Statement of Charles P. Blahous

Public Trustee for Social Security[1]

Before the Subcommittee on Social Security

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 proposals to use the chained Consumer Price Index (C-CPI) to determine Social Security Cost-of-Living-Adjustments (COLAs) as well as to index other federal programs.

How Social Security COLAs are Calculated under Current Law

Discussions of the possible use of C-CPI are relevant to Social Security because, as with other federal programs, certain aspects of Social Security benefit growth are tied to measures of price inflation. Specifically, Social Security benefits of those who have already begun to receive them are adjusted for general price inflation via an annual COLA. The COLA is currently calculated on the basis of reported change in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), a measure of price inflation maintained by the Bureau of Labor Statistics (BLS).[2] The text of the Social Security Act specifies that the COLA for the next calendar year is calculated based on how much the CPI has risen from September 30 of the previous year to September 30 of the current year. It has become typical for the Social Security Administration to announce these annual COLA adjustments in mid-October.

The annual COLA adjustment, based on the CPI-W, is but one of several forms of indexation of Social Security payments and revenues. For the purpose of calculating participants' initial benefits, both the individual's own wage history as well as the benefit formula itself are indexed to growth in the national average wage index (AWI). The amount of a worker's wages annually subject to the Social Security payroll tax is also indexed to the AWI. These other forms of Social Security indexation would be unaffected by a change in the measurement of CPI.

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

[2] Many other federal programs are indexed to another measure of price inflation, CPI-U, which had not yet been introduced when Social Security COLAs were first established.

Using Chained CPI to Measure General Price Inflation

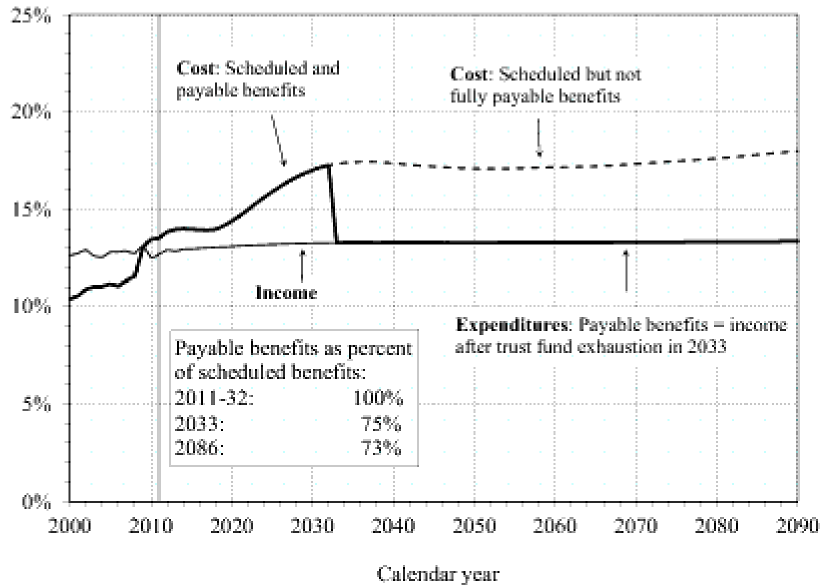
Many economists have concluded that the CPI-W systematically overstates actual price inflation because it fails to account for changes in consumption patterns that arise as the prices of different goods and services rise by different amounts. A fully accurate measure of inflation must take into account changes in purchasing patterns, rather than assuming that an individual's purchases from different categories remain unchanged regardless of whether some items' prices grow more rapidly than others. Many economists regard C-CPI as a more accurate measure of general inflation because it accounts for such changes in buying patterns whereas CPI-W does not.

Clearly, whether C-CPI is a preferable measure for indexing annual Social Security COLAs is primarily a function of whether policy makers are persuaded that it represents a technical improvement in how general inflation is measured. Other witnesses at this hearing are in a better position to discuss the extent to which C-CPI represents a technical improvement over CPI-W. If C-CPI is technically meritorious, it would be fairest to apply the measure to all federal programs indexed to general price inflation including Social Security, as well as to the federal tax code. Social Security should neither be singled out among federal programs for application of the change, nor should it be selectively exempted. The rest of my testimony will be focused on describing the change's effects on Social Security operations in the event that lawmakers are persuaded of C-CPI's technical merits.

Current Social Security Financial Projections

Social Security faces a substantial and growing financing shortfall consisting of a significant excess of scheduled benefits over incoming revenues. The latest trustees' report estimated the actuarial deficit in Social Security's combined trust funds at 2.67 percent of its tax base, which consists of worker wages subject to the payroll tax. This is the highest deficit recorded since the last major Social Security reforms in 1983. Social Security's financing shortfall embodies an enormous public policy challenge as well as a significant threat to the financial security of millions of program participants.

Figure 1: Social Security Costs and Income as a Percentage of Taxable Payroll

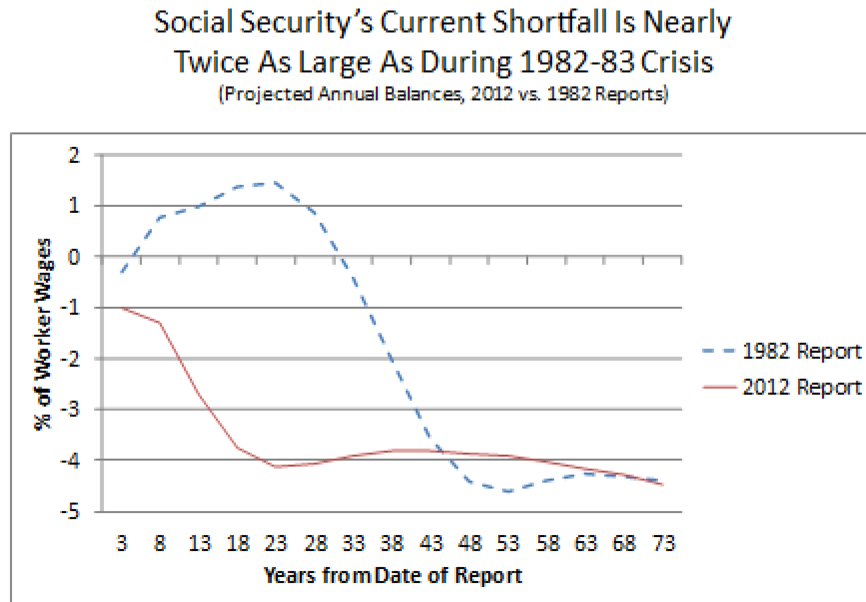


(Source: 2012 Social Security Trustees' Report)

Social Security's shortfall arises because expenditures are growing substantially faster than the program's base of tax income. A leading cause of this cost growth is an increase in the numbers of beneficiaries relative to taxpaying workers, a phenomenon driven both by increasing longevity and changes in fertility rates. Various aspects of program law also play critical roles in driving cost growth, including the indexation of initial benefit formulas to the AWI (which tends to grow faster than price inflation), and statutory eligibility ages that permit individuals today to claim retirement benefits at younger ages than permissible at Social Security's inception despite living generally longer lives.

It is significant that Social Security's projected financing shortfall is already much larger than the one addressed in the landmark 1983 program amendments. Averting insolvency in 1983 required several extremely controversial measures, including a six-month delay in COLAs, the first-time exposure of benefits to income taxation, bringing newly hired federal workers (and their payroll taxes) into the system, a full retirement age increase, and an acceleration of a previously-enacted payroll tax increase, among others. Social Security's currently-estimated shortfall is already much larger even in relative terms, such that a long-term financing solution enacted today would require tax increases and benefit restraints nearly twice as severe as those necessitated in 1983.

Figure 2: Comparison of 1982 and 2012 Social Security Projections



(Source: 1982 and 2012 Social Security Trustees' Reports)

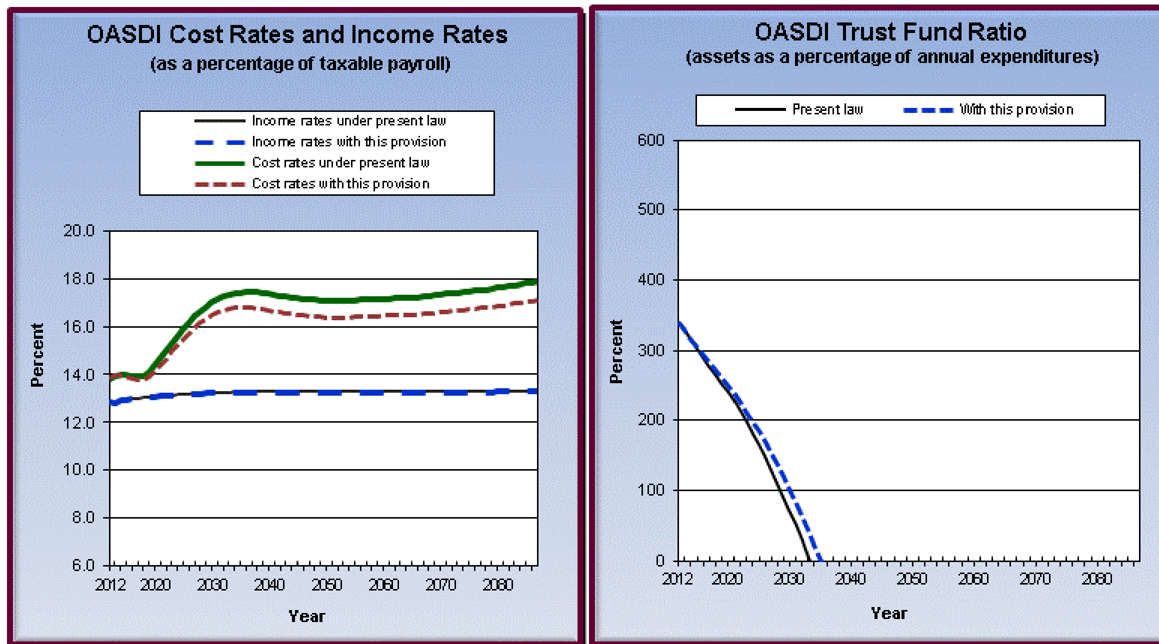
With each passing year of further legislative delay, Social Security's shortfall becomes more difficult to resolve, especially when factoring in lawmakers' historical desire to avoid sudden reductions in benefits for those already receiving them. Among the near-term consequences of a continued failure to enact financing reforms is that depletion of Social Security's disability trust fund would force sudden disability payment reductions of roughly 21% by 2016.

Projected Effects of CPI Reform upon Social Security Finances

The projected effects of using C-CPI to index Social Security COLAs would be positive for program finances, though small relative to Social Security's total financing shortfall. Accomplishing lasting Social Security financing reforms will require far more substantial action to align the program's basic benefit formula and eligibility rules with future tax schedules. CPI reform may be technically meritorious as a broader government-wide correction in the measurement of inflation, but it does not constitute Social Security reform or entitlement reform any more than it constitutes comprehensive tax reform.

The most recent available actuarial estimates of the long-term effect of basing Social Security COLAs on C-CPI are that it would improve the program's actuarial balance by approximately 0.54% of taxable payroll and annual program operations over the long term by approximately 0.73% of taxable payroll. This would eliminate either 20% or 16% of the long-term shortfall depending on the measure employed.[3] The currently-projected decline in trust fund assets would decelerate only slightly.

Figure 3: Projected Effects of C-CPI on Social Security Finances

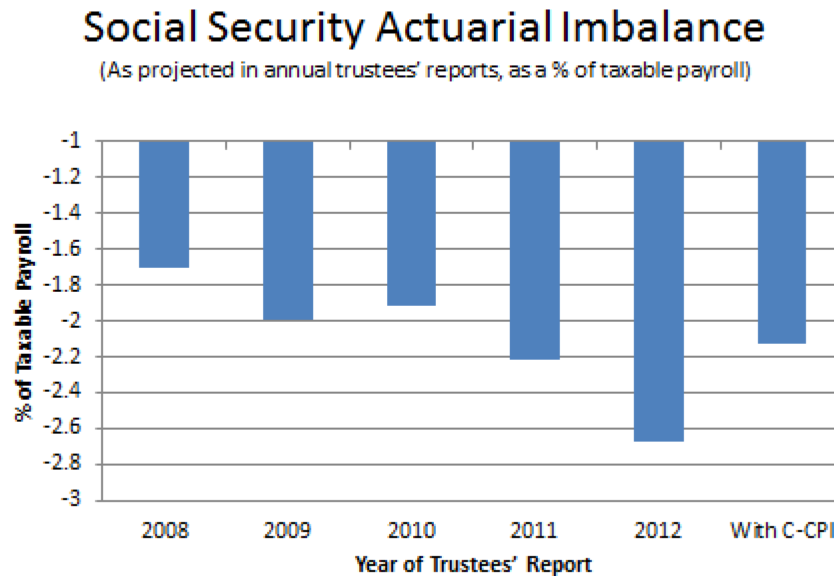


(Source: Social Security Administration Office of the Chief Actuary)

Though this would represent an improvement in program finances, by itself it would not even make up for their deterioration in just the last few years. The remaining actuarial imbalance of 2.13% of taxable payroll would still be larger than the shortfall estimated as recently as 2010. The shortfall would also remain much larger than the one confronted in the crisis year of 1983. With or without CPI reform, repairing Social Security's financial outlook will remain an urgent public policy challenge.

[3] Net savings would be substantially less if combined with other benefit enhancements that some have proposed be coupled with CPI reform.

Figure 4: Social Security Financing Shortfalls, with C-CPI vs. Recent Reports



(Sources: 2012 Social Security Trustees' Report, SSA Office of the Chief Actuary)

Intergenerational Equity Considerations

In addition to modestly improving program finances, CPI reform would also create a slight improvement in program equity across generations. One current policy challenge is that the interaction between Social Security financing methods and demographic trends causes worsening treatment of younger generations, threatening the continued efficacy of Social Security as a future bulwark against old-age poverty.

It is estimated that scheduled benefits for current and past participants in Social Security exceed the total taxes they will have contributed by approximately $22.2 trillion in present value. A great deal of this excess is because the earliest Social Security beneficiaries received far more in benefits than they contributed in taxes. If current benefit schedules remain unchanged, those now entering the system will on balance lose approximately 4.2% of their career taxable wage income to Social Security, assuming that they receive all currently-scheduled benefits. Even future workers of modest income would be subject to these net income losses. A medium-wage two-earner couple now entering the workforce can currently expect to receive only 82 cents of each Social Security tax dollar back as benefits unless something is done to significantly slow the growth of program costs in the upcoming decades.

A substantial portion of these income losses are virtually inevitable under nearly any realistic policy scenario, as lawmakers have historically been reluctant to reduce benefits for those in or near retirement. These losses facing younger generations would be exacerbated, however, if they are taxed to pay annual COLAs to current participants that exceed actual price inflation.

Alternative Proposals for Calculating Social Security COLAs

Some have suggested that an alternative method of indexing for inflation be used for Social Security COLAs, such as one developed specifically to model the purchasing patterns of seniors. I believe that this approach faces a number of disqualifying problems. The first and most obvious problem is that no such technically accurate measure currently exists. The BLS currently maintains an experimental measure known as the CPI-E, but it suffers from a number of widely-acknowledged flaws. For one, like the CPI-W it is not a chained measure and thus does not account for relevant changes in purchasing patterns. For another, it is more greatly affected by expenditures on health services, a sector in which a significant portion of cost growth is driven by advances in technology and quality rather than by actual price inflation. The Congressional Budget Office has recently cited research finding that CPI-E might overstate health price inflation by more than 1 percent per year.

However, even if a technically improved senior-specific inflation index could be developed, I do not believe it would be appropriate for use in calculating Social Security COLAs. The clear intention in adding COLAs to Social Security was to adjust for general price inflation rather than that affecting seniors specifically, as evidenced by the fact that the section of the Social Security Act establishing the COLA applies the same calculation to the benefits of older retirees and younger disability recipients alike.

Social Security provides various types of benefits, many of them to individuals who are not elderly. 19% of all benefits are paid to disabled workers and their dependents; 11% to survivors of deceased workers. Within the disability benefit program, 7% of payments are for children. Individual Social Security beneficiaries sometimes move from one category to another. For example, a worker receiving disability benefits converts to old-age benefits upon reaching the full retirement age.

The use of a special senior-specific CPI to calculate Social Security COLAs could potentially have confusing and divisive consequences. It would be inappropriate to calculate benefits for children or young disabled adults using an inflation index developed only for the elderly. However, it also risks chaos for Social Security to employ different inflation indices for different

recipient groups, with each individual's COLA calculation changing as they move from one beneficiary category to another. Adopting separate inflation indices in Social Security for seniors in comparison with children and the disabled invites other potential subdivisions as well, for example if it is later discovered that price inflation in a particular year is markedly different in different geographic regions. I recommend against lawmakers going down the road of employing subpopulation-specific inflation measures, and instead continuing the use of a single measure of general price inflation.

Broader Concerns about Distributional Effects, Benefit Adequacy and Tax Burdens

Some have expressed concern about the use of C-CPI on the grounds that slower growth of Social Security COLAs could result in inadequate benefits, especially for those who live to particularly advanced ages. I share the concern about benefit adequacy for vulnerable groups, and have long advocated comprehensive Social Security reforms that would buttress benefits and protections against poverty for low-income populations. In the context of enacting a comprehensive financing solution, I recommend that lawmakers consider a number of such potential changes, including proposals for enhanced benefits for those at very advanced ages, while carefully considering interactions between Social Security and the Supplemental Security Income (SSI) program.

Having said that, I believe it would be a mistake to enact such benefit enhancements outside of the context of a credible and comprehensive Social Security solvency solution. To date, lawmakers have not yet proved willing to assess payroll taxes sufficient to finance now-scheduled Social Security benefits (regardless of whether COLAs are calculated with CPI-W or C-CPI), let alone with additional benefit enhancements. As long as Social Security finances remain on a course toward insolvency, scheduling increased benefits represents a hollow promise that does not add meaningfully to the income security of the beneficiary population.

In conclusion, I believe that whether C-CPI should be used for Social Security COLAs is primarily a function of whether lawmakers are persuaded that it represents an improved measure of general price inflation. If so, it should be applied to Social Security COLAs as with other federal programs, neither selectively targeting nor exempting any. Such a change, however, does not embody Social Security reform or entitlement reform; it would create a slight improvement in Social Security finances but not enough even to offset their worsening over the last two years. Though it may be technically meritorious, it is in no sense a substitute for significant Social Security financing reforms, the need for which grows more urgent with each passing year.