Testimony to the House Committee on Ways and Means

Subcommittee on Social Security

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Chairman Johnson and Other Distinguished Members of the Ways and Means Subcommittee on Social Security,

It is an honor to testify to you today about Social Security. I view Social Security as a fantastic, yet catastrophic success. The system has been a lifeline for generations of Americans who would otherwise have spent their retirements in abject poverty. And it has provided essential disability insurance, survivor insurance, divorce insurance, spousal dependency, child dependency, and parent dependency insurance.

But Social Security's amazing achievements don't erase its enormous problems. To begin, the Social Security system is insolvent. And it's not bankrupt in 30 years, or 20 years, or 10 years. It's bankrupt today.

This is not my opinion. This is only conclusion one can draw from Table IVB6 of the 2013 Social Security Trustee's Report. This table reports that Social Security has a $23 trillion fiscal gap measured over the infinite horizon.

Social Security is in Worse Shape than Detroit's Pensions

Twenty-three trillion dollars is 32 percent of the present value, also measured over the infinite horizon, of Social Security's future revenues. Hence, Social Security is 32 percent underfinanced, which means it is in significantly worse financial shape than Detroit's two pension funds taken together.

Social Security's $23 trillion debt, which Congress has chosen to keep off the books, swamps the $13 trillion of official debt in the hands of the public. The value of any debt is larger the closer in time it must be paid. And in Social Security's case, every passing year brings us to the point that the baby boomers will all be retired and all collecting their benefits. Consequently, the system's off-the-books debt is growing at leaps and bounds – by $1.6 trillion between 2012 and 2013 -- thanks to the approaching retirement of vast numbers of baby boomers.

Economics Doesn't Let Us Pick Which Debts to Count and Which to Ignore

The value of a government I.O.U., whether Congress labels it official and puts it on the books or labels it unofficial and keeps it off the books, equals the present value of the future expenditures needed to fulfill that I.O.U. Thus, the current value of all outstanding 30-year U.S. Treasury bonds, which is counted as part of official debt, is, itself, a present value. In this case, it's the present value of all future payments required to service those 30-year bonds.

Some payments the government will make in the future will occur with more or less certainty. But this uncertainty doesn't make the obligation go away or imply that the obligation's value has no present value. It simply means that, in forming the appropriate present value of the obligation one needs to adjust for its risk.

Social Security benefit commitments are, actually, much more certain than are the commitments to repay, say, 30-year U.S. Treasuries. Thirty-year Treasuries aren't protected against inflation. Nor are they protected by the political power of the AARP with its 50 million members. Hence, were I forced, based on the surety of the obligation, to choose between a) including the present value of Social Security's benefit obligations as an official debt or b) including the present value of the obligations to pay off U.S. Treasuries as an official debt, I'd put Social Security's debt on the books.

But economics doesn't let us pick and choose which debts to include and which to exclude in properly present valuing the government's future liabilities. Nor does it let us pick and choose which assets, including which future revenue streams, to include in properly present valuing the government's ability to meet it's future liabilities. Economics tells us that we need to consider the present value *all* future government spending obligations, no matter their risk or timing, and net them against the properly formed present value of *all* future government revenues, no matter their risk and timing.

In the context of Social Security, this means we need to form and take seriously the system's infinite horizon fiscal gap. The need to do fiscal gap accounting, *over the infinite, not 75-year or any other finite horizon,* isn't a matter of my opinion. It's a dictate of economic theory. This is why 17 economics Nobel Laureates and over 1,000 economists, from every political persuasion and from every top economics department in the country, have endorsed The Inform Act at www.theinformact.org.

The Inform Act – H.R. 2967 and S. 1351 -- is a bipartisan bill that requires the CBO, GAO, and OMB to do infinite horizon fiscal gap and generational accounting on an ongoing basis and for every major fiscal bill introduced in Congress. The Inform Act would revolutionize government accounting and show in stark relief the enormous fiscal bills we are leaving for our children to pay. I strongly urge all members of Congress to support and pass The Inform Act.

Social Security's Trustees Are Ignoring the System's Infinite Horizon Fiscal Gap

Economic theory doesn't wear blinders and doesn't endorse blinders. It doesn't tell us to look at obligations only over the next year, or only over the next 10 years, or only over the next 75 years. It tells us to properly present value all future government obligations net of receipts over the infinite horizon.

It is now 31 years since the Greenspan Commission met and chose to "fix" Social Security over a 75-year horizon. Today, we are looking, in the current 75-year projection widow, at 31 years of negative cash flows, which the Greenspan Commission knew were coming and willfully ignored. It should be no surprise then that Social Security is in worse financial shape today than when the Greenspan Commission "fixed" it.

To their great credit, Social Security's actuaries have been reporting the system's infinite-horizon fiscal gap every year since 2002. And to their great shame, Social Security's Trustees have been ignoring this comprehensive measure of the system's insolvency every year since 2002. You will, for example, find no mention of the infinite-horizon fiscal gap in the 2013 Trustees Report summary of the system's finances.

Instead, the Trustees have been focusing on the system's 75-year fiscal gap. Unfortunately, the 75-year fiscal gap captures only 42 percent of the system's true shortfall. Hence, the Trustees have been warning us only about two fifths of Social Security's funding problem. This is a terrible dereliction of their fiduciary duties as Trustees of the country's primary saving system.

How Broke Is Social Security?

To pay its scheduled benefits in full through time, the Social Security system needs a 32 percent immediate and permanent increase in the future path of payroll tax revenues. Based on the current covered earnings ceiling, this represents a 4-cent-on-the-covered-dollar higher payroll tax *starting today and continuing forever*.

Alternatively, to prevent having to raise its FICA payroll tax rate, the system needs to immediately and permanently cut all benefits payments by 22 percent. Delay in raising the OASDI tax rate or cutting OASDI benefits will require even larger percentage adjustments in the future.

The bottom line is that Social Security does not have small problems that can be easily and gradually fixed as many people, including the President, believe thanks to years of disinformation provided by the Social Security's Trustees. Instead, Social Security is in dire financial shape. Nothing short of a fundamental reform of the system will preserve Social Security for today's and tomorrow's retirees.

Chairman Johnson and other Subcommitee Members, I invite you to visit www.thepurplesocialsecurityplan.org. This website lays out a very simple (postcard length), but fundamental reform of Social Security. In conjunction with other simple, but radical reforms, laid out at www.thepurpleplans.org, the Purple Social Security Plan can help put our country back on a safe fiscal path.

One final point about Social Security's finances. Social Security cannot be bailed out by the rest of our fiscal system. The rest of our country's fiscal affairs are in worst financial shape than Social Security. Indeed, based on CBO's recently released Alternative Fiscal Forecast, which includes all expenditures and taxes, our government has a $210 trillion infinite-horizon fiscal gap. This colossal shortfall represents 58 percent of the present value of all future federal revenues. Clearly, Social Security, which is 32 percent underfinanced, cannot be rescued by an overall fiscal system that is 58 underfinanced.

Unfortunately, those who proclaim the strongest desire to preserve and protect Social Security, particularly its Trustees, are doing their level best to destroy the system by ignoring or substantially understating its financial problems.

Social Security's Complexity

With these financial facts of life, let me now turn to Social Security's second terrible problem, namely its truly unbelievable complexity. Social Security is our nation's basic saving system. But it is so complex that no one can figure out, without the help of sophisticated software, which benefits they can claim, when they can claim them, when they must claim them, and when they should claim them.

I know a lot about Social Security's complexity. In addition to being a professor of economics at Boston University, I have a small financial planning software company called Economic Security Planning, Inc. One of our products is called Maximize My Social Security, which we market at www.maximizemysocialsecurity.com. The program suggests to users what benefits to collect and when to collect them to maximize their lifetime benefits from the system.

In addition to developing this program in conjunction with my software engineers and in consultation with technical experts from Social Security, I also write a weekly column for PBS NEWSHOUR in which I answer highly detailed questions about Social Security.

Social Security's "Simple" Benefit Formula

Social Security's Handbook has 2,728 rules and its Program Operating Manual has tens of thousands of rules to explain these rules. The rules and the rules to explain the rules are written in a language that no one can remotely understand unless they have spent years immersed in the system's provisions.

To give you a sense of Social Security's complexity, consider the formula determining the benefits at age a of a married spouse. Let's call the left hand side of this equation $B(a)$ to stand for the spouse's benefit at age. This formula, when written down as a mathematical expression is:

$$B(a)=PIA(a)x(1–e(n))x(1 + d(n))xZ(a)+max((.5xPIA^{*}(a)–PIA(a)x(1+d(n)))xE(a),0)x(1-u(a,q,n,m))xD(a)$$

The formula has 10 mathematical functions on the right hand side. One of these is in four dimensions. One is a maximum function. What's not shown here is that there are addition complex mathematical functions, one of which – my favorite – involves a maximum function defined over a minimum function, that restrict the values of the variables that can enter these 10 functions.

Some people looking at this formula would say, "Well, democracy is messy. And this is the price of democracy." This, frankly, is hogwash. New Zealand has a very fine democracy and its social security system couldn't be simpler. You reach retirement age, you get a monthly check. It's the same check for everyone.

I'm advocating the Purple Social Security Plan, not the New Zealand's system. The Purple Social Security Plan shows we can redesign Social Security from scratch, make it fair across and within generations, protect lower-earning spouses, but also make it extremely simple.

The Implications of Social Security's Complexity

We have 10,000 Baby Boomers retiring every day. I wish I could say all 10,000 were using my company's software to make appropriate claiming decisions. They aren't. We have the top ranked, least expensive, and best-known software. But if 20 people buy it on a given day, that's a lot.

What most people are doing is relying on Social Security's calculators and staff in making their collection decisions. But Social Security's calculators tell you about your own benefits, not about the benefits you can collect based on your current, ex, or deceased spouse. Consequently, they don't handle most households' collection decisions. Moreover, Social Security's benefit calculators, which are used by Social Security's telephone and local office staff, produce benefit estimates that are generally incorrect. This is thanks to the calculators' default assumptions that the economy will experience no future wage growth or inflation.

In addition, Social Security staff, although extremely well meaning, are not sufficiently well trained to render correct or appropriate benefit collection information or advice. Finally, the information that one can glean from Social Security's website is often highly misleading if not outright wrong. It appears that Social Security is limiting what it presents on its website because it realizes that making any general statements about benefit collection is fraught with danger. With Social Security the exception is always the rule, so saying anything requires saying everything.

The combination of a fantastically complex set of benefit provisions, Social Security online calculators that are incomplete and biased, Social Security staff that are constantly providing misinformation and wrong advice, the outrageous fact that divorcees and widow(er)s don't have access to their ex's and deceased spouse's earnings records, and a range of extremely nasty Social Security gotchas makes Social Security benefit collection a lottery. If you get the right information and make the right decisions, you can get far more benefits than if you don't.

Let me illustrate the dollars at stake in making the right decisions by using my company's software.

The Importance of How and When Someone Chooses to Claim Benefits
Consider a 62 year-old couple that's contributed the maximum amount to the system each year they worked. If they do what far too many people do, namely take their retirement benefits at the earliest possible date (age 62), their lifetime benefits will total $1.2 million. But if they wait until 70 to collect and if a) one of the two spouses files for a retirement benefit at full retirement age, but suspends its collection, b) the other spouse files just for a spousal benefit, and c) both spouses take their retirement benefit at 70, the couple's lifetime benefits total $1.6 million. The $400,000 difference is enormous. It's also at the upper end of the dollar gain that making smart Social Security decisions can mean. For most households, the increase in lifetime benefits from maximizing Social Security are either smaller or much smaller. But they are generally significant for all households.

Where are the gains coming from? In the main, the gains are coming from waiting a relatively small number of years to collect much higher benefits for potentially a very long number of years. Social Security will tell you that, on an actuarial basis, when you take your benefits is pretty much a wash. But none of us are insurance companies. We have only one life to live. And we have to plan to live to our maximum ages of life for the simple reason that they might. Because of this longevity risk, Social Security can't be valued as a standard investment. It's a longevity insurance policy and its value to households has to incorporate the value of this insurance.

Economic research on this valuation problem dates back 60 years. This research tells us to value a household's Social Security benefits using simple discounting, i.e., without applying actuarial factors.

Valuing insurance products in a special manner is not restricted to longevity insurance. To see this, consider valuing homeowners insurance. No one values homeowners insurance simply as an investment. Were we to do so, we'd apply actuarial/break-even analysis and conclude that buying homeowners insurance doesn't pay.

What Factors Does a Worker Need to Consider in Determining When to Claim Social Security Benefits?
This is another important question. The answer is multifaceted. There are so many different and major factors that come into play that I would take a book to fully respond. Instead, let me illustrate, via examples, three of the many factors workers need to consider.

The first factor is that workers need to understand the benefits for which they may be eligible. Take my friend Jerry who is 65 years old and a high earner. His wife recently passed away. When we were having dinner in January he told me he planned to retire at 70 and take his Social Security at that time. He had no idea that he could collect widower benefits based on his deceased wife's earnings record, which was quite high. Indeed, he was astounded when I told him that by taking his widow's benefit starting at age 66, when the earnings test no long applies, he would be able to collect roughly $120,000 prior to age 70. Needless to say, he paid for dinner.

Now why should my friend, who by chance learned about his rights to collect widower benefits, receive an extra $120,000 from the system whereas someone in his same shoes would have, out of ignorance, lost $120,000 for good? This is an example of the capricious and unjust redistribution and inequity arising from Social Security's terrible complexity.

My second example involves a marvelous doctor, who I just met by shear accident. The example illustrates the need to know how benefits are calculated. The doctor is age 68. One month ago he was diagnosed with pancreatic cancer. He figures he has two years left to live. He's married, his wife is 64, and she had a very limited earnings history. Upon learning his diagnosis, the doctor went to the local Social Security office where the representative told him he should try to get as much out of the system as possible before he passes away and that he should immediately begin collecting his retirement benefit.

The doctor followed this advice and signed up for his retirement benefit. It was the wrong advice. In taking his retirement benefit before age 70, the doctor reduced his wife's future widow's benefit by 16 percent. Neither the doctor nor the Social Security representative understood that the Delayed Retirement Credits the doctor would accrue between ages 68 and 70 would extend to the wife in the form of higher widow's benefit. Had I not accidently met this doctor, who is now suspending his retirement benefit, his wife would have spent, perhaps decades, receiving 16 percent lower widow's benefit than would otherwise have been the case.

A third thing that workers need to know in collecting benefits is that they can't trust much of anything they read online from Social Security or are told at the local office. I get emails on a daily basis from people who tell me they were misled by Social Security personnel. Here is an email I just received from Donna Strong, a divorcee living in Huntington Beach, CA.

"Larry, I'm currently 63. My ex is older than me and has earned much more. Over the past year, I tried to determine what benefits I could collect. I spoke with three different Social Security reps. One told me I couldn't receive divorcee spousal benefits unless my ex applied before 66, and since my ex is quite well off, I knew that wouldn't happen. This, I discovered, was wrong. All my ex needs to be is over 62 for me to collect a spousal benefit on his work record provided we are divorced for two years (which we are). So I got that right. But no one told me about deeming. I applied for my retirement benefit five months back thinking I'd be able to collect my full spousal benefit at 66.

I just learned about deeming and that I was, without my knowledge, forced to take my divorcee spousal benefit early. Had I been made aware that I would be deemed and be forced to take a permanently reduced spousal benefit, I would never have applied for an early retirement benefit. People really shouldn't have to deal with this kind of stress to receive a benefit for their retirement. I do also acknowledge that with Social Security cutting its hours, providing less training and more turnover, the situation is guaranteed to get worse for us all. Best, Donna"

Let me conclude my testimony by answering several questions either raised by Subcommittee staff or posed by me.

How can Social Security's rules for file and suspend and deemed filing affect the benefits someone receives? Do most Americans know about these provisions?

File and suspend can be used by one spouse to help another spouse file exclusively for a spousal benefit once that other spouse reaches full retirement age. But it can also be used by workers to accrued Delayed Retirement Credits while leaving open the option of taking one's suspended benefits as a lump sum if there is a sudden need for a large infusion of cash. File and suspend is not the only way that a spouse can receive a full spousal benefit at full retirement age while letting his/her own retirement benefit continue to grow via the accumulation of Delayed Retirement Credits. If one's spouse has filed for, but not suspended his/her retirement benefit, one can collect a full spousal benefit at full retirement age. Also, divorced spouses can collect full divorcee spousal benefits starting at full retirement age without anyone having filed for and suspended a retirement benefit.

Deemed filing can force spouses and divorced spouses to file for their spousal benefits early if they file for their retirement benefits early and force them to file for their retirement benefit early if they file for their spousal benefit early. This provisions keeps people who file early from being able to collect one benefit first while letting the other benefit grow.

Most people appear not to know about these and many other Social Security provisions. But those that do are not necessarily taking advantage of the system. One can argue that all the benefits that people can collect based on their own and their current and former spouses' contributions to the system were fully paid for by those contributions. In this case, the injustice is not in people claiming all their benefits, but rather in many people not knowing enough about the system to ensure that they get back what they paid for.

What are common questions workers ask when they are trying to decide when to apply for benefits?

The most common question that workers appear to ask is no question. Instead, they figure out when is the earliest date they can take their retirement benefit and apply at that date. They appear to have little or no idea about their eligibility for spousal, widow(er), divorcee spousal, and divorced widow(er) benefits, little or no idea about deeming provisions, little or no idea about Delayed Retirement Credits, file and suspend options, start-stop-start strategies, family benefit maximums, the Adjustment of the Reduction Factor that can mitigate the Earnings Test, and the list goes on.

Should We Eliminate the Option to File and Suspend?

Social Security is such a maze of provisions that it is very difficult to claim that one option, like File and Suspend, is either fair or unfair. It certainly benefits certain households. But those households that are benefited can, as indicated above, be viewed simply as being given the same benefit collection opportunities as other households who don't need to use file and suspend to, for example, get a full spousal benefit or provide their spouse with a full spousal benefit.

Certainly, restricting File and Suspend for high-income households, as the President proposed in his budget, will save the system money. But the system is so broke and so poorly structured that only a truly radical reform will cure what really ails it.

Should We Eliminate Deeming?

Deeming is a particularly nasty gotcha that differentially harms lower-earning households who can't afford to wait until full retirement age to collect a full spousal benefit while letting their own retirement benefit accrue Delayed Retirement Credits. Presumably those who thought up deeming had their reasons. But at least to me, Deeming is just another crazy Social Security provision that traps unsuspecting workers like Donna and makes the system complex beyond any reasonable person's belief.

$$B(a) = PIA(a) \times (1 - e(n)) \times (1 + d(n)) \times Z(a) + \max((.5 \times PIA^*(a) - PIA(a) \times (1+d(n))) \times E(a), 0) \times (1- u(a,q,n,m)) \times D(a)$$