

CBO TESTIMONY

**Statement of
Douglas Holtz-Eakin
Director**

The Future of Social Security

**before the
Special Committee on Aging
United States Senate**

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**CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515**

Chairman Smith, Senator Kohl, and Members of the Committee, thank you for the opportunity to testify on the future of Social Security. In evaluating possible changes to the Social Security system, it is important to consider not only the implications for the program itself but also for the federal budget and the United States' economy.

The Budgetary Context

If current spending and tax policies do not change, the aging of the baby-boom generation, combined with rising health care costs, will cause a historic shift in the United States' fiscal situation. Consistently large annual budget deficits would probably lead to an ever-growing burden of federal debt held by the public. As the government claimed an increasing share of national savings, the private sector would have less to invest in creating new business equipment, factories, technology, and other capital. That "crowding out" would have a corrosive and potentially contractionary effect on the economy. Although placing federal fiscal policy on a sustainable path will not be easy, the sooner that policymakers act to do so, the less difficult it will be to make economic and budgetary adjustments.

Outlays for mandatory programs have increased from less than one-third of total federal spending in 1962 to more than one-half in recent years. Most of that growth has been concentrated in Social Security, Medicare, and Medicaid. Together, those programs now account for about 42 percent of federal outlays, compared with 25 percent in 1975. The aging of the population will accelerate that trend.

The aging of the baby-boom generation is the beginning of a significant, long-lasting shift in the age profile of the U.S. population, which will dramatically alter the balance between people of working age and retirees. Over the next 50 years, the number of people ages 65 and older will more than double, whereas the number of adults under age 65 will increase by less than 20 percent.¹

As a result, the Social Security trustees project that the number of workers per Social Security beneficiary will decline significantly over the coming decades: from about 3.3 now to 2.0 in 2050. Unless immigration or fertility rates change substantially, that figure will continue to decrease slowly after 2050 as longevity continues to grow. The interaction of that growth in the retired population with the current structure of the Social Security program leads the Congressional Budget Office (CBO) to project that the cost of Social Security benefits will rise from 4.2 percent of gross domestic product (GDP) now to 6.4 percent in 2050.

1. For a more extensive discussion, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003) and *The Outlook for Social Security* (June 2004).

Over the same period, health care costs are likely to continue to grow faster than the economy. Between 1960 and 2001, the average annual growth rate of national health expenditures exceeded the growth rate of GDP by 2.5 percent.

Driven by rising health care costs, spending for Medicare and Medicaid is increasing faster than can be explained by the growth of enrollment and general inflation alone. If spending per enrollee were to grow 2.5 percent faster than per capita GDP in the future, federal spending for Medicare and Medicaid would rise from 4.2 percent of GDP today to about 21 percent of GDP in 2050—roughly the current size of the entire federal budget. The Medicare trustees assume that the difference between the growth in spending per enrollee and the growth in GDP will gradually decline to 1 percent, on average; however, even at that rate, federal spending for Medicare and Medicaid would almost triple—to about 12 percent of GDP—by 2050.

Unless taxation reaches levels that are unprecedented in the United States, current spending policies will probably be financially unsustainable over the next 50 years. Policy changes that restrict the growth in retirement and health programs will be necessary even if outlay growth slows for defense, education, transportation, and other programs funded through discretionary appropriations. The projected imbalances will occur under all but the most favorable assumptions about the aging of the population and the growth of health care costs.

Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the budget that economic growth alone is unlikely to alleviate. Moreover, issuing ever-larger amounts of debt or dramatically raising tax rates could significantly reduce economic growth. Consequently, policymakers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those three approaches.

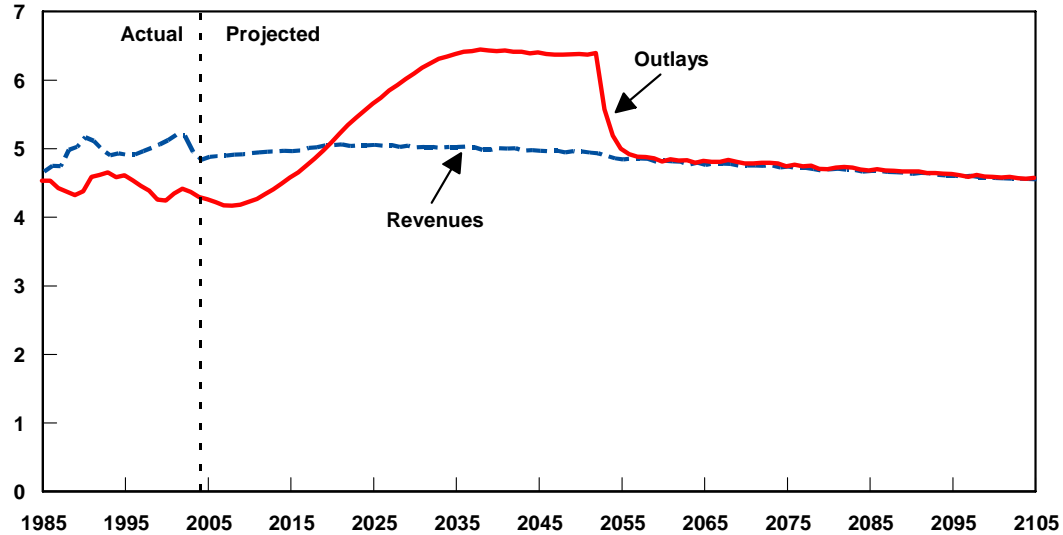
The Outlook for Social Security

Tracing the likely path of Social Security spending under current law may provide some insight into the timing and magnitude of the program's budgetary impact. In 2008, the leading edge of the baby-boom generation will become eligible for early retirement benefits. Shortly thereafter, the annual Social Security surplus—the amount by which the program's dedicated revenues exceed the benefits paid to recipients—will begin to diminish (see Figure 1). That trend will continue until about 2020, when Social Security's finances will reach a balance, with the revenues coming into the system from payroll taxes and taxes on benefits matching the benefit payments going out. Thereafter, outlays for benefits are projected to exceed the system's revenues. To pay full benefits, the Social Security system will rely on interest on, and ultimately the redemption of, government bonds held in its trust funds. At that point, the Treasury will have to find the money to cover

Figure 1.

Social Security Revenues and Outlays as a Share of GDP Under Current Law

(Percentage of GDP)



Source: Congressional Budget Office.

Note: Based on the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include trust-fund-financed Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenues in 2020; starting in 2053, scheduled benefits will not be able to be paid.

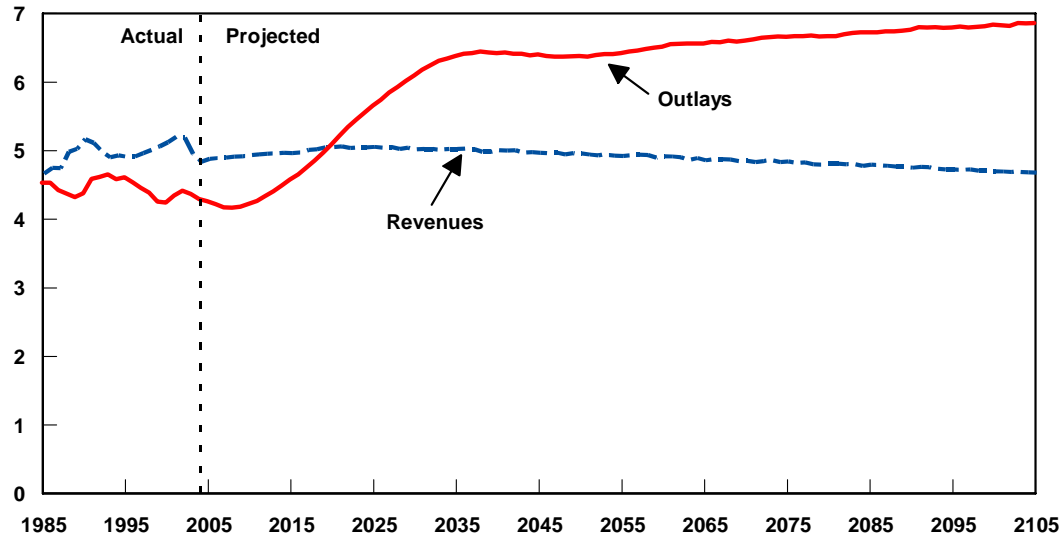
those obligations. Policymakers can provide that money in three ways: by cutting back other spending in the budget, by raising taxes, or by increasing government borrowing.

In the absence of other changes, the redemption of bonds can continue until the trust funds are exhausted. In the Social Security trustees' projections, that happens in 2042; in CBO's projections, it occurs about a decade later, largely because CBO projects higher real (inflation-adjusted) interest rates and slightly lower benefits for men than the trustees do. Once the trust funds are exhausted, the program will no longer have the legal authority to pay full benefits. As a result, it will have to reduce payments to beneficiaries to match the amount of revenue coming into the system each year. Although there is some uncertainty about the size of that reduction, benefits would probably have to be cut by 20 percent to 30 percent to match the system's available revenue.

Figure 2.

Social Security Revenues and Outlays as a Share of GDP with Scheduled Benefits Extended

(Percentage of GDP)



Source: Congressional Budget Office.

Note: Based on the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs.

The key message is that some form of the program is, in fact, sustainable indefinitely. With benefits reduced annually to match available revenue (as they will be under current law when the trust funds run out), the program can be continued forever. Of course, many people may not consider a sudden cut in benefits of 20 percent to 30 percent to be a desirable policy. In addition, the budgetary demands of filling the gap between benefits and dedicated revenues in the years before the cut may prove onerous. But the program is sustainable from a financing perspective.

What is not sustainable is continuing to provide the present level of scheduled benefits (those based on the benefit formulas that exist today) given the present financing. Under current formulas, outlays for scheduled benefits are projected to exceed available revenues indefinitely after about 2020 (see Figure 2). That gap cannot be sustained without continual—and substantial—injections of funds from the rest of the budget.

The Impact of Social Security on the Federal Budget

I would like to make two points about Social Security in the larger context of the total budget. First, Social Security will soon begin to create problems for the rest of the budget. Right now, Social Security surpluses are still growing and contributing increasing amounts to the federal budget. But as explained above, those surpluses will begin to shrink shortly after 2008, when the baby boomers start to become eligible for early retirement benefits. As the rest of the budget receives declining amounts of funding from Social Security, the government will face a period of increasing budgetary stringency. By about 2020, Social Security will no longer be contributing any annual surpluses to the total budget and, after that, it will draw funds from the rest of the budget to make up the difference between the benefits promised and payable under current law and the system's revenues. As noted previously, policymakers will have only three ways to make up for the declining Social Security surpluses and emerging Social Security deficits: reduce spending, raise taxes, or borrow more.

CBO's projections offer some guidance about the potential impact of those developments on the budget. By CBO's calculations, the Social Security surplus (excluding interest) will reach about \$100 billion in 2007; but, by 2025, that surplus is projected to become a deficit of roughly \$100 billion (in 2005 dollars). That \$200 billion swing will create significant challenges for the budget as a whole.

Second, the stresses on the budget from Social Security will take place simultaneously with the even larger demands generated by Medicare and Medicaid. Currently, outlays for Social Security benefits equal about 4 percent of GDP, as does federal spending on Medicare and Medicaid. Social Security outlays are projected to grow to almost 6.5 percent of GDP by 2050, but, as discussed above, spending on the two health programs is expected to grow substantially more. Although Social Security will place demands on the federal budget, those demands will coincide with much greater demands from Medicare and Medicaid.

Comparing the Projections of CBO and the Social Security Trustees

The projections of the financial future of Social Security by both CBO and the Social Security trustees are identical in character: under current law, the program's scheduled outlays will exceed its scheduled revenues over the next 50 years, and annual Social Security deficits will be large and growing over the long term.² The projections differ only in numerical detail.

2. CBO released its most recent projections on January 31, 2005. See www.cbo.gov/showdoc.cfm?index=6064&sequence=0. For the projections of the Social Security trustees, see *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 23, 2004), available at www.ssa.gov/OACT/TR/TR04/index.html

CBO has benefited from continued discussions with the Social Security actuaries. CBO also appreciates the support the Social Security Administration has provided to CBO's efforts by sharing much of the data underlying the projections.

Under both sets of projections, outlays for Social Security will grow substantially within the next decade. Looking out 20 years, outlays as a share of GDP will increase by 32 percent under CBO's projections; the trustees project slightly higher growth of 36 percent in their 2004 report. Over the next 30 years, outlays will be 49 percent larger, CBO projects; the trustees project an increase of 51 percent. The differences in projected revenues are somewhat larger, but both projections show substantial imbalances. CBO projects that in 30 years, outlays will be 26 percent higher than revenues; the trustees project that they will be 33 percent higher.

A bit more than half of the differences between the two organizations' projections stem from different modeling techniques; the rest result from varying economic assumptions. CBO's modeling techniques result in lower projected outlays than the trustees' do when using the same economic assumptions. CBO and the trustees take different approaches to projecting the distribution of future beneficiaries' earnings; that and other modeling differences cause CBO to project lower average retirement benefits than the trustees do, especially for men retiring around 2020 and later.

Although CBO uses the same demographic assumptions as the trustees, its long-term economic assumptions are consistent with the ones used in its 10-year projections (see Table 1). CBO assumes slightly higher wage growth and lower inflation. On net, those assumptions result in projections of outlays that are slightly lower relative to GDP.

Table 1.

**CBO's and the Social Security Trustees'
Long-Term Economic Assumptions**

(Percent)

	CBO	Social Security Trustees
Real Earnings Growth	1.2	1.1
Real Interest Rate	3.3	3.0
Inflation	2.2	2.8
Unemployment Rate	5.2	5.5

Source: Congressional Budget Office.

Finally, CBO assumes a higher real interest rate than the trustees do. The interest rate does not affect projections of annual outlays or revenues, but it is used as the discount rate in calculations of the present value of future revenues and outlays. Thus, CBO's assumption of a higher interest rate places a lower weight on the large deficits in the distant future and results in lower projected summarized balances. The assumption also results in higher interest being credited to the trust funds, which results in a later projected trust-fund exhaustion date.

Reform Now or Later: The Economic and Budgetary Effects of Postponing Action

The sooner efforts are made to address the long-term imbalance in the federal budget—and in Social Security in particular—the less difficult the adjustments will be. Currently, workers, employers, and beneficiaries face uncertainty about the rules they will face in the future. Actions that resolve this uncertainty will allow them to more confidently plan how to work, save, spend, and hire. Resolving uncertainty about the budgetary outlook for Social Security would also allow policymakers to better understand future budgetary constraints when considering other aspects of federal budget policy.

Economic growth is the principal engine to ensure that future needs, both public and private, can be met. However, it is unlikely that the federal government will “grow its way out” of budget imbalances. Implementing gradual action today avoids the need for precipitous and disruptive action later—which could take the form of either sudden, large reductions in benefits or sudden, large increases in taxes, which can depress work effort and incentives to invest.

Phasing in programmatic changes allows for gradual accommodation, giving people time to modify their expectations and to adjust their work and saving behavior. For example, younger workers who learned that they would receive lower-than-anticipated retirement benefits would have many years to respond. They could work or save a little more each year. If the same benefit reductions were announced as those workers neared retirement, they might be forced to make dramatic changes and still might not have time to accumulate sufficient savings.

One way to gauge the advantage of acting earlier is to examine potential changes to the current pay-as-you-go Social Security program. As noted above, under current law, CBO projects that the Social Security trust funds would become exhausted in 2052; after that, the Social Security Administration would lack the authority to pay full benefits and, without Congressional action, outlays would be limited to annual revenues, which would be 22 percent lower than scheduled costs. Put differently, current law constitutes a “wait and reform” strategy in which beneficiaries in 2052 will actually get lower benefits than they are sched-

uled to receive according to the current formula. In the interim, beneficiaries will continue to receive scheduled benefits, and the program as a whole will contribute hundreds of billions of dollars to annual budget deficits.

Alternatively, policymakers could reduce the benefits paid to earlier cohorts, for example, by lowering benefits by the same fraction for all new beneficiaries. Under such a policy, and assuming no other changes to federal outlays or revenues, the reduced federal outlays would result in a smaller amount of debt held by the public.

CBO has estimated the effects of a simple illustrative example: reduce all new Social Security benefit awards by 10 percent—relative to those currently scheduled—beginning with people retiring or becoming disabled in 2012. This exercise would lower benefits for retirees born in 1950 and later, thereby affecting many more cohorts—including much of the baby-boom generation—than the “wait and reform” policy.

In general, lifetime benefits for current workers—those now 25 or older—would be lower under this policy than if no changes were made to the program. However, holding other government finances constant, such a change would allow greater benefits to be paid to future generations. In Figure 3, which compares the benefits that different generations would receive to those that are scheduled to be paid according to the current benefit formula, the “current law” bars show the benefits that would be paid if no changes were made to the law and all benefits were reduced starting in 2053. The other set of bars demonstrates the effects of acting earlier. The reduced benefits paid to earlier generations would result in government savings, probably in the form of lower debt, that could be used to pay higher benefits to future generations.

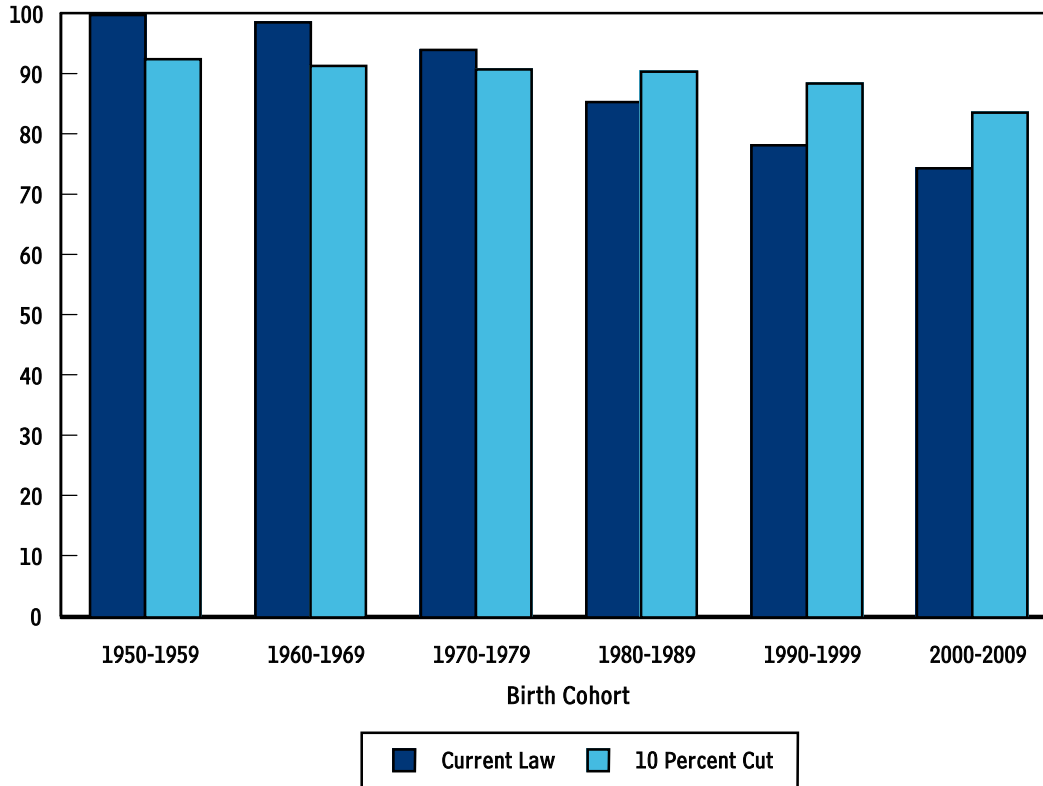
The conclusion of this analysis—that lower benefits for older workers would allow smaller reductions for future generations—is based on the notion that all other tax policy and spending decisions are unchanged. If the savings from earlier benefit reductions led policymakers to adopt tax policies that lowered national saving, the money could not be used to moderate future reductions in benefits. Similarly, if the lower unified deficits induced higher spending in other government programs, there would be no extra resources for future generations to share.

Decreasing benefits by 10 percent beginning in 2012 would substantially reduce debt held by the public (see Figure 4). Delaying action by 10 years would mean higher benefits for retirees born in the 1950s. Allowing that group—approximately 40 million people—to avoid sharing in the burden of the benefit reductions would halve the savings that would be realized over the next 40 years. Alternatively, policymakers could achieve the same savings through more drastic benefit reductions or tax increases borne only by younger generations.

Figure 3.

Lifetime Social Security Benefits Under Current Law and Under a 10 Percent Benefit Cut Beginning in 2012

(Percentage of scheduled benefits)



Source: Congressional Budget Office.

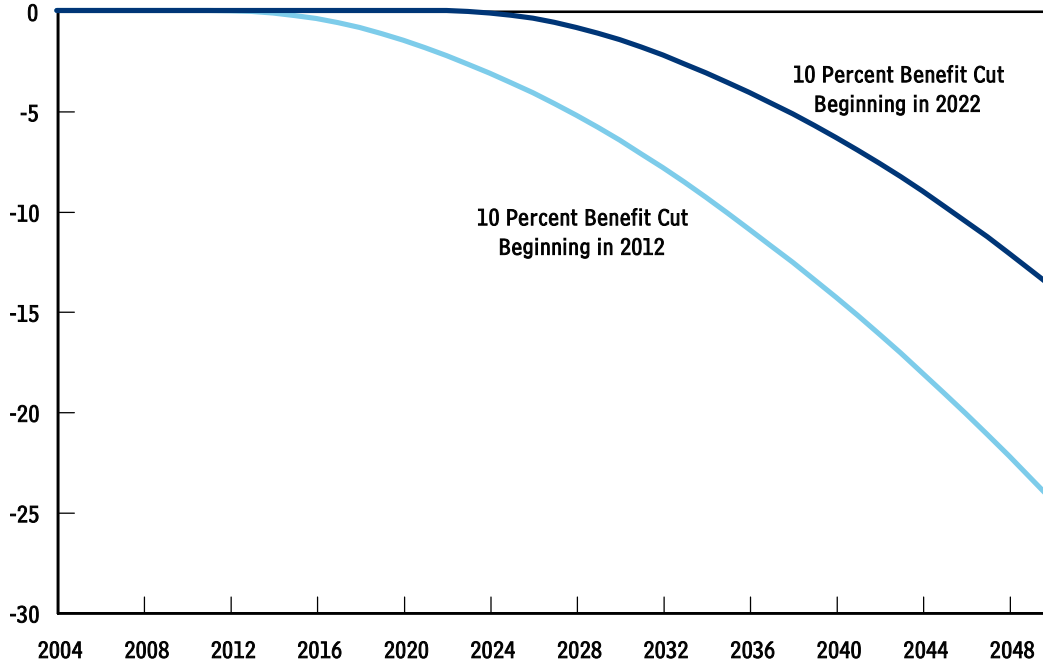
Growing federal debt would most likely slow the growth of investment in business equipment, factories, and housing and thus would curb the growth of the economy and, in the extreme, cause a sustained economic contraction.³ In contrast, any moderation in the growth of debt will generally lead to stronger economic growth. However, even if different budgetary strategies—such as lowering benefit payments to the elderly or raising taxes—had identical effects on government debt, they would have varying effects on how much people chose to save and work. For example, one would expect that reducing benefits would lead to greater economic growth as individuals worked and saved more in order to accumulate additional assets for retirement and as a cushion against the risk of disability.

3. See Congressional Budget Office, *The Long-Term Budget Outlook*, pp. 12-18.

Figure 4.

Change in Public Debt Under a 10 Percent Cut in Social Security Benefits

(Percentage of GDP)



Source: Congressional Budget Office.

However, policies should not be evaluated on a single dimension. Policymakers may choose to prioritize goals other than economic growth, such as the redistribution of income and wealth between different generations or the protections of a government-financed social insurance system.

The mechanistic approach of this example is not intended as a recommendation or a comprehensive gauge of options. More-realistic proposals would include multiple provisions and would be instituted gradually. Rather, the example is a convenient means of demonstrating the implications of earlier versus later adjustments. Whatever the policy—whether benefit reductions, tax increases, a transfer of resources from other federal programs, or a combination of those approaches—earlier action would allow for a broader distribution of the required changes, time for a gradual phase-in, and time for workers and beneficiaries to adjust their work and saving decisions.

