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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 the findings of the latest Trustees' report with respect to projected Social Security finances. My written testimony begins with some basics of Social Security operations before proceeding to a discussion of the program's projected financing shortfall.

Social Security Taxes, Trust Funds and Benefits

Taxes: Under current law, the vast majority of financing for Social Security benefit payments is provided by a payroll tax upon covered wages. The total payroll tax rate is 12.4%.[1] Though nominally divided into two 6.2 point halves assessed respectively upon employer and employee, most economists agree that the entirety of the 12.4% tax is levied on the worker's wage compensation. Wage earnings subject to this tax, as well as any benefit credits based on those earnings, are both capped. This cap reflects Social Security's historical design as a floor of protection in the event of income loss due to old age, disability, or death of a primary household wage earner. The current cap is $106,800 annually, and is indexed to grow generally with the national Average Wage Index (AWI). In addition to payroll taxation, a much smaller amount of program revenue (about 3%) is generated via income taxation of Social Security benefits.

The Trust Funds: Beyond revenue generated from current taxation, further authority and resources to finance benefit payments are provided by the Social Security Trust Funds.[2] The economic significance of the Trust Funds is a source of persistent controversy. But though there is controversy over the Trust Funds' economic meaning, there is much less so over what the Trust Funds literally contain; specifically, special-issue Treasury bonds. These bonds are on the one hand real assets to the Social Security program, backed by the full faith and credit of the

[1] Recent legislation has temporarily reduced the payroll tax rate to 10.4%, with general revenues being used to restore the foregone revenue to the Trust Funds.

[2] There are separate Trust Funds for the OASI (Old-Age and Survivors) and DI (Disability) programs, though public discussions often refer to the combined operations of the Funds.

federal government, while on the other they are equally a real obligation of the general budget accounts. If we look at the bonds from the perspective of the Trust Funds, they are assets. If we look at them from the perspective of the unified federal budget, they are a net wash, as are the interest payments that they receive. The total amount of the Trust Funds, now roughly $2.6 trillion, represents the interest-compounded value of past annual program balances, including the many years of surpluses since the 1980s.

Benefits: Americans tend to think of retirement benefits first when thinking of Social Security. This is understandable given that the majority of benefit payments (about 63%) are made to retired workers. But Social Security also provides for a number of other forms of benefits as well, including disability benefits, spousal benefits, and benefits for widows, widowers and survivor children. Although there are differences in the methods of computing benefits for these respective populations, they all hinge in some fashion on the basic retirement benefit formula. The total value of one's Social Security benefit is not solely a function of one's own contributions. One's benefit is instead a function of a formula written into the law. An overriding problem we face is that the total amount of projected benefit obligations that would result under current formulas is significantly higher than the amount of revenues that the program would receive under current law. One way or the other, this imbalance between revenues and scheduled benefits must be corrected.

Social Security's Financing Challenges

Social Security expenditures exceeded the program's non-interest income in 2010 for the first time since 1983. This deficit stood at $49 billion last year and is projected to be $46 billion in 2011.[3] This deficit is expected to shrink to about $20 billion for years 2012-2014 as the economy strengthens. After 2014, cash deficits are expected to grow rapidly as the number of beneficiaries continues to grow at a substantially faster rate than the number of covered workers. The 2011 Trustees' report is the first in which Public Trustees have ever participated to have concluded that an era of permanent annual deficits has been reached (assuming no future change in law).[4]

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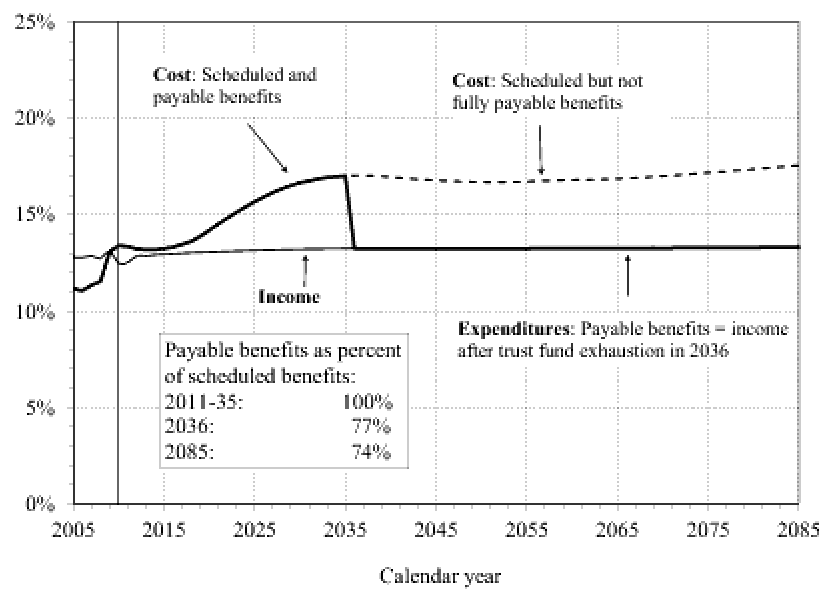
[3] Due to a recently-enacted temporary payroll tax reduction, incoming program tax revenues will fall short of expenditures by $151 billion in 2011. The total non-interest deficit is smaller (at $46 billion) due to the provision of $105 billion in general fund reimbursements, offsetting the revenue effects of the payroll tax reduction.

[4] Technically, Social Security would not be permitted to run annual deficits after Trust Fund exhaustion due to its lack of borrowing authority. The deficits are permanent in the sense that annual benefit obligations are projected to exceed annual non-interest revenues.

Through 2022, these annual cash deficits will be made up by redeeming Trust Fund assets from the General Fund of the Treasury. Because these redemptions will be less than interest earnings, combined Trust Fund balances will continue to grow. After 2022, Trust Fund assets will be redeemed in amounts that exceed interest earnings until combined Trust Fund reserves are exhausted in 2036, one year earlier than was projected last year. Thereafter, tax income would be sufficient to pay only about three-quarters of scheduled benefits through 2085.

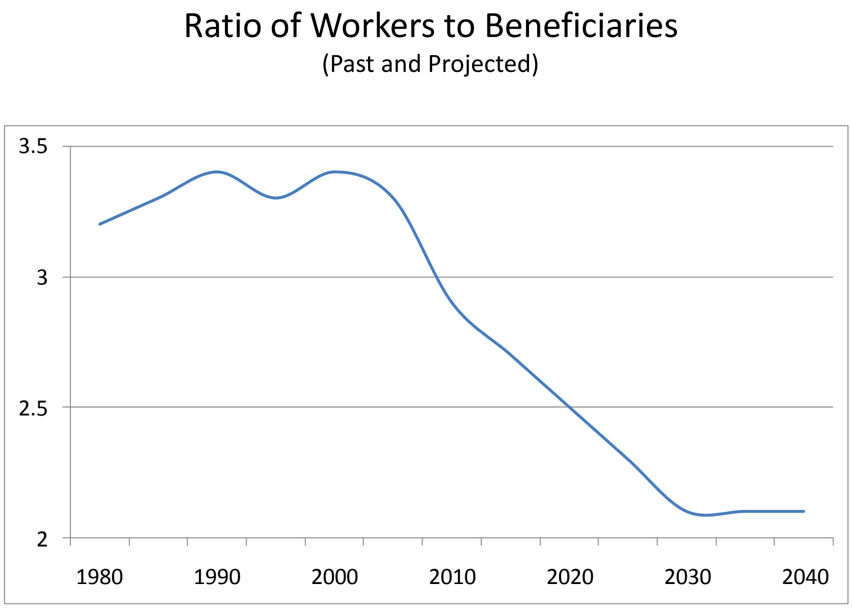
Though the nominal balance of the Trust Funds is still rising, there are important caveats to bear in mind about this. One is that the combined Trust Funds' ability to finance benefits is already in decline, as evidenced by the combined Trust Fund Ratio having peaked at 358 in 2008.[5] This is because the cost of paying benefits is rising proportionally faster than the Trust Funds' nominal value, resulting in a progressively shortening duration of the benefits the Funds can finance. Also, while interest payments and general revenue transfers increase the balance of the Funds, they do not reduce the unified budget deficit. Accordingly, Social Security operations are currently adding to the unified federal deficit and will add substantially more in the years to come.

Under current projections, the annual cost of Social Security benefits expressed as a share of workers' taxable wages will grow rapidly from 11-1/2 percent in 2007, the last pre-recession year, to roughly 17 percent in 2035, and will then dip slightly before commencing a slow upward march after 2050.



5 The Trust Fund Ratio (TFR) indicates the duration of benefit payments that can be financed by the Trust Funds. A TFR of 100 would mean that there are sufficient assets in the Trust Fund to finance one year's worth of benefits.

This cost increase primarily reflects population aging, in particular the diminishing ratio of workers to beneficiaries as the large Baby Boom generation moves from the ranks of the workforce to the ranks of the beneficiary population.



These results just described pertain to the combined OASDI Trust Funds. Considered separately, the Disability Insurance (DI) Trust Fund is in more serious condition. DI costs have exceeded non-interest income since 2005 and Trust Fund exhaustion is projected for 2018; thus changes to improve the financial status of the DI program are needed soon.

Actuarial balance measurements over long spans of time are inherently imprecise and can obscure the more salient issue of trends in annual program cost growth. Because our projections show increasing annual deficits over the long term, a hypothetical immediate tax rate increase sufficient to achieve long-term actuarial balance would result in large annual surpluses early in the period but would still be followed by increasing and unsustainable deficits in later years. This is because the annual deficits projected at the end of the 75-year projection period -- equal to 4.24 percent of taxable payroll in 2085 – are much larger than the average long-range actuarial deficit of 2.22 percent of taxable payroll.

The Costs of Delay for Program Participants

The financial challenges facing Social Security should be addressed soon. If action is taken sooner rather than later, more options and more time will be available to phase in changes so that those affected have adequate time to prepare. Earlier action will also afford elected officials with a greater opportunity to minimize adverse impacts on vulnerable populations, including lower-income workers and those who are already substantially dependent on program benefits.

Reluctance to resolve the Social Security shortfall is understandable, as doing so involves slowing the growth of program benefits, increasing the age at which individuals become eligible for benefits, or increasing program taxes. Failure to enact such measures, however, will not shield participants collectively from adverse effects. One way or the other the imbalance between scheduled benefits and future revenues must be resolved. Further delay in enacting corrective legislation to do so as equitably as possible would simply mean that continued uncertainty will surround how the imbalances will be resolved and that the unavoidable adjustments will be compressed into a shorter time period, be concentrated upon fewer affected individuals, and be more disruptive as a result.

For many years, the Trustees Reports have contained illustrations of the magnitudes of changes to benefits or taxes required to place Social Security on a financially sustainable path. Useful though these illustrations are, they understate the likely effects of legislative actions over time. First, such illustrations often assume that the full effect of legislation takes place immediately, with no phase-in or lead time. Perhaps even more importantly, the benefit examples assume that legislators would be equally willing to reduce support for current beneficiaries as to restrict the growth of benefits to future participants. In the past, policy makers have been reluctant to significantly reduce the benefits of those who have already begun to collect them. In a practical sense, therefore, changes adversely affecting younger generations are likely to be much more severe than indicated in these simple illustrations. The costs that will be borne by younger generations will grow significantly each year that a new cohort of baby boomers joins the benefit rolls.

For example, imagine that no legislative action is taken until the Trust Funds' exhaustion date of 2036 is approached, despite the substantial growth in financial pressure exerted by the program on the general budget in the decades prior to that time. In 2036, incoming tax revenues would be sufficient only to fund 77% of promised benefits. This constraint, however, would apply to pre-existing as well as new benefit payments. Even the complete elimination of benefit payments to new claimants would not then by itself balance system finances. Accordingly, unless there was then an unprecedented increase in payroll tax assessments, the opportunity to confine any benefit changes only to prospective ones would have been long lost. Legislators can minimize these adverse impacts by acting promptly to repair Social Security's financial outlook.

Conclusion

The essential message conveyed by the Trustees' report is clear and will not change, absent legislation: that Social Security faces real and substantial challenges, and that elected officials will best serve the interests of the public if financial corrections are enacted at the earliest practicable time.