

# **CBO TESTIMONY**

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**Statement of  
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Director**

## **Social Security: The Challenges of an Aging Population**

**before the  
Special Committee on Aging  
United States Senate**

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WASHINGTON, D.C. 20515**



Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you to discuss the Social Security program. The Social Security Act of 1935, enacted in the midst of the Depression, is widely seen as one of the most important legislative accomplishments in U.S. history. Since then, Social Security has grown to become by far the largest federal program. Over the next 30 years, the retirement of the baby-boom generation will pose new challenges for the Social Security program, the federal government, and the U.S. economy.

The Congressional Budget Office (CBO) has examined those challenges in a new report, *Social Security: A Primer*. My testimony today summarizes that report and will make the following major points.

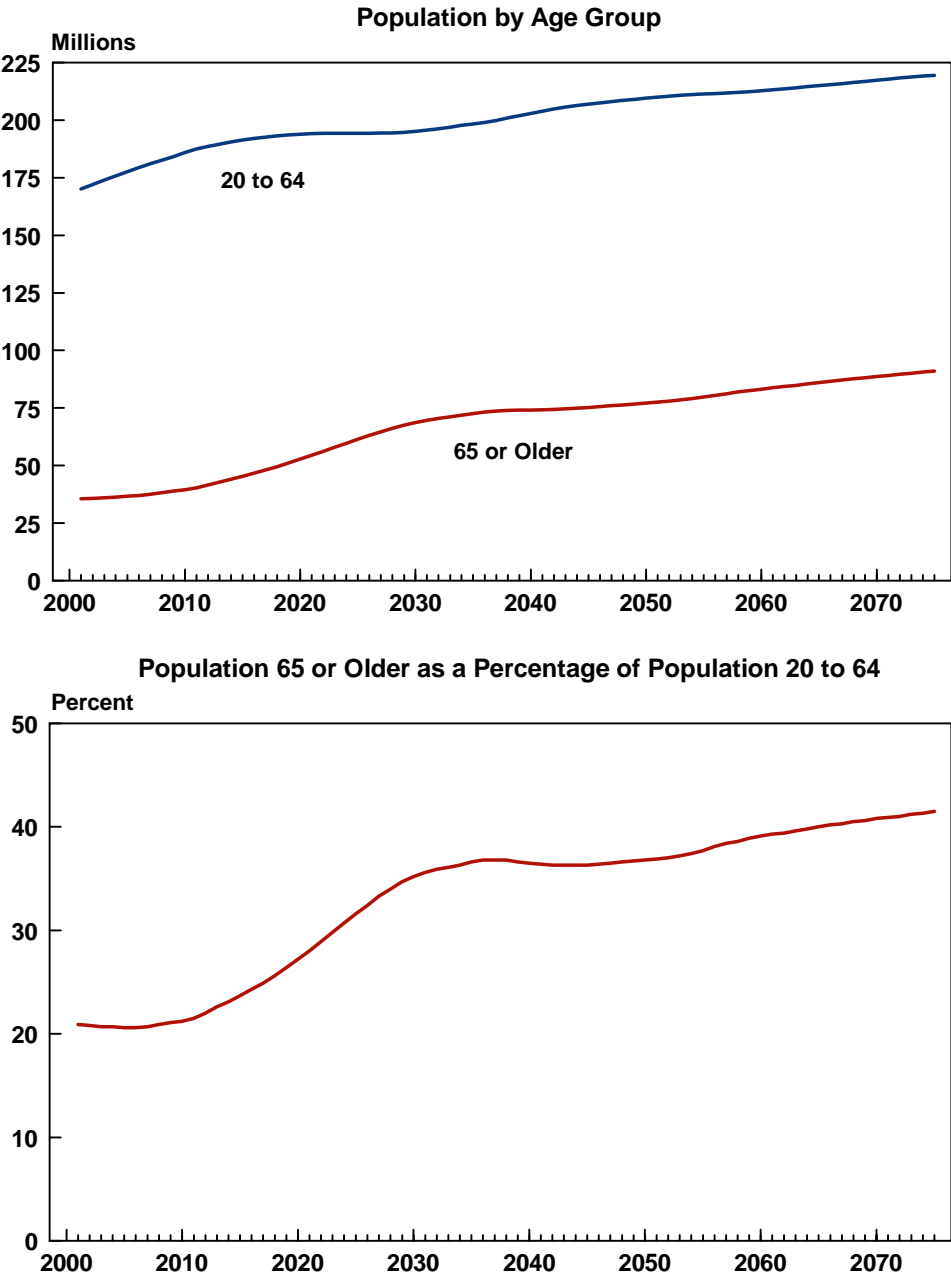
- Once the baby-boom generation retires, the portion of the nation's output that the federal government will spend on Social Security will increase by more than 50 percent—from 4.2 percent of gross domestic product (GDP) in fiscal year 2001 to an estimated 6.5 percent in 2030.
- Addressing the growing cost of Social Security would not by itself relieve the economic and budgetary pressure caused by the aging of the U.S. population. The rapidly escalating costs of the government's health care programs are a major source of that pressure. CBO projects that federal spending for Social Security, Medicare, and Medicaid combined will account for roughly 15 percent of GDP in 2030—double the current share.
- Although policymakers have many goals, if they want to limit the growth of spending on the elderly as a share of GDP, they have only two options: slow the growth of total payments to the elderly or increase the growth of the economy.

- The nation's ability to sustain an aging population will ultimately depend on how many goods and services the economy will produce and how they will be distributed, not on how much money is credited to Social Security's trust funds.
- Social Security is much more than a retirement program. About two-thirds of its beneficiaries are retired workers. The rest are disabled workers, survivors of deceased workers, and workers' spouses and minor children.
- Policymakers could pursue a variety of strategies to help prepare the nation for an aging population. Those strategies include paying down federal debt, creating private retirement accounts, and changing the benefits or revenues of the Social Security program. Each of those approaches has advantages and disadvantages.

## **THE CHALLENGES OF AN AGING POPULATION**

Over the next three decades, the retirement of the baby boomers (the large group born between 1946 and 1964) will put new pressure on Social Security, the federal government, and the U.S. economy. The Social Security Administration projects that the number of people age 65 or older will rise by more than 90 percent during that period (from about 36 million now to 69 million in 2030), according to its intermediate assumptions (see Figure 1). At the same time, the number of adults under age 65—who will largely be the ones paying the taxes to support their elders—will grow by only about 15 percent (from 170 million to 195 million). Moreover, even after all the baby boomers are retired, the number of elderly people is expected to keep rising at a faster rate than the number of nonelderly people as life spans continue to lengthen.

**Figure 1.**  
**Projected Growth in the Adult Population, 2001-2075**



SOURCE: Social Security Administration, *The 2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 19, 2001), Table V.A2 (intermediate assumptions).

The economic and budgetary consequences of the aging of the U.S. population can be viewed from at least three perspectives. The most common perspective is that of Social Security's financial structure. The program is financed largely by a tax on workers' wages (a payroll tax). The revenues from that tax are credited to two accounts ("trust funds") in the federal budget, one for each of the program's two parts: Old-Age and Survivors Insurance, and Disability Insurance. Those trust funds, which are maintained in the U.S. Treasury, function mainly as accounting mechanisms to track Social Security's revenues and spending and to monitor whether the program's designated sources of revenue are producing enough money to cover expected benefits. The program's benefits, administrative costs, and other authorized expenditures are paid from those funds. Balances in the funds are held in the form of special interest-bearing Treasury securities.

A broader perspective takes into account the pressures on the total federal budget, not just the part of the budget specific to Social Security. In particular, as the population ages, spending on Medicare and Medicaid will probably rise rapidly because of increases in federal costs per beneficiary as well as in the percentage of the population eligible for benefits (unless major changes are made to those programs). Medicare provides health insurance to most U.S. residents age 65 or older and to eligible disabled people. Most of its participants also receive Social Security benefits. Medicaid is a joint federal/state program that provides medical assistance to low-income people; in recent years, a large share of its payments have gone to provide long-term care (mainly for elderly or disabled people). The federal government spent a total of about \$370 billion on Medicare and Medicaid in fiscal year 2001. Those programs, together with Social Security, already account for nearly half of all federal spending, excluding interest payments on federal debt (see Table 1). If the programs are not changed, by 2030 they could consume two-thirds of the federal budget.

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**Table 1.**  
**Federal Spending for Social Security, Medicare, and Medicaid in Fiscal Year 2001**

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	In Billions of Dollars	As a Percentage of Total Federal Spending
Social Security	429	26
Medicare	237	14
Medicaid	<u>129</u>	<u>8</u>
Subtotal	795	48
Rest of Government	<u>862</u>	<u>52</u>
Total (Excluding net interest)	1,657	100

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SOURCE: Congressional Budget Office.

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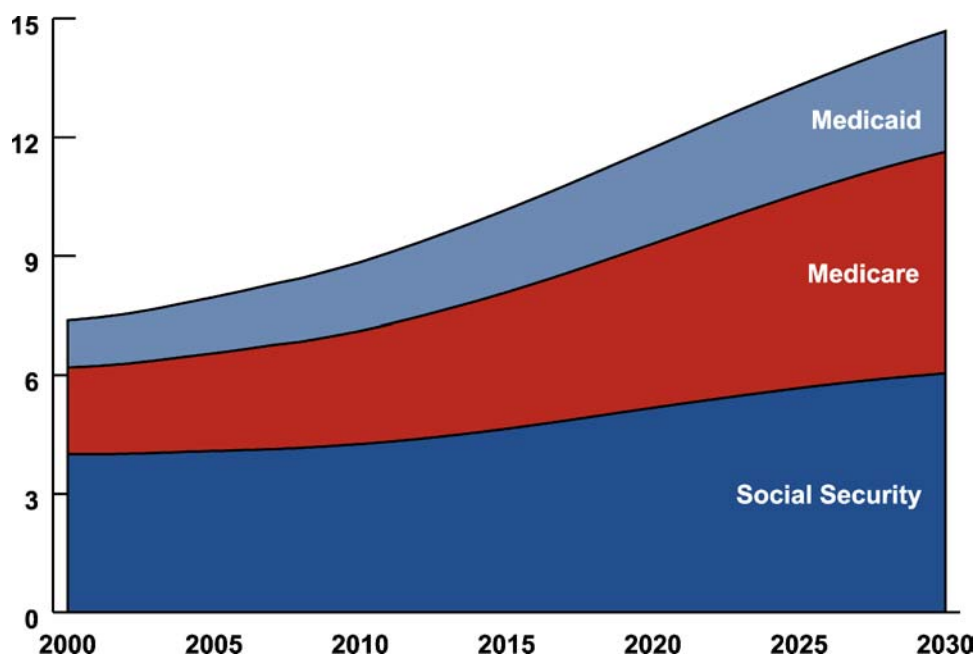
The broadest perspective—and the one emphasized in CBO's new report—takes into account what might happen to the overall U.S. economy, not just to the federal budget, as the population ages. CBO projects that federal spending for Social Security, Medicare, and Medicaid will account for about 15 percent of the nation's total output by 2030—twice the current share (see Figure 2). That large increase in spending, combined with any taxes or federal debt needed to finance it, could have significant effects on the economy. Examining how changes to those programs could affect the future size of the economy is important because the goods and services that baby boomers will consume in their retirement will largely be produced by future workers.

## **ISSUES TO CONSIDER IN REFORMING SOCIAL SECURITY**

Several aspects of the Social Security program and its outlook as the population ages are especially important in considering changes to the program. First, throughout its long history, Social Security has had multiple goals—some related to redistributing income, others related to offsetting lost earnings. In 2000, only about two-thirds of Social

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**Figure 2.**  
**Projected Federal Spending for Social Security, Medicare,**  
**and Medicaid, 2000-2030 (As a percentage of gross domestic product)**



SOURCE: Congressional Budget Office (October 2000 estimates).

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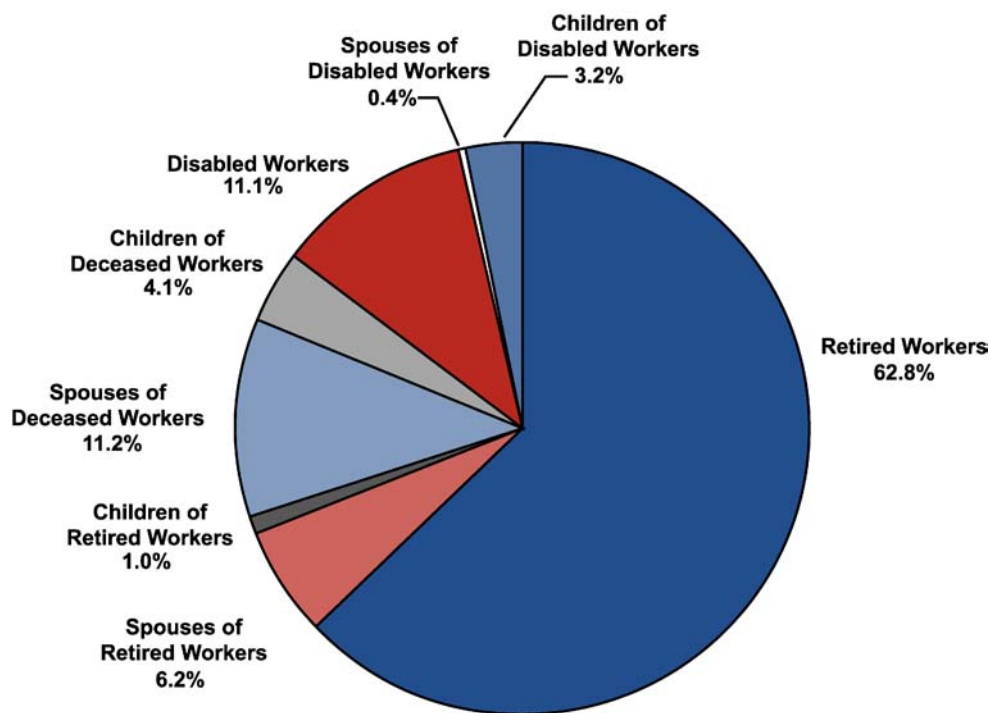
Security's beneficiaries were retired workers; the rest were disabled workers, survivors of deceased workers, and workers' spouses and minor children (see Figure 3). Policymakers will need to decide whether the program's goals are still appropriate, and if so, how changes to Social Security would aid or hinder the achievement of those goals and would affect various types of beneficiaries and taxpayers. Those decisions will also need to take into account the dramatic increase in the elderly population that is expected in coming decades.

Second, issues about how to prepare for an aging population ultimately concern the amount of goods and services that the economy will produce and how they will be distributed, not how much money is credited to the Social Security trust funds. In that sense, the projected



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**Figure 3.**  
**Distribution of Social Security Beneficiaries, by Type of Benefit Received,**  
**December 2000**



SOURCE: Social Security Administration, *Annual Statistical Supplement, 2001* (draft), Table 5.A1 (available at [www.ssa.gov/statistics/Supplement/2001/index.html](http://www.ssa.gov/statistics/Supplement/2001/index.html)).

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depletion of those funds—which is the focus of much of the popular debate about Social Security’s future—is irrelevant. The challenge of adjusting to an aging population would need to be faced even if the trust funds never existed.

Third, deciding how to prepare for an aging population is likely to require weighing the interests of today’s workers and Social Security beneficiaries against the interests of future workers and beneficiaries. No matter how it is packaged, any plan to increase national saving today means that the U.S. population will consume fewer goods and services now so that consumption can be greater in the future, when a larger share of the population is retired. Gone are the days when expansion of the labor force could pay for the growth of

Social Security benefits. (In past decades, Social Security's payroll tax revenues grew substantially as the baby-boom generation and women of various ages entered the labor force in large numbers.) As the Congress looks at policy changes, one consideration is that future workers and Social Security beneficiaries are likely to have higher standards of living, on average, than current workers and beneficiaries do, because of future increases in productivity.

## **STRATEGIES FOR PREPARING THE NATION**

Spending more on the elderly may be appropriate in light of their increasing numbers, but questions can be raised about the extent to which that spending should rise. Policymakers have many goals, but if they want to limit the growth of spending on the elderly as a share of the economy, they can do so in only two ways: either by slowing the growth of payments to the elderly or by increasing the rate of growth of the economy.

Different options for reform would have different effects on economic growth. To the extent that those options boosted the future size of the economy and increased the nation's accumulation of assets, they could lessen the burden on future workers from government programs that serve the elderly.

My testimony today focuses on three strategies for preparing for an aging population that have generated a lot of public attention: paying down federal debt, creating private retirement accounts, and making changes to the benefits or revenues of the current Social Security program. Those approaches are not mutually exclusive; they could be combined in any number of ways. (In addition, many people have put forward proposals for curbing the rising costs of federal health care programs. Such proposals could also help the nation

deal with its impending demographic changes, but they are beyond the scope of my testimony.)

## **Pay Down Debt**

One strategy for preparing for the needs of an aging population is to pay down federal debt. If the government spends less than it receives in revenues (and private saving does not fall too much in response), national saving will rise, boosting the stock of private capital and expanding the productive capacity of the economy in the long run. Indeed, federal debt held by the public has fallen sharply in recent years—from about 50 percent of GDP in 1995 to about 33 percent today. That decline has freed up funds for investment in private capital.

CBO is in the midst of revising its 10-year projections for the budget, but it does not expect any significant surpluses to be available for paying down debt in the next year or two. However, the present downturn will not last forever, and if current tax and spending policies are maintained, the budget will eventually return to surplus.

Nevertheless, even paying off all of the federal debt available for redemption would not fully address the pressures created by Social Security, Medicare, and Medicaid spending over the long run. In principle, the government could continue to run surpluses and use them to buy nonfederal assets, such as stocks and bonds, although that prospect seems less likely than it did a year ago. It would also require changing current laws that restrict the Treasury's investment choices.

Such asset accumulation could increase the funds available for capital investment and boost economic growth; but it would be unprecedented for the federal government to hold

a large stock of private assets. The possibility of such holdings raises important questions. Would it be appropriate for the government to own shares in and possibly control private companies? Could the government's involvement distort market signals and corporate decisionmaking? Moreover, is it politically realistic to assume that the government could build up a stock of private assets and that policymakers would refrain from spending more or cutting taxes further?

### **Create Private Accounts**

A second strategy is to create private retirement accounts. Proposals for private accounts differ in many ways, but they share a common feature: the income from an account would depend on the payments made into it and the rate of return on the account's assets. Many types of accounts are possible, and their effects would vary widely.

Many proposals for creating private accounts include a contribution from the government to help finance the accounts. According to some supporters, using government resources in that way could prevent policymakers from using those resources for other purposes and could thus provide many of the same economic benefits as paying down debt. In addition, it could allow the government to encourage asset accumulation while avoiding the problems of having the government own shares in private companies.

Some people argue that private accounts would offer higher rates of return than the traditional Social Security system does, but that argument can be misleading. Social Security has a low rate of return largely because initial generations received benefits far greater than the payroll taxes they paid. That difference would have to be made up even if the Social Security system was entirely replaced by private accounts. Moreover, investing in the stock market—either through private accounts or through government

purchases of stock for the Social Security trust funds—is no panacea. Simply raising the average rate of return on assets by taking on more risk would not change the economic fundamentals. Only if the investment proposal increased national saving and enlarged the economy would it reduce future burdens.

In setting up a system of private accounts, policymakers would have to address many practical issues. How much would the system cost to administer? Would it provide insurance against downturns in the stock market? Would the system require that accounts be converted into annuities and, if so, under what conditions? How would it handle benefits for workers' families, for survivors of deceased workers, and for disabled workers? Would the system give subsidies to people with low income and intermittent work histories? How would the system be regulated and investors informed?

The answers to those questions could have implications for the economy. For example, government guarantees that people would receive a minimum level of retirement income in the event of a market downturn would probably reduce national saving below what it would be without those guarantees. And subsidies to low-income workers that were phased out as wages rose could impose implicit taxes on work and could discourage some people from working more.

### **Make Programmatic Changes**

A third approach is to modify the current Social Security program. Changes that have been proposed include reducing benefits (for example, by raising the retirement age, lengthening the period over which benefits are computed, or reducing annual cost-of-living adjustments) or increasing payroll taxes. The effect on the economy would depend on the particular kind of change.

Many types of benefit reductions could increase the size of the economy in the long run because they could encourage some people to save more. However, those long-term gains could take a couple of decades to materialize fully, and the effects in the near term would be uncertain. Slowing the growth of Social Security benefits could reduce the lifetime resources of some transitional generations, but it could also lead to higher wages and lower tax burdens for later generations. If benefits were to be cut, changing the law now rather than later would give workers time to adjust their plans for saving and retirement.

Raising taxes to pay for future Social Security benefits would have an uncertain effect on the size of the economy in the long run. Moreover, the effect would depend on the type of tax increase and other factors. To limit the scope of the analysis, CBO's new report focuses on the Social Security payroll tax, although in principle, other taxes could be used to finance future Social Security benefits. If the revenues from a tax increase did not change the government's decisions about other spending or taxes, national saving could rise. But the extra revenues could encourage more government spending, which would limit any rise in national saving. Moreover, increases in marginal tax rates on payroll or income could reduce people's incentives to work or save, also dampening any increase in national saving.

Although long-term projections of the federal budget and the economy carry huge uncertainties, one fact seems fairly certain: the U.S. population will age significantly over the next 30 years, and unless policies are changed, spending on the elderly will rise sharply, posing new challenges for the federal government and the nation's economy.