

CBO TESTIMONY

**Statement of
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Alternative Perspectives on Social Security

**before the
Committee on Finance
United States Senate**

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Chairman Grassley, Senator Baucus, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss the Social Security program from three perspectives: economic, budgetary, and programmatic. Those perspectives illuminate some of the policy issues that arise as the United States confronts the aging of its population.

First, Social Security can be viewed through the lens of the economy. Beneficiaries make decisions about when to retire and how much to work before retirement partly on the basis of the amount of taxes they pay and the amount of benefits they expect to receive. Social Security also influences people's decisions about how much to save, which plays a role in determining the size not only of their retirement income but also of the nation's capital stock as a whole. Consequently, Social Security has important implications for aggregate economic performance—for the flow of income that the economy will be able to generate and for the total stock of wealth and overall economic resources that will be available in the future. As a result, Social Security can significantly affect the nation's standard of living as well as the distribution of income within and among generations.

Second, from a budgetary standpoint, Social Security is the single largest program of the federal government. This fiscal year, outlays for Social Security are expected to top \$500 billion and account for 23 percent of total federal spending (excluding interest). Looking farther ahead, the Congressional Budget Office (CBO) projects that Social Security outlays will grow from 4.2 percent of gross domestic product (GDP) in 2005 to 6.5 percent in 2050. Although that growth is significant, it pales in comparison with the projected growth of the government's two big health programs, Medicare and Medicaid.

Last, Social Security can be analyzed from the perspective of the program itself. The most recent programmatic focus has been on the "sustainability" of the system's finances. However, several other aspects of the program are also important. Throughout its long history, Social Security has had multiple goals—some related to redistributing income, others to offsetting lost earnings. In 2004, only about two-thirds of Social Security's beneficiaries were retired workers; the rest were disabled workers, survivors of deceased workers, and workers' spouses and minor children. Policymakers will need to decide whether the program's goals are still appropriate, and if so, how changes to Social Security would aid or hinder the achievement of those goals and affect various types of beneficiaries and taxpayers. Those decisions will also need to take into account the dramatic increase in the elderly population that is expected in coming decades.

My statement examines the prospects for Social Security from each of those three perspectives, in reverse order, beginning at the programmatic level.

The Outlook for the Social Security Program

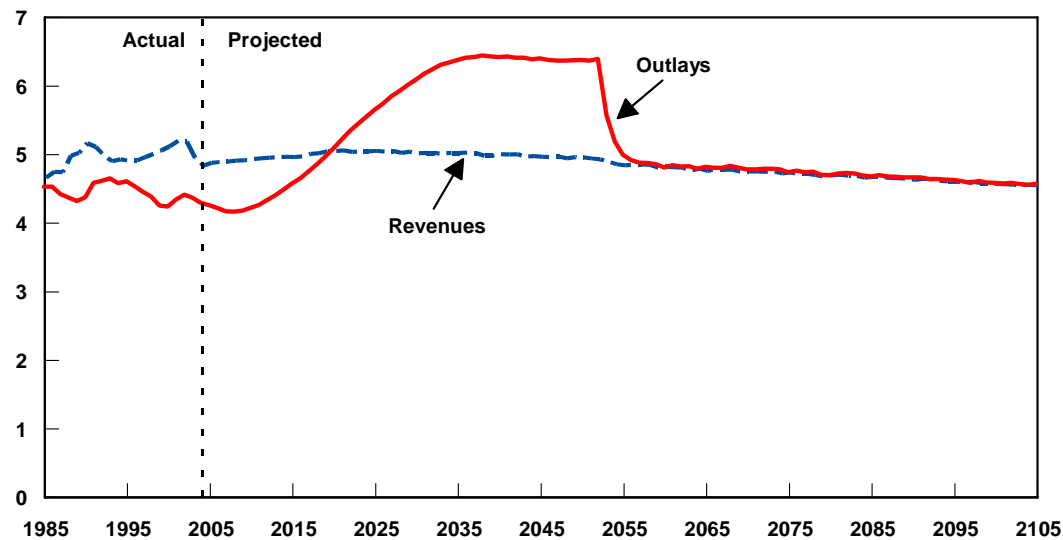
Although there is significant uncertainty involved in making numerical projections of the future of Social Security, the basic trajectory is widely accepted. The outlook for the Social Security program is generally the same regardless of whether one turns to the long-term projections of Social Security's trustees or to those of the Congressional Budget Office.

A key date for the program is 2008, when 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 benefits paid—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

Figure 1.

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

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure is based on a simulation from CBO's long-term model using 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, the program will no longer be able to pay the full amount of scheduled benefits.

Security system will eventually have to redeem the government bonds held in its trust funds. But where will the Treasury find the money to pay for those bonds? Will policymakers cut back other spending in the budget? Will they raise taxes? Or will they borrow more?

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 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.

The key message from those numbers is that some form of the program is, in fact, sustainable for the indefinite future. 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 or sustained forever. Of course, many people may not consider a sudden cut in benefits of 20 percent to 30 percent to be desirable policy, but it 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 forever after about 2020 (see Figure 2). That gap cannot be sustained without continual—and substantial—injections of funds from the rest of the budget.

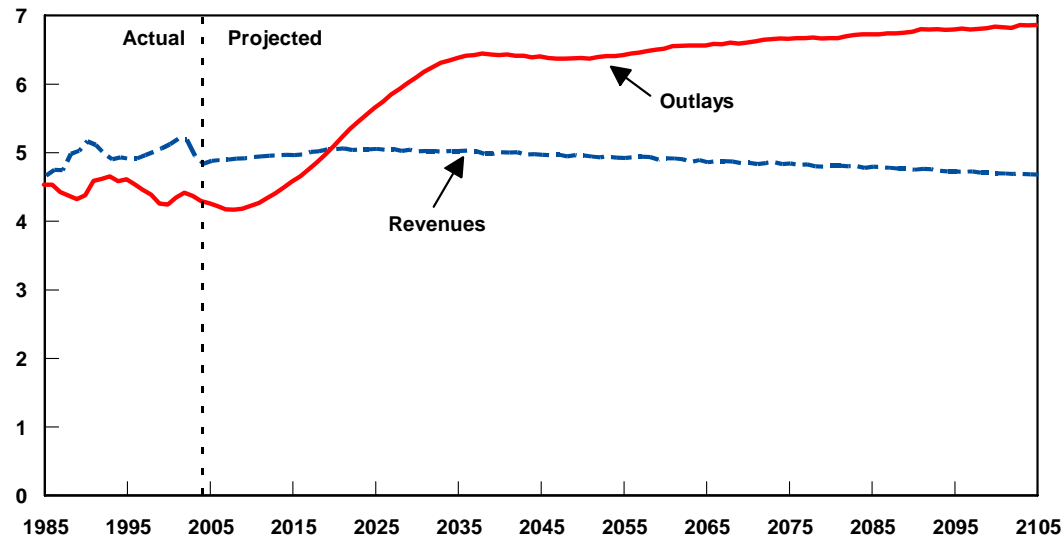
The Impact of Social Security on the Federal Budget

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 rest of the 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 surpluses to the total budget, and after that, it will be drawing 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. Policymakers will have only three ways to make up for the declining Social Secu-

Figure 2.

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

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure is based on a simulation from CBO's long-term model using 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. In this simulation, currently scheduled benefits are assumed to be paid in full after 2053 using funds from outside the Social Security system.

rity 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 2010. But by 2025, that surplus is projected to become a deficit of roughly \$100 billion (in current dollars). That \$200 billion swing will create significant challenges for the budget as a whole.

Second, the demand on the budget from Social Security will take place simultaneously with—but be eclipsed by—the demand 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. But whereas Social Security outlays are projected to grow to almost 6.5 percent of GDP by 2050, spending on the two health programs is expected to grow substantially more. Over the past few decades, excess growth in health care costs—the extent to

which per-beneficiary health care costs increase faster than per capita GDP—has been about 2.5 percent annually. If that trend is extrapolated, federal spending on Medicare and Medicaid will rise from about 4 percent of GDP now to about 20 percent in 2050, which is roughly the current size of the entire federal budget. If one assumes a fairly dramatic shift to a slower increase in health care costs—that excess cost growth will decline to less than half of its historical rate—federal spending on Medicare and Medicaid will still roughly triple by 2050, to 12 percent of GDP. The clear message is that while Social Security will place demands on the federal budget, those demands will coincide with much greater demands from Medicare and Medicaid.

Social Security and the Economy

Although looking at the overall budgetary context is important, Social Security and its possible reform also carry significant implications for the economy and economic policy.

One of the major achievements of reform could be to resolve uncertainty about the future of the program. Uncertainty is an economic cost in its most fundamental form, and in the current context, there is uncertainty about the future of Social Security, its configuration, and who will be affected. The sooner that uncertainty is resolved or reduced, the better served will be current and future beneficiaries, who must make various decisions about their retirement (from how much they should save to when they will be able to stop working).

A key uncertainty stems from a central policy question: to what extent should the Social Security program in the 21st century resemble the program in the 20th century? There are two separate aspects to consider: insurance and financing.

In terms of insurance, the major issue is finding the appropriate balance between social responsibility and individual responsibility. On one side, some people argue that the nation needs a program of universal social insurance that allows for the redistribution of resources among individuals and provides a hedge against such adverse outcomes as poor health, unemployment, low wages, or simply having bad luck. On the other side, some people argue that it would be better to have a retirement system that relied more on individuals (which proponents view as desirable in itself) and included provisions that strengthened incentives for individuals to work and save.

In terms of financing, the major issue is striking the appropriate balance between prefunding retirement (with each generation saving for its own retirement) and employing a traditional pay-as-you-go method of financing (in which assets are not accumulated, but instead current revenues are used to finance benefit payments to retirees). Prefunding retirement benefits has the potential to increase the

nation's capital stock, boost productivity, and raise GDP in the long run. However, prefunding requires some people to consume less or work more than they would otherwise during a transitional period.

Although prefunding could be carried out either by having individuals save more or by having the government save more (through smaller budget deficits or larger budget surpluses), analysts disagree on the extent to which the government could actually prefund retirement benefits, for several reasons. The experience of recent years, for instance, raises questions about the likelihood that the government would be able to maintain budget surpluses for long periods of time.

Regardless of one's views about those issues, any approach to Social Security will have to confront the new demographic situation—low fertility rates, declining mortality rates, and changing patterns of marriage, divorce, participation in the labor force, and immigration—as well as a host of other factors that are very different now than they were in the past. Reconfiguring Social Security to reflect those new realities, and better insulating the system from unexpected demographic or economic changes, will be a major challenge for policymakers.