CBO TESTIMONY

Statement of
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on
Social Security Financing

before the
Committee on Ways and Means
U.S. House of Representatives

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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Tuesday, November 9, 1999.

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Mr. Chairman, Congressman Rangel, and Members of the Committee, I appreciate this opportunity to appear before you today to discuss Social Security financing and the President's recent proposal to extend the solvency of the Social Security trust funds.

My testimony focuses on several major themes:

- Financing the nation's current promises to the elderly will require a major reallocation of society's resources once the baby-boom generation has retired.

- A strong and growing economy will make it easier to fulfill pledges to Social Security and Medicare recipients, but it is not the entire solution.

- Although government trust funds arguably have some value as an accounting mechanism, their projected solvency does nothing to ensure that economic resources are available to cover program costs.

- The President's proposal to transfer general revenues to the Social Security trust funds would extend the funds' solvency from an

accounting point of view but would not alter the underlying long-run imbalance between total federal revenues and spending.

- Changes in the budget process do not eliminate the need for substantive policy action.

THE CURRENT OUTLOOK

This past summer, the Congressional Budget Office (CBO) projected that under current law, the federal government would accumulate total surpluses of about $3 trillion over the next 10 years. About two-thirds of those surpluses come from Social Security revenues that exceed the program's spending. Two important caveats apply to these projections:

- First, demographic and economic forces already in place are expected to erode the surpluses, renewing the federal government's fiscal imbalance of previous years. CBO's long-term projections indicate that under current policies, federal deficits will return by the time the baby boomers have fully retired, causing the federal debt and its

corresponding interest costs to escalate rapidly as a percentage of national income.

- Second, deficits will reappear even earlier if the government spends more or taxes less than CBO projects. Developments since CBO's July update to *The Economic and Budget Outlook: Fiscal Years 2000-2009* suggest that the Congress and the Administration may identify more pressing priorities—increasing spending or reducing taxes—that conflict with devoting the entire projected surplus to retiring the federal debt.

The projected long-range fiscal shortfall is associated with three phenomena: the aging and eventual retirement of the baby-boom generation; increased life expectancy, which will lengthen the time people spend in retirement; and escalating per capita medical costs. Under the intermediate assumptions of the Social Security trustees, the number of elderly Americans increases by 80 percent over the 2010-2030 period while the population ages 20 to 64 grows by only about 2 percent. Those diverging growth rates mean that by 2030, there will be only two workers for every Social Security recipient compared with today's ratio of 3.4 to 1 (see Figure 1).

With demographic trends such as those, federal programs for the elderly will consume a sharply increasing share of national income and the federal budget (see

Figure 2). The trustees project that spending for Social Security and Medicare as a percentage of gross domestic product (GDP) will rise from 7 percent in 1998 to almost 12 percent in 2030. Using similar projections, CBO expects that in 2030, the programs will constitute about 55 percent of total federal spending excluding interest, compared with about 35 percent in 1998 (see Figure 3). In addition, the Medicaid program will experience severe budgetary pressures in meeting the long-term care needs of increasing numbers of elderly people. Indeed, the ramifications of such demographics extend well beyond the federal budget to labor markets, private pensions, housing, and other sectors of the economy.

Social Security and Medicare compete with other federal programs for the government's resources, and that competition will become more acute over time. By 2014, Social Security benefits will outstrip payroll tax collections. Twenty years later, annual earmarked revenues will cover only about 70 percent of promised payments. The gap between revenues and benefits in 2030 is estimated at 1.8 percent of GDP, or about $160 billion in today's economy. An even larger shortfall—2.7 percent of GDP—is estimated for Medicare in that year. Addressing projected deficits of those magnitudes will require some combination of tax increases, benefit reductions, and cuts in other federal spending.

If left unchecked over many years, the budgetary pressures posed by an increasingly elderly population and burgeoning medical costs will lead to economic problems, because the resulting deficits crowd out private investment, slowing the growth of capital and output. High deficits would retard long-term economic expansion beyond the slowing of labor and capital growth that would occur in any case as people retire and draw down their savings. Thus, inaction on the budgetary problems associated with the population's aging risks a future drop in U.S. living standards.

PREPARING FOR THE FUTURE

A strong and growing economy provides funds for the services that the federal government supplies. To fulfill the nation's promises to Social Security and Medicare beneficiaries, the government must acquire resources (through taxation or borrowing repaid by future taxation) from existing production when benefits are due. That is, in 2030, as in any year, pledges to the elderly as well as other federal priorities such as national defense, assistance to state and local educational agencies, public health services, and transportation projects will require the government to draw on economic production available at that time.

Additional capital accumulation, enhanced productivity, and increased work effort could help build a larger economy in the future. By implementing policies that promote capital accumulation, the nation could boost both its productive capacity and its wealth and essentially help prefund future consumption. But adding to the supply of capital requires less current consumption in exchange for more national saving and investment. One direct approach to increasing national saving is for the federal government to run annual budget surpluses. Strategies to encourage private saving might accomplish the same objective.

Economic growth would expand the capacity to fund future Social Security benefits and other federal commitments, and a larger economy could ease the transfer of additional resources to retirees. Strong growth swells revenues and reduces interest costs, improving the overall outlook for government budgets. Yet despite those benefits, growth is unlikely to eliminate fully the imbalances of the current Social Security program. The reason is that economic growth generally increases real (adjusted for inflation) wages, and under the current benefit formula, higher wages subsequently translate into higher Social Security benefits. Therefore, although the nation might be wealthier, it would still face a sharp increase in the budgetary resources necessary to pay for the Social Security and health care costs of the baby-boom generation during retirement.

The federal government's trust funds, including Social Security, are not trust funds in the usual sense but accounting mechanisms. They record the income from Social Security taxes, the expenditures for Social Security benefits, and interest that accrues on the difference. Private trust funds preserve assets for future use. Government trust funds do not do that because the government does not have financial assets to preserve. On the contrary, it currently owes the public $3.6 trillion. The government’s ability to pay Social Security benefits depends ultimately on the total financial resources of the government—not on the balances attributed to the trust funds.

For much of its history, Social Security has been financed on a pay-as-you-go basis—current payroll tax collections fund current benefits. In recent years, however, tax collections have exceeded outlays, and trust fund balances have begun to mount. The Treasury credits a trust fund with nonmarketable special-issue bonds whenever the fund’s income exceeds outgo; it redeems those securities whenever the fund's current income cannot cover current expenditures. To get cash for redemptions, the Treasury uses tax revenues or borrows money from the public.

In 1999, Social Security tax revenues exceeded benefits by about 14 percent. Moreover, interest and other intergovernmental payments boosted trust fund income

so that the funds' total holdings grew by $125 billion, bringing total Social Security balances to $865 billion. Projections show those balances rising steadily over the next two decades, peaking at $4.5 trillion at the beginning of 2022 and then diminishing until the balances are exhausted in 2034. But the existence or absence of trust fund balances bears no relationship to Social Security's obligations or to the country's ability to fund benefits. The true obligations of the program are defined by its benefit structure and what the nation has promised to provide. As the President's budget states, "[T]he existence of large trust fund balances . . . does not, by itself, have any impact on the government's ability to pay any benefits."

Even as an accounting device, the Social Security trust funds leave much to be desired because the assets credited to those funds would cover only a small share of the future benefits promised under Social Security's current benefit structure. By contrast, a private pension plan is required to fund benefits on an accrual basis (as the benefit rights are earned); otherwise, solvency of the plan would depend on the uncertain viability of the plan's sponsor. Arguably, government retirement programs need not be held to the same standard because the government may extract the resources it needs to pay benefits by exercising its sovereign power to tax. If Social Security operated like a private pension plan—that is, it kept enough reserves on hand so that if the plan terminated and no new contributions were received, it could still pay all accrued benefits—its unfunded liability would total $10.4 trillion.

Another frequently cited measure bases the Social Security program's unfunded liability on the future revenue from and benefits to the population currently 15 years of age or older. The unfunded liability in that case would be $8.7 trillion. However, if the calculation assumed that revenues and benefits over the next 75 years continued as under current law, the estimated unfunded liability would be $3.1 trillion. From the narrow perspective of trust fund accounting, crediting the Social Security trust funds with a one-time infusion of government securities could eliminate the fund's solvency problem. But such an action does nothing to resolve the long-term problem of acquiring the resources necessary to meet benefit commitments.

Trust fund accounting practices have exerted an important influence on program financing and have at times signaled the need for corrective action. In 1983, the imminent depletion of the Old-Age and Survivors Insurance Trust Fund compelled the Congress and the Administration to agree on tax and benefit changes that restored balance in the program into the 21st century. Similarly, projected shortfalls in the Hospital Insurance portion of Medicare have spurred legislative action over the past two decades, with the Balanced Budget Act of 1997 being the latest installment. In contrast, growing trust fund balances could provide a sense of security unwarranted by underlying long-range fiscal conditions.

President Clinton recently proposed extending the solvency of the Social Security trust funds through 2050 by providing transfers from the general fund. The plan, which does not change the program's tax or benefit structures, differs from the Social Security framework in the President's budget because it does not include equity investments, Universal Savings Accounts, additional discretionary spending, or specific transfers to Medicare. It contains changes in Congressional procedural rules to make it more difficult to create on-budget deficits or to diminish on-budget surpluses. The proposal would impose no requirements on the Administration, such as submitting a federal budget without an on-budget deficit. Nor does it include any enforcement mechanisms such as sequestration. The plan also does not make the new Social Security transfers conditional on achieving actual surpluses, either in the on-budget portion or in the total budget.

The President's plan has been introduced as H.R. 3165 and contains the following main provisions:

- An amount equal to the interest on the cumulative Social Security surpluses from 2000 to each year during the 2011-2016 period would be credited to the Social Security trust funds. Those transfers would be added to the interest credited to the trust funds under current law.

Social Security program actuaries estimate that such credits for the six-year period would total $951 billion.

- For each year from 2017 to 2044, the annual credit would equal the amount transferred in 2016.

- The points of order relating to Social Security in the Deficit Control Act would be extended through 2014.

- Any future legislation that decreased the new transfers to Social Security could not be credited as savings in pay-as-you-go calculations.

- A new point of order would be created to discourage any legislation that reduced on-budget surpluses or increased on-budget deficits.

- The President proposes to reserve one-third of the on-budget surplus that CBO projects for the 2000-2009 period to enhance Medicare solvency or provide a Medicare prescription drug benefit. A new point of order would be established to further that goal.

- o The discretionary spending caps, with some increases, would be extended through 2014. Pay-as-you-go enforcement procedures would be extended through that year as well.

The Social Security actuaries estimate that on paper, the credits proposed by the President would postpone the trust funds' exhaustion from 2034 to 2050. The proposal would achieve that extended solvency without changing outlays or revenues of either Social Security or the budget as a whole. The President argues that the new accounting will reserve a portion of the on-budget surplus and make it more difficult to use those funds for most other purposes. (The two exceptions are transfers to Medicare and a new Medicare prescription drug benefit.) In effect, the proposal would commit future general revenues—to redeem the additional trust fund balances—when the funds are needed to meet obligations to future retirees.

Using general revenues to fund a portion of Social Security costs is not a new idea. The Social Security Amendments of 1983 contained a number of transfers, including payments for military wage credits and temporary payroll tax credits for wage earners and the self-employed. The general fund transfers under the President's plan, however, would be much larger than previous transfers, equaling one-sixth of total Social Security outlays during the 2011-2015 period.

Nor are the proposed transfers under the President's plan unique among recent Social Security proposals. Many other plans include general revenues as an element of a more fundamental restructuring of the Social Security program. For example, H.R. 1793, sponsored by Representatives Kolbe and Stenholm, would gradually scale back benefits but would also create payments from the Treasury to the trust funds. Under recent proposals by Martin Feldstein of Harvard University, the Treasury would transfer funds on the basis of assumptions about corporate income taxes. Another proposal earlier this year by Chairman Archer and Representative Shaw would essentially introduce general revenue funding for Social Security. Under that plan, income taxes equal to 2 percent of wages would go to individual accounts; when people were ready to collect benefits, the government would recoup those revenues and transfer them to the Social Security trust funds. (The proposals would redirect general funds much sooner than the President's plan.)

Shoring up government accounts such as the Social Security trust funds is often confused with maintaining fiscal soundness. For example, Medicare's Supplementary Medical Insurance (SMI) Trust Fund is frequently referred to as "actuarially sound" because the underlying law requires payments from the general fund of the Treasury to cover any costs not financed by enrollees' premiums. Thus, SMI may meet certain accounting standards for soundness, but those measures may have little relevance to the program's viability in the long run.

Assessing viability requires examining a program's resource requirements and society's willingness to provide those resources out of future production. Proposals like the President's to redirect general revenues to the Social Security trust funds address the narrow issue of trust fund solvency but not the broader one of overall fiscal soundness. Adding to the trust fund balances does nothing to ensure that the necessary economic resources will be there to support the programs; it simply shifts money from one government pocket to another. In fact, by relieving the most visible symptom of the program's fiscal distress, additional transfers from the general fund may lull the nation into overlooking the funds' less obvious problems. Such transfers could reduce the fiscal discipline imposed by the trust fund accounting mechanism and make it easier to delay the spending and revenue changes necessary to sustain the program in the long run.

BUDGET-PROCESS CHANGES AND SOCIAL SECURITY

The President's Social Security legislation is the latest in a set of proposals designed to ensure that publicly held federal debt shrinks by at least the amount of the Social Security surpluses. Like the other budgetary mechanisms proposed during this Congress—the so-called lockboxes—the new procedural hurdles that the President proposes would limit Congressional action on future legislation that might reduce projected on-budget surpluses. Advocates of such mechanisms argue that making it

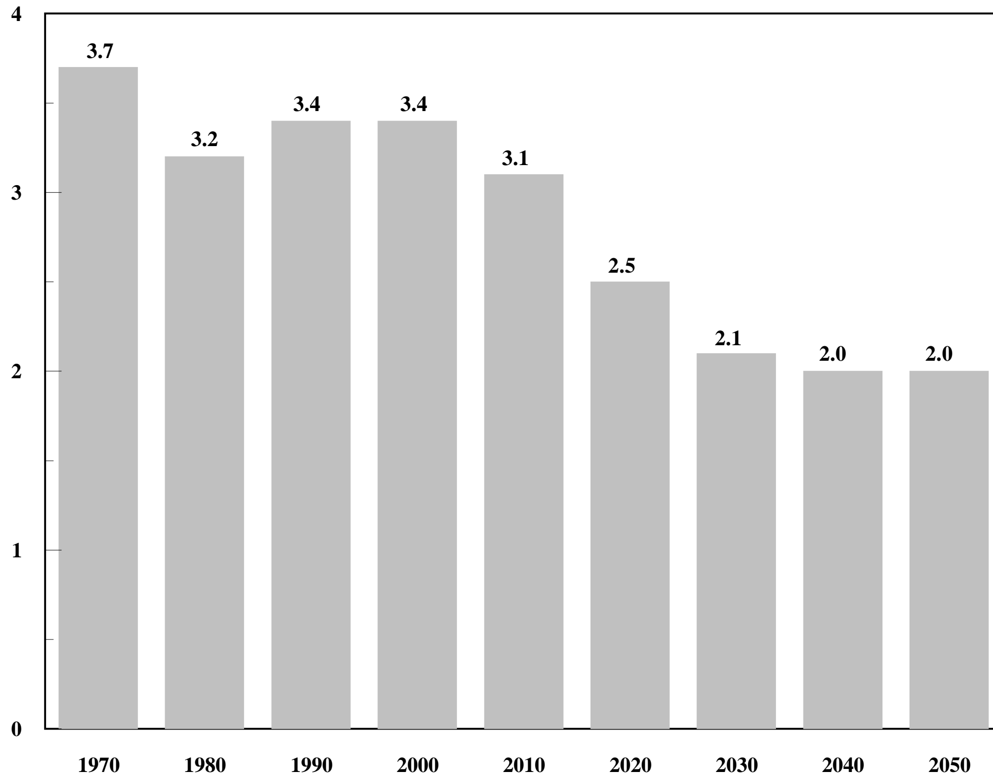
more difficult for future Congresses to increase spending or reduce taxes would help prevent the erosion of recent improvements in the budget's bottom line. The perceived need for such constraints reflects the view that the federal government finds it difficult to operate effectively with persistent surpluses. Unless the mechanisms actually influenced behavior, however, they would have no direct effect on taxes and spending or on the economy. Nor would they ensure that the stated goal of debt reduction was, in fact, achieved.

CONCLUSION

Addressing the long-term budgetary impact of Social Security and Medicare outlays requires making difficult choices about the federal government's tax and spending policies. What are fair and appropriate levels of benefits for the elderly? How are the costs for those benefits best allocated among workers of different generations? Should benefit formulas for Social Security be scaled back, should eligibility criteria be tightened, or should Medicare reimbursement practices be made less generous? Should tax increases be scheduled to raise additional revenue? Plans that shift funds from one government pocket to another do nothing to address those programs' actual financing problem—the underlying imbalance between federal spending and taxes—and in fact could postpone corrective action.

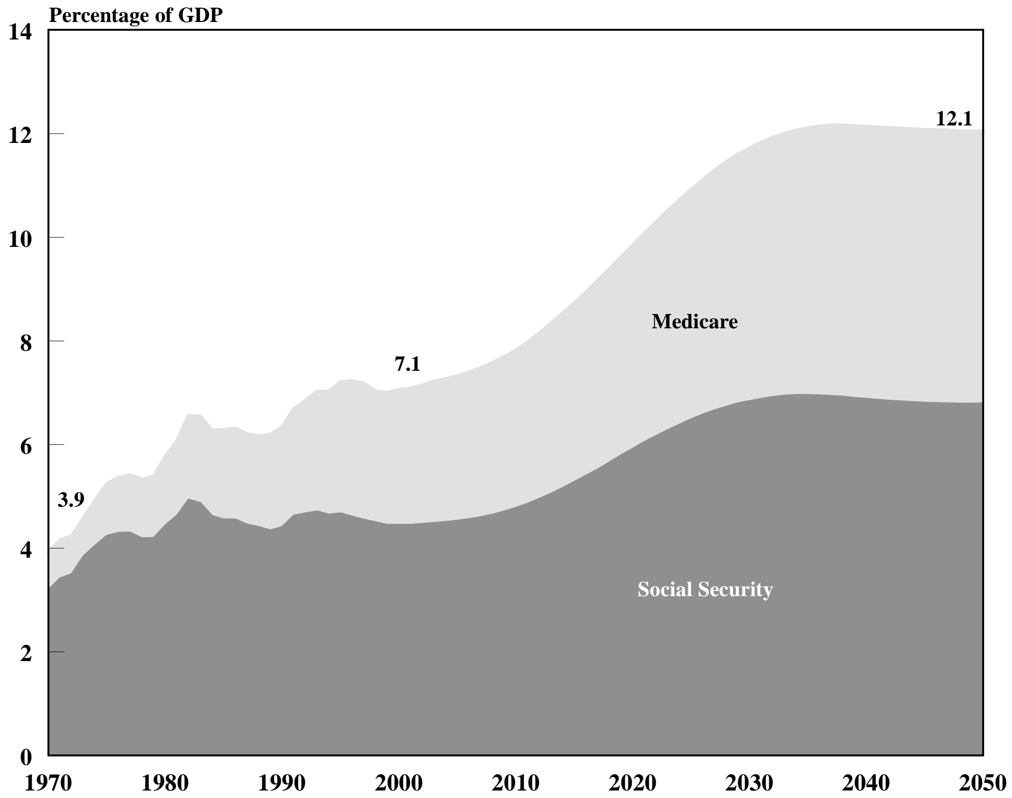
Such a postponement would have implications beyond those for the federal budget. Changes enacted in the near future need not be as drastic as the changes that would be necessary if action was delayed. The promises made under such programs as Social Security and Medicare are often a substantial part of people's financial arrangements for the future. By announcing significant policy changes well before their actual effects would be felt, the federal government would allow people to plan more effectively for their retirement.

FIGURE 1. NUMBER OF WORKERS PER SOCIAL SECURITY BENEFICIARY



SOURCE: Congressional Budget Office based on Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *Annual Report* (1999).

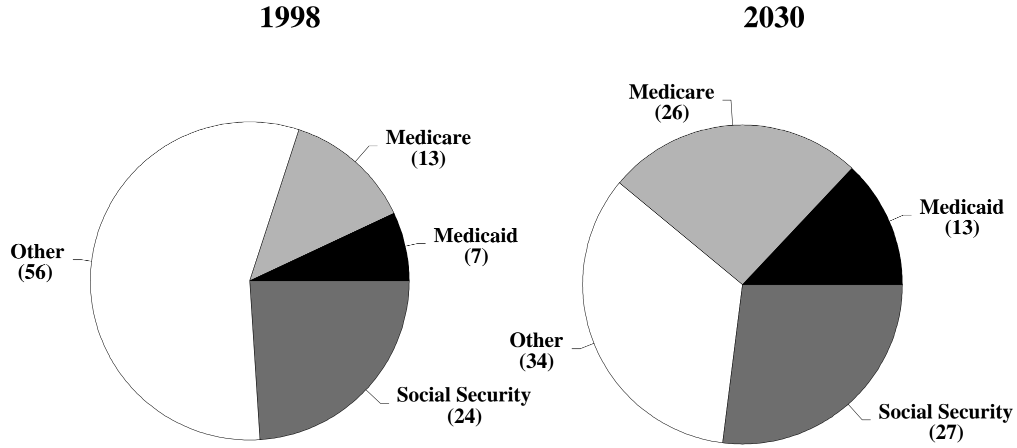
FIGURE 2. SOCIAL SECURITY AND MEDICARE SPENDING



SOURCE: Congressional Budget Office based on Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *Annual Report* (1999); and Board of Trustees of the Federal Hospital Insurance Trust Fund, *Annual Report* (1999).

NOTE: GDP = gross domestic product.

FIGURE 3. SOCIAL SECURITY, MEDICARE, AND MEDICAID SPENDING AS A PERCENTAGE OF NONINTEREST FEDERAL EXPENDITURES



SOURCE: Congressional Budget Office.

NOTE: Based on measures from the national income and product accounts.