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Touching the Third Rail: Alternative Solutions for Bringing the Social Security Retirement System into Long-Term Balance

by Richard V. Burkhauser

In 1974, when I was a long-haired graduate student at the University of Chicago looking for a dissertation topic, I got the idea that retirement plans, either employer-based or Social Security, were best thought of as assets whose value varied over a worker's lifetime. In a world with perfect capital markets in which the decision to take a pension was not related to job exit, a worker would do so at the age that maximized the pension's present discounted value. In my dissertation I used this model to predict the retirement age of members of the United Auto Workers, who had the option of leaving their job and receiving early retirement benefits from a very actuarially unfair pension plan, one whose present discounted value fell dramatically at older ages. In my dissertation and in a series of subsequent papers (see, for instance, Burkhauser 1979, 1980; Burkhauser and Quinn 1983), I showed that pension plans whose asset value fell after a given age effectively reduced the net compensation for working past that age and hence encouraged retirement. Richard Ippolito (1987) extended this theory to show that such pension plans also encouraged younger workers to stay on the job to some optimal age. This type of life-cycle model now dominates the way economists think about the incentive and redistributive aspects of both employer pensions and Social Security.

The public policy point of these papers is that the "normal" retirement age in the United States—that is, the age at which the typical worker leaves a career job—can be and has been greatly affected by the incentive structure of employer and Social Security pension plans. Today the retirement decision is primarily driven by economic factors, not health factors. Hence, if the political will to change this incentive structure materializes, the labor force participation rates of older workers will also change.

It is this life-cycle model of pensions, which looks at lifetime contribution and lifetime benefits, that I had in mind when in 1980 I reviewed Martha Derthick's seminal book on Social Security, *Policymaking for Social Security* (Derthick 1979). Although it is always daunting to revisit past work, in this case I was pleased to see that the Derthick book has become the landmark on the politics of the Social Security system I thought it would be, and that many of the predictions I made about future Social Security policymaking in that review have indeed come to pass.

A few passages from that *Journal of Human Resources* review will illumine my long-term perspective on our Social Security system. To begin, "Derthick's major thesis is that key Social Security administrators were able to produce a major income transfer system under the protection of a Social Security 'myth' which opponents were unable to discredit or even successfully debate." The myth, as many people recognize, is that Social Security is an "earned right" and that Social Security is simply returning benefits based dollar for dollar on past contributions. Derthick was particularly impressed by program executives' abilities to deflect criticism by public policy experts. She states, "The critics were rationalists. Conservatives or liberals, they sought to strip the program of its propaganda and to correct public misperceptions. . . .They consistently criticized the program for the inconsistency of its goals. All this put expert critics at odds with program executives who were highly pragmatic" (p. 165).

To those who were bold enough to persist in criticizing the system publicly, these program executives were quick to respond. Jodie Allen (then a reporter and now an editor of the *Washington Post*) is quoted by Derthick as saying

> I was deluged by calls and letters from the guardians of the social security system—you know, from Wilbur Cohen on down—saying, "Gee, Jodie, we always liked you, but how could you say this?" I acted very politely, and I said, "Well, what's the matter with this; isn't it true?" And they said, "Oh, yes, it's true, but once you start saying this kind of thing, you don't know where it's going to end up." Then I came to perceive that social security was not a program; it was a religion. It's very hard to reform a religion.

My reaction to this in the review was to say

> There is no question that executives at many government agencies have a missionary zeal with respect to their programs, and anyone who has seen Ball, Cohen, or the other former executives in debate can attest to their abilities to persuade. Nevertheless, it is difficult to accept Derthick's thesis that the growth of Social Security was based primarily on the administrative abilities of a few program executives. Or for that matter, that the ability of these same wily executives to deflect their economist or public policy critics was of great moment in shaping policy.

It was my view that, "in the second part of Derthick's book, more fundamental reasons for the growth in the Social Security system are found. From its inception, the expected value of future Social Security benefits has exceeded the total taxes (both employer and employee) paid into the system by virtually every beneficiary."

In early work on this point, Burkhauser and Warlick (1981) estimated that those who were aged 65 in 1956 received, on average, nine times the value of taxes paid into the system over their lifetimes. By 1972, those who were aged 65 were still receiving twice the value of their lifetime tax payments. Subsequent work by Boskin, Kotlikoff, Puffert, and Shoven (1978), Steuerle and Bakija (1994), and most recently Panis and Lillard (1996) all confirm the point that the short-run gains of a pay-as-you-go program were low taxes and high benefits, but as the system matured these became less and less possible. I argued in my review that it was this inevitability, rather than the decreasing skill of program executives, that was and continues to be at the base of the mounting debate over the Social Security system.

I went on to say, "Despite the increasing debate and the fall in the rate of return on Social Security taxes, Derthick is pessimistic about the possibility of significantly altering a system where 'policy choices can be summed up in two maxims: a little bit more is always a good thing; anything less is inconceivable' " (p. 412). I certainly agree that this maxim captures the agenda of Social Security executives; it may be the general theme of all bureaucrats. But my inspection of the evidence leads to exactly the opposite conclusions concerning Social Security. Social Security will change significantly over the next 20 years, but not because an aroused public has finally become aware of an ineffective program. On the contrary, Social Security was the most significant and successful program of its time. Rather, it will change because the system, as it now stands, continues to apply a cure developed for past social ills to a country suffering from different ailments.

When Social Security was first established it was the only major federal program that met the income needs of the low-income aged. Its across-the-board system of redistributing income was a politically popular method of fulfilling both social insurance and social adequacy goals. However, the system is now mature, and the large across-generational transfers provided previous generations a higher than actuarially fair return on their money in old age. Younger generations now perceive that, like other welfare programs, gains to one group within their age cohort must mean losses to others. This, together with the fall in the birthrate, makes the system's across-the-board approach to income distribution possible only at the expense of significant tax increases on younger generations.

In addition, other programs now exist to meet social adequacy goals. Supplemental Security Income (SSI), a negative income tax system established in 1974, is a real alternative for redistributing income to the low-income aged, and it does so through general revenues.

SSI makes this type of redistribution within Social Security redundant.

Concentrating only on redistribution issues, Derthick totally ignores what I believe is the major reason for the likelihood of real change in Social Security. Social Security was developed in an era of mass unemployment, and a major justification for its creation was to encourage older workers to leave the labor force. There is little doubt that the earnings test, together with a payment system that penalizes those who postpone acceptance of benefits, has drastically altered the life-cycle behavior of workers. Most economists have long argued against this method of reducing work at old age. But as we approach the end of this century, the cost in lost manpower will greatly increase. The fall in the birthrates makes it clear that programs that drive workers away from productive work must be changed. The passage of the 1977 amendment to the Age Discrimination in Employment Act, which raised the minimum mandatory retirement age from 65 to 70, is a first political response to this cost. The end of the earnings test, a fairer increase of benefits to those who postpone retirement, the taxing of Social Security benefits, or even a postponement to 68 of eligibility for such benefits may all be argued on income distribution grounds, but some or all must occur, because each would reduce the tremendous negative effect of our current Social Security system on work.

The political power of the elderly will certainly be a factor in whether the carrot or the stick approach is used to increase work at older ages, but some combination of these pro-work proposals will emerge. The Social Security myth cannot be sustained because its increasing cost to society makes change inevitable. It is this force and not the changes in process that Derthick recommends that will overcome "even the most skillful of bureaucrats."

Since 1980, when I wrote that review, the earnings test has been substantially liberalized. On March 29, 1996, President Clinton signed the latest liberalization, which, by the year 2002, will raise the earnings limit to $30,000 for beneficiaries aged 65 to 69. In addition, as part of the Social Security amendments of 1983, the tax on earnings above the minimum was reduced from 50 to 33⅓%. Even more importantly, the concept of actuarial fairness was used to allow those who postpone benefits past age 65 to eventually enjoy an 8% increase in benefits. In addition, up to 85% of Social Security benefits are now taxed for those at the upper end of the income distribution. Most importantly, the "normal retirement age" is scheduled to begin to rise to age 67 right after the turn of the century. All these pro-work changes encourage work at older ages and hence increase the size of the economic pie from which future Social Security benefits will be cut.

The encouraging news is that the set of pro-work Social Security reforms put in place in the early 1980s have already begun to change behavior. As can be seen in Table 1, the dramatic decline in the labor force participation rate of men aged 62 to 64, which began in the 1960s when men were first allowed to take early Social Security benefits and accelerated through the recession years of the early 1980s, has ended. The labor force participation rate of men aged 63 in 1996 was at approximately the same level as it had been for the last decade. Labor force participation rates have also bottomed out and even increased for men aged 65, 68, and 70 over this period.

Over the 15 years since I wrote the Derthick review, my hair has turned gray, and like President Clinton I am now part of the aging baby-boom population who will begin to retire less than two decades from now. But my conviction that greater changes in the system are coming is even stronger today than it was back

TABLE 1
UNITED STATES MALE LABOR FORCE PARTICIPATION RATES BY AGE, 1940 TO 1994

	Age						
Year	**55**	**60**	**61**	**63**	**65**	**68**	**70**
1940	90.9%	82.9%	79.2%	78.2%	66.1%	54.9%	43.4%
1950	87.8	82.1	78.4	77.6	67.7	54.2	44.5
1960	89.9	83.2	79.4	75.7	53.6	39.4	33.2
1970	91.8	83.9	80.1	69.4	49.9	39.4	30.1
1980	84.9	74.0	69.6	52.3	35.2	24.1	21.3
1985	83.7	71.0	66.5	44.7	30.5	20.5	15.9
1986	84.1	69.2	66.2	44.3	30.7	20.7	17.1
1987	83.9	69.8	65.2	45.6	31.7	22.9	17.1
1988	82.5	68.8	65.0	45.0	31.1	22.5	18.1
1989	83.7	70.7	66.4	44.5	31.4	22.2	17.9
1990	85.3	70.5	67.0	45.5	31.9	23.4	17.1
1991	82.5	70.6	66.4	44.6	30.6	21.2	16.9
1992	83.9	68.6	65.7	45.7	32.0	20.7	16.8
1993	83.4	68.3	63.9	45.8	30.5	22.2	17.3
1994	80.9	65.9	63.6	45.1	33.0	22.7	18.6
1995	81.1	68.9	62.0	43.2	33.5	22.4	20.6
1996	81.9	67.5	64.8	45.3	33.4	22.7	21.3

Source: Labor force participation rates for 1940, 1950, and 1960 are based on decennial United States census data. Thereafter, they are from unpublished Department of Labor statistics, based on annual Consumer Population Survey labor force participation questions.

then. They must come because to survive, the system, like government in general, must recognize that redistribution works best when the economic pie is expanding, and the key to expansion is increased savings and greater employment.

The 1995 Social Security Trustees Annual Report (Social Security and Medicaid Board of Trustees 1995) predicts that Social Security expenditures will exceed taxes received by the year 2013 and that the trust fund will be exhausted by 2030. Although concern for this economic reality is well below the political surface, and politicians of both parties are still wary of touching the "third rail" of American politics, a national debate on how to bring Social Security back into long-run solvency cannot be far away.

As a member of the Technical Panel on Trends and Issues in Retirement Savings (TIRS) for the most recent Social Security advisory council, I worked with an outstanding group of Social Security experts on both a set of criteria for evaluating proposal changes in the system and overall recommendations to the council to bring the system into long-run balance.

Our report (Technical Panel on Trends and Issues in Retirement Savings 1995) stresses that some combination of benefit cuts or revenue increases is necessary to restore the Social Security system to actuarial balance, and it urges that appropriate legislation be enacted promptly. Relevant policy options were analyzed in a three-step process. First, the panel developed six criteria against which to judge any specific proposal. Then a straightforward baseline benefit cut (an across-the-board decrease in the PIA formula for future retirees) was compared to a straightforward baseline revenue increase (an increase in the OASI payroll tax rate). Finally, the panel compared other means of lowering benefits with the baseline PIA decrease, and other means of raising revenues with the baseline payroll tax increase.

The panel adopted the following six criteria:

- Adequacy of retirement income, relative to poverty thresholds and to the household's preretirement income
- Insurance against unforeseen income fluctuations (for example, those caused by disability, the death of an earner, unanticipated early retirement, or unexpected longevity)
- Avoidance of market inefficiencies, in particular, in the labor-leisure choice (the allocation of time during and at the end of the work life) and in the consumption-savings choice (the allocation of lifetime income between consumption during the work life, consumption during retirement and bequests)
- Equity of lifetime Social Security taxes and benefits, both within generations and among generations
- Encouragement of private and aggregate national saving
- Strengthening the financial integrity of the nation's retirement income systems.

The panel did not attempt to reach a consensus on the appropriate mix of benefit cuts and revenue increases. Our goals were to analyze the pros and cons of achieving balance with different mixes of reduced benefits and increased taxes (or, equivalently, with options that would result in Social Security systems of different size and scope) and to compare alternative means of both benefit decrease and revenue increase.

I want to focus here on one set of recommendations because I believe they are the most significant in terms of increasing the pie from which future benefits can be taken. They relate to increases in the age of both early and normal retirement. The panel concluded that the availability and magnitude of Social Security retirement benefits induce some older workers to leave the labor force earlier than they otherwise would. Benefit cuts, rather than tax increases, are likely to reduce this incentive. In addition, payroll taxes may discourage the labor supply of younger workers, a labor market distortion that is more likely to decline if benefits are cut than if payroll taxes are increased.

The panel came to the following conclusions:

- If benefits are to be reduced, one mechanism overwhelmingly supported by the TIRS panel is to increase further the early and normal retirement ages. Most panel members believe that delaying retirement ages is a sensible response to the increases in life expectancy, one that prevents lifetime benefits from automatically increasing as recipients live longer.
- If benefits are to be reduced, a large majority of panel members believe that the normal retirement age for Social Security benefits, currently scheduled to increase to age 67, should be increased further to age 69 or 70, and that it should be tied eventually to increases in life expectancy. Most agree that the scheduled hiatus between the increases to age 66 (2000–2005) and 67 (2017–2022) should be eliminated.
- A large majority of panel members believe that the early entitlement age for Social Security benefits should also be raised, with most supporting raising

it to age 64 or 65 at a rate of change of one month per year.

The Social Security Advisory Council, to which our report was directed, released its final report in 1997. It provides evidence that a serious debate on this subject is beginning and that dramatic differences on how to close the deficit exist. The council unanimously recognized the looming financial crisis but split into three distinct camps on how to avert it. All three camps, however, recommended a combination of tax increases and benefit reductions. Further increases in the normal retirement age are part of two of the camps' proposals.

I believe one reason our panel was not unanimous in recommending an increase in the earliest age of retirement, and one of the reasons the Advisory Council did not recommend this proposal, was the concern that many workers who first take Social Security benefits at age 62 cannot work and would suffer dramatic losses in economic well-being if they had to wait until age 64 or 65 to first get benefits.

Burkhauser, Couch, and Phillips (1996) address this concern. We use data from what will be the primary source of information on the cohort of workers who will retire over the next decade, the Health and Retirement Survey, to measure the health and economic well-being of those who first take Social Security retirement or spousal benefits at age 62 relative to those who postpone benefits.

Contrary to conventional wisdom, we find that the typical early Social Security beneficiary in 1993 and 1994 was about as healthy and wealthy as the typical postponer. As can be seen in Table 2, most men who took Social Security benefits at age 62 were healthy (80% report having no health problems that limit the type or amount of work they can perform), nearly two in three were receiving an employer pension to go along with Social Security, and the net assets of the median male early beneficiary were just over $160,000, more than the net assets of the median male postponer. The data for women who took benefits at age 62 are the same.

In tables not shown here, we find that fewer than 10% of male early Social Security beneficiaries were in poor health and also had Social Security as their only source of pension income, and that this vulnerable group made up fewer than 3% of the population of 62-year-old men in our sample.

It will be necessary to trim Social Security liabilities further to guarantee the fiscal integrity of the Social Security system when we baby boomers retire. Our generation will have to agree to lower our benefits for the sake of our children and grandchildren. Returning the age of first eligibility for Social Security benefits to age 65, where it was before 1961, is in my view and the view of the majority of the TIRS panel a better alternative than cutting yearly benefits. It will not dramatically lower the economic well-being of the typical person aged 62, since most men and women that age are neither in poor health nor dependent on Social Security benefits alone for their income. Hence, they could, if necessary, continue to work or retire and depend on private pension benefits until age 65.

As Table 1 shows, in 1960, the year before early Social Security benefits were first introduced, 79.4% of men aged 61 and 75.7% of men aged 63 were in the labor force. By 1996, despite improvements in both mortality and morbidity, those percentages had fallen to 64.8% and 45.3%, respectively. The dramatic drop in work between ages 61 and 63 over this period is an artifact of our retirement system. (See Quinn and Burkhauser 1994 for a review of the evidence of the labor supply consequences of our current retirement system.) As we have seen, pro-work reforms have ended the downward trend in work at older ages, but raising the earliest age of eligibility would start a chain of events in our retirement system that would push labor force participation dramatically upward at ages 62 through 64, and thus overall productivity and the labor earnings base on which Social Security taxes are collected. Requiring us to work longer would lower the tax burden on our children and at the same time increase the overall pie from which distributions are made.

No cut in Social Security benefits will be painless for our cohort. A small minority of men and women aged 62 are in poor health and, on average, live in households with substantially less income and net assets than the healthy majority. When raising the early retirement age, other changes—such as lowering the age for eligibility for Supplemental Security Income—should be implemented to provide alternative income for this relatively small minority of vulnerable people. But in a world of difficult choices about the use of tax dollars, it is no longer sensible policy for the Social Security system to encourage the vast majority of healthy employed workers to leave their jobs at age 62. It is time to return the earliest age of eligibility for Social Security retirement benefits to 65.

TABLE 2
CHARACTERISTICS OF MEN AND WOMEN FIRST ELIGIBLE TO RECEIVE SOCIAL SECURITY RETIREMENT OR SPOUSAL BENEFITS AT AGE 62 IN 1993 OR 1994 BY BENEFIT STATUS[a]

	Social Security Benefit Status					
	Men			Women		
Characteristics	**Total**	**Takers**	**Postponers**	**Total**	**Takers**	**Postponers**
Sample Size (n = 1,235)	580	162	418	655	203	452
1992						
Employed (%)	72	56	78	51	38	57
	(45)	(50)	(41)	(50)	(49)	(50)
Poor health (%)	16	16	16	20	23	18
	(37)	(37)	(37)	(40)	(42)	(39)
Median income[b] ($)	43,679	40,124	45,014	31,933	31,000	33,468
Median net worth ($)	150,000	162,800	144,750	120,000	152,600	106,400
Respondent eligible for pension (%)	59	65	57	34	24	38
	(49)	(48)	(50)	(47)	(43)	(49)
Respondent pension income (%)	21	35	16	10	10	10
	(41)	(48)	(37)	(30)	(31)	(30)
Household pension income (%)	24	38	19	32	41	28
	(43)	(49)	(39)	(47)	(49)	(45)
In poverty (%)[b]	8	9	7	14	15	13
	(27)	(28)	(26)	(34)	(36)	(33)
1994						
Employed (%)	53	22	66	38	23	45
	(50)	(41)	(47)	(49)	(42)	(50)
Poor health (%)	20	20	21	27	31	25
	(40)	(40)	(40)	(44)	(46)	(43)
Median income[c] ($)	40,000	31,750	45,582	29,396	24,656	32,000
Median net worth ($)	160,600	164,650	155,500	126,000	151,000	116,000
Respondent pension income (%)	36	64	25	19	24	17
	(48)	(48)	(43)	(39)	(43)	(37)
Household pension income (%)	41	67	30	44	54	40
	(49)	(47)	(46)	(50)	(50)	(49)
In poverty (%)[c]	10	12	9	18	15	21
	(30)	(33)	(28)	(39)	(35)	(41)
Differences						
Median income[d] ($)	600	−1,906	1,010	−850	−1,276	−650
Median net worth[e] ($)	4,450	1,500	5,400	550	500	644

[a]Standard deviations, multiplied by 100, are reported in parentheses.
[b]Income and poverty measures reported are from 1991 and only for respondents aged 62 in 1993 with valid information on pensions (574 total across all groups).
[c]Income and poverty measures reported are from 1993 and only for respondents aged 62 in 1993 with valid information on pensions (574 total across all groups).
[d]Change in median income is defined as the median of the differences between each household's wave 1 (1991) and wave 2 (1993) income. This is only reported for respondents aged 62 in 1993 with valid information on pensions (574 total across all groups).
[e]Change in median net worth is defined as the median of the differences between each household's wave 1 (1992) and wave 2 (1994) net worth.
Source: Burkhauser, Couch, and Phillips (1996).

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Discussion by Bruce D. Schobel

I never know whether to laugh or cry when college professors and others with comfortable jobs tell average Americans that they need to work longer. Maybe professors can work to any age they choose, but most people can't and apparently don't want to even if they could. Even healthy people don't seem to like their jobs very much—at least, not by the time they approach retirement age—and they retire as soon as they can afford to. Don't take my word for it; the data speak for themselves!

Mr. Burkhauser observes that the trend toward ever-earlier retirement in the U.S. has slowed or even bottomed out. Still, I would prefer to see the policy follow the trend rather than try to influence it. Also, we should at least be concerned that economic growth might not be sufficient to provide jobs for everybody, young and old alike. Few older people would want to continue working at the expense of younger workers who may be their own children and grandchildren.

Social Security allows people to retire at any age from 62 to 70 with—eventually—actuarially fair adjustments in benefits. In 1983, when the normal retirement age (NRA) was raised gradually to 67, the earliest eligibility age was kept at 62, reflecting Americans' actual retirement behavior. I much prefer keeping the freedom of choice provided under present law to a coercive system that tries to force people to retire later. What would happen in many cases is either people would retire when they planned to and just live off their savings until they reach Social Security's eligibility age or else they would apply for disability benefits, in the hope of receiving an unreduced benefit payable at any age. Neither result is desirable.

Policymakers tread very carefully around the subject of cutting Social Security benefits. Even when benefits must be reduced (to maintain the program's solvency, for example), it is done with great reluctance. Some people seem to believe that masking a benefit cut by calling it an increase in retirement age makes it more palatable. I believe that policymakers are not so naive. Cutting benefits will never be easy, no matter how we sugarcoat it. Taking away the opportunity to receive benefits at age 62 may be even more unattractive to workers, who would prefer to make their own choices in these matters.

Mr. Burkhauser makes two minor errors in his paper:

1. He says that "a major justification for [Social Security's] creation was to encourage older workers to leave the labor force." People who were there at the time, notably Robert Myers, reject this assertion. In particular, under the original 1935 act, retirement benefits would not have been paid until 1942; this nearly seven-year delay would have been a strange way to encourage older workers to retire!
2. He notes that a recent change in law will raise the annual exempt amount under the retirement earnings test to $30,000 in 2002. At that time, however, the new, higher amount will apply only to workers who are at least age 65½ (the NRA for workers attaining that age in 2002) and less than 70.