusted value of their future benefits by around 35 percent.
- Social Security does not do enough to encourage delayed retirement. A typical near-retiree who chooses to work an additional year receives less than 3 cents in extra benefits for each dollar of additional taxes he or she pays. Likewise, the Retirement Earnings Test is viewed as a 50-percent tax on work by early retirees. Changing policies to encourage longer work lives could improve retirement security and ease the way to a financially sustainable program.

The Retirement Crisis is Overstated

A number of recent studies claim that vast numbers of Americans are underprepared for retirement and that the nation faces a “retirement savings gap” of up to $14 trillion. However, as I detailed in an article co-authored with Sylvester J. Schieber in the summer 2014 issue of *National Affairs*, most of these claims are difficult to support and, in many cases, are contradicted by research conducted by academic economists using better data and more sophisticated methods.[1]

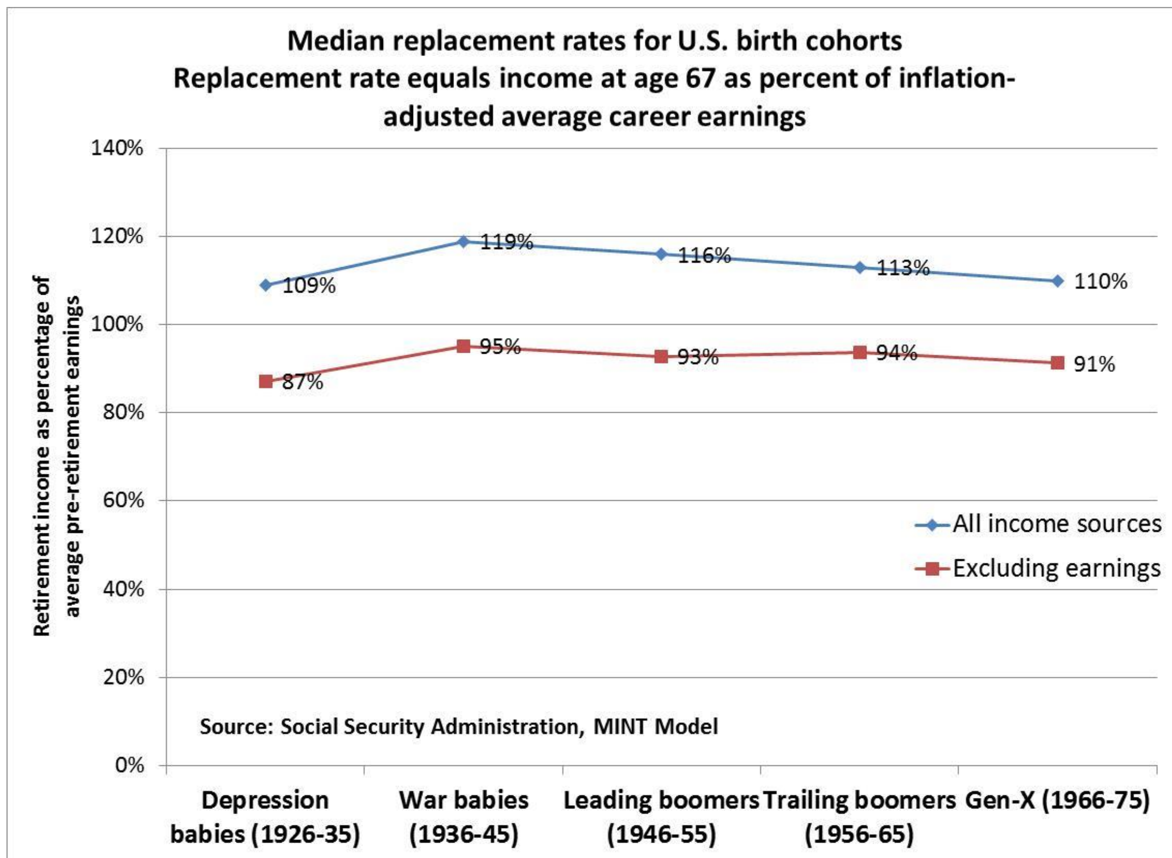
But perhaps the most compelling results come from the Social Security Administration’s Office of Retirement and Disability Policy, which has for almost two decades built and improved the most detailed model of retirement income in the country. SSA’s Mint model – which stands for “Modeling Income in the Near Term” – was constructed in cooperation with researchers from the Urban Institute, the RAND Corporation, the Brookings Institution and elsewhere, and it is regularly updated and reviewed by outside analysts.

MINT simulates individuals over their full working lives, incorporating education, work, marriage, divorce, and saving—practically the full range of factors that affect individuals’ preparations for retirement. The MINT model reports not simply Social Security benefits, but also pensions, welfare benefits, housing equity, and other potential sources of retirement income. In terms of sophistication, MINT is a quantum leap beyond the models used in popular retirement-crisis literature.

In a 2012 study, analysts from SSA and the Urban Institute used the MINT model to project retirement income for four groups: “Depression Babies,” born from 1926–1935; “War Babies” (1936–1945); “Leading Boomers” (1946–1955); “Trailing Boomers” (1956–1965); and “GenXers” (1966–1975).[2] For each group, the study calculated replacement rates relative to inflation-indexed average lifetime earnings. The median, or typical, replacement rate for Depression Babies was 109%, rising to 119% for War Babies, then gradually declining to 116% for Leading Boomers, 113% for Trailing Boomers, and 110% for GenXers. These figures hardly support political scientist Jacob Hacker’s dire contention that “we live in the waning days of the Golden Age of Retirement.”

[1] Andrew G. Biggs and Sylvester Schieber. “Is There a Retirement Crisis?” *National Affairs*. Issue Number 20 ~ Summer 2014.

[2] Barbara A. Butrica, Karen E. Smith, and Howard M. Iams. “This Is Not Your Parents' Retirement: Comparing Retirement Income Across Generations.” *Social Security Bulletin* 72 (2012): 37.



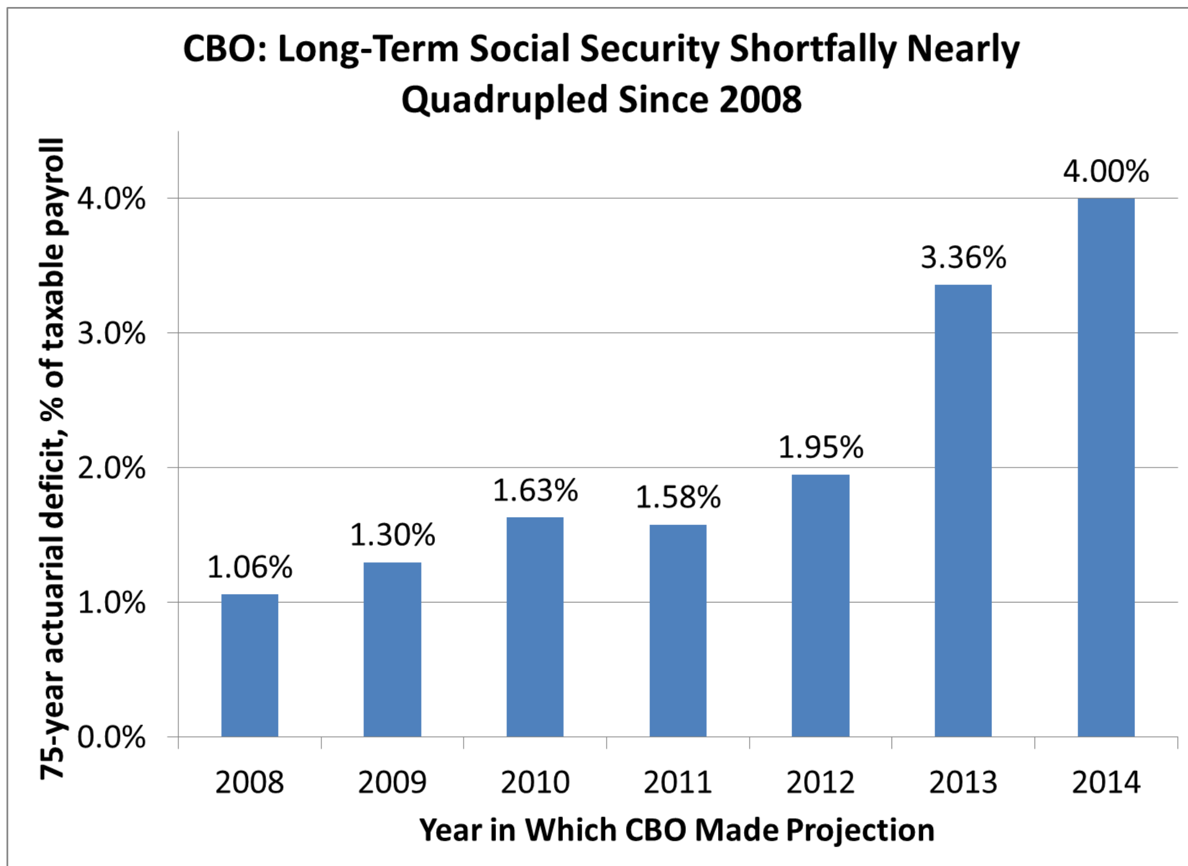
Nor do the MINT model's projections show an emerging underclass in terms of retirement security, a group that lives in poverty even as others do well. For instance, MINT estimates that only 26% of Depression Babies had replacement rates below 75% of their average pre-retirement earnings, and only 8% had replacement rates below 50%. MINT's comparable figures for the supposedly under-saving GenXers are 25% and 8%.

In other words, SSA's premier retirement model projects that despite significant changes in the composition of retirement income—future retirees will rely more on asset income and less on traditional defined-benefit pensions than do present retirees—the overall level and distribution of retirement income will remain roughly the same.

This is not to deny that many Americans are falling short in preparing for retirement. But high-quality studies tend to find that far fewer Americans are falling short, and by a smaller amount, than the cruder, but more attention-grabbing, studies conclude. Thus, hasty or drastic policy responses are unwise; rather, policy attention should focus on subsets of the population – for instance, single women – who appear to be less prepared for retirement than other groups.

But Americans Do Face Retirement Risks

According to the Congressional Budget Office, Social Security's 75-year funding shortfall has nearly quadrupled over the last six years, from around 1 percent of payroll in 2008 to 4 percent of payroll today.[3] I estimate the present value of this shortfall at approximately $15 trillion, which is nearly the value of the entire publicly-held federal debt. Perhaps more importantly in a practical sense, while CBO once projected that Social Security would remain solvent until nearly 2050, today it projects insolvency in 2030.



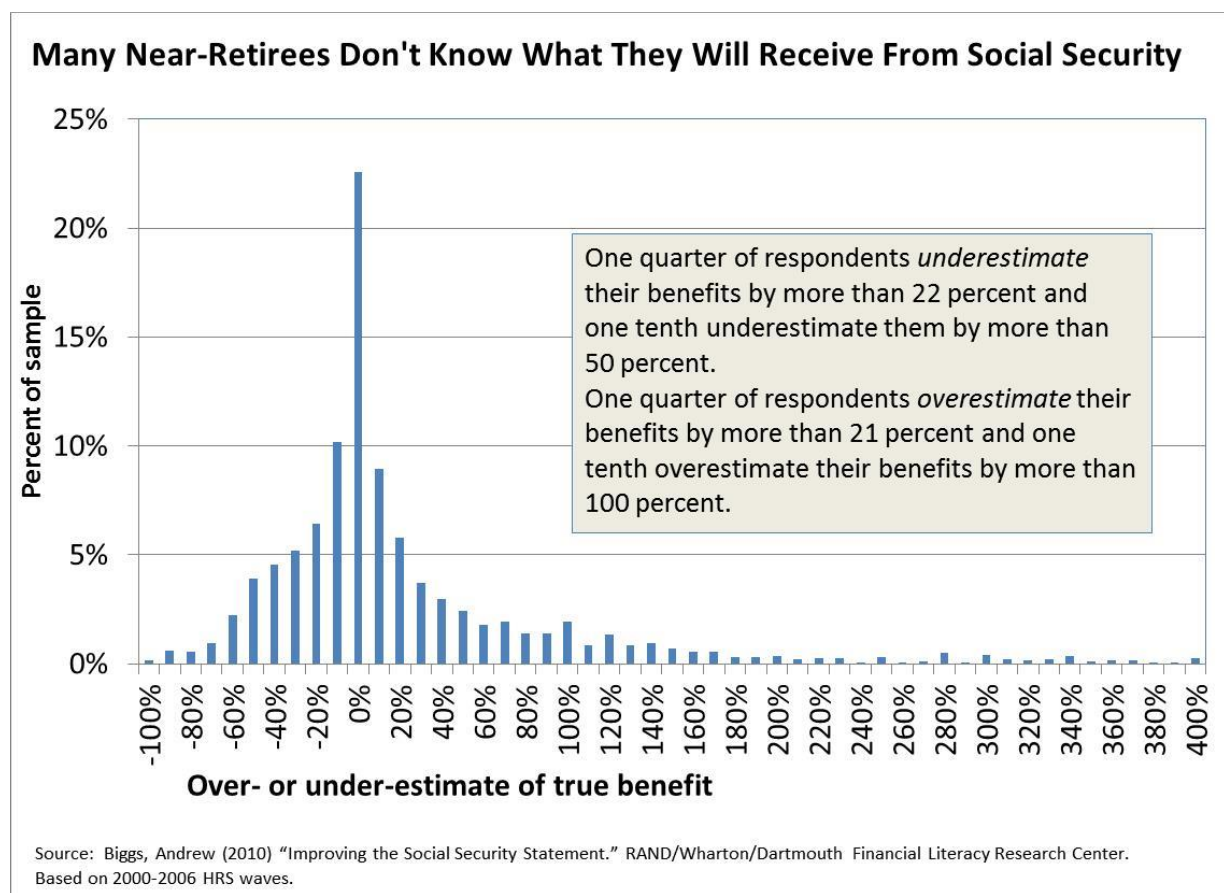
One might assume that a quadrupling of the long-term deficit would bring both parties together to finally take Social Security reform seriously. Instead, a number of Congressional proposals would use tax increases that once had been seen as a way to buttress Social Security's finances to instead expand the program and increase benefits. For instance, a proposal from Sen. Tom Harkin (D-IA), for instance, would add just 10 years to the trust fund's life, while a separate plan from Sens. Mark Begich (D-AK) and Patty Murray (D-WA) would address just 3 percent of Social Security's unfunded liability.

But there is more to Social Security risk than just solvency. Even assuming Social Security could pay full scheduled benefits forever, there are many retirees – particularly low-income retirees –

[3] See Congressional Budget Office. "The Long-Term Budget Outlook." July 15, 2014.

who will receive very different benefits from what they might anticipate. One reason for this is simply that Social Security benefits are extremely hard for ordinary Americans to predict, due to the complexity of the program's benefit formula.

In a 2010 study, I compared the benefits that near-retirees *predicted* they would receive to the benefits they *actually* received just a year or two later.[4] Large numbers of near-retirees either over- or underestimate their actual benefits by a significant amount. This "predictability risk" imposes costs on Social Security participants. Simply put, what is the use of a "defined benefit" if actual individuals do not understand how it is calculated and cannot predict what they will actually receive? Under these circumstances, how can they decide how much to save on their own or when to retire?



One might think that the Social Security Statement would address this issue by providing benefit estimates to workers each year. However, my 2010 research paper showed no improvement in Americans' ability to predict their benefits even with wider distribution of the Statement.

[4] Andrew G. Biggs, "Improving the Social Security Statement." RAND/Wharton/Dartmouth Financial Literacy Research Center. 2009-2010.

A second reason benefits are uncertain is that individuals with the same lifetime earnings can often receive very different levels of benefits. This is particularly true for low earners, which makes Social Security a social insurance program that may or may not pay off when it is needed the most.[5] Social Security is progressive on average, meaning that low lifetime earners tend to receive higher replacement rates than high earners. But it is not *consistently progressive*: at any given level of lifetime earnings, there can be considerable variation in the replacement rates paid by Social Security. Some will receive replacement rates far above the average for their income level, while others will receive much lower replacement rates.

The reason for this is that, in the program's benefit formula, many other factors matter. For instance, imagine two households who had the same total earnings and paid the same taxes into Social Security over their working careers. A household in which one spouse worked and the other stayed home would receive significantly higher benefits than a two-earner couple with the same total household earnings. Likewise, workers with shorter careers receive higher benefits than workers who earned the same total amount over their lifetime, but had longer working careers. A number of other aspects to the benefit formula have similar unintended consequences. And in total, it is these other factors – *not* the household's lifetime earnings – which have the greatest influence on the replacement rate the household receives. This makes very little sense from the perspective of providing social insurance.

Both the United Kingdom and New Zealand have moved toward pension systems in which a flat benefit is allocated to all retirees regardless of earnings level. This flat benefit is then supplemented by defined contribution accounts, similar to IRAs or 401(k) plans. I outlined a similar program for the United States in a 2013 article.[6] Such an approach would provide a superior safety net to the current benefit formula, which leaves roughly 9 percent of seniors in poverty. Moreover, it would be far simpler and easier for workers and retirees to understand.

The Social Security Statement

In 2009, the Social Security Advisory Board stated that "it is imperative that the Social Security Statement provide the most accurate information possible and that information be communicated in a clear and objective manner." But this does not seem to be happening. The problem is not in how SSA estimates the benefit amounts that today's workers are likely to receive when they retire. The problem is that SSA *expresses* these benefit amounts in a form – so-called "wage indexed dollars" – that are incomprehensible to most Americans and essentially useless in terms of retirement planning.[7]

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[5] This section follows Andrew G. Biggs "Will Your Social Insurance Pay Off? Making Social Security Progressivity Work for Low-Income Retirees." AEI Retirement Policy Outlook 1 (2009).

[6] Andrew G. Biggs. "A New Vision for Social Security." *National Affairs* Number 16, Summer 2013.

[7] The discussion here draws on Andrew G. Biggs, "Exploring Alternate Ways to Express Estimated Future Retirement Benefits in the Social Security Statement." RAND/Wharton/Dartmouth Financial Literacy Research Center. 2010.

Ordinarily, a future dollar amount would be expressed either in nominal dollars (meaning the actual dollar amounts that will be written on benefit checks) or in inflation-adjusted dollars, which represents the current purchasing power of those future benefits. Either approach can be useful, and ideally both figures would be provided.

But the SSA's Social Security Statement does neither. The Statement expresses benefit amounts in "wage-indexed dollars." To the best of my knowledge, wage-indexed dollars are never used in financial planning calculations, are difficult to explain in plain English and are irrelevant to the "life cycle model" through which most analysts view retirement saving decisions.[8]

The effects of wage-indexing on the estimated Social Security benefits an individual sees in his Social Security Statement can be substantial. For instance, a typical worker retiring 30 years from today will receive a nominal Social Security benefit of about $64,750 per year. Adjusted for inflation, that future benefit will be $27,683. That's a figure that a person planning for retirement can more easily understand. But that's not the figure he will see on his Social Security Statement. Rather, because the SSA wage-indexes his future benefits, the figure on his Statement will be just $17,982, which is 35 percent lower than the true purchasing power of his benefits.

I first pointed out this issue publicly in 2008.[9] The agency's response was not to correct the way projected benefits are expressed. It was to remove the phrase "in today's dollars" from the Statement. As a result, recipients are now left with no explanation whatsoever of what the dollar amount on the statement means. Some might interpret the figure to mean inflation-adjusted dollars while others might see the estimates in nominal dollar terms. But almost no one would understand the Statement's estimates as "wage indexed" dollars nor know how to employ these figures if they did know what they meant. This makes these benefit estimates of very little value to individuals are planning how much to save on their own for retirement.

To be very frank, the benefit estimates presented in the Social Security Statement are wrong. But no one – be it an individual or a government agency – wishes to acknowledge that its figures are incorrect, and so the SSA continues to generate them. That may save the agency a little embarrassment, but in the process does a disservice to millions of Americans who are attempting to prepare for retirement.

[8] Specifically, wage-indexing discounts (or reduces) the future benefit amount by the rate of annual wage growth in the economy, which is generally around 4 percent. Inflation, by contrast, is generally around 3 percent which means that the wage-indexed figure will be lower than the inflation-indexed figure by around 1 percent for each year between today and the time the Statement recipient will collect benefits. Perhaps the most intuitive way wage of thinking about wage-indexing of future benefit amounts is that it calculates the projected benefit as a percentage of the average economy-wide wage at the time the benefit will be collected; the wage-indexed equivalent is the same percentage of *today's* economy-wide average wage. Leaving aside that this figure is difficult to understand, it is not very meaningful from the standpoint of a person planning their own retirement saving.

[9] Andrew G. Biggs. "Good News on Social Security?" *Christian Science Monitor*. April 15, 2008.

Encouraging longer work lives

While most Americans appear to be adequately preparing for retirement, for those who approach retirement with insufficient resources the most effective way to increase retirement income is to work a few additional years. Longer working lives increase retirement savings while reducing the number of years over which those savings must generate retirement income. A study published by the Urban Institute concluded that an additional five years in the labor force would raise total retirement income for the typical individual by roughly 60 percent; for an individual in the lowest earnings quintile, total retirement income would almost double, with a 98 percent increase.[10]

However, the Social Security program itself does little to encourage delayed retirement. Yes, benefits are increased for those who choose to delay claiming, but not nearly enough to compensate for the additional payroll taxes the individual will pay if he or she continues to work. In a 2009 analysis co-authored with David Weaver and Gayle Reznik of the SSA, we found that for each dollar of additional taxes paid by a near-retiree who works an additional year, he or she will receive only around 3 cents in additional lifetime benefits.[11] Put another way, the rate of return on this additional contributions was around -50 percent.

There are two reasons behind the poor marginal returns provided to near-retirees: first, Social Security benefits are based upon the highest 35 years of work, so an additional year of work increases benefits only to the degree that year's earnings exceed the lowest of the previous 35; and second, most women continue to receive a benefit based upon their spouse's earnings, in which case they are unlikely to receive any additional benefits in return for working longer.

The best way to make the program actuarially fair for near-retirees and to encourage longer work lives would be to reduce the payroll tax rate for older workers. While such a policy would reduce Social Security revenues slightly, greater labor supply from older workers would increase federal income tax and Medicare tax revenues, along with state income taxes. Based on academic studies of the sensitivity of near-retirees' labor supply to changes in after-tax wages, I estimate that a payroll tax cut for older workers would be revenue-neutral if state tax revenues were included, and would have only a small cost to the federal budget if counting only federal income and Medicare taxes.[12] Some of these ideas have been incorporated into S. 2336, the Let Seniors Work Act of 2014 introduced by Sen. Marco Rubio.

But there is a second impediment to longer work lives: the Retirement Earnings Test.[13] For individuals claiming benefits who are between age sixty-two and the full retirement age, Social

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[10] Barbara A. Butrica, Karen E. Smith, and C. Eugene Steuerle, "Working for a good retirement," Retirement Project Discussion Paper No. 06-03, (Washington, DC: Urban Institute, 2006).

[11] Gayle Reznik, David A. Weaver, and Andrew G. Biggs. "Social security and marginal returns to work near retirement." Social Security Issue Paper 2009-02 (2009).

[12] See Andrew G. Biggs. "A Payroll Tax Cut Could Help Social Security." *Wall Street Journal*. April 24, 2012.

[13] Much of the following discussion is derived from Andrew G. Biggs, "The Social Security Earnings Test: The Tax That Wasn't," AEI Tax Policy Outlook (July 2008).

Security withholds fifty-cents of benefits for every dollar in earnings above $15,480. While most people claiming early Social Security benefits stop working, about three-quarters of those who work earn enough to trigger the earnings test.

To seniors, the earnings test appears to be a significant tax on work. Consider a sixty-three-year-old who receives a Social Security benefit while continuing to work at an annual salary of $35,000. This worker pays a marginal federal income tax rate of 15 percent, a Social Security tax of 6.2 percent, and a Medicare tax of 1.45 percent. State income taxes might add another three percentage points, creating a total marginal tax rate of around 25 percent. On top of this, however, the Social Security earnings test reduces benefits by fifty cents for each dollar by which earnings exceeded the threshold. This can amount to a perceived fifty-percentage-point increase in the marginal tax rate on earnings. Put simply, this worker perceives he is being taxed at 75¢ on the dollar, leaving him less than 25¢ in take-home pay for each dollar he earns. Many workers reduce their earnings or leave the workforce to avoid this "tax." Data shows a "bunching" of earnings just below the $13,560 threshold, indicating that seniors recognize the earnings limit and take steps to avoid triggering it.[14]

The reality is that retirees need not reduce their work to avoid a "tax." At the full retirement age, Social Security not only stops withholding benefits but increases monthly benefits to replace those taken by the earnings test. The benefit increase at the full retirement age works through the "reduction factors" that Social Security generally uses to reduce benefits for early retirees. Over a individual's full retirement, total benefits are about the same. That is to say, the earnings test delays benefits but does not tax them away.

Unfortunately, the SSA does a poor job of conveying how the RET works. During my time working at SSA, I was quoted in a news article explaining the benefit adjustment at the full retirement age.[15] At least one reader called the agency's toll-free number to inquire about this statement; he was told it was untrue and that there was no adjustment to benefits at the full retirement age. The agency's publications with regard to the earnings test are better today than in the past, but I am not confident that the earnings test is explained adequately on a day-to-day basis.

Thus, it might be better simply to eliminate the earning test. Research indicates many retirees would increase their labor supply in response.[16] However, due to the quirks in Social Security's benefit formula discussed above, most would not receive additional benefits in exchange.

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[14] See Leora Friedberg, "The Labor Supply Effects of the Social Security Earnings Test" (Working Paper 7200, National Bureau of Economic Research, Cambridge, MA, June 1999). See also David Loughran and Steven J. Haider, "Do the Elderly Respond to Taxes on Earnings? Evidence from the Social Security Retirement Earnings Test" (Working Paper 223, RAND Corporation, Santa Monica, CA, January 2005).
[15] Glenn Ruffenach, "The Baby Boomer's Guide to Social Security," Wall Street Journal, November 28, 2007.
[16] For a discussion of the literature, see Olsen, Anya, and Kathleen Romig. "Modeling Behavioral Responses to Eliminating the Retirement Earnings Test." *Social Security Bulletin 73* (2013): 39.

Moreover, some individuals might choose to claim benefits earlier if the earnings test was withdrawn; the logic here is that the pseudo-"tax" imposed by the earnings test dissuades a certain number of individuals from claiming benefits until they have ceased working. If so, incomes after the Full Retirement Age could end up being lower as the result of repealing the earnings test.

Conclusions

In simple terms, everyone needs to do better:

First and foremost, Congress needs to fix Social Security, not merely to make it solvent but also to improve its function as a safety net for those who need it the most.

Second, the Social Security Administration needs to improve its publications and other communications with the public to make them understandable and useful. Expressing Social Security benefit levels in ways that are inconsistent with common financial planning usage slants the public discussion on Social Security policy and makes basic financial planning more difficult. Likewise, the agency should ensure that it gives the public full and understandable explanations of policies such as the retirement earnings.

Third, policy analysts must also improve their work. It is tempting to generate newspaper headlines with alarming stories stating that vast majorities of Americans face a retirement crisis, but if not based upon the best research methods and data, these claims serve to frighten Americans and skew the public policy debate.

Finally, the American public must do their part as individuals, by preparing for retirement to the best of their abilities, and as citizens, by demanding that their elected officials do their jobs as stewards of Social Security and other entitlement programs.