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Before the Subcommittee on Social Security

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

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Thank you, Chairman Johnson, Ranking Member Becerra, and all of the members of the subcommittee. It is as always an honor to appear before you to discuss the financing challenges facing Social Security's Disability Insurance (DI) trust fund.

The Role of the Social Security Trustees in Developing Financial Projections

The Social Security Act provides for a Board of six program trustees, of whom four are *ex officio* trustees serving by virtue of their Executive Branch positions. These include the Secretary of the Treasury, who serves as the Managing Trustee; the Secretary of Health and Human Services; the Secretary of Labor; and the Social Security Commissioner (or those who are acting in these capacities). Two members of the public (I am one; Robert D. Reischauer is the other) also serve as trustees. The public trustee positions were created in the 1983 program amendments.

The Social Security Act requires, among other duties, that the trustees report annually on the "operation and status of the Trust Funds" and specifies certain material that the annual reports must contain, including estimates of income to and disbursements from the trust funds as well as a statement on their "actuarial status." Section 201(c) of the Act also requires that the report include an analysis of benefit disbursements from the Old-Age and Survivors Insurance (OASI) trust fund with respect to disabled beneficiaries, which appeared in the 2014 annual report beginning on page 216. Section 709 of the Act further requires that if the trustees determine that the "balance ratio of any such Trust Fund . . . may become less than 20 percent," they must provide a report to Congress that specifies, among other things, "the extent to which benefits would have to be reduced, taxes under Section 1401, 3101, or 3111 of the Internal Revenue Code of 1954 would have to be increased, or a combination thereof" to maintain the balance ratio at "not less than 20 percent." The term "balance ratio" refers to the ratio between the trust fund balance at the start of a calendar year to the total expenditures expected from the trust fund during that year. Because the trustees made such a finding in 2014, we issued a section 709 letter last July 28, as we have done in each of the last five years.

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Because the trustees' statutory duties focus on projections under current-law benefit and revenue schedules, we do not typically analyze or discuss the merits and demerits of reform alternatives during our deliberations. Accordingly, my testimony focuses on the trustees' current projections for the DI trust fund, and on trustees' statements with respect to the importance of timely financing corrections. This testimony does not address related policy issues in the DI program on which the trustees have taken no position.

Some Basics of DI and OASI Operations

Although it has become customary in many contexts to refer to the finances of the Social Security trust funds as a theoretical combination, under law Social Security has two separate trust funds: the Old-Age and Survivors Insurance (OASI) trust fund, and the DI trust fund. By law each of these separately must have a positive balance to permit benefit payments. Of the total current-law Social Security payroll tax of 12.4% on worker wages, 10.6 points are allocated to the OASI trust fund and 1.8 points to the DI trust fund. Approximately 11 million people receive benefit payments from the DI trust fund, the vast majority of which (93%) go to disabled workers, with lesser amounts distributed to spouses and children.

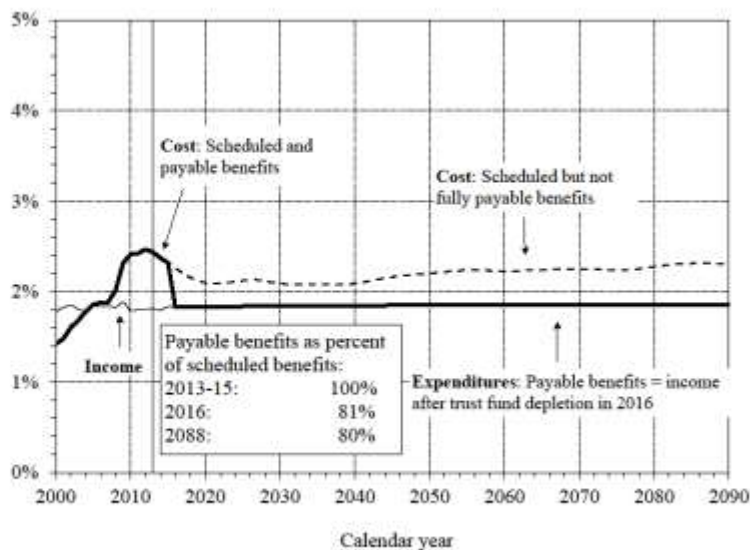
The old-age and disability components of the Social Security program are closely integrated. For example, benefit levels under each are determined using the same basic formula for calculating the "primary insurance amount," or PIA. The PIA is a function of the worker's average wages subject to the Social Security tax, and determines the benefit level payable at retirement age, as it does the benefit level payable through disability insurance. Note that this coordination permits a smooth transition without discontinuities when a disabled individual attains retirement age and his benefit payments shift from the DI trust fund to the OASI trust fund.

Current Projections for the DI Trust Fund

In calendar year 2014, the DI trust fund received roughly $114.9 billion in revenues, of which roughly $109.7 billion represented payroll tax contributions, roughly $3.4 billion interest on the trust fund paid from the government's general fund, and roughly $1.7 billion deriving from the income taxation of benefits. There were roughly $145.1 billion in expenditures from the DI trust fund in 2014, of which $141.7 billion were benefit payments, $2.9 billion administrative expenses and $0.4 billion transfers to the Railroad Retirement program. These expenditures, when netted against revenues, caused trust fund reserves to decline from $90.4 billion at the start of 2014 to $60.2 billion at year's end.

These figures are relatively close to projections in the 2014 trustees' report. At the time the report was released, we were projecting that DI trust fund reserves would equal roughly $58.2 billion by the end of 2014, for a so-called "trust fund ratio" of 62. As described above, the trust fund ratio is one hundred times the ratio of the trust fund's reserves to expected expenditures during the following year. Thus, there are now sufficient reserves in the DI trust fund only to finance a little more than half a year's worth of benefits in the absence of other tax revenue. Combining projections for annual revenues, annual expenditures, and carry-over trust fund balances, the 2014 report projected that DI trust fund reserves would be depleted in the fourth quarter of 2016. At that point there would only be sufficient revenue to finance roughly 81% of scheduled benefits.

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



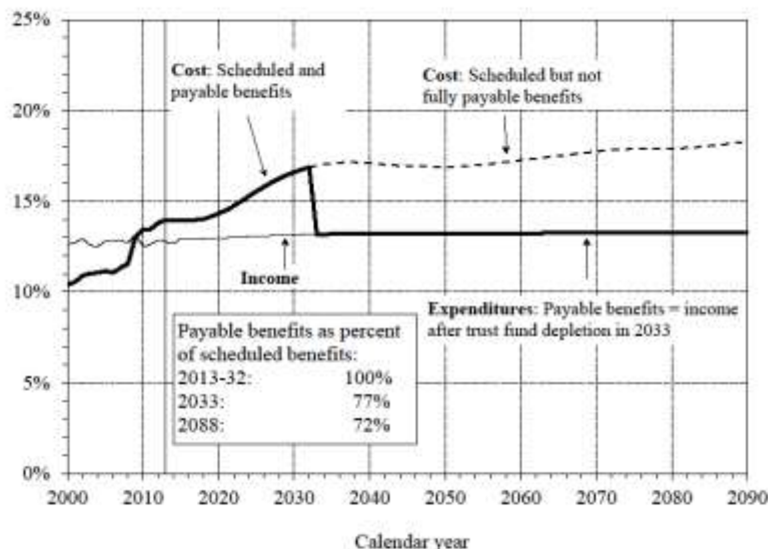
As with the old-age component of Social Security, the shortfall in the DI trust fund is arising because costs have grown faster than the program's revenue base of taxable worker wages. In 1990, the cost of paying DI benefits equaled 1.09% of taxable worker wages. Last year the relative cost was more than double that, at 2.37% of the tax base. Testimony before this subcommittee by the Social Security Chief Actuary in 2013 identified four "cost drivers" in the disability program. These four factors were the increase in the total working-age (i.e., potentially disability-eligible) population, the changing age distribution of the working-age population, the increase in the number of working-age individuals insured for disability benefits, and the increase in disability prevalence among insured workers even after adjusting for age and sex. Of these four factors, the first two are largely symptomatic of the large baby boom generation moving through working-age years and specifically through the ages of peak disability incidence; the third factor largely reflects the increased participation of women in paid employment, and the fourth factor primarily reflects policy changes since the 1980s affecting the frequency of disability benefit awards.

The Chief Actuary's testimony, as well as Figure 1, also notes that economic recessions are typically associated with increases in disability applications and awards, which was certainly true of the recent Great Recession, during which disability costs rose suddenly from 1.88% of the program's tax base in 2007 to 2.41% by 2010.

There clearly are policy issues unique to Social Security DI, ranging from the appropriateness and uniformity of disability award standards, to the adequacy of continuing disability reviews, facilitation of reattachment to the workforce, and benefit termination frequencies. But at the same time it is clear that the financial strains facing Social Security are not unique to or even concentrated on DI. To the contrary, the long-range shortfall in Social Security's OASI trust fund is larger than DI's, both in absolute terms (2.55% of taxable payroll vs. 0.33%) as well as relative to each side's revenues and costs. This is relevant to today's discussion insofar as it suggests that if both OASI and DI were kept in appropriate actuarial balance, DI would not warrant a higher share of the total payroll tax than it currently receives. The primary reason that DI is currently facing an earlier reserve depletion date than OASI is that the entirety of Social Security has been permitted to develop a significant financial imbalance, coupled with the fact that the large baby boom generation has been passing through their ages of peak disability incidence before hitting retirement age.

With the baby boomers aging into their retirement years, we are now in the process of financial pressures shifting from the DI trust fund to the OASI trust fund. This can be seen by comparing Figure 1, showing that DI costs are projected to decline in a relative sense from now through the 2030s, to Figure 2, showing total Social Security costs growing through the 2030s and beyond.

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



The Importance of Timely Action to Restore Financial Balance

Closing Social Security's financial imbalance will require some combination of cost growth reductions and revenue increases. The trustees do not take a position on the optimal balance between these. Instead the trustees' reports quantify the magnitudes of corrections required under current projections, in addition to providing illustrations of how the choices facing lawmakers grow more difficult with time. For several years, including reports signed by dozens of different trustees, the annual reports have explained that prompt action to address the financial imbalance is in the best interest of those who depend on Social Security, and that the program's future is made less certain by continued delay in enacting necessary substantive reforms. This principle applies with equal force to DI separately, OASI separately, or the OASDI trust funds in combination. From a policy perspective, the ideal course would be comprehensive action to shore up the entirety of Social Security finances at the earliest possible time. However, it may be that lawmakers can only find agreement to enact lesser measures in the near term. An important overriding principle is that any action having the effect of facilitating further delays in necessary substantive reforms is not in the interest of program participants.

The trustees' reports routinely contain both verbal explanations and qualitative illustrations pursuant to this important point. For example in our 2014 annual message, the six trustees wrote that "legislative changes are necessary to avoid disruptive consequences for beneficiaries and taxpayers," and that "earlier action will also help elected officials minimize adverse impacts on vulnerable populations, including lower-income workers and people already dependent on program benefits." The summary of the 2014 annual reports connects this principle to the question of whether funds should be reallocated between the OASI and DI trust funds, expressing concern that a standalone reallocation "might serve to delay DI reforms and much needed financial corrections for OASDI as a whole. However, enactment of a more permanent solution could include a tax reallocation in the short run." In general the trustees' communications to Congress stress that while some interfund shifting of resources might be necessary to stave off depletion of the DI trust fund in the short term, this should not be done in a way that makes more likely continued delay in enacting necessary financing corrections for the whole of OASDI.

The annual trustees' reports include numerical illustrations of the costs and risks associated with further delaying financing corrections. For example, assume that lawmakers wished to hold all current OASDI beneficiaries harmless in the course of repairing Social Security finances and, for the sake of illustration, assume that taxes are held constant as well. Within these constraints, OASDI as a whole could be put in financial balance today by a reduction of 20.8 percent in scheduled benefits for those initially eligible in 2014 or later. If on the other hand such action were deferred until 2033 (the currently projected date of theoretical combined OASDI trust fund depletion), even 100-percent reductions for those newly eligible for benefits would be insufficient to repair program finances. As the trustees' report states, such "strategies for achieving solvency would not be feasible if delayed until (combined) trust fund depletion in 2033."

This is important because if action on Social Security solvency is deferred until close to 2033, it thus becomes extremely unlikely that lawmakers will ever be able to restore financial balance, virtually forcing an abandonment of the program's historical financing structure that has in the main served the public well for three-quarters of a century. Already, Social Security's total financing shortfall is substantially larger than that closed in the landmark 1983 program reforms. Those reforms were enacted with tremendous difficulty and included a six-month delay in COLAs, a retirement age increase, exposure of benefits to taxation for the first time, covering newly-hired federal workers, and accelerating a previously enacted payroll tax increase, among other measures. Reforms enacted today would need to be roughly twice as severe and if delayed until 2033 would need to be much larger still. For practical purposes the window of opportunity to preserve Social Security's historical financing structure will close long before 2033, and might well be closing soon or even now.

The Historical Basis for the Current Tax Allocation between OASI and DI

As a general rule, reallocations of the tax rates financing the two trust funds have taken place in the context of comprehensive legislation with a significant impact on Social Security's financing outlook, or anticipating the passage of such legislation. Before automatic Social Security benefit indexing was introduced in 1972, there was sporadic legislation to increase benefits *ad hoc*, with some of these amendments including reallocations of tax rates between the trust funds to reflect changed expectations of expenditures under new benefit formulae. Examples include the benefit increases enacted in 1967, 1969, and 1972, as well as a post-indexation benefit increase enacted in 1973. Reallocations of taxes also occurred in 1977 and 1983, in the context of legislation enacting major corrections to Social Security's financing imbalance. DI amendments were also enacted in 1980 with the aim of controlling the growth of program costs, after which taxes were reallocated to reflect these updated policies. The current allocation of payroll taxes between the OASI and DI trust funds was enacted in 1994 in anticipation of the passage of legislation to reform the DI program, as the remainder of my testimony will document.

The 1994 reallocation was enacted with the express intent of providing lawmakers a considered opportunity to enact significant reforms to control the growth of DI costs and improve the program's financial stability. By 1994, DI program costs had grown far beyond projections at the time of the last major Social Security financing reforms in 1983, and were threatening to deplete the DI trust fund. The allocation of taxes between OASI and DI in the 1983 amendments was appropriate at that time given respective OASI and DI cost projections. For example, the 1983 report projected that under the trustees' "II-B" assumptions (those used for the development of the 1983 amendments), DI and OASI would both receive sufficient revenues to maintain long-range actuarial balance, separately and in combination. Indeed, under 1983 assumptions the long-range trust fund ratios for DI were somewhat better than for the OASI fund.

DI costs in the late 1980s and early 1990s, however, were significantly higher than projected in 1983. By 1994, program costs as a percentage of worker wages were over 40% higher than had

been predicted in the 1983 report. The reasons for this unanticipated cost increase were various, and importantly were not fully understood at the time of the 1994 payroll tax reallocation. One important factor was certainly 1984 DI legislation, which in the words of David Autor and Mark Duggan, "profoundly altered the disability determination system, yielding a broader definition of disability." The SSA office of policy has also theorized that a "major outreach program" instituted by SSA in 1990 "probably contributed. . . to an increase in current beneficiaries (that is, persons eligible for disability benefits under both Social Security and SSI) in the early 1990s." A recession in the early 1990s also likely contributed to an increase in disability benefit applications. Additionally there were the long-term drivers of DI program growth cited earlier in this testimony. Irrespective of the reasons, however, DI costs had grown far faster than anticipated by the early 1990s, necessitating a legislative response at a time of incomplete information. The situation in 1994 was thus very different from today both substantively and in terms of informational preparedness; in 1994, the impending depletion of the DI trust fund had not been long anticipated and there had not been time to prepare comprehensive reforms in response. By contrast, the now-arriving shortfall has long been anticipated, and more than twenty years have elapsed to allow the enactment of the substantive DI reforms the 1994 reallocation was intended to facilitate.

By the time of the 1993 trustees' report, the projected depletion of the DI trust fund was just two years away in 1995. In their 1993 annual message, the Board of Trustees together recommended that lawmakers reallocate to the DI fund "a larger share of the overall OASDI tax rate." However, the body of the 2013 report stated that the public trustees "did not consider it appropriate to participate with the *ex officio* trustees in the analysis of the DI program experience or the development of specific legislative recommendations." The report did indicate that the public trustees "concurred" in both recommendations for "a tax rate reallocation" and for "the best possible research to assist policymakers in formulating solutions to the projected long-range DI deficit." In their separate 1993 message, the public trustees again recommended that "additional research be undertaken on a priority basis to better understand the reasons for the recent adverse financial experience of the DI program and likely longer range demands in our society for disability insurance benefits."

This subcommittee held a hearing on the trustees' recommendations on April 22, 1993. For that hearing, public trustees Stanford Ross and David Walker submitted a statement reiterating their reasons for not participating in the development of the *ex officio* trustees' proposals, while also reiterating that they "concurred" in the recommendations both to reallocate payroll taxes in the near term and to conduct research "to assist policymakers in formulating solutions to the projected long-range DI deficit." The proposed tax reallocation, they stated, was intended to enable the DI trust fund to meet the trustees' 10-year test of "short-run financial adequacy." The trustees' reason for such a reallocation was stated as follows:

> "The Board recommended a reallocation designed only to meet the short-term needs of the DI Trust Fund, in part because it is not clear whether the dramatic increase in the number of workers applying for the Disability Insurance benefits that began in 1990 is a temporary phenomenon or a longer term, more permanent trend. . . . The Board of Trustees

> recommended in December and reaffirmed when we met this month the need for the best possible research regarding likely future disability experience. . . . Until this work is completed, there is, in our judgment, insufficient information to design specific proposals for the long term. . . . the proposed reallocation for the short term will provide the time and opportunity to prepare and enact any needed changes in a careful and orderly manner."

In other words, the purpose of the trustees' recommendation that taxes be reallocated was not as a DI solution in and of itself, and still less to establish the precedent of using additional tax reallocations to bypass the necessity of comprehensive financing corrections; it was, rather, recommended specifically to facilitate such comprehensive reforms. Public trustee Stanford Ross accentuated this point repeatedly in his 1993 appearance before this subcommittee, stating that "it is fundamental that the administration of the DI program needs to be improved," and later that "the prudent thing would be to meet short-term solvency so that both funds meet the 10-year test, and then to work on the long-term problems of both funds."

At the time the trustees' 1994 report was released, legislation to address the impending DI shortfall had still not been enacted. In their message to the public, the public trustees reiterated their call for action:

> "The 1994 Report continues to project that the DI fund will be exhausted in 1995. <u>Therefore, we again strongly urge that action be taken as soon as possible to ensure the short-range financial solvency of the DI trust fund.</u> We also strongly urge the prompt completion of the research efforts undertaken by the Administration at the Board's request. This research may assist the Congress as it considers the causes of the rapid growth in disability costs and addresses, as necessary, any substantive changes needed in the program. Disability Insurance under Social Security is nearly 40 years old. While some reforms have taken place over the years, the public is entitled to a thorough policy review of the program. The recent dramatic growth suggests the possibility of larger underlying issues related to the health and employment circumstances of workers and the need for responsive adjustments in the program."

Perhaps the most important trustee statements with respect to the intent of the 1994 tax reallocation were made after its enactment. Rather than treating reallocation as itself a solution to DI's financing challenges, the trustees used their 1995 message to reiterate the need for comprehensive action. In that 1995 message, the Board of Trustees stated:

> "The Board believes that the long-range deficit of the DI Trust Fund should be addressed. The Advisory Council on Social Security currently also is studying the financing of the DI program and is expected to recommend later this year ways to achieve long-range actuarial balance in the DI fund."

In their separate 1995 message, the public trustees were more explicit that the 1994 tax reallocation was only the first step in the intended reform process:

> "While the Congress acted this past year to restore its (DI's) short-term financial balance, this necessary action should be viewed as only providing time and opportunity to design and implement substantive reforms that can lead to long-term financial stability. The research undertaken at the request of the Board of Trustees, and particularly of the Public Trustees, shows that there are serious design and administrative problems with the DI program. Changes in our society, the workforce and our economy suggest that adjustments in the program are needed to control long-range program costs. Also, incentives should be changed and the disability decision process improved in the interests of beneficiaries and taxpayers. We hope that this research will be completed promptly, fully presented to Congress and the public, and that the Congress will take action over the next few years to make this program financially stable over the long term."

Lawmakers in 1994 could easily have chosen to reallocate sufficient funds to DI to postpone its projected depletion into the 2020s or 2030s but deliberately did not. The projected depletion date for the DI trust fund in the 1995 report was 2016, the same as our current projection. This was done primarily because it was believed that the 1994 reallocation would provide more than sufficient time to enact comprehensive reforms.

Summarizing, Social Security finances have been sustained to date because as a general rule, lawmakers have responded to projections of trust fund reserve depletion by enacting legislation to slow the growth of program costs, increase tax revenues, or both. In the context of such legislation, taxes have also been reallocated between the OASI and DI trust funds to reflect the effects of the legislation on program expenditures. The 1994 reallocation was an exception to this general rule because policy makers did not yet believe there was sufficient information to design appropriate reforms. A primary purpose of the 1994 reallocation was to satisfy the trustees' short-term (10-year) solvency test, which was regarded as providing more than enough time for the necessary reforms to be enacted.

Areas of Broad Continuing Agreement

As with Social Security policy generally, there is a wide range of opinions about how to best correct the course of DI trust fund finances, and the trustees do not opine on their relative merits. Statements by the trustees have maintained continuity with respect to general principles for reform despite turnover in those serving as trustees. As noted earlier, the 2014 trustees report reiterated that prompt action to correct Social Security finances is desirable, and expressed concern that a standalone reallocation of funds "might serve to delay DI reforms and much needed financial corrections for OASDI as a whole. However, enactment of a more permanent solution could include a tax reallocation in the short run." At our press conference announcing the release of that

report, Treasury Secretary Jack Lew noted similarly that some means of shifting revenues between the trust funds would probably need to be included in legislation, for the reason that "if you look from now until 2016, there's probably no other alternative which could produce the desired results between now and then." The Administration's budget, which included a proposal to reallocate taxes between the trust funds, included another proposal that would make slight improvements to overall program finances, as some members of Congress have proposed as well. Other proposals to improve both DI and broader OASDI finances to more significant degrees are being developed by numerous outside experts, including Jason Fichtner and Mark Warshawsky at the Mercatus Center, as well as experts working with the Committee for a Responsible Federal Budget and the Bipartisan Policy Center, among others. A recently enacted House rule would also permit revenues to be redistributed between the trust funds providing this is done in the context of legislation improving Social Security finances generally, as recommended consistently by the trustees. My fellow trustee Robert Reischauer and I joined to reiterate this viewpoint in our joint message to the public last year, stating that, "the DI Trust Fund's impending reserve depletion signals that the time has arrived for reforms that strengthen the financing outlooks for OASI and DI alike."

Conclusion

Social Security finances have been sustained to date because as a general rule, lawmakers have responded to projections of trust fund reserve depletion by enacting legislation to slow the growth of program costs, increase tax revenues, or both. In the context of such legislation, taxes have also been reallocated between the OASI and DI trust funds to reflect the effects of the legislation on program expenditures. In view of the short time now remaining before projected depletion of the DI trust fund, lawmakers will likely need to effectuate some means of bringing additional revenue into that fund to buy time before its outlay obligations shift further to the OASI trust fund as more of the baby boomers reach retirement age. However, to reallocate taxes between OASI and DI at this time without significant financing reforms would be counter to the trustees' expressed intent in recommending the current allocation enacted in 1994. While lawmakers would certainly be well within their rights to disregard this prior intent, it is important to be aware of potential adverse ramifications for the Social Security program of doing so. An overriding principle that lawmakers should bear in mind as they consider shifting revenues between the funds is the mounting threat that Social Security faces from continued delays in enacting comprehensive financial corrections. If for example funds were reallocated between the trust funds as a means of delaying such corrections, and lawmakers thereafter did not enact such reforms well before the combined trust fund depletion date of 2033, it is extremely likely that Social Security's historical financing structure would need to be abandoned due to the unwillingness to meet the requirements of self-financing. In my opinion this would be an unnecessary and unfortunate loss, given the countless important ways in which Social Security has successfully served millions of Americans to date through its historical financing structure.