Social Security and the Trustees Report

Statement before the Committee on the Budget, U.S. House of Representatives

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Mr. Chairman and Members of the Committee:

It is a privilege to testify before you today on the Trustees Report on Social Security. Through the various Social Security and Medicare Trustees Reports we gain a fuller understanding of the long-run costs and benefits reflected in the current design of these programs. My testimony will emphasize several basic points:

- The integrity of the process leading to the Trustees Report — including the input of the highly respected Office of the Chief Actuary — is a national asset. The report must contain projections for 75 years or longer because past Congresses and Presidents have built eternal growth into these programs, and one should try to account for what one is promising.
- When it comes to Social Security, the key dates that one should emphasize are *today* and *2008,* when the baby boomers start retiring. The main economic issue is that programs for the elderly and near-elderly continue to absorb increasing portions of the nation's output and of the federal budget, which necessarily means that other portions are already being reduced, soon at ever faster rates.
- The fundamental new long-term problem facing Social Security is a rapidly declining number of workers relative to beneficiaries, and it is a mistake to believe that this labor market problem can easily be solved by a capital market solution. Scheduled declines in the nation's employment rate affect the affordability of Social Security not simply through increases in Social Security benefits and declines in Social Security taxes (a "trust fund" concept), but through declines in national output, income tax collections, and the private assets and income of the elderly, as well.
- There are several additional items that I believe are worthy of highlighting within the Trustees Reports:
    - that Social Security continues to schedule smaller and smaller shares of benefits to those with greater needs, such as people near poverty and the truly old (say, those with less than ten years of life expectancy);
    - that tables showing annual benefit levels tend to disguise the promised growth in lifetime benefits under Social Security and Medicare, which are approaching $1 million for younger couples today;
    - that the Disability Insurance program projections imply increasing prevalence of disability insurance receipt in most age groups in a program with widely disparate payments according to geographic location;
    - that Social Security and Medicare already depend a good deal upon general revenue financing, largely through transfers of income taxes collected on Social Security benefits, through the financing of Part B, Medicare, and through future interest payments;
    - that the uncertainty of projections is a consequence of program design, such as the failure simply to adjust years of benefit receipt by changes in life expectancy.

The Process

The public policy process behind the issuance of the Trustees Report is one of the most balanced and nonpartisan in this nation. The achievement is made possible by the involvement of a variety of individuals and institutions: trustees from the Cabinet, outside "public" trustees, and departmental staffs, such as the Office of Economic Policy within the Treasury Department. Special note should be made of the long-standing reputation for integrity of the Office of the Chief Actuary of the Social Security Administration (SSA). I have also been privileged to participate in two technical panels, one of which I chaired. These panels are invited by SSA to provide an external review of its methods and assumptions — a process now called by the Social Security Advisory Board and in which SSA cooperates fully.

There are some who question why projections are made for 75 years when certain factors are very hard to predict for such a long period of time. The first answer is the most obvious one: we project for that long because past Congresses and Presidents have made promises for so long — indeed for centuries — into the future. This can be contrasted with the discretionary side of the budget, where promises are generally made for one year only. Making promises that can only meet uncertainly in the far distant future requires projections filled with uncertainty, not the other way around. Second, we do know a fair amount about the future since birth rates today affect such matters as the maximum number of non-foreign born 50-year-olds who will be alive in 50 years or 75-year olds alive in 75 years. Some of these demographic factors can be projected with a modest degree of certainty for well into the future.

Key Dates

From an economic perspective, the key "Social Security" issue facing the nation is what share of the nation's economic resources are demanded by programs for the elderly. If that share goes up, then mathematically some other share or sets of shares must decline. It turns out that the elderly share has been going up for several decades and is projected to continue along that path even *today* (Figure 1). When the elderly share of the budget was much smaller, it put less pressure on other parts of the budget. Now that the share is more than half of all non-interest domestic spending and growing, the pressure on other programs is rising. Of course, the rate of increase in the elderly share begins to accelerate once the baby boomers start retiring in *2008*.

Many of the dates in the Trustees Reports are mainly signposts along this path and have no great meaning relative to the path itself. Some have meaning for individuals — such as 2043, when current law requires a reduction of more than one-quarter in annual Social Security benefit payments to all retirees then alive.

Built-in growth in particular programs acts as a serious impediment to shifting resources to new needs or priorities, whether it be education or reinvigoration of our foreign policy in defense of freedom. But it also largely deters a shifting of resources within elderly programs themselves, such as to help those with significant impairments because of old age, to provide a drug benefit, or to remove some of the clear discrimination in Social Security against single working heads of household — who may work, pay taxes, and raise children, and yet get lower benefits than other beneficiaries who do none of these activities. These are issues for today, not just decades into the future. Even the budget debates in Congress this year prove how the pressure of these automatically growing entitlement programs affects discretionary choices. The issues aren't postponed until some year like 2017.

The Labor Market Problem

Social Security faces a significant labor market problem that is somewhat hidden in trust fund accounting. Indeed, too much emphasis on "trust funds" implies that there is some sort of capital market solution. Simply put, it is the scheduled decline in the number of workers to retirees that forms the core of the new dilemma facing Social Security.

Now it is true that our mandated retirement system — unfortunately in my view — has always had only very modest funding or saving levels relative to potential liabilities. This has led to a worthy debate both about saving the temporary and relatively small surpluses now being generated on a cash flow (but not liability) basis or trying to put more money aside in individual accounts or in the trust funds. But, quite bluntly, the adoption of dozens of saving incentives over the past few decades has shown that the government of a free society has trouble mandating net increases in national saving rates, since private individuals may with one hand offset what the government does or requires them to do with their other hand.

The typical worker now fully retires in late middle age — at least if old age and middle age are defined by life expectancy. When he does so, our current federal programs encourage him to become dependent upon other taxpayers. His drop in output reduces the amount of transfers he is making to support government through Social Security taxes, federal income taxes, and other taxes, including those paid to State and local governments. In addition, his own after-tax income falls, thus reducing the amount of earnings he has to spend that year or to put aside to support himself more in later years. (See example in Figure 2.) It is this multiple hit that so dramatically affects the affordability of Social Security and Medicare.

The United States was lucky in the post-World War II era. Despite substantial decreases in male labor force participation due to more and more years in retirement, females entered the labor force in such numbers that the employment rate among adults still increased. If no adjustments in retirement behavior are made, however, this nation faces the reverse situation — a decline in the percentage of adults employed along with an increase in the percentage of those more dependent upon government. The potential scheduled decline in the employment rate is so strong and so long that it is equivalent to an increase in the unemployment rate of about 0.4 percentage points per year every year for over two decades running (see Figure 3).

Other Issues

Serving the Less Needy. The Social Security Trustees report is mainly focused on whether assets and liabilities of the system come into balance. However, it does contain some data on projected benefit levels for workers and couples at different income levels. These data tend to show some aspects of the distribution of benefits but mask a number of potential problems and inequities in the program. In particular, the program as now designed continually provides higher and higher percentages of benefits to those further and further from likely death (see Figure 4). The antipoverty effectiveness of each additional dollar spent is declining.

The system also strongly discriminates against divorced and unmarried individuals, many of whom work, pay

taxes, and raise children by themselves, yet in the end get fewer benefits than individuals who do none of these. The discrimination is caused by the design of spousal and survivor benefits, which are available for no additional tax contributions but only to certain individuals (those who remain married to a worker for more than ten years). Another problem caused by this same structural design of spousal and survivor benefits is that smaller levels of benefits are provided for two-earner couples than for one-earner couples with the same amounts of earnings and taxes paid into Social Security.

Lifetime benefits. The Trustees Reports have traditionally shown the value of annual Social Security benefits over time. However, a large share of the growing costs of Social Security (as well as Medicare) has come from an expansion in the number of years of benefit support. The expected value of lifetime benefits conveys much more about the nature of Social Security promises being made than do annual benefits, and I — along with the technical panel I chaired — have recommended inclusion of these amounts in the Trustees Reports. These lifetime benefits have climbed from about $290,000 for an average-income couple retiring in 1960 to about $650,000 today and are scheduled to grow to over $1 million for an average-income couple retiring in 2030 (Figure 5).

An additional reason for showing these lifetime figures is that policy makers considering reform should focus considerable attention on what type of package of benefits they want to provide for the future, not just on individual pieces of a package. A benefit of $25,000 a year for 20 years, for instance, might provide more protection against poverty than a benefit package of $20,000 a year for 25 years, even if the lifetime cost is the same.

Directions for Disability Insurance (DI). Almost all the recent public attention to OASDI is on the old age or OASI part of the program. However, the Trustees Report on OASDI does cover DI, and it demonstrates, among other things, the *incidence* levels of disability insurance. Incidence levels reflect mainly the number of new recipients added per year to the system, and these projections tend to show a leveling out in the program for numbers of new beneficiaries. However, this can be misleading, as can be understood theoretically by thinking about moving from 99 percent to 100 percent of the population being covered. Upon hitting 100 percent, the incidence rate would show a decline to zero, but the program clearly would not be declining in cost or in percentage of the population covered. In other words, the incidence of new recipients must be added to the stock of people who remain in the program to figure out the *prevalence* of DI within the population. A steady incidence rate can mean a growing stock or prevalence rate.

The Social Security Administration calculates prevalence — the percentage of the population of different ages who receive DI (Figure 6) — but it doesn't show these figures in the Trustees Reports. These prevalence rates are projected to grow in most age groups even while health care improves. That age-adjusted prevalence rates of *disability insurance* go up over time even while there is no projected increase in age-adjusted prevalence of *actual disability* implies either that people today are being under-served or people tomorrow are being over-served. These difficulties within DI, as well as the wide geographical differences in incidence and prevalence of DI recently brought to light by the Social Security Advisory Board, imply that serious thinking needs to be applied to this program as well.

Dependence Upon All Revenue Sources. One issue often debated with Social Security and other elderly programs is whether they are adding to net saving or not. Although the answer is unclear, any potential savings of these programs are reduced substantially by the general revenue sources that they already tap. Other than interest payments, the largest among these are those that derive from the income taxation of Social Security benefits and the general revenue financing of the Supplementary Medical Insurance (SMI) program (Figure 7).

Interest payments to Social Security also essentially come out of general revenues. The trust fund concept tends to hide the nature of all these general revenue obligations, although the reports do show the figures in separate tables on income and cost. The total effect should be shown together in a separate table, perhaps following along the lines of presentation of general revenue effects already in the HI and SMI report. After all, the more that comes out of general revenues, the less that such revenues are available for other societal needs and obligations.

One can graphically display the dependence of Social Security and Medicare on all tax sources. Figure 1 shows the demands of Social Security and Medicare over time. Of course, if all obligations in elderly programs were to be counted, we would also add in Medicaid (long-term care) and civil service and military retirement systems. These elderly programs as a whole are essentially scheduled to absorb almost all taxes, which remain relatively constant as a percentage of national income.

The Uncertainty of Projections. Commendably, SSA calculates projections not only for some average or intermediate set of circumstances but for various alternatives as well. Following upon the advice of several groups, including the Technical Panel which I chaired, SSA is investigating ways to improve upon its measures of the risk that the system will do worse or better than projected.

As currently presented, however, policy makers who focus almost entirely on intermediate projections ignore most of this analysis. What the Trustees Reports do not make clear is that these risks and uncertainties about future imbalances are a consequence of program design. Therefore, they can largely be built out of the program. For instance, there is significant risk that people will live longer (or shorter) lives than projected and the system will be further out of (or in) balance than projected. But there is no reason this financial risk has to be in the program. If the program were "indexed" so that as people lived longer, they did not receive more years of benefits, then that additional "risk" of imbalance would be eliminated (Figure 8).

Similarly, it is possible to adjust the system over time so that it pays out benefits according to the number of

workers and taxpayers in the economy, which itself is affected by demographic and economic factors such as the fertility rate. Sweden recently enacted a sweeping reform that makes that type of adjustment so that the risk of long-term imbalance is significantly reduced, if not eliminated, for a whole variety of demographic and economic factors.

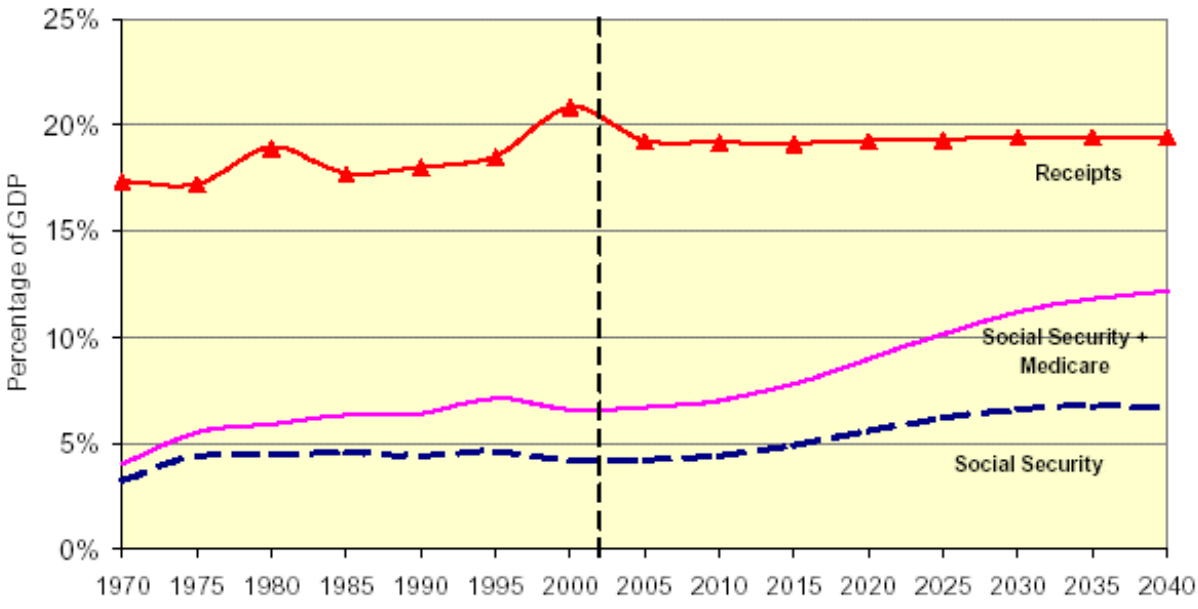
By the way, the current Social Security system already is essentially adjusted for changes in economic growth levels. For instance, when the rate of wage growth declines, then so does the rate of future benefits — which is why the sensitivity of the system to changes in economic assumptions is not great (see p. 151 of the 2002 OASDI Trustees Report). On the flip side, when wages increase unexpectedly, so do future benefits. It turns out that if unexpected growth in wages in the last part of the 1990s hadn't been allowed to raise substantially the level of future benefits promised to such people as those of us sitting in this room today, then the long-run actuarial deficit of Social Security would have been cut almost in half. Thus, Social Security could have shared in the same budgetary gains that in the late 1990s created substantial slack in the non-entitlement part of the budget.

Summary

The process leading to the development of the Trustees Reports is one of the finest in government. That individuals like myself are able to make recommendations on improvements speaks well of the process itself. Here I have emphasized that the key economic dates coming out of the reports are *today* and *2008,* when the baby boomers begin to retire — basically any dates when the programs for the elderly as a whole force reduced shares of national income to be spent on other items. I have also suggested that Social Security funding problems relate primarily to a remarkable scheduled drop in labor force participation, and trust fund accounting tends to hint a bit misleadingly that this problem can be met by a capital market solution.

Various aspects of Social Security programs could also be better clarified within the Trustees Reports: how increasing shares of total benefits are being spent on those who are younger and have less relative needs, how growth in costs is better reflected in lifetime than annual benefits, how prevalence rates of Disability Insurance are growing but are masked by more constant "incidence" rates, how much these programs are scheduled to be supported by general revenues over time, and how the uncertainty of actuarial estimates can be reduced through policy design.

FIGURE 1. Federal Receipts Versus Social Security and Medicare Spending as Percentages of GDP, 1970-2040



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the 2002 Trustees Reports and the "FY 2003 Budget Briefing Book," OMB, February 6, 2002. Various Tables.

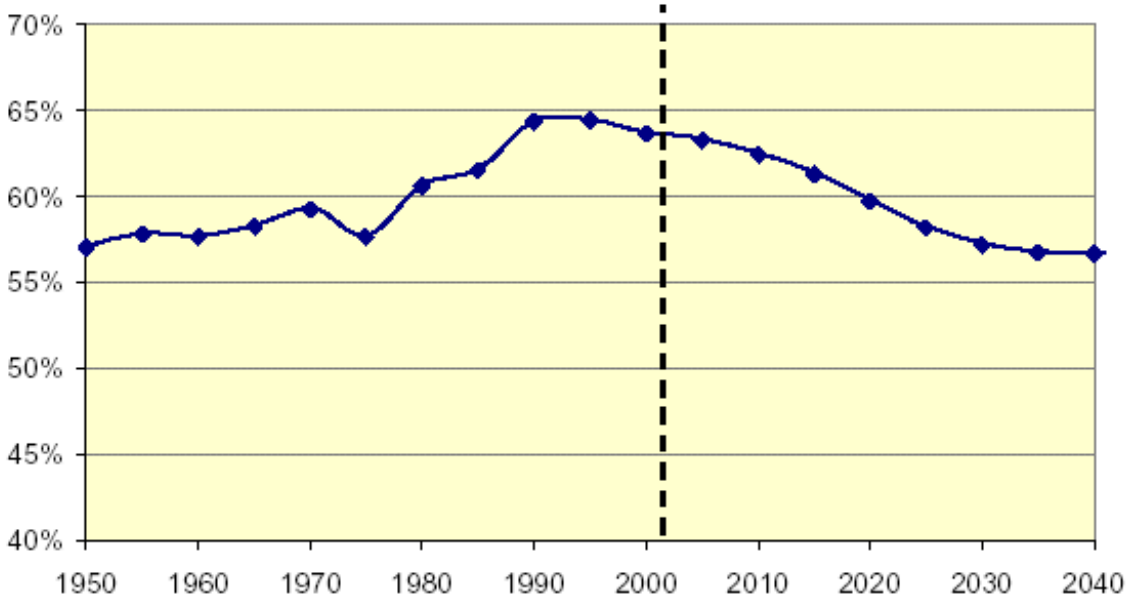
FIGURE 2. Example of Shift In Resources Upon Retirement

For a worker who earns $50,000...

Increases in Resources Transferred from Others	
Social Security Benefits	$18,500
Medicare Benefits	$5,000
Total 1	$23,500
Decrease in Resources Transferred to Others	
Social Security Taxes	-$7,700
Federal Income Taxes	-$6,600
Other Taxes (Including State and Local)	-$4,000
Total 2	-$18,300
Net Change in Transfers Received (Total 1 - Total 2)	**$41,800**
Addendum: Additional decline in retiree's after-tax earnings otherwise available to meet current and future needs	$31,700

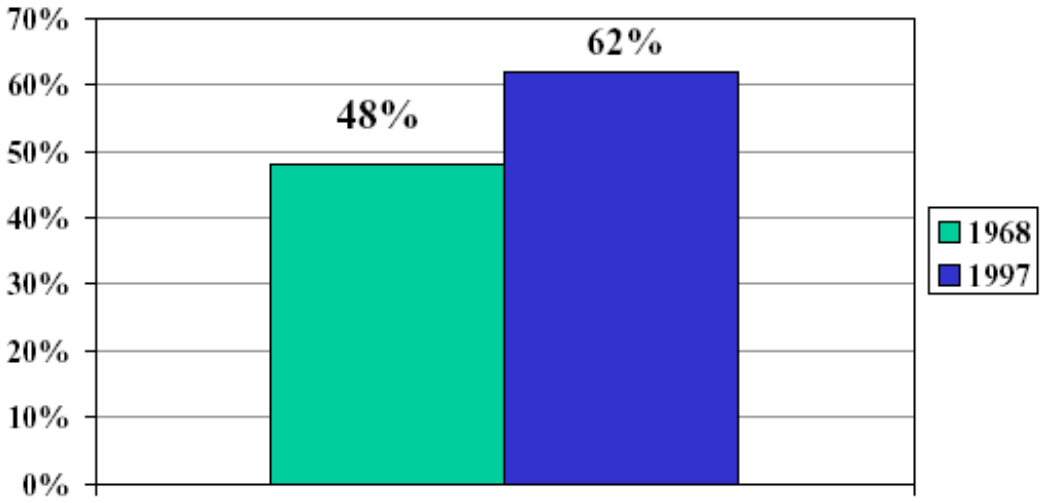
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

FIGURE 3. Adult Employment Rate (Absent Changes in Retirement Patterns), 1950-2040



Note: Projections show what happens if there is a change in age-specific employment rates as the population ages.
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the U.S. Bureaus of Census and Labor Statistics.

FIGURE 4. Proportion of Social Security Benefits for Males Going to Those with More Than 10 Years of Life Expectancy



Source: C. Eugene Steuerle, The Urban Institute, 2000.

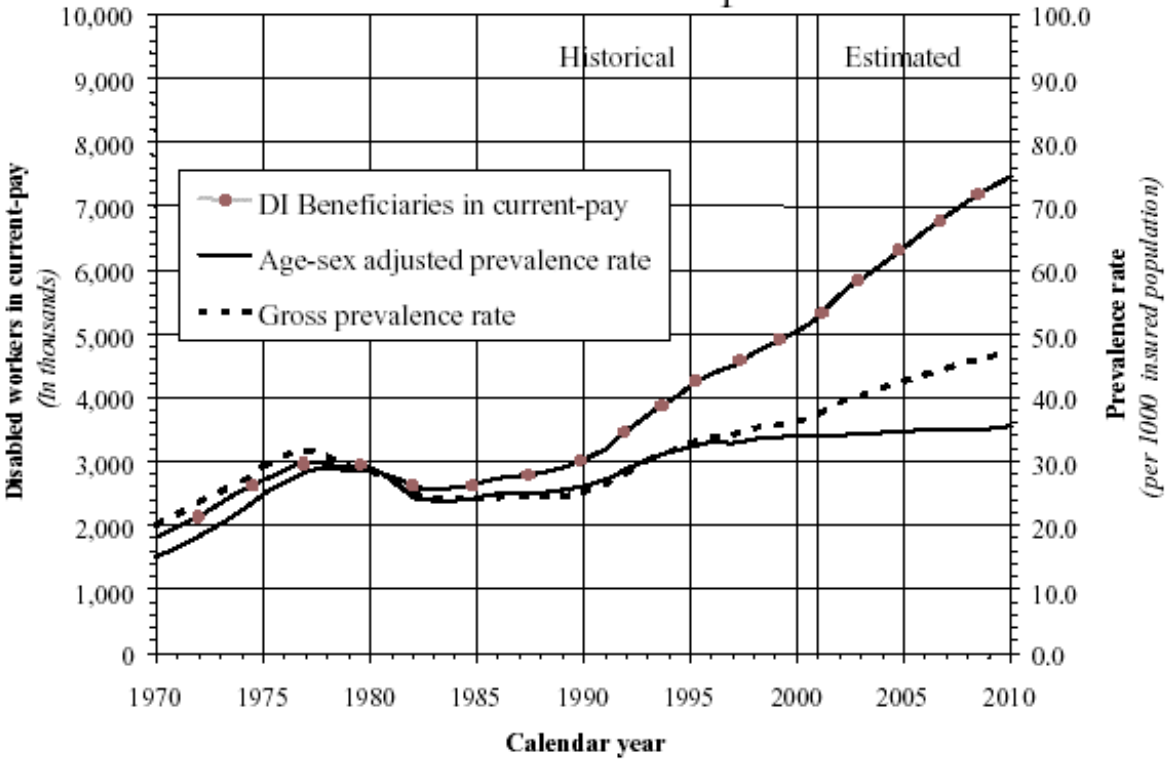
FIGURE 5. Social Security and Medicare Benefits for Average-Wage, Two-Earner Couple

—Real 2002 Dollars—

Year Cohort Turns 65	Soc. Security Annual Benefits	Soc. Security Lifetime Benefits	Medicare Lifetime Benefits	Total Lifetime Benefits
1970	$15,000	$210,000	$80,000	$290,000
2000	$20,000	$300,000	$350,000	$650,000
2030	$30,000	$460,000	$600,000	$1,060,000

Notes: Data are discounted to present value at the normal retirement age (NRA) using a 2 percent real interest rate. Table assumes survival to NRA. Projections based on intermediate assumptions of the 2001 OASDI and HI Trustees Reports.
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

FIGURE 6. The Growing Prevalence of Disability Insurance Receipt



Source: Social Security Administration, Office of the Chief Actuary.

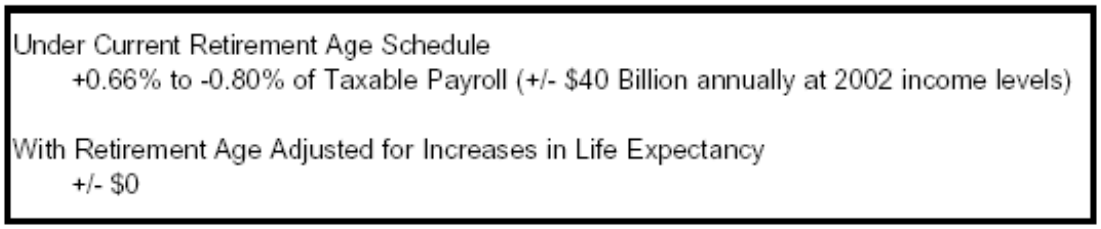
FIGURE 7. Primary Sources of General Revenue Transfers Obligated to Social Security and Medicare in 2011

— In Billions of Nominal Dollars —

	OASDI	HI	SMI	Total
Income Taxation of Benefits	27.6	18.9	—	**46.5**
Government Contributions to SMI	—	—	145.2	**145.2**
Interest Payments*	204.6	42.0	3.3	**249.9**
TOTAL	232.2	60.9	148.5	**441.6**

* Other payments not shown in table also include transfers like the cost of noncontributory wage credits, the cost of benefits for some uninsured persons turning age 72 before 1968, and one-time transfers between the Treasury and the Trust Funds.
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Calculations based on tables in the 2002 Trustees Reports.

FIGURE 8. Sensitivity of OASDI Actuarial Balance To Changes in Mortality



Source: Based on Trustees' "high" and "low" cost assumptions in Table VI.D2 of the 2002 Trustees Report

Other Publications by the Authors

- C. Eugene Steuerle