AMERICAN ACADEMY of ACTUARIES

July 9, 1998

The Honorable Jim Bunning
Ways and Means Subcommittee on Social Security
B-316 Rayburn Building
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Bunning:

The American Academy of Actuaries appreciates your further interest in our February 26, 1998 testimony before your subcommittee. The following are responses to questions (shown in italics) posed in your June 10, 1998 letter.

1. *In your testimony, you discuss the importance, when increasing the retirement age of avoiding any sudden decline in benefits, and therefore avoiding a "notch". How was this avoided in the 1983 amendments and how can we be sure to avoid it in the future, should an increase in the retirement age occur?*

There were many changes in the 1983 amendments that did not decrease benefits and thus avoided the notch problem. However, it did increase the Normal Retirement Age (NRA), or age for full benefits, which could be perceived as a decrease in benefits, if someone still takes their benefit at the same age. As I stated in my testimony (including footnote 1), if someone born in

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say 1938 “still retires at age 65, their retirement benefit will be about 1% lower[1] than if the Normal Retirement Age had remained at age 65. If the NRA had increased to age 66 all in one year, benefits would have dropped immediately by about 7%. This large decrease would be similar to the notch baby benefit decreases which caused much alarm among the elderly in the 1980's. Phasing in the increase in retirement age over 6 years from 2000 to 2005 avoids this problem.” As I stated in my footnote, when wage increases exceed the CPI, it reduces (and can eliminate) the size of the notch. By a notch, I mean someone getting a benefit in early January that is less than a similar person (born a week earlier) retiring in late December of the prior year. In addition, the change was delayed until the year 2000, so not much fuss was made over this change in 1983. It only affected people who were age 45 or younger at the time. That was probably more than enough lead time back then.

Some people do not consider increasing the retirement age as a decrease in benefits because we are living longer. They would contend that future retirees will live longer than current retirees, and thus get benefits for just as many (or more) years. In town hall meetings across the country sponsored by Americans Discuss Social Security and the Pew Charitable Trusts, we have found that people don’t categorize “Increasing the Retirement Age” with benefit decreases. In electronically-taken votes, people ranked the 3 major benefit decreases (benefit decreases across the board, reduced COLAs, and increased taxes on Social Security benefits) at the bottom of 10 options, while ranking “Increase the Retirement Age” at 3rd from the top. See chart showing rankings at the forums.

Thus, ways to avoid the notch problem are to:

(a) Phase-in each one-year increase in Normal Retirement Age over 6 years (4 years might be enough, if wage increases are expected to exceed the CPI by more than 1%), and

(b) Delay its effective date (so that near-retirees who are already planning their retirement are not affected).

Other ways, of course, are to not decrease benefits directly (e.g., increase payroll taxes, increase coverage, increase taxes on benefits, delay or reduce COLA’s, or decrease the benefits of a small group, etc.).

2. *What are the advantages to creating a minimum benefit level through Social Security reform and how would that work? What are the advantages and disadvantages?*

We will respond to this question, by analyzing the proposal for a minimum benefit equal to 100% of the poverty level from the National Commission for Retirement Policy (Center for Strategic and International Studies).

Minimum Benefit would offset benefit decreases to low paid: Under the CSIS/NCRP proposal, Social Security would provide a minimum benefit equal to 100% of the poverty level (currently almost $8,000 per year), beginning in 2010. This would offset to some degree changes in their proposal that decrease benefits (e.g., Increasing the Normal Retirement Age (NRA),

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[1] Since people born in 1938 get their wages indexed one more year than people born in 1937 (and one less COLA), there is little likelihood that a notch will occur (assuming the wage index for 1997 wages will be more than the COLA in 1999). Even a 4 year phase-in would probably not create a noticeable notch.

using more years in Average Indexed Monthly Earnings (AIME), BLS reductions in the CPI that is used for indexing benefits, reducing survivor benefits, reducing the benefit formula, no mandatory annuitization or pre-retirement withdrawal restrictions[2]).

Cost: Of course, a minimum benefit also increases costs, but probably not as much as expected, due to the progressive nature of the benefit formula and subsidies in spousal benefits[3]. It would reduce the costs of the Supplemental Security Income (SSI) program.

Disincentives to Work: Flat minimum benefits can create a disincentive to work, once their eligibility rules have been satisfied. (After that point, the marginal money's worth can drop to zero for awhile.) The NCRP proposal reduces this concern by phasing the minimum benefit in over 40 years of work[4]. Thus, the more years worked, the greater the benefit. Under their proposal, the 60% of poverty benefit after 20 years of work would phase into 100% after 40 years of work. A low income person would have some disincentives to work (or report income or pay taxes) after 40 years of service, which could be reached by someone age 58. If the formula was 2½ % times the number of years worked, the incentive to work would continue beyond 40 years of work. Someone with 50 years of work would then get 125% of poverty level. This approach may not increase costs much. If you want to preserve the 60% after 20 years of work, the formula could use 3% times the first 20 years worked. Under this formula, someone with 50 years of work would get 120% of the poverty level. The costs should not be much different.

Some will not receive the full poverty level benefit: In order to have incentives for working, some people (who cannot work the full 40 years) will not receive the 100% poverty benefit. Therefore, the NCRP proposal's benefit reductions will create some inadequate benefits for some people. The government may have to pay them public assistance, which means government may have to pay the costs anyway. Furthermore, without a full poverty benefit, a proposal may then have to mandate annuitization of the Individual Accounts.

No Minimum for 19 years of work or less: The NCRP proposal creates a large cliff at 20 years of work, below which, a worker would get no minimum benefit. Providing proportionately lower benefits for workers with less than 20 years of work should not cost much. The benefit would be inadequate of course, but so is the benefit after 21 years (equal to 62% of poverty level). We are unaware of any concern, abuse, or moral hazard that minimum benefits would cause for people with short work histories. Eliminating the 20-year requirement would be simpler, provide benefits proportional to years that contributions were made, and not have any cliff effect, which would

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[2] It was unclear whether CSIS/NCRP mandated annuitization of their Individual Security Accounts or restricted pre-retirement withdrawals.

[3] The CSIS/NCRP proposal for a minimum benefit equal to the poverty level could also have been deceptively less expensive, since poverty levels may only increase with inflation. However, it appears that they did not take the easy (less expensive) choice. Their *initial* minimum benefit is wage-indexed after 2010. This implies that productivity gains in the economy will be shared with all retirees (at the point of their retirement), including low income ones. After retirement, their benefit would increase with just inflation, like other retirees' benefits.

[4] This would need to be defined. It could be say 15% of the wage base. Once reached, some might stop working.

primarily affect low-paid immigrants and women who care for children. In fact, lowering the 20-year requirement could create incentives for people with short work histories to work more.

Early Retirement Reductions: If the minimum poverty level benefit is not reduced by early retirement reduction factors (and increased by delayed retirement factors) just like other PIA benefits, there will be a strong incentive to retire when first eligible. If it is reduced, then the benefit payable before NRA will be less than the poverty level (e.g., it would be 30% less in 2029 when the NRA reaches 70 for someone retiring at age 65). If the minimum benefit was set at 150% of poverty levels at the NRA then the age 65 ERA benefit would be at least 100% of poverty level. The benefit could reach 150% at age 70, if the formula was 3% times years worked (e.g., 3% x 50 years of work = 150%).

Disability Benefit: Under the NCRP proposal, it is unclear whether an individual receiving the disability benefit would get the minimum. If yes, and if total income exceeded income while working, there would be little incentive for rehabilitation and returning to work. Current rules limit disability benefits so that total income is less than 80% of average earnings, and that could help allay this concern if applied here too.

Spouse Benefits: Should the dependent spouse of a worker receive the full poverty minimum? If yes, then the couple will receive more than the poverty level for a couple. If the spouse receives 33% of the poverty level, it will be closer to the poverty level for a couple. Also, we assume that the surviving spouse will also receive the minimum poverty benefit because very elderly single women have the highest poverty levels among the elderly.

Minimum could be a windfall: The minimum could provide an individual with a benefit that is larger than recent salary amounts for the person, and thus could encourage them to retire. Having a maximum equal to the worker's Highest 5 year salary average (or something similar to the disability maximum) would reduce this problem.

3. *Can Americans be encouraged to work longer? (and how?)*

Retirement policy is one way to affect American's retirement decisions. Here are some ideas:

Retirement Ages May Be Increasing: Recently, labor force participation rates (see charts) have increased, possibly due to (for example) a relaxation of the Social Security retirement earnings test.[5] This also shows that some people can work at age 70. In addition, 401(k) plans don't subsidize pensions at younger retirement ages, like traditional retirement plans. If 401(k) participants want to retire early, they have to suffer the full actuarial reduction. This may force many people to work longer in the future.

Delayed Retirement Ages or Reduced Benefits: The labor force charts also show that Americans used to work to later retirement ages. The average male worked to age 70 before Social Security and Medicare (inter alia) inadvertently encouraged them to retire earlier. With

[5] Workers over 70 can now earn a wage and not have their Social Security benefit reduced.

not only our life spans improving, but also our health improving[6], it would be possible for most people to work longer. If Social Security, SSI, Medicare, and Medicaid delayed or reduced benefits at younger ages, people would be more likely to work longer in order to have a secure retirement. Eliminating benefits at younger ages would have an especially powerful effect. That's because many people may still take reduced benefits at younger ages even if they are not adequate.

Decrease Social Security Benefits: Proposals to decrease Social Security benefits may also encourage us to retire later. However, even though they are similar to proposals that increase the NRA, they may not register until too late. Most people don't know what their Social Security benefit amount is, so decreasing it won't affect their thinking now. Only when they reach age 65 will they realize how much the benefits dropped. At that point, they will finally realize that they have to work until a much later age. Thus, raising the retirement age could be the more effective way of making changes to Social Security. It is more likely to affect our thinking now than just decreasing benefits.

Relax or Eliminate Retirement Earnings Test: Another chart shows how Social Security has a clear and direct impact on people's decision to work. The chart shows that large numbers of older people work up to the retirement earnings test exempt amounts and then stop. This not only shows that Social Security affects our decisions, it also points to another way for Social Security to encourage us to work - by eliminating (or increasing) the retirement earnings test exempt amounts. Social Security actuaries estimate that this would not hurt the actuarial balance. However, it does increase cash outlays in the short term.

35-Year Average Earnings: Another way is to modify the benefit formula. Currently, many people commence benefits at age 62. That's because, even though there is a 20% penalty for early retirement, the Social Security PIA benefit is not improved much after a person has 35 years of work. Paying more contributions after 35 years of work does not improve the benefit much. This could be changed by determining average wages over say 40 years rather than 35 years (or NRA minus 20 minus 5 drop out years, which would automatically update it when NRA is changed). However, this change could hurt women who leave the workforce for children. This concern can be alleviated by allowing additional drop out years for taking care of children up to age 5 for example. The law already allows drop out years for women caring for children for some disability calculations.

Allow/Encourage increased retirement ages in Private Sector Pension Plans: The current Internal Revenue Code (IRC) still references age 65, 59 ½ , and 70 ½ for various pension-related rules[7]. (A couple IRC rules reflect the new Social Security NRA, but not many.) These ages could be updated, to encourage employers to raise the ages in their pension plans. In addition, Congress changed the Social Security NRA without protecting prior benefit promises. If

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[6] See Chronic disability trends in elderly US populations: 1982 - 1994 by Manton, Corder, & Stallard. In 1982, 14.1% 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%. For ages 75 to 84, it dropped from 31.9% to 26.9%.

[7] See the definition of Normal Retirement Age (65 & 5) in §411(a)(8), the maximum distribution age of 70 ½ for owners in §401(a)(9), the anti-cutback rule in §411(d)(6), and the commencement rules (65 & 10) in §401(a)(14).

Congress gave employers some flexibility in this area, it might make it easier for employers to increase retirement ages in their pension plans. This should be changed only after careful study.

Provide some flexibility to employers to encourage hiring older workers: As I testified, older workers can cost more due to higher health costs, etc. If Congress added some flexibility to the Age Discrimination in Employment Act, so that **total** compensation costs for older employees did not have to increase, then employers might be more willing to hire and retain older workers. Rules making it easier to have phased-retirement would also help. For example, IRS regulations could be changed to allow in-service distributions to be payable before a pension plans's NRA[8] and partial Social Security benefits could be paid to reflect an older person's phased retirement.

4. *How is the Congress sending mixed signals about its policies on retirement age and what issues are the most important for us to address to ensure consistency?*

Social Security is moving its retirement age to 67, but Medicare is still 65. In addition, the federal laws for employer-sponsored pension plans still use age 65. (Note: If Congress amended pension law to use the same ages as Social Security, some companies might take advantage of it. This could be a revenue raiser for the government, because employer contributions could go down - or at least not go up.) Another inconsistent signal is the requirement that IRA's and some certain pension benefits begin their distributions by age 70 ½ even if the individual wants to continue to work. Raising the 70 ½ would defer government revenue however. You could also raise the 59½ age for earliest distributions, but that could discourage people from putting money into IRAs and 401(k) plans, since it would lock the money up longer. It would also be a revenue loser for the government.

5. *What do you see as possible options for indexing the retirement age and what are the advantages and disadvantages of each?*

As provided in my written testimony, here are some choices.

Pay Benefits for the Same Number of Years. One way to index the NRA would be for Social Security to provide benefits for the *same number of years* (i.e., keep the life expectancy at NRA the same). When Social Security was created, life expectancies at 65 were about 12.7 years[9]. If we used this method, the NRA would be around age 72 today. It would have gone up 7 years in 6 decades. (This figure is cited to show what the effects would be if this had always been in law. If you change the law now, you would probably not go back to the 1930's, but start the change at a current or future date.)

Under this method, the ratio of workers to beneficiaries would continually go up and thus the costs of our unfunded system would generally decline under this suggestion. Similarly, in a funded system, the costs of buying the indexed annuity would remain the same. However, since it

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[8] IRS reg §1.401-1(b)(1)(i) requires that retirement plans be exclusively for retirement and other incidentals.

[9] The Trustees' report uses composite life expectancies based solely on the death rates for the year in question. Actual life expectancies (with an assumed mortality improvement) for people living in that year might be more appropriate, especially in a funded system.

can now be funded over 7 more years (i.e., ages 65 to 72), the annual amount that needs to be saved would continually decrease.

Keep the ratio of years in retirement to the working lifetime the same. Another way to index the retirement age would be to determine the age that maintains the same ratio of retirement years to working years. This could be accomplished in several ways. One example would be to divide the life expectancy at NRA by the potential years worked (e.g., the years from age 20 to 65). This would be a compromise between freezing the NRA at 65 (which would dramatically increase costs) and freezing the life expectancy at NRA (which could dramatically decrease costs). In fact, it was recommended by a majority of the members of the 1983 National Commission on Social Security Reform. This idea could stabilize the costs of the system and it wouldn't go out of balance every year as another deficit year was added to the 75-year projection. If this idea had been used since the creation of Social Security, the NRA would be age 70 now. This is an easy calculation. However, it doesn't reflect whether our health is continuing to improve also. This could be handled by using a health index. For example, we could look at the disablement rates (or some sort of health index) at the NRA and prohibit an increase if the rates (or index) were getting worse. However, this has problems. A health index could be quite subjective and it could trap us into setting different Retirement Ages for men and women, and for different worker classifications, minorities, or income levels. Multiple retirement ages and provisions are some of the reasons the Chilean and other foreign systems were collapsing, so we may not want to open that Pandora's box.

Maintain Same Cost Levels: Another method would be to use the calculation of the NRA to maintain a level cost for the system. Other similar methods would be to maintain the same dependency ratio of workers to retirees. In a funded system, it would require an actuarial calculation to maintain the same contribution or savings rate for each person. However, these methods entail a much more difficult calculation, and it would depend on many different assumptions about the future. For example, it could mean that the NRA could go up even if we weren't living longer - for example, if fertility rates declined or if the economy got worse. That might not be appropriate. In fact, it might be more appropriate for those variables to affect the tax rates. For example, if national birth rates decline, then maybe we should contribute more, not raise the retirement age.[10]

NRA changes in law or updated by Social Security's Actuaries: The law could specify the increase in the retirement age, as it does now. Currently, the law stops the increases at age 67. If, as expected, we continuing living longer, the system will go out of balance again. A gradual increase in the retirement age would keep the system in balance (which keeps the trust fund stable in the out years). Thus, some proposals increase the NRA by 1 month every 2 years. Other proposals increase it by as much as 2 months every year. One can use different periods in the past (or in projections) to support either of these indexing proposals (or something in between).

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[10] Congress could index the system now, or wait until the problems occur. If they decided to index, there would need to be rules on how big the problem would have to be before change occurred, and how to phase it in gradually. Changes could be subject to an override by Congress and would need a cap on how much change could occur and how often a change could occur. There are many issues which would have to be worked out on this.

An alternative, would be to set the increase in law, but allow the Social Security Actuaries to adjust it if and when life spans change faster or slower than expected (within constraints set by Congress and subject to their override). This would help Congress avoid reopening the difficult debate on how to fix Social Security every 20 years or so. However, some people might contend that it is not appropriate for a non-elected individual (Social Security's Chief Actuary) or agency to adjust something this important. (However, it should be noted that BLS economists can affect the COLA amounts, and Canada has invested similar powers in its government actuary.) Another concern is that people like to know their NRA in advance. A response would be that Congress could set constraints on the adjustments, so that no one over age 55 would be affected.

6. *I'm interested in knowing your views on the degree to which age discrimination may ultimately prevent increased participation of older workers in the work force.*

An SSA publication by John Straka, *The Demand for Older Workers*, asserts that employers that limit the number of older workers (or reduce their earnings) do so for productivity and market efficiency reasons and not for prejudicial discriminatory reasons. He bases this on his theory that (ultimately) in an efficient market, people are paid what they are worth. He also says that job opportunities for older workers will be mostly confined to relatively low-paying, labor-hungry sectors and occupations such as certain retail and clerical work and part-time or temporary work (e.g., on holidays). These jobs may not be attractive to many elderly workers who once had well-paying jobs. His position is that the Age Discrimination in Employment Act (ADEA), shortages of younger workers, and SSA policies to encourage work will not be adequate to both get jobs for the elderly and safe-guard their well-being. He suggests more subsidized training and resources for older job searchers.

My expertise in this area is limited, so I will just discuss those areas with which I am familiar. In my testimony I noted that in 10 years, employers may need more workers due to the start of the retirement of the baby boomer generation. (See chart showing declines in Increase in Labor Force.) This may already be happening. Unemployment levels are decreasing dramatically, and this could encourage the retention and hiring of older workers. Anecdotal evidence is that many older workers that were laid off in the early 90's have been rehired (at least on a part-time basis).

However, it is still true that the employee benefits of older workers can cost more[11] than for a younger employee. Unless employers can offset this higher cost somewhere else, they may prefer hiring anyone else that is cheaper (e.g., younger workers, aliens, part-time older workers who don't have to get employee benefits, etc.). Thus, ironically, Congress could decrease discrimination by relaxing the Age Discrimination in Employment Act to allow, for example, employers to offset salary increases by increases in an employees health costs.

7. *Will there be enough jobs for older workers, jobs with the level of physical activity that most persons over age 67 can perform?*

The issue of whether there will be enough jobs ultimately depends on the nation's economy/productivity. However, as discussed above, the retirement of the baby boomers (see

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[11] Especially health costs, although the existence of a post-retirement health plan or unreduced pension plan benefit can offset this higher active employer health cost.

chart) should dramatically increase job opportunities in the first 30 years of the next century. However, the question for older workers is not whether the jobs are there, but whether *they* will get them. If as discussed in #6 above, it is not efficient for an employer to hire the older worker, then the older worker could lose out to younger workers, aliens, etc. Whether older workers will be able to perform the jobs of the future is better discussed by gerontologists, futurists, and others. Many will be, especially now that our economy has more service-oriented jobs than physically-arduous ones, especially if an older worker's knowledge is valued. However, older blue collar workers will have to be trained for the less physically demanding jobs. In addition, your decisions now on the NRA will apply in future years, long after the baby boom retires. Whether there will be enough jobs then, is difficult to predict.

8. *Do you have thoughts on how the increasing number of older workers might impact rates of unemployment, job opportunities, and career advancement for younger workers?*

The issues you note in these last 3 questions are all very important and call for the expertise of many professionals in addition to actuaries. Raising the retirement age and encouraging people to work longer can increase unemployment and reduce job opportunities and advancement for younger workers.

However, the aforementioned graph of increases in labor force shows it is now lower than in any time on the graph (and soon will be less than the increases in the total population for the first time since 1960). Thus, you could increase the NRA and still keep the labor force increase below the increase in the population. In fact, you might ask the Social Security actuaries to revise this forecast based on various proposed changes to Social Security.

We want to thank you again for holding the hearing and inviting us to testify. We are more than happy to answer further questions or meet with you to discuss these and other items at any time.

Sincerely,

Ronald Gebhardtsbauer, FSA, MAAA
Senior Pension Fellow