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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 recently-released projections of the Social Security trustees and their implications for workers' retirement planning.

Social Security's Financing Challenges

Americans tend to think of retirement benefits first when thinking of Social Security. This is understandable given that the majority of benefit payments (about 65%) are made to retired workers. But Social Security also provides for a number of other 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. This linkage helps avoid discontinuities in benefit levels when an individual changes status, for example if a disabled worker reaches the age of full entitlement to old-age benefits.

Payments for retired workers as well as their spouses, children and survivors are made from the Old-Age and Survivors Insurance (OASI) trust fund. Payments for disabled workers and their dependents are made from the Disability Insurance (DI) trust fund. Although it is common to refer to the total finances of Social Security by combining the operations of these two funds into a theoretical single trust fund (OASDI), by law each of Social Security's separate trust funds, OASI and DI, can only make benefit payments from revenues allocated to that specific fund.

Of Social Security's two trust funds, its DI trust fund faces the more immediate threat of depletion. Under our latest projections released yesterday, DI reserves will be depleted in the fourth quarter of 2016, at which time there will only be sufficient revenues to finance 81 percent of scheduled benefits.

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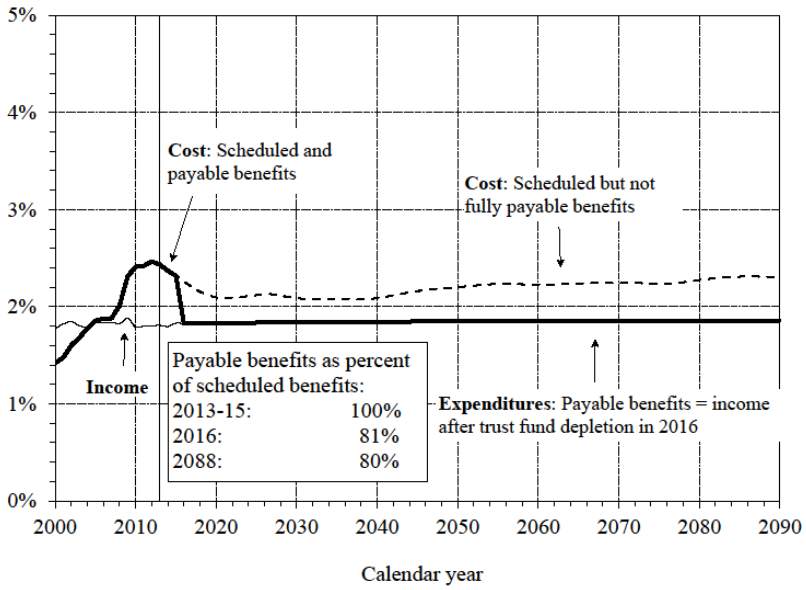
Figure 1: Projected DI Income, Cost and Expenditures
(As a Percentage of Taxable Payroll)



The significance of the DI fund's imminent depletion is that the financing crisis facing the Social Security program, of which trustees' reports have warned for several years, is now beginning to be realized. Although under current law the program's OASI fund can finance benefit payments for several more years, this does not mean that it is in stronger long-term condition than DI. To the contrary, the projected long-term financing shortfall in OASI is larger, in both absolute and relative terms, than it is for DI.

	OASI	DI
75-year average income rate	12.02	1.87
75-year average cost rate	14.57	2.20
Actuarial balance	-2.55	-0.33

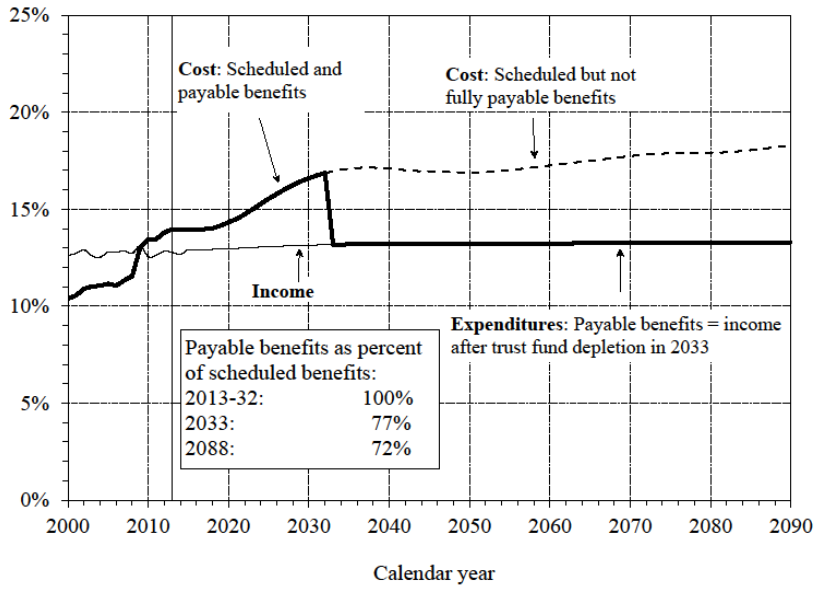
All figures given as a percentage of taxable worker wages.

Although there are policy challenges unique to DI that warrant attention, the current situation is very different from 1994 when lawmakers reallocated taxes from the OASI fund to the DI fund, responding then to the fact that DI's sooner-projected depletion date reflected a larger relative shortfall. By contrast, the earlier depletion date now projected for DI primarily reflects the fact that the baby boomers are moving through the ages of peak DI incidence before reaching retirement age. This impending trust fund depletion is the first crisis triggered by factors that affect DI and OASI alike, and signals the urgency of enacting financial repairs to Social Security as a whole.

If lawmakers took no action other than to reallocate taxes between the Social Security trust funds, then in 2033 all program beneficiaries would be subject to a sudden benefit reduction of 23% upon

depletion of the combined trust funds. Historically, lawmakers have never permitted benefits to be reduced or delayed as a result of trust fund insolvency. Thus, for practical purposes, more likely outcomes are either that lawmakers will act with dispatch to repair the financing shortfall, or that it will simply be left uncorrected, forcing an eventual abandonment of Social Security's historical financing structure.

Figure 2: Projected Social Security Income, Cost and Expenditures
(Theoretical Combined Trust Funds, as a Percentage of Taxable Payroll)



Some numerical illustrations may help to illuminate the toll associated with further delaying legislative corrections. Historically, lawmakers have been reluctant to reduce Social Security benefits for those already receiving them. If lawmakers continued to protect current recipients from benefit reductions under a solution enacted today, the benefits of future recipients would need to be reduced by roughly 21% to avoid a Social Security tax increase.[2] If, however, financing corrections were postponed until 2033, even the complete elimination of payments to new beneficiaries would be insufficient to maintain solvency while permitting the uninterrupted flow of benefits to those already receiving them.

For additional perspective, consider that Social Security's current financing shortfall has grown substantially larger than that corrected in the landmark program amendments of 1983. The current shortfall of 2.88% of taxable worker wages well exceeds that of 1.82% projected in the 1982 trustees' report. This comparison actually understates the difference because the trustees' actuarial methodology has changed substantially since then. Employing actuarial methodology similar to that used in 1983 would show a financing shortfall today of roughly twice the size of the previous crisis, even relative to today's larger economy and tax base. Thus closing the current shortfall

[2] This would not be a reduction of 21% from today's levels but rather from the higher level of future benefits scheduled under current law.

would require legislators to enact measures roughly twice as severe as those of 1983; those measures included delaying COLAs by six months, exposing benefits to income taxation for the first time, bringing newly hired federal employees into the system to contribute payroll taxes, raising the eligibility age for full retirement benefits, accelerating a previously-scheduled increase in the payroll tax rate, and other measures. Continuing delay would ultimately require even more severe measures. Thus we are already at the point where it has become uncertain whether lawmakers will act quickly enough to sustain Social Security's historical financing design, or whether it will eventually need to be abandoned in favor of a new design in which the program is subsidized permanently from the government's general fund.

Risks for Participants

As the previous illustrations suggest, continued delay in addressing the Social Security financing shortfall poses substantial risks for beneficiaries. As long as the means of closing the shortfall remains unidentified, participants are deprived of critical information with respect to their own eventual contributions to program financing, and cannot adjust their retirement planning accordingly. Moreover, the longer legislative corrections are postponed, the fewer the number of birth cohorts that can contribute to the solution, and the greater the likelihood that affected cohorts will suffer substantial net income losses.

Program participants face mounting risks to their incomes both as taxpayers and as beneficiaries. Projections in this year's trustees' report show that the current shortfall results from an excess of scheduled benefits over tax contributions for individuals who have already entered the Social Security system. This shortfall equals 4.4 percent of projected future wages. In other words, if current formulae remain unchanged for those now in the system, future workers will be subjected to a net income loss through Social Security equal to 4.4 percent of earnings. Whether this net income loss is imposed on them as higher taxes during their working years, or as lower benefits than now scheduled, it will cause the same net reduction in their lifetime income – unless, that is, action is taken to slow the rate of benefit growth for older generations.

The declining certainty of legislative corrections adequate to preserve Social Security's historical financing structure exposes beneficiaries to additional risk. If lawmakers ultimately prove unable or unwilling to balance scheduled benefits with dedicated program taxes, the gap might have to be filled from the federal government's general fund, which Americans fund largely with their income taxes. Because not every American pays income taxes, and because Social Security benefits are not and are unlikely to ever be based on income tax contributions, this would destroy the historical link between contributions and benefits, and with it the philosophy of an "earned benefit." Historically, programs financed from the general fund have been much more prone to frequent changes in eligibility rules and benefit levels than Social Security has historically been. Programs financed from the general fund are also often formally means-tested, suggesting that in this scenario individuals' other retirement saving could cause them to lose Social Security benefits. In general, a continued failure to repair Social Security's finances reduces Americans' retirement income

security in part because of the increased risk that the program will eventually need to be supported with income taxes, support that has historically come with strings attached.

Problematic Implications of Rising Social Security Costs

Under current formulae Social Security costs have risen and will continue to rise faster than our national economic output. In 2007, before the baby boomers began to enter retirement, program costs equaled 4.1% of GDP. Costs have already risen to 4.9% of GDP this year, and will continue to rise swiftly as the baby boomers swell the retirement rolls. Under current projections these costs will exceed 6% of GDP in 2030. This unsustainable trajectory of cost growth will be temporarily interrupted in the years 2040-55 as low-birthrate cohorts join the beneficiary rolls. Afterwards costs will resume rising relative to GDP due to increasing longevity interacting with fixed eligibility ages and scheduled benefits that grow faster than price inflation. Such cost growth is inherently problematic because it means program finances are not sustainable within a stable tax rate. Unless cost growth is slowed, Americans are continually at risk of unspecified income losses in the form of further tax increases.

Rising Social Security costs would be less of a problem if they reflected a greater capacity to finance higher retirement benefits as a result of increased retirement saving. Social Security, however, operates as an income transfer program rather than a savings program. Each generation's benefits are financed primarily from taxes collected from subsequent generations. One generation's financial gain through the system is another's financial loss. As scheduled benefits and costs rise, an increasing share of our national resources is committed to financing benefit payments without increasing our stock of capital available to finance them. Thus, instead of increasing our overall retirement preparedness, rising pay-as-you-go Social Security obligations reduce the amount of saving otherwise available to finance retirement income.

Problematic results of current policy include the paucity of other savings held by groups most reliant on Social Security, and are reflected in academic literature finding that Social Security has a negative effect on saving. These adverse effects would be exacerbated if lawmakers react to projected financing shortfalls by increasing taxes rather than by containing cost growth. Long before the point of combined OASDI trust funds depletion, these rising costs exert increasing pressure on the government's general fund, which provides the resources to make cash payments of interest as well as to redeem bonds held in the program's trust funds. Thus even during a period of solvency, Americans are at risk of further income losses as a result of rising income tax burdens or because of slower income growth resulting from rising federal indebtedness. Rising income tax burdens in particular would interfere with Americans' ability to accumulate retirement saving outside of the Social Security system, a problematic effect because only by increasing saving can the total resources available to finance retirement income be increased.

Retirement security depends heavily not only on retirement income and assets but on the number of years over which financial resources must be stretched. Thus, policies that induce Americans to leave paid employment prematurely undercut retirement security. Research has shown that the current structure of Social Security creates ample incentives for Americans to leave the workforce and thereby increase their risk of outliving their retirement savings. When Social Security was first established more than three-quarters of a century ago, 65 was the youngest age at which old-age benefits could be claimed. Today the most common age for benefit claiming is 62, despite substantial improvements in health and longevity since Social Security's inception. Research by Andrew Biggs has shown that seniors who extend their working lives only receive 2.5 cents in lifetime Social Security benefits for each additional dollar of taxes contributed. Research by Jeff Liebman *et al* has shown that individuals are more likely to retire at times when such marginal Social Security tax rates are relatively high. These inducements for premature retirement are a major threat to Americans' long-term retirement security, and lawmakers would do well to correct them in the course of repairs to Social Security's financial outlook.

One possible reform is to apply the program's progressive benefit formula to each year of wages rather than to one's lifetime average as under current law. This would strengthen work incentives, especially for seniors contemplating retirement. This would reap dividends not only for Social Security but for the broader budget and for the economy as a whole. It would also target a higher fraction of system resources on steady, lower-wage earners, reducing benefit growth for intermittent workers.

Stabilizing the Rate of Benefit Growth

It may seem paradoxical at first to suggest that slowing the rate of scheduled Social Security benefit growth would improve workers' retirement income security. But there are multiple reasons why this is the case. First and foremost, it does not enhance workers' retirement security to promise benefits that cannot be financed under current law. In such a circumstance, workers remain uninformed of the level of benefits they will actually receive, as well as the tax contributions that will ultimately be required of them. Unsustainable benefit schedules can also further a sense of false security, reducing the amount of retirement saving Americans otherwise do. Also, as previously mentioned, Social Security is not a savings program in which the total stock of capital available to finance retirement benefits is increased; it is instead an income transfer program that somewhat depresses national saving. Thus, net benefits for some come only at the cost of lowering net income for others.

Certain methods of reducing cost growth would likely have straightforward effects of reducing poverty among elderly seniors. For example, raising the age (62) of early eligibility for Social Security benefits would result in fewer seniors being subject to the largest actuarial reductions in annual benefits, increasing lifetime Social Security benefits for seniors who live longer than average and who face greater risk of outliving their other retirement savings. It would also remove a powerful current incentive for premature withdrawal from the labor force.

Beyond this, there are several reasons to believe that the current rate of Social Security benefit growth exceeds what is optimal from an equity or income security perspective. One is that the current benefit formula aims for benefits that grow as rapidly as average worker wages. For a nation with our demographics, and with Social Security's current eligibility rules, this formula imposes costs that grow more rapidly than average worker wages. This in turn causes benefits to rise faster than after-Social-Security-tax worker wages. In other words, the current rate of Social Security benefit growth progressively depresses pre-retirement standards of living relative to post-retirement standards of living. This growth rate would need to be slowed simply to stabilize the relationship between pre-retirement and post-retirement living standards.

Current Social Security Benefit and Cost Schedules

Year Worker Turns 65	Benefit as % of Pre-Retirement (Wage-Indexed) Earnings	Approximate Social Security Cost Burden During Working Years	Benefit as % of After-Social-Security-Tax Pre-Retirement (Wage-Indexed) Earnings
1985	41.5%	5.9%	44.1%
2020	40.0%	11.8%	45.4%
2055	41.1%	16.2%	49.0%

Secondly, Social Security costs and benefits have already grown to the point that they force many low-income workers into suboptimal income and consumption patterns. Whereas a retirement income replacement rate of roughly 70% of the real value of pre-retirement income is widely recommended, research by Syl Schieber has shown that individuals in the bottom two income deciles receive income replacement rates from Social Security of over 80% at normal retirement age. While this is a modest income level in absolute terms, the high replacement rate does represent a policy problem; it means that Social Security ties up the scarce income resources of lower-income Americans to an extent that undermines their savings opportunities and reduces their labor force attachment, both of which reduce their overall income security. A better calibrated policy would aim to smooth the relationship between pre-retirement and post-retirement income, support labor force attachment, and encourage the accumulation of savings.

Thirdly, it is sometimes inaccurately assumed that, because Social Security benefits are tied to wage growth, individuals with the same real wages receive the same real benefits. This is not true. The current benefit formula causes Social Security replacement rates to rise over time relative to a given level of real wages. It is designed to pay the same replacement rates to workers at similar positions

in the wage distribution relative to their chronological peers, not to workers with the same real wages born in different years. This growth rate reflects a subjective value judgment that as society grows generally richer, the federal safety net should expand so that benefits for workers with a given real earnings level automatically become more generous. This is clearly not the only value judgment that could be made. One could alternatively conclude that a given level of real wages should always return the same level of real benefits. One could just as reasonably argue that as society grows wealthier and more self-sufficient, individuals should receive relatively less in government benefits rather than more, relative to the real value of their Social Security contributions. Under either of these latter approaches, considerable reductions in Social Security benefit growth would be in order.

Recent Changes to the Social Security Trustees' Report

Changes were made to the Social Security trustees' report this year to lessen misunderstanding of the level of pre-retirement income replacement provided by Social Security. Since 2002, the annual trustees' reports had contained a comparison between benefit levels for retirees of different wage histories with the earnings of workers then in the contemporary workforce. For example, a table in the 2013 trustees' report indicated that a typical "scaled medium earner" retiring in 2015 at the normal retirement age would receive a benefit equal to 41.2% of the earnings of a worker still in the labor force who was deemed comparable. This presentation had been widely misread as indicating that a typical worker received a benefit at the normal retirement age that was roughly 40% of his *own* previous earnings. In actuality, Social Security's rate of replacement of the worker's own previous earnings is substantially higher.

The trustees addressed this confusion by redesigning the presentation this year to present scheduled benefits alongside estimates of the national average wage index. This enables readers to compare projected benefit levels both to the levels of wages in the surrounding workforce at the time benefits are received, as well as to earlier wage levels when that hypothetical worker was moving through the workforce. Because there is no universally agreed-upon method of measuring replacement rates, the trustees did not choose to provide a replacement rate calculation, instead removing the previous measure that had caused confusion.

Conclusion

The financing shortfall facing Social Security creates substantial income risks for Americans planning for retirement. This risk can be minimized by the prompt enactment of financing reforms that preserve Social Security's historical financing structure while reducing cost growth to rates to those that can be financed within a stable tax rate. Retirement income security will also be generally enhanced by reforms that increase labor force attachment, remove disincentives to saving, and reduce reliance on pay-as-you-go income transfers.