This Testimony is Embargoed Until Thursday, June 21st at 9:00 AM

Statement of Charles P. Blahous

Public Trustee for Social Security[1]

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

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Thank you, Mr. Chairman, Mr. Ranking Member and all of the members of the subcommittee. It is an honor to appear before you today to discuss the findings of the latest Social Security Trustees' report. My written testimony begins with some basics of Social Security finances before describing the causes and magnitude of the program's projected financing shortfall.

Social Security Taxes, Trust Funds and Benefits

Taxes: Under current law the vast majority of financing for Social Security benefit payments is provided by a payroll tax upon covered wages. In most recent years the payroll tax rate has been 12.4%, though it was temporarily reduced to 10.4% for the years 2011 and 2012. The tax is currently scheduled to return to 12.4% in 2013 and beyond. The usual 12.4% tax is nominally divided into two 6.2 point halves assessed respectively upon employer and employee, but most economists agree that the entirety of the 12.4% tax is taken from 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 $110,100 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 federal

[1] I am also a research fellow with the Hoover Institution and a senior research fellow with the Mercatus Center.

[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.

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, as is the interest that they earn. The total amount of the trust funds, now roughly $2.7 trillion, represents the interest-compounded value of past annual program balances, including years of surpluses from 1984 to 2009 inclusive.

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 64%) 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. Importantly, one's total Social Security benefit is not limited to the amount of one's own contributions plus interest. One's benefit is instead a function of a formula written into the law. An overriding problem we face is that the total amount of projected benefit obligations that would result under current formulas is significantly greater 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.

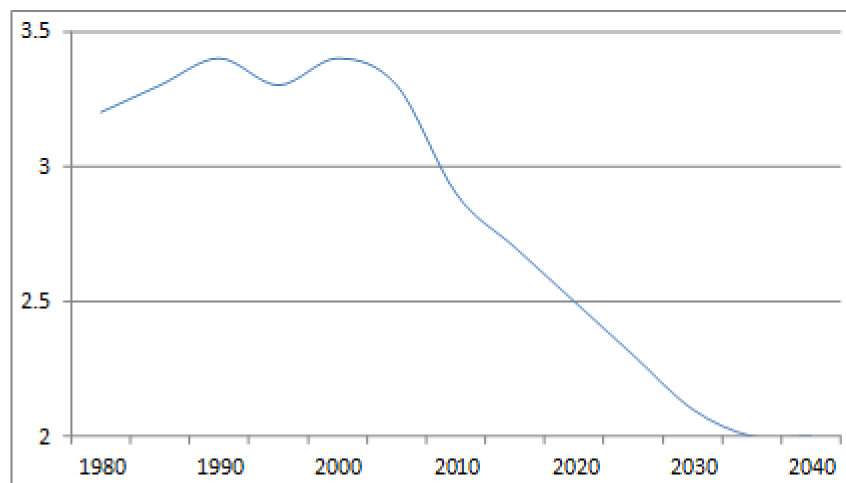
Sources of Financing Strains

Under current financing methods the vast majority of program revenues at any given point in time derives from payroll taxes contributed by current workers. Program benefits, cost rates and demographics can be related by the following formula:

$$\frac{\text{(Individual benefits as \% of current worker wages)}}{\text{(Ratio of workers to beneficiaries)}} = \text{(Cost rate as \% of current worker wages)}$$

For example, if hypothetically a typical benefit were equal to 40% of the average worker's wages, and if there were four taxpaying workers for each beneficiary, then the average program cost rate would equal 10% of the average worker's wages.

Under current law, individuals' initial Social Security benefits are indexed to grow with national average wages while the program's 12.4% tax rate is scheduled to remain constant. But as the preceding formula shows, the ongoing decline in the worker-beneficiary ratio must either result in higher tax burdens upon workers or in benefits that grow less rapidly than worker wages. It is this collision between current benefit and tax schedules, program financing methods and demographics that is at the heart of Social Security's projected financing shortfall.



Various demographic factors contribute to the ongoing decline in the ratio of contributing workers to beneficiaries. Increasing longevity is an important factor, though prior to 2035 a more significant one will be the continued movement of the Baby Boom generation from the ranks of workers to the ranks of beneficiaries.

Current Financing Projections

Social Security expenditures exceeded the program's non-interest income in 2010 for the first time since 1983 and are projected to do so for the indefinite future.[3] In the near term, redemption of trust fund assets from the General Fund of the Treasury will provide the resources needed to offset annual cash-flow deficits of the combined trust funds. Since these redemptions will be less than trust fund interest earnings through 2020, nominal balances of the combined trust funds will continue to grow. After 2020, Treasury will redeem trust fund assets in amounts that exceed interest earnings until depletion of trust fund reserves in 2033, three years earlier than projected last year. Thereafter, tax income would be sufficient to pay only about three-quarters of scheduled benefits through 2086.

Though the nominal balance of the combined trust funds is still rising as a result of annual interest credits, there are important caveats to bear in mind about this. 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.[4] 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.

Also, and very importantly, the results just described pertain to the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) trust funds. Under law each of Social Security's separate trust funds must have a positive balance in order to maintain scheduled benefit payments. Considered separately, Social Security's Disability Insurance (DI) trust fund faces a much more immediate crisis. DI costs have exceeded non-interest income since 2005 and trust fund depletion is now projected for 2016. Changes to improve the financial status of the DI program are thus needed very soon.

Under current projections, the annual cost of Social Security benefits expressed as a share of workers' taxable earnings will grow rapidly from 11.3 percent in 2007, the last pre-recession year, to roughly 17.4 percent in 2035, and will then decline slightly before slowly increasing after 2050. The projected 75-year actuarial deficit for the combined OASDI Trust Funds is 2.67 percent of taxable payroll, up from 2.22 percent projected in last year's report. This is the largest actuarial deficit reported since prior to the 1983 Social Security amendments, and the largest

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[3] Technically, Social Security would not be permitted to run annual deficits after trust fund depletion due to its lack of legal authority to make payments from financing sources other than the trust funds. The deficits are permanent in the sense that annual benefit obligations are projected to exceed annual revenues.

[4] 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.

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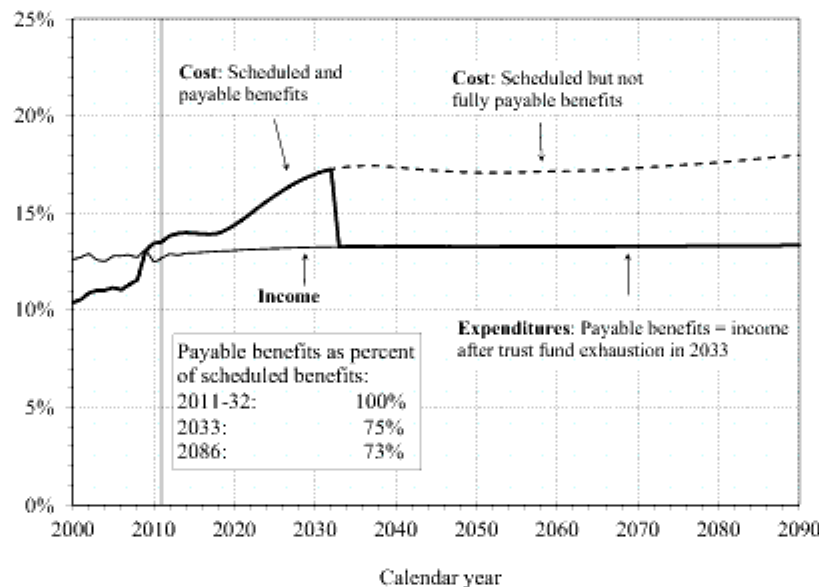
single-year deterioration in the actuarial deficit since the 1994 Trustees Report. My colleague Robert Reischauer will provide additional detail about the reasons for this deterioration.

A useful interpretation of the actuarial deficit is that it represents the percentage points that would have to be either added to the current-law income rate or subtracted from the cost rate for each of the next 75 years to bring the funds into actuarial balance. The actuarial balance equals zero if trust fund assets at the end of the period are equal to the following year's cost. The relatively large deficits at the end of the 75-year projection period—equal to 4.50 percent of taxable payroll in 2086—indicate that sustained solvency would require payroll tax rate increases or benefit reductions (or a combination thereof) by the end of the period that are substantially larger than the average actuarial deficit of 2.67 percent.



The Growing Urgency of Legislative Corrections

By almost any objective measure, the financial health of the Social Security system has entered a concerning decline. While there is no way to know what mixture of additional tax revenues and restraints on benefit growth will prove to be the most palatable means of strengthening Social Security's financial position, lawmakers should be aware that it will become increasingly difficult to avoid adverse effects on current beneficiaries, those close to retirement, and low-income beneficiaries in all birth cohorts if legislative changes are delayed much further.

For many years the Trustees Reports have contained illustrations of the magnitudes of changes to benefits or taxes required to place Social Security on a financially sustainable path. Useful though these illustrations are, they understate the likely effects of legislative actions upon those affected. First, such illustrations often assume that the full effect of legislation takes place immediately, with no phase-in or lead time. Perhaps even more importantly, the benefit examples assume that legislators would be equally willing to reduce support for current beneficiaries as to restrict the growth of benefits to future participants. In the past, policy makers have been reluctant to significantly reduce the benefits of those who have already begun to collect them. In a practical sense, therefore, changes adversely affecting younger generations are likely to be much more severe than indicated in these simple illustrations. The costs that will be borne by younger generations will grow significantly each year that a new cohort of baby boomers joins the benefit rolls with current formulas in place.

For example, imagine that no legislative action is taken until the Trust Funds' depletion date of 2033 is approached. In 2033, incoming tax revenues would be sufficient only to fund 75% of promised benefits. This constraint, however, would apply to pre-existing as well as new benefit payments. Even the complete elimination of benefit payments to new claimants would not then by itself balance system finances, if previous retirees are protected. Accordingly, unless there was then an unprecedented increase in payroll tax assessments, the opportunity to confine benefit changes only to prospective ones would have been long lost. The trustees are currently exploring how the illustrations in the trustees' report might be refined to better capture these practical costs of further delay in legislative corrections.

Budget Implications of Social Security Operations

Concern about the long-range financial outlook for Social Security often focuses on the depletion dates for the trust funds—the time when projected trust fund balances under current law would be insufficient to pay the full amounts of scheduled benefits. A more immediate issue is the growing burden that the program will place on the Federal budget well before depletion of its trust funds. Social Security operations will exert rapidly rising pressure on the Federal budget for the next two decades, as general revenues must cover growing OASDI deficits through 2033.

The 2011 deficit of Social Security tax income relative to cost was $148 billion and the projected 2012 deficit is $165 billion. The large sizes of these deficits are primarily due to a temporary reduction in the Social Security payroll tax for 2011 and 2012. The legislation establishing the payroll tax reduction also provided for transfers of revenues from the General Fund of the Treasury to the trust funds to "replicate to the extent possible" revenues that would have occurred in the absence of the payroll tax reduction. If the payroll tax cut is permitted to expire on schedule at the end of the year, pressure exerted by Social Security on the federal budget will be immediately reduced, but will grow substantially thereafter as the number of beneficiaries and the total cost of benefit payments both rise.

The current policy of lowering the Social Security payroll tax and financing a portion of benefit payments with general revenues represents a substantial departure from historical practice. Under this policy, roughly $217 billion will be transferred from the General Fund of the Treasury to replace foregone Social Security tax collections and to finance Social Security benefit payments. In 2011, due in large part to this change in program financing, payroll tax revenue represented only 70 percent of total Social Security income. Lawmakers should carefully consider whether continued significant General Fund financing for Social Security could threaten to undermine long-standing public perceptions of the program as an earned benefit financed by workers according to contributory social insurance principles.

Conclusion

The legislative achievement in creating the Social Security program remains a remarkable one, in that it has provided critical social insurance protections for hundreds of millions of Americans, at exceptionally low administrative cost, with financing methods that have been accepted historically as generally equitable. With responsible bipartisan action, Social Security and Medicare can continue to fulfill these vital roles, but such action must be prompt and sufficiently decisive if these programs are to serve future generations as well as they have served earlier ones.