Statement of Charles P. Blahous[1]

Before the U.S. Senate Committee on Homeland Security and Government Affairs

January 28, 2020

Thank you, Chairman Johnson, Ranking Member Peters, and all of the members of the committee. It is an honor to appear before you today to discuss the leading contributors to the federal government's long-term fiscal imbalance.

My remarks today will focus on the financial challenges associated with the federal government's largest two mandatory spending programs, Social Security and Medicare. These two vital programs warrant emphasis in this context, first because so much of projected federal spending growth is concentrated within them, and second because, as programs financed through dedicated trust funds, they face enormous financial challenges of their own, even when considered separately from the larger federal budget context. Social Security and Medicare warrant attention and reform irrespective of whether they are viewed from a unified budget perspective or are instead evaluated narrowly, from within the confines of their own program purposes and operations.

Why Social Security and Medicare Finances Matter

First, I will present some background on trust fund financing as it operates within Social Security and Medicare. The Social Security and Medicare trustees, of which I was one from 2010-15, are charged under the Social Security Act with monitoring the financial conditions of four separate trust funds: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) within Social Security, and Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) within Medicare. The financing frameworks of Social Security OASI and DI as well as Medicare HI are qualitatively similar. For each of these three trust funds, the predominant source of revenues is a payroll tax assessed on taxable worker wages, with a relatively small fraction of program revenue coming from the income taxation of Social Security benefits. Because the trust funds' holdings consist of U.S. Treasury securities, they all also earn interest income, paid from the federal government's general fund.

These three trust funds are each designed such that program spending authority is limited to the assets the trust funds hold. Unless additional authority is granted in legislation, the programs cannot borrow or draw further upon the federal government's general fund. If, hypothetically, a trust fund's reserves were ever to be depleted, benefit payments would be postponed until sufficient

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dedicated revenues were received to finance those payments. This would effectively cut benefits through the mechanism of delay. Accordingly, one of the core responsibilities of the programs' trustees is to monitor trust fund finances, and to alert lawmakers and the public if it is projected that future program revenues will be insufficient to finance scheduled benefits. The intended purpose of these alerts is to prompt lawmakers to enact the necessary changes to program outlays and/or revenues so that trust fund reserves are not depleted, and so that benefit payments can continue without interruptions that would cause hardship to program participants. Such warnings have been contained in all recent trustees' reports for both Social Security and Medicare.

The fourth trust fund monitored by the trustees, Medicare SMI, operates somewhat differently. The SMI trust fund is always kept in balance by statutory construction. Roughly one-quarter of SMI spending is financed by premiums paid by or on behalf of beneficiaries; these premium assessments are automatically adjusted each year in proportion to total program spending. The other approximately three-quarters of SMI revenue is automatically appropriated from the federal government's general fund. Because of the different way SMI is financed relative to the other three trust funds, the trustees do not produce projections of SMI shortfalls. This, however, does not mean that SMI is immune to financing strains. Instead, it means that SMI's financial challenges are experienced differently; not in threats of program insolvency and sudden benefit cuts, but in rising premium assessments facing beneficiaries, and worsening pressure on government budgets.

It is important to understand these distinctive aspects of SMI's financing structure for several reasons. One is that SMI, which pays for important Medicare benefits such as physician services and prescription drugs, actually represents a larger portion of total Medicare spending than does HI. This year, for example, the Congressional Budget Office (CBO) projects that SMI spending will total $471 billion, as opposed to $341 billion under HI. Consequently, when the trustees report annually on the HI trust fund's actuarial imbalance as well as its projected insolvency date, these projections represent substantially less than half of Medicare's total operations.

SMI's unique financing design also reminds us that trust fund solvency, while a necessary condition for financial soundness, is not a sufficient one. SMI is always in actuarial balance by definition, but this does not necessarily mean that premium-paying beneficiaries or the federal government as a whole will find its rising costs affordable. Accordingly, ensuring the financial viability of Social Security and Medicare requires much more than simply decreeing that their trust funds will be credited with any revenues we want to spend. Instead it requires that the long-term growth of program obligations not exceed the growth in beneficiaries' and taxpayers' ability to pay.

Before I turn to the trustees' latest projections for Social Security and Medicare, another point is worth especial emphasis. It is that the actuarial status of Social Security or Medicare is not a mere accounting abstraction, of interest only to government budget wonks. The concept of actuarial balance is central to the well-being of program participants, and vital to individual Americans' economic security.

Social Security and Medicare enjoy exceptionally privileged positions in federal economic policy. Social Security has long been referred to as the third rail of American politics ("touch it, and you die"), and there is truth in the description. Participants in Medicare and especially Social Security have generally been spared the sorts of frequent, occasionally sudden reassessments of benefit levels and eligibility criteria to which beneficiaries of so-called "welfare" programs can be subjected. Indeed, the last significant changes to Social Security's benefit structure and eligibility ages were enacted nearly four decades ago, in 1983. This stability is extremely important to program beneficiaries, whose retirement income planning would be undermined if these programs' benefits were potentially on the chopping block every budget season.

This stability of the Social Security and Medicare programs, upon which beneficiaries rely, is no accident. It derives directly from their financing structures. President Franklin Roosevelt, whose administration spearheaded the effort to create Social Security, was adamant that it be structured as contributory insurance rather than as a welfare program. FDR's successful implementation of this principle matters greatly even today because it underlies shared perceptions that Social Security participants are receiving benefits for which, at least in the aggregate, they have paid. In contrast, in a traditional welfare program, it is generally understood that many Americans will provide financing without ever receiving the benefits, while others will receive benefits without paying the taxes that fund them. The political dynamics of welfare programs reflect inherent tensions that force periodic reassessments of where benefit levels should be set as well as who should receive benefits. This happens far less frequently with Social Security, because of the widely shared perception that its essentially universal benefits have been earned by worker contributions, and are thus not appropriately subject to frequent renegotiation.

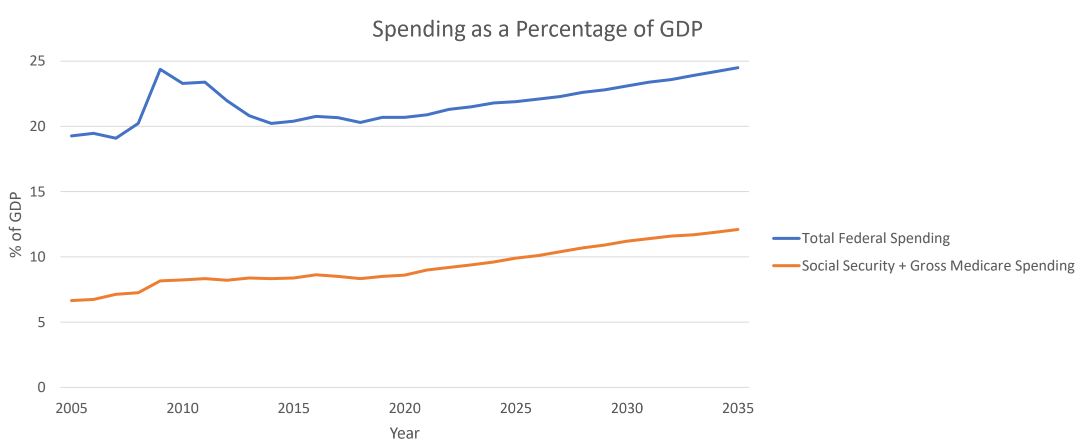
To be sure, Social Security's self-financing design is not perfectly pure in practice. Individual participants may receive benefits over their lifetimes that are either far more or far less than they personally contributed. Social Security is also only required to be self-financing on average over time, not in every individual year. In some years (such as the decades immediately prior to 2010), Social Security collected more taxes than it paid out in benefits, and thus effectively subsidized other federal spending during those years as debt held by its trust funds built up. In the years since 2010 and extending indefinitely into the future, it will pay out far more in benefits than it will generate in taxes, and during these years it contributes significantly both to recent and future federal budget deficits. In addition, lawmakers have occasionally waived strict self-financing. For example, in 2011-12, a temporary payroll tax reduction took effect, which was coupled with an injection of $217 billion of general revenues into Social Security's trust funds, a substantial subsidy from the federal government's general budget accounts for which program participants had not paid.

Even with its imperfections, the preservation of Social Security's self-financing framework remains important to the economic security of millions of program participants. Unless lawmakers are willing to moderate benefit growth and/or increase program taxes sufficiently to balance Social

Security's books, then its historical financing design will have to be abandoned, and with it the exceptional income security Social Security has delivered to beneficiaries for decades. In addition, unless lawmakers successfully eliminate projected financing shortfalls sufficiently far in advance of the necessary changes' implementation, today's workers will not be able to make informed plans for their own retirement years. As long as Social Security and Medicare's funding shortfalls remain uncorrected, Americans face future income losses about which they are not being told.

While restoring Social Security and Medicare finances to sound footing is critical from the perspectives of the programs and their beneficiaries, it bears mentioning that doing so is also imperative from the standpoint of the larger federal budget. CBO's latest long-term budget outlook projects, under its extended baseline scenario, that federal debt held by the public will surpass our Gross Domestic Product by the early 2030s. The principal reason for this projected debt accumulation is federal spending growth. From today through 2033, federal spending is projected to rise from 20.7% to 23.9% of GDP, far higher than historical norms. Future revenue collections are also projected to exceed historical averages as a percentage of GDP, but not by nearly as much, and thus deficits will rise. This baseline scenario assumes that full scheduled Social Security and Medicare benefits continue to be paid despite projected insolvency of certain of their trust funds. Strikingly, under CBO's baseline, the entirety of federal spending growth (relative to GDP) through 2033 can be accounted for solely by projected growth in gross Medicare spending and Social Security. See Figure 1.

Figure 1. Social Security and Medicare Spending Growth Drive Total Federal Spending Growth



Federal spending growth to date tells a similar story. In 2005, total federal spending equaled 19.3% of GDP. This year it is projected to equal 20.7%. All federal spending growth relative to GDP over the last 15 years can be accounted for by growth in gross Medicare spending and Social Security. Our national politics have a tendency to focus on legislation in other areas of the budget affecting the fiscal outlook, especially when this focus permits opposing political parties to draw contrasts between their respective policy positions. What we find less pleasant to acknowledge is that nearly all federal spending growth, recent and projected, spanning the first four decades of the 21st century, can be explained by Social Security and Medicare spending growth alone.

Our shared failure to contain the growth of mandatory spending programs undercuts policy priorities across the political spectrum, whether they are conservative objectives of keeping federal tax burdens within historical norms, or progressive objectives of increasing investments in education, infrastructure and environmental protection. None of these objectives can realistically be met if current mandatory spending trends continue.

Budget impact aside, Social Security and Medicare warrant attention and reform for their own sakes. The next section of my testimony will summarize the financial outlooks for the two programs.

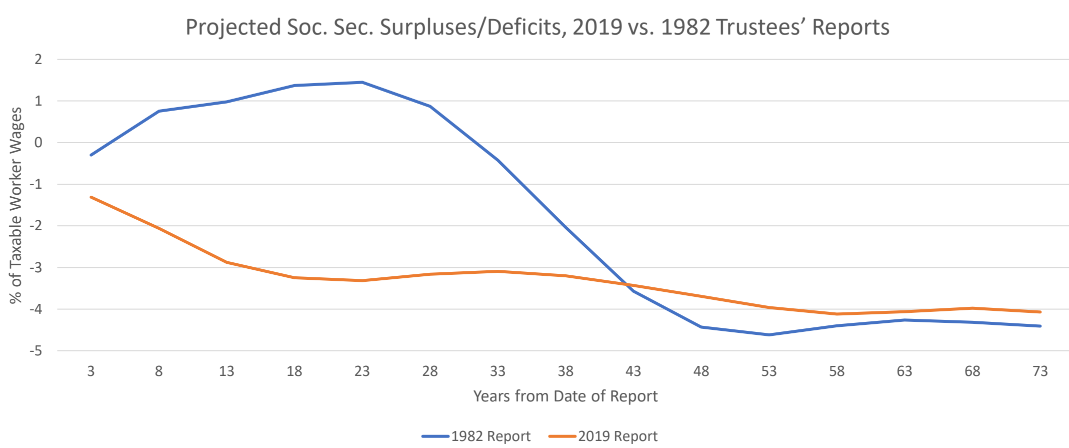
The Trustees' Projections for Social Security and Medicare Finances

The trustees traditionally summarize Social Security's financial outlook with reference to the combined operations of its two trust funds, OASI and DI, although under law the balance of each trust fund must be maintained separately. Their latest report projects that these trust funds face a combined shortfall over the next 75 years equal to 2.78% of the program's revenue base of taxable worker wages. This 2.78% figure appears deceptively small; perhaps a clearer way to understand the magnitude of the shortfall is to note that closing it by cutting projected benefit obligations across the board would require reductions of 17 percent – that is, if they are enacted immediately and if they affect not only future claimants but also everyone already receiving benefits. Alternatively, a solution consisting solely of raising the payroll tax rate would require an increase of nearly 22 percent -- specifically, a 2.70 percentage point increase on top of the current 12.40% Social Security payroll tax, resulting in a Social Security tax rate of 15.10%.

Even these sobering illustrations understate the magnitudes of the changes that will almost certainly be required. This is because historically, lawmakers have been extremely resistant to reducing Social Security benefits for those already receiving them. Consequently, any legislated moderation of future benefit growth is likely to affect only those who have yet to claim benefits. If applied prospectively in this manner, the required reductions would need to be 20 percent rather than the 17 percent described in the previous paragraph. But again, this assumes a sudden cut effective next year, legislative action that would likely face insurmountable political obstacles. It is far more likely that any future moderation of benefit growth would be phased in gradually, so that it affects near-term retirees far less than under these illustrations, requiring in turn much larger changes affecting later retiree cohorts.

These illustrations dramatize how large the Social Security financing challenge has already become, even if lawmakers were to act immediately to address the situation. For comparison, consider the last major Social Security financing reforms enacted in 1983 with great difficulty after several false starts. Those reforms included delaying COLAs by six months, exposing benefits to income taxation for the first time, bringing in all newly hired federal employees to contribute payroll taxes, increasing the full retirement age, and accelerating a previously-enacted payroll tax increase, among other provisions. Controversial though those changes were, today's Social Security shortfall is much larger by any measure; not only in absolute terms, but also relative to the current program's larger contribution base and benefit schedules. See Figure 2. We are already in a position where we need an historically exceptional degree of bipartisan cooperation and compromise to avert Social Security insolvency, and to preserve its historical financing design. Even in the best possible scenario for expeditious action, Republicans and Democrats would need to join together to overcome enormously difficult politics, to support a package of reforms that deviates markedly from either of their competing policy preferences.

Figure 2. We Face a Much Larger Soc. Sec. Shortfall Now than in 1982

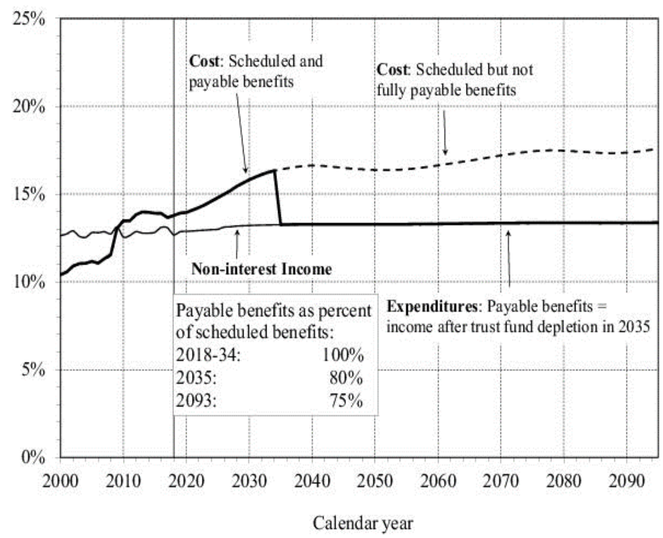


Dates given are in increments of five years because the 1982 report did not provide long-term projections for individual years.

Other dire illustrative scenarios highlight the immense cost of continued delay in enacting corrections to Social Security's financial imbalance. If lawmakers were to wait until the brink of combined trust fund depletion in 2035 to enact repairs, the size of the benefit reductions required to do the job would reach 23 percent. Again, this 23 percent figure assumes that the reductions are applied to all beneficiaries regardless of age or need, even those who have been dependent on Social Security benefits for decades. And if nothing at all were done, combined trust fund depletion would cause immediate reductions of 20 percent, as shown in Figure 3, a percentage reduction that would increase to 25 percent by the end of the trustees' long-range valuation window.

Figure 3. Trustees' Projections of Combined Soc. Sec. Income/Costs

(All Numbers Expressed as a % of US Workers' Taxable Wages)



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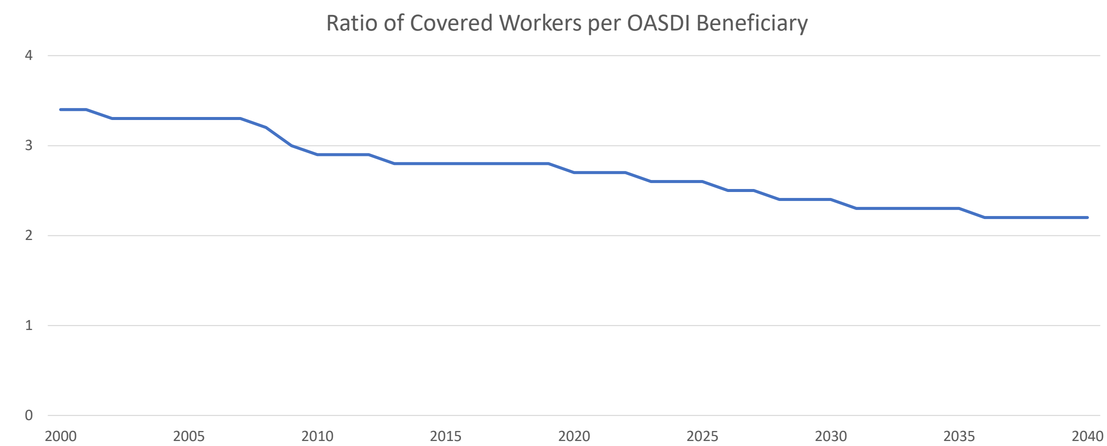
Again, it is not realistic to expect that lawmakers would react to impending insolvency in 2035 by immediately cutting all participants' benefits by 23 percent. However, by then there would be a huge additional problem. By that late date, it would no longer be possible to repair system finances through prospective benefit changes alone. Even total elimination of all new benefit claims in 2035 would be insufficient to prevent the combined Social Security trust funds from being depleted. We simply do not have the luxury of waiting until trust fund depletion is imminent if we wish to maintain a realistic chance of preserving Social Security's self-financing design. Prompt, expeditious action is required if Social Security is to function in the future as it has in the past.

The causes of Social Security's shortfall are relatively straightforward and essentially boil down to three. The first is the rise in the number of beneficiaries relative to the number of taxpaying workers. This is driven primarily by population aging (the fact that we are generally leading longer, healthier lives than previous generations) and is accelerated by the movement of the historically large Baby Boomer generation from the ranks of workers onto the retirement rolls. We have failed thus far to adequately adjust Social Security law to these demographic realities. Cohort life expectancy today at age 65 is 20.3 years as compared with 13.7 years in 1940, and yet due to the subsequent introduction of early eligibility for old-age benefits, the most common age of benefit claim today is actually three years younger (62) than it was those eighty years ago (65). The resulting dramatic decline in the ratio of workers to beneficiaries (see Figure 4) not only strains Social Security finances, it undermines participants' retirement security. This occurs for the simple reason that when a fixed amount of income resources must be stretched over a larger number of retirement years, the annual income it can provide must inevitably become smaller.

Figure 4: The Declining Worker-Collector Ratio



The second primary cause of the shortfall is Social Security's predominantly pay-as-you-go financing method. Social Security is not a savings program in which each generation advance-funds their own retirement benefits. Instead, since Social Security's inception, each generation's benefits have been paid primarily from the tax contributions of the following generation of workers. The finances of such a system are extremely sensitive to changes in the ratio of workers to beneficiaries. The third main cause of the shortfall is the dramatic expansion of benefits enacted in stages during the 1970s, including pegging the growth of initial benefit levels to growth in the national Average Wage Index (which generally rises faster than price inflation) and adding Cost of Living Adjustments. A consultant panel advised Congress at that time, and subsequent events have confirmed, that these benefit indexation methods result in program costs rising faster than can be financed with a stable tax rate.[2]

There were rationales underlying all of these policy decisions, just as there were policy arguments arrayed against them. But irrespective of the merits of these competing policy perspectives, the

[2] Report of the Consultant Panel on Social Security, prepared for the use of the U.S. Senate Committee on Finance and the U.S. House of Representatives Committee on Ways and Means, 1976. https://www.ssa.gov/history/reports/hsiao/hsiaoChapter1.PDF

substantive consequence of combining pay-as-you-go financing, an aging population, minimal changes to eligibility ages, and real per capita benefit growth, is that program costs grow faster than our capacity to finance them.

It is important to understand that the total size of the changes required to balance Social Security's finances is not a matter of policy discretion. Rather, the magnitude of the changes required is determined solely by the gap under current law between the program's projected revenues and its projected benefit obligations. No lawmaker who offers a solution to this shortfall should be attacked on the false premise that they would inflict unnecessary pain. The only policy discretion lawmakers have pertains to how much of the shortfall is filled by increasing revenues vs. moderating benefit growth, and to whether continued delay forces affected participant cohorts to shoulder a disproportionate share of the necessary changes.

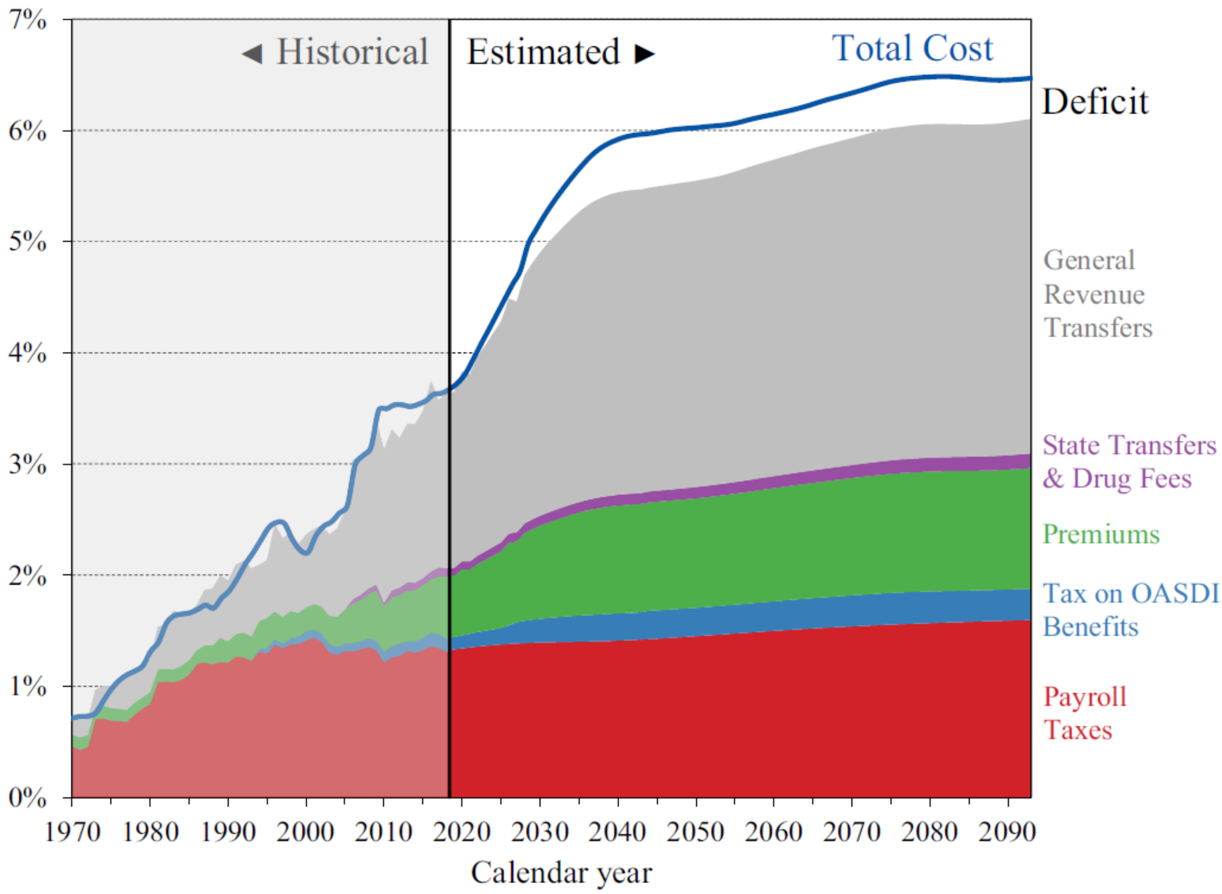
The younger generations who would be most adversely affected by further delays are also the ones who already stand to lose substantial net income through Social Security in the absence of reforms. Simply playing for time, allowing costs to rise, and raising taxes periodically would effectively prevent Social Security from bolstering younger Americans' income security, because this strategy would force those generations to make tax contributions to the program that far exceed (in present value) the benefits Social Security could later pay. Under current projections, future workers would experience net income losses under Social Security equal to 3.4% of their taxable career earnings, even after accounting for all benefits that they receive. If Social Security reaches the point wherein it causes such large net income losses for entire generations, as it would if today's participants do not make a significant contribution to solving the problem, then it will no longer function as effective social insurance.

Medicare's finances are more complex than Social Security's, but show similar strains. The Medicare HI trust fund faces a projected actuarial imbalance over the next 75 years equal to 0.91% of its revenue base in taxable worker wages. Again, the small-seeming 0.91% number belies the magnitude of the HI shortfall. HI's shortfall equals 19 percent of all scheduled benefits over the next 75 years. If full HI benefit payments are made until trust fund depletion in 2026, then closing the shortfall would require cost savings equal to 20 percent of subsequent scheduled benefits. Alternatively, if the shortfall were to be eliminated by an immediate revenue increase, an increase equal to 0.91% of taxable worker wages would be required. This would be an increase of roughly 23 percent in Medicare HI's total income rate, which would need to be roughly 26 percent if delayed until 2026.

As previously noted, HI is but one part of Medicare, and SMI is larger. SMI by definition faces no actuarial imbalance, but its costs are projected to rise dramatically as a share of overall federal spending. SMI costs are projected to rise from roughly 2.2% of GDP this year to nearly double that amount as a share of our economy, nearly 4.2% of GDP by the end of the trustees' 75-year valuation period. For comparison, consider that SMI alone, which is just one trust fund within

Medicare, would then spend a larger share of our economy than either all defense spending or all non-defense discretionary appropriations do today.

Figure 5: Medicare Cost and Non-interest Income by Source



Medicare is buffeted by the same cost-driving forces as Social Security, notably an aging population, a declining ratio of workers to collectors, a failure to adjust eligibility criteria for demographic changes, and pay-as-you-go financing. In addition, Medicare faces the additional factor of health cost growth, which is generally faster than economic growth. These factors cause Medicare costs not only to rise faster than Social Security's (see Figure 5, reproduced directly from the trustees' report summary), but to be more difficult to project. Whereas the size of the Social Security shortfall has a high degree of certainty, and the depletion of its trust funds is highly unlikely to occur more than a few years earlier or later than currently projected, feasible long-range Medicare cost projections cover a wide span. The trustees' projections for the 75-year actuarial balance of Medicare HI alone range from a deficit that is five times larger than the central projection (4.55% of taxable payroll vs. 0.91%), to no HI deficit at all. That said, the projected depletion of the HI trust fund is near enough (2026) that it is highly certain to occur in the absence of additional financing reforms.

There is a tendency to think of Social Security and Medicare financing reforms as inherently imposing pain because they necessarily require restraints on benefit growth and/or increases in tax collections. Yet there are substantial potential upsides to Social Security and Medicare reforms. Done properly, program reforms could improve incentives for workforce participation as well as individual saving, achieve more equitable treatment of different generations, lessen the risk of old-age poverty from premature retirement, and more efficiently target income gains on households of greatest need, all while producing substantial financial savings. Fiscal considerations are powerful reasons to pursue Social Security and Medicare reforms, but they are by no means the only ones.

What Should Be Done?

Addressing the Social Security and Medicare shortfalls involves critical policy value judgments and tactical decisions that are properly in the purview of legislators rather than program trustees or former trustees. Nevertheless, pursuant to this objective, I offer the following principles for Senators' consideration.

First: act as rapidly as circumstances allow. Every year that we wait means that the eventual solution imposes additional hardship on affected participants, either as taxpayers or as beneficiaries. It also, importantly, means that the barrier to bipartisan agreement rises higher, increasing the risk that the historical financing framework for these vital programs cannot be preserved, leading it to be abandoned in favor of another structure that offers far weaker protections to beneficiaries.

Second: don't make the problem worse. The reason the Social Security and Medicare shortfalls are as large as they currently are is that legislators have found it substantively and politically daunting to tackle them. We do not yet know what amounts of tax increases, or what rates of benefit growth, a critical mass of voters and legislators will be willing to support in order to restore these programs to balance. It would be irresponsible in the extreme to make this daunting problem even more intractable by pursuing significant expansions of program obligations. The appropriate time to discuss any across-the-board increase in Social Security benefit obligations, or an expansion of Medicare to Americans of younger ages, is after -- and only after -- lawmakers have demonstrated, through enacted legislation, a willingness to fully fund these programs' current-law obligations.

Third: compromise will be necessary. There are many who prefer to avoid any and all tax increases. There are many on the other side who prefer to avoid any deceleration in the rate of benefit growth. Neither side can get its preferred way completely. Unless one party alone controls the White House, the House of Representatives, and commands a supermajority of 60 in the Senate, a solution will need to be negotiated that lands somewhere in the middle between opposing policy perspectives. For one party or the other to hold out until they control all the branches of government almost certainly will not work. The last time the federal government was under one-party control that included a Senate supermajority, no attempt was made to address the Social Security shortfall. This job will not get done without bipartisan cooperation.

Fourth: remember that individuals participate in Social Security and Medicare both as taxpaying workers and later as beneficiaries. To understand individuals' net treatment by these programs, policy makers must take into account both sides of the equation; not only the effect of these programs on beneficiaries' income security during retirement years, but also the effects of program costs on the standards of living of taxpaying workers. Analyses conducted in support of any policy proposal should examine the net treatment of affected individuals over their lifetimes, with attention to how this net treatment varies according to income level, birth year, marital status, employment history, and other factors.

While I cannot say what process is most likely to produce the necessary bipartisan agreement, I would offer one technical suggestion with respect to the TRUST Act bill. I would recommend that in any expedited process, CBO perform the calculations of proposals' effects on the unified federal budget, while the Social Security and Medicare trustees perform analyses of proposals' effects on the actuarial balances of the Social Security and Medicare trust funds. The Social Security Act reflects an historical judgment by lawmakers that the trustees' process is the preferred mechanism for monitoring the programs' actuarial status, which is why Congressional budget points of order have historically drawn upon the trustees' tests of long-term financial adequacy. I would further state on the basis of my personal experience that the trustees' process is well constituted to take the long-term view of the trust funds' financial condition that appears to be intended in the bill as introduced. Finally, I would express the hope that the Senate will soon have an opportunity to confirm a bipartisan pair of public trustees to resume critical independent oversight of the trustees' annual projection and reporting process.

Conclusion

In the recent past as well as for the foreseeable future, the rising costs of Social Security and Medicare both contribute significantly to a worsening federal fiscal outlook. However, apart from their effects on the federal budget, both Social Security and Medicare warrant reform for their own sakes, to place both programs on sound financial footing, and to better serve program participants. Prudent reforms to eliminate the Social Security and Medicare shortfalls, in addition to improving the financial outlook, would reduce participant uncertainty in planning for retirement, and could achieve a more equitable distribution of program benefits and financing burdens.