Social Security's Financial Condition

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SPECIAL COMMITTEE ON AGING

Mr. Chairman and members of the Committee, my name is David M. Walker. I am a Partner and Global Managing Director with the international accounting and consulting firm of Arthur Andersen LLP. My background includes serving as one of two Public Trustees of the Social Security and Medicare Trust Funds, as Assistant Secretary of Labor for Pension and Welfare Benefits and as head of the Pension Benefit Guaranty Corporation (PSBG). Most recently, I authored a book entitled: Retirement Security: Understanding and Planning Your Financial Future (John Wiley and Sons, 1997, New York, NY). This book includes a significant amount of useful information regarding Social Security, Medicare, private pension and retiree health plans, individual retirement savings vehicles and personal retirement planning and investment matters.

I am appearing before you today at the request of the Committee staff to address the current and projected financial condition of the Social Security retirement income program, the Old Age Survivors Insurance (OASI) program. To do so, I will first outline the relevant information contained in the 1996 Annual Trustees' Report. I will then discuss some of the related implications and the need for action to address our related challenges.

CURRENT AND PROJECTED FINANCIAL CONDITION OF THE OASI PROGRAM:

The Trustees of the Social Security and Medicare programs prepare an annual accounting of these programs for the Congress and the American public. This annual accounting is due by April 1 of each year. Since the 1997 Annual Trustees' Report has yet to be issued, I will base my comments primarily on the 1996 Annual Trustees' Report. This report was issued in the first half of 1996 and covered the 1995 fiscal year. It also included a projection of the financial condition of the OASI program over the 75 year period ending in 2070. This long-range projection is important as a means to advise the Congress and the American people as to the likely condition of these programs in the years in which several generations can be expected to receive OASI program benefits. Specifically, a 75 year projection period is necessary in order to assess the likely financial condition of the OASI program for all individuals currently paying OASI payroll taxes, including new entrants into the workforce.

According to the Trustees' 1996 Annual OASDI Report, the OASI Trust fund held approximately $458 billion in U.S. government securities as of December 31, 1995. In addition, the OASI program ran an approximate $45 billion surplus for the year then ended. While the 1997 Trustees' Annual Report has yet to be issued, it is expected that it will show that the OASI Trust Fund about $514 billion in U.S. Government securities at December 31, 1996 and an experienced an approximate $56 billion surplus for the year then ended. Importantly, under current law, all annual OASI program surpluses must be invested in certain U.S. government or agency securities. The current government bonds held in the

OASI Trust Fund bear market rates of interest at their date of issue, carry maturities of up to 15 years and are not readily marketable.

According to the Trustees' 1996 OASDI Annual Report, the OASI program met the Trustees short-term (10 year) test of financial solvency. The OASI program did not, however, met the Trustees' long-range (75 year) test of financial solvency. The 1996 Annual Report also disclosed that the estimated 75 year financial imbalance amounted to approximately 1.85% of taxable payroll.

The 1996 Annual report projected that, based on the Trustees' intermediate (best estimate) set of assumptions, the OASI Trust Fund would be exhausted in the year 2031. The projected exhaustion date is significant since, beginning in that year, the government will no longer be able to pay full OASI benefits on a timely basis. However, while the program would not be able to pay full benefits, the OASI program would still have a significant revenue stream for benefits and program expenses. Specifically, the OASI program is expected to have revenues equal to approximately 75% of projected benefit payments and administrative expenses during the period 2031-2070.

Given the above, based on the 1996 Trustees' Annual Report, OASI program revenues would have to be increased by 25% or benefit payments reduced by 20% beginning in 2031 in order to restore the financial integrity of the current program. Alternatively, more timely reforms would serve to lessen the degree of changes necessary to restore the financial integrity of the OASI program.

The 2031 projected OASI exhaustion date may be a number of years away, however, history shows that it is likely to come sooner than projected. Specifically, after Congress enacted the 1983 Social Security reforms, the Trustees' projected that the OASI program would have adequate assets to pay full program benefits on a timely basis until about 2062. By 1991 the Trustees' projected exhaustion date has accelerated to 2045. As previously noted, the 1996 Annual Trustees' report projected the OASI Trust Fund will be exhausted in 2031. This is 31 years sooner than predicted in 1983. All of these projected dates are based on the Trustees' intermediate (best estimate) assumptions for the respective years. Unfortunately, history has generally shown that actual program experience in likely to fall between the Trustees' best estimate and high cost sets of assumptions. As a result, a further acceleration of the projected exhaustion date should not be surprising.

While the 1996 Annual Trustees' Report noted that the OASI Trust Fund would be able to pay full benefits on a timely basis until 2031, there is a much earlier fiscal challenge relating to the OASI program which needs to be addressed. Namely, based on the Trustees' 1996 Annual Report, the OASI program is projected to enter a negative cash flow position in the year 2014, just two years after the first "baby boomer" is eligible for normal retirement. Beginning in that year, annual benefit payments and administrative expenses are expected to exceed payroll taxes and other revenues. In addition, the projected annual OASI deficits accelerate rapidly each year thereafter. For example, these annual OASI cash flow deficits are expected to grow to over $374 billion in the year 2025 alone.

Once the program begins to experience a negative cash flow position, the federal government will generally be required to take one of three steps in order to generate the necessary cash to pay OASI benefits and expenses on a timely basis. Specifically, absent any OASI program changes before 2014 or the government's simply resorting to increasing the money supply in an inflationary manner beginning in 2014, the government will either have to increase OASI tax revenues, decrease OASI benefits/expenses, or revise the current nature of the government bonds held by the trust fund and sell them to willing third party investors. Obviously, the government could also take some combination of these actions in order to bring the OASI program into annual balance if it so chose.

RECENT OASI PROGRAM REFORM RECOMMENDATIONS:

A number of groups have recognized the projected financial imbalance associated with the OASI program. In fact, an ever increasing number of organizations have began to call for reform of the existing OASI program. Many of these organizations have made specific recommendations for consideration by the Congress and the Administration.

The most notable OASI program reform group which has made already made recommendations is the 1994-1996 Advisory Council on Social Security (the "Council"). This statutorily mandated group issued their report in December 1996. While the Council agreed on the need to reform the OASI program, they did not agree on how to do it. In fact, the Council's report included three separate sets of recommendations for reforming the OASI program. Importantly, none of the three reform proposals received the support of a majority of the 15 Council members. This division serves to underscore the degree of difficulty in reaching agreement on how to reform the OASI program.

While time does not allow me to summarize the three reform proposals submitted by the Council, a few related comments are appropriate. Seven of the fifteen Council members voted for a "maintain benefits" option. Under this proposal, the basic defined benefit oriented structure of the current OASI program would not be changed. However, some program changes would be enacted and the current investment restrictions relating to the OASI Trust Fund would be modified to allow for investment of up to 40% of the Trust Fund balance in equity securities.

The remaining two Council reform options called for more fundamental changes to the current OASI program. These were called the "individual accounts" and "personal security accounts" options. Both of these options included recommendations to move from the current defined benefit OASI program structure to a "two-tiered" benefit structure. Under the two tiered structure, a base (but generally lower) defined benefit element would be retained in order to provide for a foundation of certainty and security for lower income retirees. In addition, both options recommended creating a second defined contribution oriented individual account tier. The nature, amount, transition and investment of this second tier benefit varied between the two proposals. Generally, the "personal security account" option called for a smaller base defined benefit amount, a larger individual account element and a quicker transition. This results in sizable "transition obligations" which would need to be addressed.

While none of the three Quadrennial Commission reform proposals received the support of a majority of the fifteen members, nine members voted for one of two "two tiered" reform proposals. This two tiered approach is receiving increasing attention and support from a variety of groups. In addition , the Council did agree on a number of common elements. For example, the Council agreed that the OASI program should be a compulsory program whose base should be expanded to cover all new state and local government employees. The Council also agreed the any related program reforms should be enacted as soon in order to minimize the degree of change necessary and to provide more program flexibility in the future.

While the Council's report may be the most notable one to be released to-date, it is not the only one. Several other organizations have made OASI program reform recommendations and others plan to do so. For example, the Committee for Economic Development (CED) issued a OASI reform proposal in February 1997. This report called for timely action to reform the OASI program to meet three primary objectives. These primary CED objectives were to: 1) Restore the long-range financial integrity of the OASI program; 2) Improve the rate of return that individuals of various generations will receive on their OASI contributions; and, 3) Increase national savings associated with the OASI program.

The CED report included a number of OASI program reform recommendations and no additional payroll tax increases to fund the existing benefit structure. It did, however, call for a transition to a "two tiered" benefit structure comprised of a revised base defined benefit amount and a mandatory individual retirement savings account element. This new individual account element would be funded through a 1.5% mandatory contribution by workers and their employers. Individuals would have the ability to decide how to invest their individual account funds among a variety of specified passive investment options. This investment approach recommended by the CED is consistent with the general structure of the current Federal Thrift Savings Plan for federal workers.

Most recently, the Center for Strategic and International Studies (CSIS) formed a National Commission on Retirement Policy (the "Commission") to address a range of OASI, employer/union pension and personal retirement savings issues. This Commission is comprised of four members of Congress and approximately 18 members from the private sector. The Commission is bi-partisan in nature with a number of co-chairs, including Senators Gregg (R-NH) and Breaux (D-LA) and Congressmen Kolbe (R-AZ) and Stenholm (D-TX). The private sector Commission members include a variety of knowledgeable individuals, many of which have prior executive level experience in the federal government, including myself.

The CSIS Commission will attempt to make a range of retirement income policy recommendations spanning the Social Security (i.e., OASI), employer and union sponsored pension programs and individual retirement savings arrangements. The Commission is expected to issue its recommendations in 1998. Importantly, the Commission is expected to make a significant contribution to the effort to educate the Congress and the American public on the nature and extent of our retirement income policy challenges and the various options to address them.

CURRENT PUBLIC OPINION REGARDING THE OASI PROGRAM:

The OASI program does not face an imminent financial crisis. However, I believe that we are currently experiencing a growing crisis of confidence among the American public in connection with the OASI program. This crisis of confidence is primarily attributable to a general and growing concern regarding the financial integrity of the OASI program and the apparent inability of the federal government to communicate candidly and deal effectively with the known challenges facing this important federal program. Both the legislative and executive branches of the federal government have a responsibility to address this growing crisis of confidence. In addition, the private sector also has a responsibility to steps to eliminate this crisis of confidence.

NEED FOR ACTION:

While the OASI program does not face a imminent financial crisis, it does face a mid-term financial challenge due in large part to known demographic trends. The most notable of these trends relates to the need to finance the significant OASI program obligations associated with the "baby boom generation" in the face of declining worker/retiree ratios. Specifically, we face rapidly accelerating OASI program obligations beginning in 2014. In addition, worker/retiree ratios have declined from 16:1 in 1950 to 3.4:1 today. They are projected to decline to less than 2:1 by 2030. Importantly, these demographic trends are a virtual certainty and the related implications on the financial condition of the OASI program must be addressed.

A growing number of individuals and organizations are calling for fair and timely action to restore the financial integrity of and public confidence in the OASI program. Fairness requires that any related program changes be balanced among different generations. At the same time, we need to consider the ability of individuals to adapt to any related program changes. Timely action is also appropriate since delay will only serve to increase the both the severity and difficulty of achieving the needed OASI program changes.

Achieving the needed OASI program reforms will require the development of non-partisan policy options and the pursuit of bi-partisan Congressional action. Any successful reform package will also require a balancing of policy and political considerations. Importantly, Congressional action will also have to be preceded by a concerted national campaign to educate the American public as to the nature and extent of our challenges, various options and their implications, and any recommended approaches to reform. After all, Social Security is the third rail of American politics and no politician wants to commit political suicide by getting to far in front of the American people of this important national policy issue.

Finally, in pursuing reform of the OASI program, policymakers must recognize that any modifications of the OASI program will also have a ripple effect on other important retirement income programs. Specifically, OASI program reforms will necessitate Congressional action designed to strengthen employer and union sponsored retirement income programs and individual retirement savings arrangements. These actions should include, but not be limited to, steps to increase current contribution and benefit limits, strengthen minimum funding standards, reduce inappropriate administrative burdens, enhance pension portability, improve the fairness of PBGC variable rate premiums and encourage preservation of pension savings for retirement income purposes.

SUMMARY:

The OASI program is one of the most successful in our nation's history. This program has served as a primary element in our fight to reduce poverty among the elderly. It has also served as the foundation in our nation's effort to assure that all Americans have a reasonable standard of living during their retirement years.

While the OASI program represents one of our most successful national programs, it faces a mid-range financial challenge. This financial challenge when coupled with the more immediate financial challenge facing the Medicare program has resulted in a growing crisis of confidence among the American public.

This current crisis of confidence spans several generations. Many seniors are concerned that their OASI benefits will be slashed and they won't have either the time or the means to compensate for it. Many baby boomers and Generation Xers don't think that the OASI program will be there when they retire. All of these groups are incorrect and we can prove that to them through enacting comprehensive, timely and fair reforms that serve to achieve the following key objectives: 1) Restore the long-range financial integrity of the OASI program, 2) Improve the rates of return on OASI related contributions; 3) Enhance the level of public understanding and support for the OASI program; 4) Stimulate the employer sponsored retirement income system; 5) Encourage personal planning, savings and investment for retirement, and 6) Increase overall national savings rates.

As stewards of our nation, we have a responsibility to address this growing crisis of confidence. Doing so will require fair and timely reform actions. It will also require a balancing of policy and political considerations. Congressional actions will also have to be preceded by a major national campaign to educate the American public regarding the nature and extent of our related challenges, options, and any recommended approaches. Determining the key principles to be followed and the key players who will be involved in this process will be critical to success.

While the natural tendency may be to delay action until it is required, this is not in the national interest. In addition, reforms of the OASI program should also be coupled with additional action in connection with employer and union sponsored retirement income programs and individuals retirement savings arrangements.

While action on OASI reform may be politically risky, it is an economic necessity. In addition, we need to begin to address this issue in order to restore the confidence of the American people in the OASI program and the Congress' ability to deal with it. Importantly, if we act in an appropriate manner, we can create a "win/win scenario) with legacy potential for those who dare to act. After all, a properly designed and communicated reform proposal should exceed the expectations of all generations of Americans.

The time for statesmanship and action is now. I stand ready to assist the Congress in addressing these important policy issues in a comprehensive, fair and timely manner.