U.S. SENATE COMMITTEE ON

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Opening Statement of U.S. Sen. Chuck Grassley of Iowa
Chairman, Senate Committee on Finance
Hearing on Social Security: Achieving Sustainable Solvency
Wednesday, May 25, 2005

Today's hearing is the third in a series of hearings on Social Security.

The first hearing focused on the long-term outlook for Social Security. The second focused on plans to achieve sustainable solvency, with and without individual accounts. Today's hearing will focus on a menu of options to achieve sustainable solvency, and address the potential payroll "tax gap."

The menu of options was developed by the Congressional Budget Office. However, I requested CBO to score each item on the menu to reflect the economic and demographic assumptions in the latest Social Security Trustees report.

I made this request for two reasons. First, the Social Security Trustees are required by law to report each year on the actuarial status of Social Security. I do not believe we want to adopt a reform plan based on more optimistic CBO assumptions only to have the Trustees tell us in their next report that we did not accomplish our intended goal.

Second, when it comes to Social Security, I believe we should always err on the side of caution. Using overly optimistic assumptions is exactly what brings us here today.

Social Security was enacted in 1935 and began paying monthly benefits in 1940. Over the next three and a half decades, Congress expanded coverage and increased benefits on an ad hoc basis.

By the late 1960s, there was growing interest in adopting automatic cost-of-living adjustments. But, there was a significant impediment to doing so. Since 1935, the actuaries who prepared long-range cost estimates for Social Security had utilized an actuarial technique known as the "level earnings assumption."

Basically, the actuaries assumed wages would remain fixed at their current level forever into the future. In 1935, that was not an unreasonable assumption. Indeed, wages in 1935 were still below the level that had prevailed in 1920.

The actuaries believed this assumption imposed a measure of fiscal discipline and provided a cushion against unanticipated events. Congress was willing to go along because, as time passed and wages grew, it was able to periodically dispense the "windfall" in the form of

higher benefits.

Despite the availability of such windfalls, critics began to suggest a new approach was needed. They pointed out that rising inflation imposed an undue burden on Social Security beneficiaries who were forced to wait on Congress to enact a benefit increase. The proposed solution was an automatic cost of living adjustment.

The idea of indexing benefits to prices, or even wages, had been contemplated for several years. But, the implementation of an automatic benefit increase was incompatible with the level earnings assumption. Any long-range projection based on rising benefits and level wages would show large and growing deficits.

So, critics began a campaign to discredit the level earnings assumption and adopt "dynamic assumptions." This campaign led to the 1969-71 Advisory Council recommendation that Social Security projections be based on the assumption that earnings would rise in the future.

By adopting dynamic assumptions, Social Security suddenly appeared to have a significant surplus. But, unlike the windfall that resulted from an actual wage increase, the surplus under dynamic assumptions was merely assumed.

Nevertheless, several members of Congress seized on the Advisory Council's recommendation and urged an immediate 20 percent across-the-board increase, accompanied by automatic benefit increases thereafter.

Bypassing the normal committee process, an indexing amendment was offered on the Senate floor to a "must pass" bill increasing the statutory debt limit. It passed overwhelmingly in June of 1972.

The congressional debate that preceded passage of the indexing amendment focused on keeping benefits up with inflation. For those who were already collecting benefits, the amendment delivered as promised. But, for those who were not yet receiving benefits, the amendment had an entirely different effect. Depending on the relative change in wages and prices, initial benefits for newly eligible recipients would rise faster than prices or even wages.

This critical distinction between initial benefits and subsequent benefits might have gone unnoticed for years, but economic and demographic forces soon intervened to reveal the formula was flawed and the goal of wage-indexing was no longer affordable at the scheduled payroll tax rate.

The 1972 amendment was based on two assumptions: that wages would rise nearly twice as fast as inflation, and the number of births would remain near the baby-boom level. Under these two conditions, initial benefits would rise in line with wages, and there would be plenty of workers to support each beneficiary, without raising the payroll tax beyond 12.5 percent.

However, the decade of the 70's saw rising inflation and the end of the baby boom. The flawed formula caused benefits to rise faster than wages and the declining birth rate resulted in a projected decline in the ratio of workers to beneficiaries. As a result, the Social Security Trustees began to report ever-rising deficits.

In response to these Trustees' reports, the Senate Finance Committee and the House Ways and Means Committee requested the appointment of an independent consultant panel to examine the problem and develop alternatives.

The panel issued its report in 1976 and recommended that Congress index initial benefits to prices, instead of wages. But, advocates for higher benefits sought to replace the flawed '72 formula with another wage-indexing formula that was less erratic and unpredictable.

Ironically, the flaw of the '72 formula became its biggest asset. Between 1972 and 1977, the projected cost more than doubled from 12 percent to 24 percent of taxable wages. Advocates of wage-indexing sought to portray their version of wage-indexing as a significant savings because it cost "only" 18 percent of taxable wages.

Advocates of wage-indexing persuaded Congress to adopt their plan in 1977 by simultaneously arguing that it was cheaper than current law and more generous than price-indexing.

The fact that changing demographics had rendered the promised level of wage-indexed benefits unaffordable at the scheduled payroll tax rate did not seem to matter. Advocates dismissed the projections of future deficits by suggesting economic and demographic changes might solve the problem. If not, Congress would have plenty of time to think of something.

Well, here we are today still tying to think of something. Members of this Committee will no doubt find the menu of options presented by our witnesses today less than appetizing. They are welcome to put their own options on the table, and we will consider them. But, the time has as come to address this issue.

Let me conclude by sharing with you the admonition given to this Committee by the consultant panel in 1976: "This Panel gravely doubts the fairness and wisdom of now promising benefits at such a level that we must commit our sons and daughters to a higher tax rate than we ourselves are willing to pay."