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Before the
U.S. Senate Committee on Finance
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Thank you, Mr. Chairman, Mr. Ranking Member, and all of the members of this distinguished committee. It is an honor to appear before you today to discuss the Social Security program -- a cornerstone of retirement security for millions of Americans -- and its relation to our larger fiscal challenges. My written testimony begins with some basics of Social Security operations before proceeding to a discussion of the program's projected financing shortfall.

Social Security Taxes, Trust Funds, Benefits and Financing Issues

Taxes: Under current law, the vast majority of financing for Social Security benefit payments is provided by a payroll tax upon covered wages. The total payroll tax rate is 12.4%.¹ Though nominally divided into two 6.2 point halves assessed respectively upon employer and employee, most economists agree that the entirety of the 12.4% tax is levied on the worker's wage compensation. Wage earnings subject to this tax, as well as any benefit credits based on those earnings, are both capped. This cap reflects Social Security's historical design as a floor of protection in the event of income loss due to old-age, disability, or death of a primary household wage earner. The current cap is \$106,800 annually, and is indexed to grow generally with the national Average Wage Index (AWI). In addition to payroll taxation, a much smaller amount of program revenue (about 3%) is generated via income taxation of Social Security benefits.

The Trust Funds: Beyond revenue generated from current taxation, further authority and resources to finance benefit payments are provided by the Social Security Trust Funds.² The economic significance of the Trust Funds is a source of persistent controversy. But though there is controversy over the Trust Funds' economic meaning, there is much less so over what the Trust Funds literally contain; specifically, special-issue Treasury bonds. These bonds are on the one hand real assets to the Social Security program, backed by the full faith and credit of the

¹ Recent legislation has temporarily reduced the payroll tax rate to 10.4%, with general revenues being used to restore the foregone revenue to the Trust Funds.

² There are separate Trust Funds for the OASI (Old-Age and Survivors) and DI (Disability) programs, though public discussions often refer to the combined operations of the Funds.

federal government, while on the other they are equally a real obligation of the general budget accounts. If we look at the bonds from the perspective of the Trust Funds, they are assets. If we look at them from the perspective of the unified federal budget, they are a net wash. The total amount of the Trust Funds, now roughly \$2.6 trillion, represents the interest-compounded value of past annual program balances, including the many years of surpluses since the 1980s.

Benefits: Americans tend to think of retirement benefits first when thinking of Social Security. This is understandable given that the majority of benefit payments (about 63%) are made to retired workers. But Social Security also provides for a number of other forms of benefits as well, including disability benefits, spousal benefits, and benefits for widows, widowers and survivor children. Although there are differences in the methods of computing benefits for these respective populations, they all hinge in some fashion on the basic retirement benefit formula. The total value of one's Social Security benefit is not solely a function of one's own contributions. One's benefit is instead a function of a formula written into the law. Social Security redistributes income in a variety of ways: from higher earners to lower earners; from shorter-lived to longer-lived; from two-earner couples to one-earner couples; and from younger generations to older ones, among other trends. An overriding problem we face is that the total amount of projected benefit obligations that would result under current formulas is significantly higher than the amount of revenues that the program would receive under current law. One way or the other, this imbalance between revenues and scheduled benefits must be corrected.

The financing shortfall: Specific measurements of Social Security's projected financing shortfall vary from report to report. I will focus primarily on the projections contained in the 2010 Social Security Trustees' report.³ The updated 2011 Trustees' report is scheduled for release later this week. As this committee is aware, the Congressional Budget Office has released more recent figures showing a further deterioration of near-term finances relative to the 2010 Trustees' projections. I will nevertheless draw upon the Trustees' report's projections for long-term finances because they contain some additional details about program operations, and because the Trustees' report embodies the projection mechanism sanctioned by the Social Security Act.

Social Security expenditures began in 2010 to exceed incoming program tax revenue for the first time since the last major Social Security repairs in 1983. CBO recently estimated the FY 2010 cash deficit to be \$37 billion; the Trustees' updated estimate is scheduled for release on May 13.⁴ Some of the cost growth that resulted in this deficit arose from the long-anticipated event of the large Baby Boomer generation beginning to enter retirement. The date of these annual deficits'

³ Although I currently serve as a Public Trustee, the 2010 report was published prior to my confirmation to serve.

⁴ CBO's 2011 projections are somewhat more complex due to the recently-enacted payroll tax rate reduction and accompanying general revenue transfers. In FY 2011, program tax income is expected to fall short of payment obligations by \$130 billion (the net unified budget impact), of which \$85 billion would be made up with general revenue transfers, resulting in a \$45 billion primary program deficit before interest payments are considered.

arrival was further accelerated by the recent recession, which both depressed payroll tax collections and stimulated additional benefit claims, especially disability benefit claims. For multiple reasons, therefore, Social Security is now experiencing cash-flow shortfalls earlier than anticipated in any Trustees' report issued since the 1983 reforms.

Despite this shortfall of tax income relative to benefit obligations, Social Security is still able to meet benefit payments due to the positive balance in its Trust Funds. We are currently in a somewhat unusual period in that the nominal balance of the Trust Funds continues to rise even as program tax income lags behind benefit obligations. This occurs because the annual interest credited to the Trust Funds, combined with the general revenues transferred to compensate for the temporary payroll tax reduction, together exceed the program's annual cash shortfalls. As a result, part of the general government accounts' annual payments of interest are now tapped immediately to pay current benefits, while the remainder adds to the balance of the Trust Funds.

Though the nominal balance of the Trust Funds is still rising, there are important caveats to bear in mind. One is that the combined Trust Funds' ability to finance benefits is already in decline, as evidenced by the combined Trust Fund Ratio having peaked at 358 in 2008.⁵ This is because the cost of paying benefits is rising proportionally faster than the Trust Funds' nominal value, resulting in a progressively shortening duration of the benefits the Funds can finance. Also, while interest payments and general revenue transfers increase the balance of the Funds, they do not reduce the unified budget deficit. Accordingly, Social Security operations are currently adding to the unified federal deficit and will add substantially more in the years to come.

By any measure, Social Security faces a significant long-term financing shortfall. The 2010 Trustees' report projected that the net excess of benefit obligations over incoming tax revenue over the following 75 years would equal \$7.9 trillion in present value. Even after \$2.5 trillion⁶ of general revenues is paid to redeem the assets in the Trust Funds through 2037, this would still leave Social Security with a 75-year shortfall of \$5.4 trillion. This shortfall further increases beyond the 75-year period.

Such summary figures over long spans of time are inherently imprecise and can obscure the more salient issue of program cost growth over time. As a number of bipartisan technical panels and advisory councils have noted, it is insufficient for Social Security merely to be in average balance over long spans of time, if that average aggregate balance consists of impracticable

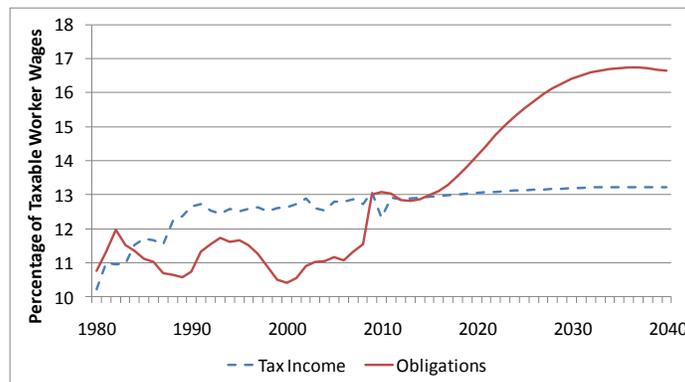
⁵ The Trust Fund Ratio (TFR) indicates the duration of benefit payments that can be financed by the Trust Funds. A TFR of 100 would mean that there are sufficient assets in the Trust Fund to finance one year's worth of benefits.

⁶ The Trust Funds' balance on January 1, 2010, the date used for the calculations in the 2010 Trustees' Report.

annual *imbalances* in different years of the valuation period.⁷ This is one reason why for over a decade now Social Security Administration evaluations of Social Security financing proposals have included measures not only of their averaged effects over 75 years, but also of whether they lead to sustainable annual program balances within the 75-year period.

Figure 1 shows the projected growth of annual program revenues and costs under current law as a percentage of each worker’s taxable wages, in comparison with rates over previous decades.⁸ The cost of paying Social Security benefits absorbed roughly 11.5% of such wages in 2008, on the eve of the recession and the retirement of the Baby Boom generation. Costs will grow dramatically over the next two decades, resulting in a cost rate of roughly 16.7% by the mid-2030s. In other words, the cost of paying benefits under existing formulas in this one program alone would amount to roughly one out of every six taxable dollars that American workers earn.⁹

Figure 1: Social Security Tax Income and Obligations
(2010 Trustees’ Estimates)



Under current law, this cost growth would mean dramatically rising pressures on the general budget from today through the mid-2030s. By 2020, annual program deficits would be larger,

⁷ In theory, program surpluses in some years could effectively offset deficits in other years if a foolproof mechanism could be established to ensure that excess revenues in surplus years were always saved. This has not been the case in practice.

⁸ “Obligations” on this graph include scheduled benefit obligations beyond 2037, even though due to projected Trust Fund depletion in 2037, benefits would under current law be suddenly cut by 22% in that year. More recent projections from CBO indicate that the small program surpluses projected in 2012-14 on this graph will not materialize. The Trustees are scheduled to update these projections later this week.

⁹ Under current law such costs would be met by a combination of payroll taxes, benefit taxes and general revenues.

relatively speaking, than in the program's so-called crisis years of 1977 and 1982, when urgent reforms were necessitated. Even if these rising costs were successfully shouldered within the general budget, Social Security benefits would still be suddenly cut by 22% in 2037 due to Trust Fund exhaustion in the absence of a legislative correction.

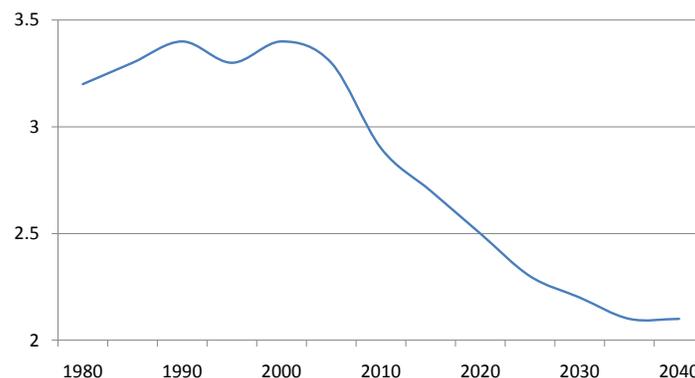
Why Social Security Costs Grow

The rapid cost growth projected through the 2030s is predominantly a function of three factors:

- 1) The aging of the population;
- 2) Pay-as-you-go financing;
- 3) The current Social Security benefit formula.

Social Security costs will grow, first, because there will be many more beneficiaries to support. In 2008, the total number of Social Security beneficiaries topped 50 million for the first time. There were 3.2 taxpaying workers to support each beneficiary, the same ratio that existed in 1975. But these numbers are changing dramatically as the Baby Boomers leave the ranks of workers to join the ranks of retirees. The 2010 Trustees' report projected that there will be 90 million beneficiaries by 2036, and only 2.1 taxpaying workers to support each beneficiary.

Figure 2: Ratio of Workers to Beneficiaries
(Past and Projected)

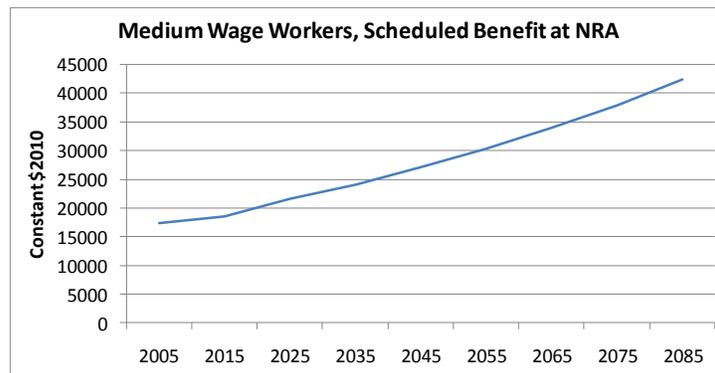


The second reason that costs rise is that the program is financed on a pay-as-you-go basis. Benefits are paid from tax contributions made by current workers, rendering program finances very sensitive to changes in the worker-collector ratio. If, hypothetically, Social Security had

been constructed as a savings program -- in which each generation always constrained its own consumption and put aside savings sufficient to fund the entirety of its own future benefits -- its finances would be less susceptible to demographic shifts. Instead, Social Security has been operated on a pay-as-you-go basis in the sense that workers' tax contributions are not saved. Most of these contributions finance current benefit payments, while any surplus finances ongoing federal government consumption. The consequence is that the entire rising cost of paying benefits shown on Figure 1 must be met by future contributing taxpayers.

The third reason that costs rise is rooted in program amendments in the 1970s. It was then that a benefit formula was put in place that pegs the growth of initial benefit payments to increases in the national Average Wage Index (AWI). The rationale behind this benefit formula was to maintain constant "replacement rates" -- i.e., benefits as a percentage of pre-retirement wages. Because wages tend to grow faster than prices over time, this formula results in the payment of higher benefits, relative to inflation, to younger generations of retirees.

Figure 3: Growth of Initial Benefit Payments Relative to Inflation



It is the combination of these three factors that causes Social Security costs to grow faster than the underlying tax base. An equation may be helpful in understanding this phenomenon. Under a financing method like that in Social Security, the following equation governs:

(Per-capita benefits as a % of worker wages)

$$\frac{\text{Per-capita benefits as a \% of worker wages}}{\text{Ratio of workers to beneficiaries}} = (\text{Worker tax burden, as a \% of wages})$$

(Ratio of workers to beneficiaries)

Accordingly, if the ratio of workers to beneficiaries declines, then tax rates must rise to fund benefits that grow as rapidly as wages. Alternatively, to avoid a tax increase as the population ages, per-capita benefits must grow more slowly than wages. With our demographics we can afford a rate of per-capita benefit growth somewhat faster than price inflation, but not as fast as wage growth, without raising taxes. This benefit growth in excess of inflation will no longer be affordable within stable tax rates, however, after several more years of legislative inaction.

The Costs of Delay for Program Participants

Were a solution enacted today, we could repair Social Security's projected shortfall while facing comparatively benign choices. We would be able to honor current benefit obligations to those now in retirement and on the verge of retirement. We could ensure that future retirees receive benefits that are at least as high as today's retirees receive relative to inflation, and we could do so without a tax increase. This would still require changes to the current benefit formula and might not be everyone's preferred solution. Some others might argue to raise taxes even under a solution enacted today, so as to fund the full rate of benefit growth projected under the current formula, or something closer to it. The point remains, however, that if we act today we needn't necessarily raise taxes on workers, nor must we compel future retirees to accept a standard of living in retirement that is lower than for today's retirees.

Now let us examine the opposite extreme; the worst-case scenario. Suppose that we do nothing at all. Each year from now until the 2030s, burdens on taxpayers would grow. By the mid-2020s, in addition to the 12.4% Social Security payroll tax, taxpaying workers would need to finance another \$200 billion a year (in \$2010) in Trust Fund bond redemptions just to keep full benefits flowing. By the 2030s, these additional annual obligations would be over \$300 billion. As previously mentioned, the total cost of paying benefits would amount to fully one out of every six taxable dollars earned by workers by the 2030s. And even after that, the Trust Fund would still be exhausted in 2037, causing a sudden 22% reduction in benefit payments.

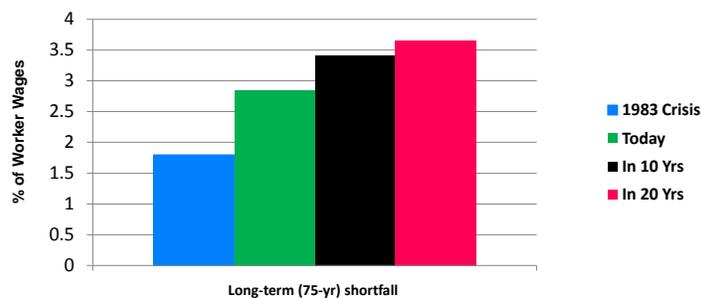
Dire though this scenario is, it actually understates the costs of inaction as they are felt in a practical sense. Further costs of delay arise because we have a fairly firm bipartisan consensus that we should not cut benefits for people who are already receiving them. The 22% benefit reduction just referred to assumes we would be willing to allow benefits for a 95-year-old widow in 2037 – someone who is already collecting benefits today in 2011 – to be suddenly and dramatically cut. This is very unlikely. In practice, any changes we make to our cost obligations will likely only prospectively affect future retirees, not those already retired.

And so we need to run this thought experiment again, and to ask how deep the cuts would have to be in 2037 if limited to new retirees. When we do so, it turns out that in 2037 the program still wouldn't be in balance even if 100% of benefit payments to that year's new retiree class were eliminated. This outcome also appears implausible. And so one must start working through the problem backwards from 2037 and ask, "How soon would any changes have to begin so that they don't result in disruptive cuts for those already retired, and do not produce unprecedented Social Security tax burdens?" The answer is: quite soon. If we don't want to raise worker taxes or to change benefits for those within five years of retirement, we probably need to legislate in the next couple of years. Beyond that, we likely must raise taxes substantially or affect those closer to retirement.

There is another very important practical reason why delay is potentially threatening to Social Security's long-term viability as a self-financing program. It is simply very challenging to bring opposing perspectives together around a common plan of action that involves either tax increases or reductions in the growth of scheduled benefits. It only gets harder to do so with delay, as the required adjustments for affected generations grow larger.

In 1983, the program came within mere months of insolvency and an interruption of vital checks to beneficiaries. That was with both parties agreeing on the immediacy of the problem, and on the dire consequences of failure. Many people do not realize, due to a subsequent change in the Trustees' accounting methods adopted in 1988, that the long-term Social Security shortfall we now face is much larger than the one corrected in 1983 – more than 50% larger if measured by the same methods in use then. By 2021, it will be more than 90% larger, and by 2031 more than twice as large. See Figure 4.

Figure 4: The Growing Social Security Shortfall



Source: Annual Trustees' Reports, using 1983 actuarial methodology

Even this illustration, however, may understate the adverse consequences of delay if our goal is a bipartisan solution that preserves Social Security's continued operation as a self-financing system enjoying special budgetary protections. If we delay long enough, our long-term problem will become a short-term crisis. Moreover, it will be a short-term crisis that utterly dwarfs the one that was solved with considerable difficulty in 1983.

The 1983 reforms involved intensely controversial immediate measures, including a delay of COLAs, a new imposition of income taxation upon Social Security benefits, an acceleration of a payroll tax increase, and bringing federal employees (and their payroll tax contributions) into Social Security. These difficult changes together altered system finances by roughly 0.84% of worker wages annually over the following ten years, on average. If going forward we were to wait as much as twenty years before acting, legislation would need to impose immediate sacrifices upon workers and beneficiaries more than *three times* as great as in the 1980s -- even in a relative sense -- simply to preserve system financing in the short-term. Given the difficulties of enacting even the 1983 reforms, it is highly doubtful that this could be achieved.

Some Common Objections to Social Security Reform

Before I close, Mr. Chairman, I would like to address some of the objections often raised against taking action to repair Social Security finances.

One objection that received attention for some time was the argument that the Trustees' Social Security projections were overly conservative; that we shouldn't implement unnecessarily severe measures when much of the problem was likely to fade by itself under more optimistic projections. With Social Security finances in much worse shape today than any of the Trustees, CBO, OMB or GAO had previously projected, this is now asserted much less frequently than was recently the case. But it was actually never true. The Trustees' projection history since 1983 is actually one of generally consistent accuracy, and their errors have tended to be slightly more on the financially optimistic side of the line than on the pessimistic side of the line. Moreover, there was not a single projection scenario within the entire 95% confidence band of the Trustees' 2010 analysis in which the program would not become insolvent.

Today, it is also sometimes said that Social Security is not a significant contributor to the larger federal deficit. First, an important factual point: the Social Security imbalance is the largest contributor to long-term deficits within any federal spending program other than Medicare or Medicaid. Over the next ten years, according to CBO's latest projections, not only will Social Security be running substantial cash deficits, and will involve more expenditures than any other

single federal program, but its aggregate cost growth will exceed that of either Medicare or Medicaid.¹⁰ But even if Social Security weren't a significant contributor to long-term deficits, this would not render corrective action unimportant: whether the rest of the budget is in surplus or in deficit, Social Security -- if it is to remain self-financing -- must be brought into balance. And the earlier that we repair Social Security's imbalance, the better off Social Security participants will be, and the stronger the program will be.

Finally, it is sometimes said that we should not take action to resolve the Social Security imbalance because doing so would cause harm to people on Social Security. I would respectfully submit that this is not true. Right now, there is a substantial imbalance between what the program is promising beneficiaries and the resources it will have available to pay benefits. One way or the other, that imbalance has to be resolved; the government cannot send out the checks without in some way producing the revenue to do so. Thus, a failure to act is simply a failure to disclose to the affected parties how this imbalance will ultimately be resolved.

Conclusion

My conclusion is best summarized by some sentences from an article I was recently privileged to co-author with Robert Greenstein of the Center on Budget and Policy Priorities. "Social Security faces a significant shortfall, which policy makers would be better off addressing sooner rather than later. Reasonable and well-intentioned people will have differences over the best way to resolve the Social Security shortfall. We share a common interest, however, in taking action to do so at the earliest possible time."

¹⁰ See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, p. 58.