AN ANALYSIS OF SELECTED DEFICIT REDUCTION OPTIONS AFFECTING THE ELDERLY AND DISABLED

Staff Working Paper
March 1985

The Congress of the United States
Congressional Budget Office

PREFACE

Concern with large and rising federal budget deficits has prompted interest in options for curtailing growth in programs that provide cash benefits to retired and disabled people or help pay their health care costs--programs that together constitute one of the largest components of federal spending. This paper examines 16 specific options, all but one of which would reduce future outlays for such programs or would raise federal revenues by subjecting additional benefits to the income tax. Estimates of budgetary savings and of impacts on beneficiaries are provided for each option.

This paper was prepared by members of three divisions of the Congressional Budget Office. Ralph Smith of the Human Resources and Community Development Division coordinated the project. He and Sandra Christensen, also of the Human Resources and Community Development Division, prepared the sections dealing with options for altering cost-of-living adjustments and for increasing cost-sharing under Medicare. David Lindeman of the Tax Analysis Division prepared the section on options for increasing the taxation of benefits. Estimates of outlay savings were provided by Carmela Pena, Paul Cullinan, and Diane Burnside of the Budget Analysis Division; revenue estimates were provided by staff of the Joint Committee on Taxation. Estimates of effects on beneficiaries were prepared by Richard Kasten and Roald Euller of CBO's Human Resources and Community Development Division.

The project was conducted under the general supervision of Nancy M. Gordon and Martin Levine of the Human Resources and Community Development Division; Rosemary Marcuss and Eric Toder of the Tax Analysis Division; and Charles Seagrave of the Budget Analysis Division. Numerous people provided useful comments on earlier drafts of the paper. Sherry Snyder edited the paper, which was typed by Ronald Moore, Jill Bury, and Toni Foxx.

In keeping with CBO's mandate to provide objective and impartial analysis, the paper presents no recommendations.

Questions regarding the analysis should be addressed to the authors of the separate sections: options for curtailing COLAs, Ralph Smith, 226-2659; options for increasing cost-sharing under Medicare, Sandra Christensen, 226-2665; options for increasing the taxation of benefits, David Lindeman, 226-2632.

CONTENTS

SUMMARY

Several proposals have been made to reduce the federal budget deficit by limiting the growth in expenditures under programs that provide cash benefits for the elderly and disabled or help pay their health care costs. Other proposals would subject an increased share of benefits to the federal income tax. This study illustrates the effects that such options could have--both on the federal budget and on program recipients.

The analysis examines 16 specific options:

- Seven options would eliminate or modify for one year the cost-of-living adjustment (COLA) under Social Security and other non-means-tested benefit programs.
- Four options would increase premiums or copayments for Medicare enrollees.
- Five options would increase tax revenues--primarily by increasing the taxation of Social Security or other benefits.

The budgetary effect of each option--either reduced outlays or increased revenues--was estimated for fiscal years 1986 through 1990, assuming that the policy change would be implemented in January 1986. Estimates reflect changes that would occur relative to the Congressional

Budget Office "current policy" baseline. The analysis of effects on beneficiaries, however, was based on data from the most recent year for which information was available, usually 1983. Thus, the two sets of estimates are not strictly comparable. The analysis is subject to several other limitations, which are described in greater detail in the text.

The Summary Table reports findings for three options that illustrate the range of alternatives considered in the paper. Those options and others are discussed briefly in this summary.

CURTAILING COLAs

As shown in the Summary Table, eliminating the COLA scheduled to be provided in January 1986 for Social Security and Railroad Retirement benefits would reduce federal outlays by $33.8 billion over the 1986-1990 projection period. About 8 percent of the reduction in benefits, relative to current policy, would be incurred by families with incomes below the poverty threshold defined by the Bureau of the Census, and 39 percent of the reduction would be experienced by families with incomes at least three times the poverty line.

Expanding a benefit freeze to encompass all non-means-tested retirement and disability programs as well (that is, Civil Service and Military Retirement, other smaller federal retirement programs, and Veterans'

SUMMARY TABLE. BUDGETARY SAVINGS AND DISTRIBUTION OF EFFECTS FOR SELECTED DEFICIT REDUCTION OPTIONS

Option	Fiscal Years 1986-1990 Budgetary Savings (in billions of dollars)	Percent Distribution of Effects on Recipients in 1983, By Recipients' Income				
		Poor a/	100%-125% of Poverty Line	125%-200% of Poverty Line	200%-300% of Poverty Line	Over 300% of Poverty Line
Freeze Social Security and Railroad Retirement Benefits for One Year	33.8	8	7	23	24	39
Increase Supplementary Medical Insurance (SMI) Premiums Under Medicare to 35 Percent of Costs	17.1	11	8	23	23	36
Lower the Income Thresholds for Inclusion of Social Security and Railroad Retirement Benefits in Adjusted Gross Income and Increase Percentage of Benefits Included	28.4	0	0	b/	1	99

SOURCE: Budgetary savings based on CBO baseline; distribution of savings based on tabulations of the March 1984 Current Population Survey, which reports incomes for calendar year 1983. See text for more detail and cautions in interpreting the findings.

NOTE: Budgetary savings estimated for fiscal years 1986-1990; distributional effects are for calendar year 1983. See text for definitions of options.

a. Poor families are those with incomes below Census poverty thresholds.
b. Less than 0.5 percent.

Compensation) would increase the 1986-1990 budgetary savings by $9.5 billion, to a total of $43.3 billion. Almost all of the additional families who would incur losses would have incomes well above the poverty thresholds.

Two alternatives examined in the paper would combine a benefit freeze with increases in the federal guarantee levels under the means-tested Supplemental Security Income (SSI) program. The specific options considered would increase benefits for nearly 3 million low-income recipients at a cost to the federal government of about $4 billion over five years. Recipients of SSI would be protected already from a benefit freeze, so this approach actually would increase their benefits. It would not, however, mitigate the adverse effects a freeze would have on other low-income individuals.

Other options considered would modify the procedures for granting COLAs in non-means-tested programs to limit the adverse effects of an across-the-board benefit freeze on low-income recipients. These options would limit the losses incurred by low-income families, but would generate smaller budgetary savings and could be difficult to implement in time to reduce the 1986 deficit.

The effects on the deficit of each of the COLA options would diminish over time as the affected population died or otherwise left the beneficiary

rolls, unless parallel changes were made in the formula used to calculate initial benefits. In contrast, the effects of each of the remaining options examined in this study would be permanent because they would also affect future beneficiaries.

INCREASING COST-SHARING UNDER MEDICARE

The next set of options would increase the share of their health care costs that Medicare beneficiaries would be required to pay. The specific alternative reported in the Summary Table would increase premiums for the optional Supplementary Medical Insurance (SMI) component of Medicare to cover 35 percent of program costs, rather than the 25 percent of costs covered under current law.

This approach would save, over five years, about half as much as a one-year freeze on Social Security and Railroad Retirement benefits, but the distributional effect would be nearly identical. About 11 percent of the higher premiums would be paid by members of poor families, even though about one-third of all poor Medicare enrollees would be protected from these cost increases because they are covered by Medicaid. At the other extreme, 36 percent of the additional costs would be paid by members of families with incomes more than three times the poverty line.

Some other cost-sharing options examined in the study would shift a greater share of the increased costs to higher-income Medicare enrollees. For example, introducing an income-related SMI premium would raise revenues by $8.7 billion and would concentrate more than 90 percent of the additional costs on families with incomes greater than three times the poverty line.

INCREASING THE TAXATION OF BENEFITS

With one exception, the last set of options would change the tax treatment of Social Security or Medicare benefits. When determining income tax liability, up to 50 percent of Social Security and Railroad Retirement benefits must now be included in adjusted gross income to the extent that that amount, when added to other income, exceeds $25,000 for an individual or $32,000 for a couple filing a joint return.

The option shown in the Summary Table would increase to 85 percent the maximum share of benefits that would be subject to taxation and would lower the income thresholds above which benefits are taxed to $20,000 for an individual and $25,000 for a couple. This change would make the tax treatment of Social Security more like that of private or public employee pensions with the same degree of after-tax employee contributions. This approach would increase revenues by $28.4 billion over the 1986-1990 period. Virtually all of the increased taxes would be paid by families with

incomes more than three times the poverty line. Other ways of altering the tax treatment of benefits examined in this study would raise revenues by between $19 billion and $36 billion. In each case, most of the additional revenues would be paid by families with incomes above 200 percent of the poverty thresholds.

TRADEOFFS AMONG APPROACHES

The options examined in this paper present two types of tradeoffs. First, there is a tradeoff between savings realized by the government and losses incurred by beneficiaries. Among alternatives that would achieve roughly the same budgetary savings, another tradeoff exists--between those strategies that would spread losses across the whole recipient population, and those that would concentrate the effects on beneficiaries with higher incomes, thus requiring that each affected recipient sustain a larger loss.

The first tradeoff is illustrated by the range of COLA options examined in the paper. The most comprehensive one--a one-year benefit freeze for all non-means-tested cash transfer programs--would save about $43 billion over five years by reducing the benefits of almost all recipients by about 3.7 percent. Modifications designed to protect those with low benefits, while continuing to provide some increase to all recipients, would substantially reduce the budgetary savings. For example, the "COLA Cap" option examined in the study would reduce savings to about $16 billion.

Other options that would give no increase to recipients whose benefits exceeded certain thresholds could maintain more of the budgetary savings. The "Poverty COLA" option, for example, would save approximately $33 billion, while still protecting almost as many low-income recipients.

Two of the options shown in the Summary Table illustrate the second tradeoff. A one-year freeze in Social Security and Railroad Retirement would yield five-year budgetary savings of about $34 billion by reducing benefits, compared with current law, for more than 20 million families. Losses would average between $200 and $250 annually (in 1983 dollars)--equivalent to about 1.2 percent of the total income of those who would be affected. By contrast, taxing a higher proportion of benefits would achieve more than 80 percent as much savings while affecting fewer than one-fourth as many families. Reductions in after-tax incomes would be about three times as large, on average. Because the losses would be concentrated on higher-income recipients, however, the average loss would be only slightly larger as a percentage of their total income.

I. INTRODUCTION

The Congressional Budget Office (CBO) projects the federal budget deficit to reach $300 billion by the end of the decade without major changes in current revenue and expenditure policies. Various proposals have been made to reduce the deficit by curtailing spending in a broad range of programs, including those that provide income assistance or health care to the elderly and disabled, or by altering tax provisions that benefit these groups. This study examines a limited number of such proposals: eliminating or altering for one year cost-of-living adjustments (COLAs) in non-means-tested programs; increasing premiums and copayments for Medicare recipients; and subjecting additional Social Security and other benefits to the federal income tax. 1/

This section provides background information on the direct spending programs and tax provisions benefiting the elderly and disabled and describes several approaches for altering these spending programs and tax

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1. The specific options considered here reflect a range of alternatives under consideration in the Congress. The inclusion or exclusion of a particular alternative does not reflect a judgment by the Congressional Budget Office regarding its appropriateness. Other approaches to reducing automatic benefit increases in cash transfer programs were recently examined by the Congressional Budget Office in "Effects of Curtailing Cost-of-Living Adjustments in Selected Federal Benefit Programs," Staff Working Paper, February 1985.

provisions. Section II examines options for changing the indexing of cash transfer programs. Section III discusses options for increasing the share of health care costs paid by Medicare beneficiaries. Section IV considers options that would amend the tax treatment of cash and in-kind benefits provided by the federal government. The last section compares the effects of these widely differing approaches.

For each option considered, answers are provided to two key questions: By how much would the policy change reduce the federal deficit over the next five years? Who would incur the losses, in terms of reduced income, increased health care expenses, or increased tax liabilities? Particular attention is paid to how low-income beneficiaries would fare.

BACKGROUND

The federal government has long assumed a substantial responsibility for providing income support for the elderly and the disabled and for helping to finance their health care costs. The Social Security program provides cash transfers to nearly all elderly and many disabled people and provides over half of the cash income for a majority of all aged individuals. In addition, low-income aged, blind, or disabled people qualify for payments under the Supplemental Security Income (SSI) program. Also, federal civilian and military retirees benefit from retirement systems that are

related to individuals' direct employment in the federal government. The Medicare program helps pay the health care costs of the elderly and disabled, thereby freeing their cash income for the purchase of other goods and services. Finally, the federal tax system encourages private pensions and other retirement savings, and taxes the income of the elderly and disabled more lightly than the income of the general population. For the most part, people qualify for these benefits solely on the basis of age, disability, or prior work history. With the exception of the SSI program, no explicit means test is required.

Over the past several decades, spending under programs benefiting the elderly and disabled has increased substantially--both in real-dollar terms and as a share of the gross national product (GNP). For example, between 1960 and 1983, average monthly benefits for a retired worker under Social Security rose from about $3,000 on an annual basis to approximately $5,300 in constant 1983 dollars. The Medicare program was created in 1966; by 1985 benefits had grown to about $2,250 per enrollee, with each person enrolled in the optional Supplementary Medical Insurance component contributing $186 in premiums. Over the last 20 years, spending for all major retirement and disability programs taken together, plus Medicare, increased from about 3 percent to approximately 8 percent of GNP, partly because the number of elderly people grew as a share of the total population from about 9.5 percent to approximately 12 percent.

In many respects, this combination of policies has been highly successful. Partly as a result of spending programs and tax provisions, the financial position of the elderly has improved substantially. For example, between 1960 and 1983, the share of all families with incomes below official poverty thresholds headed by a person age 65 or older declined from 27 percent to 9 percent--less than the 12 percent rate for families headed by nonelderly adults. On the other hand, while the poverty rate among elderly unrelated individuals has declined from 66 percent to 26 percent, it remains about one-half again as great as the comparable rate among nonelderly individuals. In addition, a greater share of the elderly than the nonelderly are clustered just above the poverty line.

BUDGET PROJECTIONS AND OPTIONS FOR CURTAILING GROWTH

If current policies are continued unchanged, both outlays for programs benefiting the elderly and the disabled and related tax expenditures will rise automatically in the future, even though in most cases the value of given benefits stays the same in real terms. All of the programs examined in this paper are entitlements; any person satisfying the criteria specified in the law automatically qualifies for benefit payments or for favored tax treatment. Thus, as the number of elderly people increases, both outlays and forgone revenues will rise. Furthermore, in the case of cash transfer programs, payments to current recipients are indexed to changes in the cost

of living as measured by the Consumer Price Index (CPI). In addition, outlays for health care are projected to grow more rapidly than spending for cash transfers, in part because the price of health care services is forecast to rise more steeply than consumer prices overall.

Table 1 shows "current policy" projections through the remainder of this decade for the spending and tax provisions examined in this analysis. Non-means-tested cash transfer programs whose benefits are indexed to the CPI are expected to total $248 billion this year and to rise to $334 billion by 1990 under current policies. 2/ (Social Security alone will account for more than three-fourths of the total.) The means-tested SSI program will contribute an additional $10 billion in 1985 and $11 billion per year by the end of the decade. Spending for Medicare is projected to increase from $71 billion this year to $121 billion by 1990.

Three of the tax provisions that benefit particularly the elderly and disabled are considered here. Social Security and Railroad Retirement benefits are entirely excluded when calculating a taxpayer's adjusted gross income for taxpayers with incomes below specified levels, and are partially

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2. These totals include Veterans' Compensation benefits, which are not formally linked to the CPI, but which have been increased annually in line with CPI changes.

TABLE 1. OUTLAYS AND TAX EXPENDITURES FOR SELECTED BENEFIT PROGRAMS, 1985-1990 (By fiscal year, in billions of dollars)

Program	Baseline 1985	Projected 1986	1987	1988	1989	1990	Total Projected 1986-1990
Outlays							
Non-Means-Tested Cash Benefits							
Social Security	192	202	215	229	244	260	1,150
Railroad Retirement	6	6	7	7	7	7	34
Civil Service Retirement	23	25	26	28	30	32	141
Military Retirement	16	18	19	20	21	23	102
Other Federal Employee Retirement	1	1	1	1	1	1	4
Veterans' Compensation	10	10	11	11	11	11	54
Total	248	262	278	296	314	334	1,485
Supplemental Security Income a/	10	10	10	12	11	11	54
Medicare							
Hospital Insurance	48	52	57	63	70	78	321
Supplementary Medical Insurance	23	26	29	33	38	43	169
Total	71	78	86	96	108	121	489
Tax Expenditures							
Partial Exclusion of SS/RR Benefits from Adjusted Gross Income	18	19	20	21	22	22	104
Extra Exemption for the Elderly and Blind	2	3	3	3	3	3	15

SOURCE: Outlay estimates are Congressional Budget Office baseline projections. Tax expenditure estimates for 1985-1989 are from the Joint Committee on Taxation; figures for 1990 are CBO estimates.

a. Fiscal year 1988 includes 13 months of payments; fiscal year 1990 includes only 11 months of payments.

excluded for others. The value of Medicare benefits not paid for through past employee contributions to the Hospital Insurance Trust Fund or through current premiums for Supplementary Medical Insurance is also excluded from taxation. Finally, individuals who are blind or at least age 65 are allowed an extra exemption when calculating their income tax liability. The estimated revenue loss from the exclusion of Social Security and Railroad Retirement benefits and the extra exemption for the elderly and blind--the two provisions for which estimates are available--is $20 billion in 1985. This revenue loss is expected to grow by $5 billion over the 1986-1990 period.

Sections II through IV examine three approaches for reducing future outlays or revenue losses under these programs:

- Eliminating for one year the cost-of-living adjustment in some or all non-means-tested programs. In some instances, this change is combined with provisions for ameliorating adverse effects on low-income recipients.
- Increasing premiums or copayments for Medicare recipients, or increasing the cost they must pay for supplementary private insurance coverage.
- Decreasing the after-tax value of Social Security or Medicare benefits, or eliminating the extra exemption for the elderly and the blind.

The remainder of this section provides information on how current program provisions developed, as background for assessing possible changes.

Cost-of-Living Adjustments

One proposal receiving considerable attention would freeze benefit levels for one year in some or all non-means-tested programs providing retirement and disability benefits. Omitting the cost-of-living adjustment (COLA) for 1986 in all such programs would lower federal outlays by reducing the incomes of recipients below what they would be under current policy. While the nominal amount received by beneficiaries would remain constant, its purchasing power would be eroded by inflation.

Automatic cost-of-living adjustments tied to the Consumer Price Index (CPI) have a history that goes back more than two decades. 3/ Automatic COLAs were enacted first in 1962 and 1963 for federal civil service retirement and military retirement pensions. Since then, the practice has spread to all the major non-means-tested retirement and disability programs, most notably to the Social Security program in 1972 (effective first in 1975) and to Railroad Retirement as part of that program's restructuring in 1974.

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3. Information on the history of cost-of-living adjustments in federal programs is drawn from Congressional Research Service, Indexation of Federal Programs, a report prepared for the Committee on the Budget, United States Senate, May 1981.

Before automatic indexing in Social Security, the Congress made periodic ad hoc adjustments in the program's basic "wage replacement rate" formula, attempting to maintain the purchasing power of those already on the beneficiary rolls and to keep the ratio of initial benefits to wage histories (the replacement rate) from deteriorating below past levels. This practice, however, resulted in some periods in which the real value of benefits eroded and replacement rates fell, and in other periods in which benefits and replacement rates rose more sharply than the cost of living. For example, after a six-year hiatus between 1959 and 1965, benefits were raised by 7 percent. Although that increase approximately equaled the increase in the CPI over that period, those people on the rolls in the interim experienced a loss in the purchasing power of their benefits, and new retirees had lower initial replacement rates than their predecessors. In contrast, between 1965 and 1971, benefits were raised three times for a cumulative increase of 43 percent, an amount well above the 27 percent rise in the CPI over the same period.

Based on this experience, in the late 1960s some people began to advocate automatic indexing to assure stability in the real value of benefits over time, while others advocated automatic indexing to dampen what was perceived to be a constant political pressure to raise benefits. In 1972, the Congress enacted a 20 percent ad hoc increase in benefits effective in September of that year and also enacted automatic indexing for Social

Security. An additional two-step ad hoc increase was provided in 1974. The first automatic increase took effect in July 1975.

The 1972-1973 legislation specified that indexing follow the procedure used in previous ad hoc adjustments--that is, that the same factor be used to increase benefits for those already on the rolls and to adjust the replacement rate formula that determines initial benefit levels for future recipients. Because initial benefits rise in any event as a result of wage growth, however, this procedure led to ever higher replacement rates and thus a more costly system, especially in a high-inflation environment. In the 1977 Social Security Amendments, the Congress separated the means by which benefits are initially set at retirement from the way benefits are adjusted after retirement. The former is now based on a wage-indexing procedure that attempts to assure that the ratio of initial benefits to lifetime earnings will be the same for successive generations of retirees with similar wage histories.

The 1983 Social Security Amendments made additional changes concerning indexing and the setting of replacement rates. 4/ The July 1983

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4. The legislation also contained provisions to increase the program's "normal" retirement age--the age at which unreduced benefits are payable--from age 65 to age 66 in the years 2000-2005, and then to age 67 in the years 2017-2022. One way of viewing the effects of this latter change is that replacement rates will be lower in the future for individuals who decide to retire before age 67, compared with the replacement rates that now exist.

cost-of-living adjustment was delayed to January 1984, and future automatic adjustments were shifted to be effective in each subsequent January.

Proponents of curtailing forthcoming Social Security cost-of-living adjustments point out that it is one means of achieving substantial budgetary savings, while spreading losses across many people, rather than by concentrating them on a smaller group. Some people also argue that limiting future COLAs could be justified in part because past practices for adjusting benefits were more generous than those used now. For example, the procedure in effect for adjusting the wage replacement rate before the 1977 amendments went into effect resulted in larger benefits for some recipients than they would receive under current practices. Also, the measure of price changes used to index benefits before this year resulted in larger benefit increases than would have occurred had the current measure been employed. On the other hand, not all of the current recipients who would be affected by a COLA limitation gained from these earlier benefit calculation procedures. Also, if COLAs were forgone for one year without making parallel changes in the formula used to calculate initial benefits for future retirees, an inequity would be created in the treatment of current recipients relative to later retirees.

Cost-Sharing Requirements in Medicare

The Medicare options considered in this study would increase the share of total program costs borne by beneficiaries. Three alternatives would increase premiums or deductible amounts for the "Part B" Supplementary Medical Insurance (SMI) component of Medicare that pays physician and outpatient costs. A fourth alternative would increase the cost of private "medigap" policies purchased by about two-thirds of Medicare enrollees to pay for health care expenditures not covered by the government.

Since the Medicare program was initiated, the share of program costs paid by enrollees has declined markedly. Enrollees in the SMI program originally paid 50 percent of program costs through monthly premiums. In addition, they faced a deductible of $50, after which the SMI program would pay 80 percent of covered medical expenses.

Since that time, the proportion of SMI costs financed by enrollees' premiums has declined to 25 percent. Between 1972 and 1982, premium receipts dropped relative to SMI costs because premiums were tied to the automatic increase in Social Security benefits, which were determined by the CPI, rather than to the faster-rising per enrollee cost of SMI. In 1982, premiums were set through 1985 (later extended through 1987) to cover 25 percent of the average benefits for an elderly enrollee. Under current law, beginning in 1988, the premium calculation will again be limited to the rate

of growth in the CPI, and thus premiums will probably decline again as a share of program costs.

The SMI deductible also has declined relative to total benefits. While the deductible has increased from $50 to $75, that amount represents only about 10 percent of the average benefit per aged enrollee under SMI now--down from 70 percent in 1967.

Cost-sharing provisions (such as the SMI deductible and 20 percent coinsurance) were included in the Medicare program to induce enrollees to avoid seeking unnecessary care by making them pay a portion of the costs of the services they obtained. About three-quarters of elderly Medicare enrollees are at least partially insulated from cost-sharing requirements, however. About 10 percent of Medicare enrollees are eligible for Medicaid, which generally pays Medicare's premium and copayment requirements. Another 65 percent of aged enrollees purchase supplemental medigap policies that pay most of Medicare's copayments and that may cover some part of disallowed charges or noncovered services as well. Because medigap policies encourage more use of the health care system, they generate additional costs for the Medicare program.

Some would argue that as a group the Medicare population can afford to pay a larger share of their SMI costs. Under current law, the combined

costs of the SMI premium plus the deductible are expected to equal 4.7 percent of the average Social Security benefit for retired workers in 1986, but might increase to as much as 7.4 percent under the SMI cost-sharing options discussed in this paper. These costs were 8.4 percent of the average Social Security benefit in 1967. On the other hand, an across-the-board increase could be a hardship for those low-income enrollees who are not eligible for Medicaid. About 65 percent of poor Medicare enrollees and nearly 80 percent of those living just above the poverty line do not receive Medicaid. Furthermore, increases in Medicare's cost-sharing requirements would lead to increased costs for states, which pay a portion of Medicaid costs.

Tax Treatment of Social Security and the Elderly

Most of the revenue options examined in this analysis would alter the tax treatment of Social Security or Medicare benefits. Another option would eliminate the additional tax exemption for the elderly and the blind.

Until the Social Security Amendments of 1983, Social Security benefits, as such, were not taxed. (Employee contributions to Social Security, however, were--and still are--made from after-tax income.) The 1983 amendments introduced limited taxation of Social Security cash benefits and related Railroad Retirement benefits. Under the 1983 act, higher-income beneficiaries must include in their adjusted gross incomes (AGI) a maximum

of one-half of benefits if the total of other AGI items, nontaxable interest, and one-half of benefits exceeds $25,000 for an individual tax filer, or $32,000 for a married joint filer. 5/ Even with partial taxation of benefits under current law, the Joint Committee on Taxation estimates that income tax revenues are some $18 billion less in 1985 than would occur if Social Security and Railroad Retirement were taxed as contributory private and public employee pensions are taxed.

As a consequence of the 1983 amendments, nearly 10 percent of beneficiaries will have to include half of their benefits in adjusted gross income, and about another 3 percent of beneficiaries will have to include a smaller portion of benefits in AGI. For a beneficiary receiving, for example, $6,000 in benefits and whose other income places him or her in the 30 percent tax bracket, the 1983 amendments have resulted in a $900 increase in tax liability, thereby decreasing the value of benefits by 15 percent.

The formerly tax-exempt status of Social Security benefits derives from administrative rulings by the Internal Revenue Service (IRS) in 1938 and 1941 (I.T. 3194, I.T. 3229, I.T. 3447). 6/ Railroad Retirement benefits

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5. Section IV describes at greater length the current tax treatment of Social Security and pensions in general.

6. Background information on the tax policy toward Social Security benefits is drawn from Congressional Research Service, "Taxing Social Security Benefits: Background and Programmatic Issues," Report No. 83-152 EPW, September 14, 1983.

were entirely exempt by statutory provisions that date from the program's 1935 enactment. Subsequent elaboration by the IRS in a 1953 letter to the Ways and Means Committee suggests that the 1938 and 1941 rulings were grounded in the logic that Social Security benefit payments were in the nature of "gifts" from the government and, therefore, should be characterized as nontaxable income in order not to defeat the underlying "welfare" purposes of the Social Security Act. By refusing to reverse these IRS rulings, the Congress effectively ratified the IRS position. Basic changes in the tax code, the maturation of the Social Security system, the increase in real benefits over time, and growth in the other income sources of the elderly altered the originally inconsequential revenue effect of the IRS rulings, and the tax exclusion of benefits became an increasingly valuable aspect of the system to many beneficiaries.

The total exclusion of Social Security and Railroad Retirement benefits was long criticized on tax equity grounds, especially in light of the extra exemption for the elderly. Some people also argued that taxing Social Security like a pension would be more consistent with its earned-right character. In contrast, others argued that the tax-free status of Social Security benefits had entered into the settled expectations of the retired and those soon to retire--at least as much as the expectation of regular cost-of-living adjustments--and thus had become part of the "social contract" underlying the program. Specifically, the tax-free status of benefits may have contributed to the acceptance of the Social Security system's

benefit formula by higher-wage individuals who receive smaller benefit amounts compared to their contributions than do lower-wage individuals. 7/ Taxing benefits amplifies this redistributional character of the Social Security system.

During the 1983 debate about Social Security's immediate and long-run financing deficits, the Congress considered the arguments for and against taxing benefits. The decision was made to include no more than one-half of benefit income within AGI, and then only for higher-income beneficiaries. Although growth in cash income over a very prolonged period will make more and more beneficiaries include benefits in their adjusted gross incomes, the tax treatment of Social Security will remain more generous than that afforded private pensions with the same degree of after-tax

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7. Under Social Security and Railroad Retirement, lower-wage workers receive more benefits as a percentage of previous earnings--a higher "replacement rate"--than do higher-wage workers, although the latter receive higher benefit amounts. If benefits are totally tax-exempt, however, they represent a higher proportion of a beneficiary's pre-retirement after-tax income than if they are taxed. Any exclusion of benefits from taxation, therefore, boosts the after-tax replacement rate of higher-wage workers facing 25 percent to 50 percent marginal income tax rates in retirement, compared with the effect of such an exclusion on the after-tax replacement rates of lower-wage workers, who are more likely in retirement to be below the tax entry levels or to face low marginal income tax rates. As a result, excluding benefits from taxation, in full or in part, tends to make after-tax replacement rates more nearly the same across the income distribution.

employee contributions. 8/ The options examined in this analysis would make the tax treatment of Social Security more nearly identical to that of private pensions, either by increasing the maximum share of benefits includable in AGI, or by lowering the total income thresholds above which some benefits are taxed.

On the other hand, Social Security is unlike a private pension in that it yields a higher rate of return to low-wage workers than to those with comparatively higher earnings. Even before the 1983 amendments, the rates of return in the system for many high-wage workers who will be retiring in the twenty-first century were estimated to fall below those attainable in private pension plans. Taxation of benefits under the 1983 act further reduced those rates of return, and some forms of increased taxation would reduce them still further. For current retirees and those in the immediate future, however, benefits are so high in relation to past contributions that taxation of benefits still leaves even those who had high earnings better off than if they had invested their contributions in private pension plans.

The tax treatment of Medicare benefits presents a different set of issues. Although the elderly and disabled derive economic benefit from

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8. The 1979 Social Security Advisory Council stated that, while it believed that the current tax treatment of private pensions was the appropriate model for the tax treatment of Social Security, administrative complications and commonly held perceptions suggested that "rough justice would be done . . . if half the benefit (the part commonly if somewhat inaccurately attributed to the employer contribution) were made taxable." See Section IV for a discussion of how private and public employee contributory pensions are taxed.

Medicare protection, they do not have to include in AGI the net value of those benefits--that is, the value in excess of the Hospital Insurance payroll taxes they paid while they were working, and their current premiums for Supplementary Medical Insurance. This exclusion of previously untaxed Medicare insurance benefits parallels comparable exclusions in the tax code of, for example, employer-paid health insurance premiums. Any proposed taxation of the net value of Medicare benefits--as examined here--thus involves consideration of larger tax questions.

Finally, the elderly enjoy other tax advantages unrelated to their receipt of government benefits. The most important of these is the extra personal exemption for any taxpayer age 65 or older. One principal argument for the extra exemption is that the elderly are more likely than others to incur high medical expenses. Since the time in which the extra personal exemption was enacted, however, Medicare has come into existence. Further, the itemized deduction for extraordinary medical expenses allows the elderly, and other taxpayers, a deduction from taxable income of medical expenses not reimbursed by Medicare or other insurance in excess of 5 percent of adjusted gross income. On the other hand, the extra exemption for the elderly has been part of the tax code for decades, and its removal would increase the number of elderly who have to pay income taxes. Moreover, it would lower tax entry levels for elderly individuals and couples to below the poverty level.

II. REDUCTIONS IN COLAs FOR NON-MEANS-TESTED PROGRAMS

Immediate budgetary savings would result from freezing benefits or otherwise limiting the cost-of-living adjustments (COLAs) scheduled to be given in January 1986 for indexed cash transfer programs. These savings would accrue for as long as the affected recipients continue to receive benefits, because subsequent resumption of COLAs would not make up for the 1986 reduction. The budgetary estimates provided in this paper cover the five-year period beginning in fiscal year 1986.

Curtailing COLAs would reduce the standards of living of recipients relative to what they would be if scheduled increases had gone into effect. The exact amount would depend on the size of the forgone COLA increase and the extent to which it would be offset by increased benefits from other programs or by lower tax liabilities. The low-income population could be protected from some or all of the losses in a number of ways, each of which would either reduce the total budgetary savings from a benefit freeze or would necessitate that other beneficiaries incur larger reductions.

BACKGROUND

Indexed cash transfer programs for the elderly and disabled provide a substantial share of their incomes. Low-income recipients are especially reliant on such transfers. As of 1983, the largest of the programs--Social Security--provided benefits to members in one out of every four families (see Table 2). 1/ Families receiving Social Security benefits obtain one-third of their total incomes from this source. Poor and near-poor recipient families, however, rely on Social Security for three-quarters of their incomes. Although very few of the families that contain recipients of civil service and military pensions are poor or near-poor, these pensions represent the majority of the total incomes for the ones who are.

Additional income is provided to low-income aged, blind, and disabled people through the Supplemental Security Income (SSI) program. About half of all families containing SSI recipients are poor, as shown in the third panel of Table 2. For these families, SSI provides almost half of their incomes. For other families containing SSI recipients, the percentage of income

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1. The Current Population Survey--the data source used here--combines Social Security and Railroad Retirement receipts. Railroad Retirement Tier I benefits are that portion of payments to Railroad Retirement beneficiaries that approximate what the Social Security system would pay them based on their combined railroad industry and Social Security covered earnings. Tier II benefits are similar to those paid by an industrial pension in the private sector that is conventionally coordinated with Social Security. Of all Railroad Retirement benefits, 85 percent are Tier I. References in text to "Railroad Retirement" apply only to Tier I benefits. All Railroad Retirement benefits, however, account for only about 3 percent of the combined outlays (see Table 1 in the Introduction). Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis.

TABLE 2. FAMILIES RECEIVING BENEFITS FROM SELECTED PROGRAMS, CALENDAR YEAR 1983 a/

Family Income Relative to Poverty Line	Percentage of Recipients in Group	Percentage of Total Program Benefits Received by Group	Number of Families Receiving Benefits		Average Benefits	
			In Thousands	As Percentage of Families in Group	In Dollars	As Percentage of Average Income
Social Security and Railroad Retirement						
Total Families	100	100	23,510	25.6	6,010	34.3
Below Poverty Line	17	9	3,890	26.0	3,370	76.0
100-125 Percent	9	8	2,190	43.4	4,840	74.2
Over 125 Percent	74	83	17,440	24.2	6,750	30.9
Civil Service and Military Retirement						
Total Families	100	100	2,820	3.1	11,590	37.2
Below Poverty Line	2	1	60	0.4	2,770	63.7
100-125 Percent	3	1	90	1.7	3,900	54.4
Over 125 Percent	95	98	2,670	3.7	12,060	37.0
Supplemental Security Income						
Total Families	100	100	2,990	3.2	2,460	24.3
Below Poverty Line	54	47	1,620	10.8	2,130	46.4
100-125 Percent	16	18	470	9.4	2,820	38.6
Over 125 Percent	30	35	900	1.2	2,860	13.2
Social Security, Railroad Retirement, SSI, Civil Service or Military Retirement b/						
Total Families	100	100	26,100	28.4	6,950	38.2
Below Poverty Line	18	9	4,620	30.9	3,620	81.2
100-125 Percent	9	7	2,400	47.5	5,120	77.4
Over 125 Percent	73	84	19,080	26.5	7,990	34.8

SOURCE: Congressional Budget Office tabulations of March 1984 Current Population Survey.

a. Unrelated sub-families and unrelated individuals are each defined as separate families in these tabulations. All numbers have been rounded.

b. Families receiving benefits from one or more of these programs. Families receiving benefits from more than one program are counted only once.

derived from the program is lower. Many SSI recipients are not members of poor families either because they live in one of the few states such as California in which the threshold for eligibility is above the poverty line as a result of state supplementation, or because they live in the household of another person who is not poor. 2/ Moreover, the majority of poor elderly families do not participate in SSI. For example, only about one-quarter of the elderly poor families represented in the Current Population Survey (CPS), the data source used here, reported receipt of SSI benefits. Many nonrecipients are not eligible because their incomes or assets exceed the eligibility limits; others might have been unaware of their eligibility, might have chosen not to participate, or might be receiving benefits not recorded on the CPS. 3/ (Two of the options examined here would increase SSI benefits in conjunction with forgoing COLAs in non-means-tested programs.)

Many families contain recipients of more than one of these programs. The number of families with members who received benefits in 1983 from any of the programs included in this analysis is reported in the bottom panel of Table 2. Among the 26 million recipient families reported on the CPS,

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2. About 6 percent of SSI recipients receive lower benefits as a result of the support provided by the householder, according to program records. The estimates reported here include an adjustment for this reduction.

3. The asset limits are $1,600 for individuals and $2,400 for couples; excluded from these limits were one's home, the first $4,500 of the value of a car, life insurance policies with a total face value of up to $1,500, and certain other household goods and personal belongings.

38 percent of average income came from these programs. For poor recipient families, however, these programs provided about 80 percent of their incomes.

SPECIFIC OPTIONS

Seven methods of achieving savings in non-means-tested cash assistance programs are examined in this section. Two COLA reduction methods are straightforward "freeze" options. One would eliminate for one year any cost-of-living adjustments for benefits from Social Security (Old Age, Survivors, and Disability Insurance) and Railroad Retirement (Tier I). The other would extend the freeze to all other indexed non-means-tested cash assistance programs: Civil Service Retirement, Military Retirement, Veterans' Compensation, and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. 4/

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4. Eliminating COLAs could create inequities between current and future program participants, because benefit levels in some programs--including Social Security--are based on earnings histories that are indexed for real wage growth. Freezing benefits for those now receiving benefits, while not reducing indexing rates for the earnings of today's workers, could result in lower benefits for current retirees than for future retirees, even if their earnings histories were identical in real terms. If the Congress chooses to modify COLAs for those already retired, it could alter also the indexing of benefit formulas to treat current and future retirees more similarly. Making parallel changes in the benefit formulas also would increase budgetary savings and make them permanent. The effects of COLA changes alone would be realized only for as long as current recipients (and eligible recipients not currently receiving benefits) are alive.

Two other options would supplement each of the above benefit freezes by concurrently raising the federal SSI guarantee levels for individuals and for couples by $20 and $30 per month, respectively. These increases would be in addition to the automatic changes that are made in the federal guarantee levels because they are indexed to the Consumer Price Index (CPI). 5/

The remaining options examined here are illustrative of COLA restraints that are intended to limit the benefit reductions for low-income recipients that would result from an across-the board freeze. These variants would be far more difficult to implement than would an across-the-board freeze and may not be feasible with respect to the December 1985 benefit increase. The first would provide COLAs to all recipients on the portion of Social Security and Railroad Retirement benefits that is below their poverty threshold. This approach will be referred to as the "COLA Cap" option.

The second would replace the COLA on Social Security and Railroad Retirement benefits with a flat dollar amount. The amount would be calculated as the COLA that would have been given to a recipient whose

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5. The size of the increases was selected so as to offset the losses in the aggregate amount of income of the poor that would result from a freeze on other program benefits.

benefits equaled the poverty threshold. Thus, some recipients would receive more than they would have under current policy and others would receive less. This approach will be referred to as the "Flat COLA" option.

The last option would exempt from the one-year freeze only Social Security and Railroad Retirement recipients whose benefits in these programs are under the poverty thresholds; other recipients would receive no COLA. This approach will be referred to as the "Poverty COLA" option.

METHODOLOGY

Two separate approaches were used to estimate the impacts of each of the options--one for the budgetary effects and one for the effects on beneficiaries.

Budgetary Effects

To provide estimates of the budgetary savings of each of the options, the following procedures were used. First, total benefits for the programs whose COLAs would be changed were estimated by substituting the allowable COLA under each option for the COLA that would be paid under current law. The Congressional Budget Office (CBO) projects that the CPI will increase by 3.7 percent between the third quarter of 1984 and the third quarter of 1985--the period that would be used as the base for the 1986

COLA. For the two options in which SSI guarantee levels would be increased, appropriate changes in SSI benefit payments and participation were made. 6/

Second, the indirect budgetary effects were estimated from program data. Because curtailing COLAs could cause some beneficiaries' SSI and food stamp benefits to increase and could limit some scheduled premium increases for Supplementary Medical Insurance (SMI), initial savings estimates were adjusted to account for these offsetting increases in federal costs. The resulting offsets were subtracted from the direct savings; the budgetary impacts reported in "Estimated Budgetary Savings," below, represent the net effects that would arise from the various options.

Effects on Recipients

The impacts on beneficiaries of implementing these options were estimated based on the March 1984 CPS, which reports before-tax incomes for calendar year 1983--the most recent data available. The CPS identifies program benefits under four non-means-tested federal cash assistance programs affected by COLAs--Social Security and Railroad Retirement,

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6. The participation increases reflect only the increases in the number of people who would be newly eligible as a result of the higher guarantees--not any increase in the participation rate among those who were already eligible.

Civil Service Retirement, and Military Retirement. It also identifies benefits provided under SSI. 7/

In estimating impacts on beneficiaries, incomes from the non-means-tested programs reported on the CPS were changed to reflect each option. For example, for the across-the-board freeze options, the benefits depicted in the CPS were replaced by reduced amounts that would reflect the recipients' decline in real benefits; the new amounts would be 96.4 percent of the original benefits. 8/ For the two options in which SSI guarantees would be increased, the incomes of SSI recipients were raised by the indicated amounts (adjusted to 1983 dollars).

LIMITATIONS

A number of problems with the estimation methods and data limit the accuracy of the results presented below. One general problem--occurring throughout this study--is that because the budgetary estimates and the estimates of the impact on the population are for different time periods and

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7. Veterans' Compensation and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard cannot be separately identified from the CPS and are therefore not included in the analysis of impacts on beneficiaries. They are, however, included in estimates of budgetary impacts.

8. In the absence of a freeze, a recipient who had been receiving $100 would have received $103.70 if the CPI increased 3.7 percent. With the freeze, the benefit would remain at $100, which is 96.4 percent of $103.70. This percentage was applied to the 1983 data.

are derived from different data sources, they are not entirely comparable. The budgetary estimates were made for fiscal years 1986 through 1990, whereas the estimates of the incidence of the effects were based on the population as it was in 1983.

A problem that affects the estimates of the budgetary and distributional impacts of all of the options for reducing the 1986 COLA is that the inflation rate for the base period (the third quarter of 1984 to the third quarter of 1985) is not yet known. Actual inflation could be higher or lower than the 3.7 percent rate forecast by CBO. In general, in considering a freeze for an extended period, the estimated savings and effects on recipients would be quite sensitive to the inflation rate assumed, and the inflation rate would be quite difficult to predict. All of the options examined here, however, involve the inflation rate for only one year.

Other problems that limit the accuracy of the distributional estimates include shortcomings of the official poverty measures; an inability to determine in detail the offsetting effects of benefit increases in means-tested programs resulting from COLA cutbacks in other programs; an inability to describe the affected population in 1986; and problems with the CPS as a source of data. These limitations are discussed in turn. 9/

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9. The general methodology used in this study--and its limitations--is similar to that used in Congressional Budget Office, "Effects of Curtailing Cost-of-Living Adjustments in Selected Federal Benefit Programs," Staff Working Paper, February 1985. Several refinements have been made that should improve the estimates of the effects on recipients of options designed to reduce the losses incurred by low-income recipients. These changes are noted in the text.

Limitations of Official Poverty Measures

This analysis uses the official Bureau of the Census definition of poverty, which compares an individual's or family's total cash income with a poverty threshold based on the size of a family, the age of the family head, and the number of children. The individual or family members are classified as poor if income is below the threshold. This definition has numerous well-documented shortcomings. Four problems are particularly significant for this analysis.

First, the official poverty measure omits in-kind income such as food stamps in assessing poverty status, even though such benefits are an important part of the resources available to low-income people. To the extent that in-kind transfers satisfy resource needs and leave cash income available to purchase other things, a family that receives some benefits in kind is less poor than a family with identical cash income that does not have any in-kind income. 10/

Second, by focusing only on cash income, the official poverty measure ignores differences in wealth--that is, tangible assets, such as savings or equity in a home. Wealth is included in the poverty determination only to the extent that it generates cash income, yet the ability to draw down

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10. Modifying the current poverty measure is exceedingly complex, however, and alternatives are not considered here. A forthcoming analysis will examine the measurement of poverty in greater detail.

accumulated assets may be an important supplement to current income, especially for the elderly. As a result, assessing whether the elderly are poor by considering only cash income may be particularly misleading.

Third, the poverty statistics make no allowance for geographic differences in living costs. It is more expensive to live in New York City, for example, than in many rural areas, but poverty thresholds are uniform across the country. While data limitations make it impossible to determine the effect of price variations on poverty rates and gaps, it is clear that these thresholds overstate income needs in some locations and understate them in others.

A fourth problem is that estimates of the effect of a policy on poverty counts, in essence, focus on the impacts on people and families in a very narrow band of the income distribution--those just above or below the poverty threshold. The analysis reported below avoids this problem, to some extent, by also calculating each policy option's effect on the poverty gap--the amount of income needed to bring the poor up to the poverty threshold. Even this measure, however, does not capture the effects on the near-poor who would remain above the poverty threshold under a particular option.

Offsets Provided Through Means-Tested Transfer Programs

This analysis does not fully reflect the effects that constraining COLAs under cash transfer programs would have in expanding eligibility under means-tested cash transfer programs. In the case of Aid to Families with Dependent Children, general assistance, and SSI, benefit increases were simulated for current recipients to make up for the reduced or forgone COLAs in other programs, but changes in the number of participants were not. While it is likely that reductions in real income caused by COLA changes in other programs would make more people eligible for cash assistance (and for Medicaid) and would induce some additional eligible people to participate, their benefits generally would be low. 11/

Eligibility for and benefit levels in the Food Stamp and housing assistance programs would also increase if COLAs were reduced in cash transfer programs. For each dollar of cash income lost because of a COLA limitation, a family's food stamp allotment would be increased by 30 cents until the maximum benefit level was reached. Similarly, the rent that a

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11. The two options in which SSI guarantee levels would be raised would provide additional income to current recipients and expand the eligible population, so the same estimation problems occur. The budgetary estimates, however, do include new eligible recipients.

family has to pay for a rent-assisted housing unit would fall by 30 cents for each dollar of lost income. These effects were not estimated. 12/

Findings Reflect 1983, Not Future Years

The effects of the options on beneficiaries have been analyzed for the population as it was in 1983. No allowance has been made for growth in the population since then, or for changes in economic circumstances that might affect the poverty levels, poverty gaps, and income distributions that constitute the starting points for measuring policy impacts. Improvement in the economy since 1983 is likely to reduce the overall poverty level by 1986 as well as the total poverty gap. Unless the shape of the income distribution has changed dramatically by 1986--which is highly unlikely--estimated changes resulting from the policy options examined here would be largely unaffected by the different starting points.

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12. A related effect would occur in the SMI component of Medicare, which pays for physician services. Under current law, the annual increase in premiums paid by Medicare beneficiaries for SMI coverage is restricted to the increase in the nominal value of the Social Security cash benefit. That is, Social Security benefits net of SMI premiums cannot fall in nominal terms. Thus, part of the cash income lost by some beneficiaries as the result of COLA restrictions would otherwise have been spent on SMI premiums. This is taken into account in the budgetary estimates, but not in the distributional analysis.

Data Limitations

Several other data limitations affect the analysis of beneficiary effects, although the resulting bias is likely to be small. First, the analysis is based almost entirely on CPS data, which do not take into account taxes paid and are subject to underreporting of income. In 1982, for example, 98 percent of earnings and 93 percent of Social Security and Railroad Retirement benefits were included in CPS data, while only 78 percent of SSI benefits, 72 percent of pension payments, and 44 percent of interest, dividend, and rental income were recorded. Because the elderly derive a larger fraction of their income from sources other than earnings, their incomes are likely to be undercounted by a larger percentage. In addition, CPS data may confuse some income from SSI and Social Security in cases where surveyed recipients do not know the source of their benefits. This may affect the results of the analysis for all options, but the direction of the effect is uncertain.

On the other hand, CPS data are used to calculate official poverty measures and other income distribution statistics, and thus the results of this analysis are consistent with published statistics. Moreover, the poor and near-poor are unlikely to have substantial amounts of unreported income from sources such as interest and dividends, although underreporting of SSI presents more of a problem. In short, while underreporting is likely to affect the starting levels of incomes, it is unlikely to have appreciable

effects on estimated changes in incomes that would result from the options examined here.

A second problem with the CPS is that it may understate the number of SSI beneficiaries because recent legislative changes had not fully taken effect in 1983. For example, the increase in basic SSI benefits that occurred in July 1983 both increased benefits to current participants and brought more eligible people into the program, but those changes are unlikely to be fully reflected on the March 1984 CPS used in this study. Further, the number of SSI recipients who would be given additional benefits under the two options in which SSI guarantees are raised would be underestimated.

Finally, CPS data make it impossible to model precisely the distributional effects of the three options in which the structure of the COLAs would be changed, because the survey does not report the information that the Social Security Administration would have to use to implement these options. The CPS reports total Social Security/Railroad Retirement benefits for a family and for each adult; it does not identify primary beneficiaries on whose earnings records benefits are based, nor does it identify all dependents on whose behalf benefits are paid. As a result, for the COLA Cap, the Flat COLA, and the Poverty COLA options, it was necessary to

impute the membership in each filing unit within each family that received benefits.

The imputation of membership in Social Security filing units was possible because the CPS does provide information on the amount of Social Security and Railroad Retirement benefits received by each adult. Primary recipients were identified from the relative amounts reported for each family member in a recipient family. Every adult was assumed to be a primary recipient, except for married individuals whose spouses had benefits at least twice their own. Minor children were assumed to be beneficiaries if either parent received benefits. This was the basis for determining, for example, whether the benefits based on one earnings record exceeded the poverty threshold and, therefore, whether a COLA would be provided under the Poverty COLA option. 13/

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13. The previous CBO study ("Effects of Curtailing Cost-of-Living Adjustments," op. cit.) did not attempt to identify recipient units within a CPS family. The current procedure should result in estimated effects on recipients that are closer to those that would result from implementation of any of the options that would change the structure of the COLAs; there is no difference between the two procedures for options that would involve across-the-board changes.

ESTIMATED EFFECTS

The remainder of this section reports estimates of the budgetary and distributional effects of implementing each of the seven options listed below:

- Omit the COLA for one year on benefits from Social Security and Railroad Retirement programs.
- Combine the freeze in Social Security and Railroad Retirement benefits with increases in the SSI federal guarantee levels for individuals and for couples by $20 and $30 per month, respectively.
- Omit the COLA for one year on benefits from all non-means-tested cash transfer programs (Social Security, Railroad Retirement, Civil Service and Military Retirement, Veterans' Compensation, and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard).
- Combine the freeze in all non-means-tested program benefits with increases in the SSI federal guarantee levels for single individuals and for couples by $20 and $30 per month, respectively.
- Exempt from the freeze in all non-means-tested program benefits the COLAs on the portion of Social Security and Railroad Retirement benefits (primary plus dependents' benefits based on a single earnings record) that are below the poverty threshold for the number of people receiving primary or dependents' benefits. That is, everyone would receive the full COLA on the part of the benefit that did not exceed the poverty threshold and no COLA on the remainder. This is the COLA Cap option.
- Freeze all non-means-tested program benefits other than Social Security and Railroad Retirement and replace the COLA on Social Security and Railroad Retirement benefits with a flat dollar amount increase. The amount would be set equal to what the

COLA would have been for recipients whose benefits equaled the poverty threshold. 14/ This is the Flat COLA option.

- Exempt from the freeze in all non-means-tested programs only those Social Security and Railroad Retirement recipients with benefits under the poverty thresholds. The COLA for recipients whose benefits are just below the threshold would be limited to the amount that would raise the total benefit up to the threshold. Recipients above the threshold would receive no increase. This is the Poverty COLA option.

Each of the last three options involves Social Security and Railroad Retirement COLAs in which the percentage increases would vary across beneficiaries. As discussed above, the distributional results reported in this section are based on the assumption that the COLA Cap, Flat COLA, and Poverty COLA options would be implemented by comparing the benefits paid on an earnings record with the poverty threshold applicable to the primary beneficiary and other members of the filing unit.

This approach would differ markedly from that now used by the Social Security Administration for making cost-of-living adjustments. The agency's procedure begins by increasing the primary insurance amount (PIA) and then making the necessary adjustments--to reflect actuarial reductions for early retirees or lower benefits for those whose earnings exceed the

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14. The relevant poverty threshold for this option (as for the COLA Cap and Poverty COLA options) would be that for the number of recipients whose benefits were based on a single earnings record.

allowed amount, for example. Consequently, options in which percentage increases would vary among beneficiaries would be much easier to implement if they were specified in terms of the PIA (comparing it with the poverty threshold for one person, for example), rather than the benefit level. It may be that, in fact, it would not be feasible to implement a COLA modification that was based on anything other than the PIA, at least if the changes were required for the December 1985 COLA; some believe that even a version based on the PIA could not be implemented in time for this COLA. 15/

Issues other than ease of implementation might be important in deciding whether to base any of these approaches on PIAs rather than on benefit levels. Using the PIA would be consistent with most past practice in

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15. The feasibility of implementing the various COLA limitations discussed in this study varies among the options. Elimination of the COLA is an administratively feasible option assuming enactment of the legislation by late summer, or even somewhat later, depending on whether SMI premiums would be affected. Options that would provide different percentage COLAs based on recipients' primary insurance amounts would need to be enacted much earlier. Given the enormous number and variety of computer programs that would need to be modified, COLA options that would pay different percentage adjustments for beneficiaries at different PIA levels would require several more months of lead-time than would regular COLAs. According to the Social Security Administration (SSA) relatively minor disruptions to the normal operation of the program would occur if legislation containing the PIA-based COLA change were to be enacted by mid-April. More severe problems would ensue with enactment between then and mid-June, likely reducing the COLA savings somewhat because of increases in administrative costs and in error rates. The SSA has stated that it would be unable to implement a variable COLA for the December 1985 benefit increase if it were enacted after mid-June.

Social Security legislation. It would mean, however, that some early retirees--whose benefits are lower than their PIAs--would not receive an increase even though their benefits were below poverty under the Poverty COLA option. Likewise, about half of widows or widowers have reduced benefits, with their average benefit equal to only 82 percent of the PIA, and most women receiving benefits only as divorced wives--which generally equal half of their ex-spouses' PIAs--would not receive COLAs (unless a special provision were made), even though their benefits are among the lowest. On the other hand, retirees with low benefits because of earnings above the allowed amount would not receive a Poverty COLA, for example, if it was based on PIAs, whereas they would if it was based on benefits.

The effects of options linked to PIAs cannot be estimated accurately using the CPS. Those data report only benefits and lack the necessary information (such as age at retirement) to impute PIAs.

Estimated Budgetary Savings

Freezing Social Security and Railroad Retirement benefits--that is, eliminating the COLA that is scheduled for all recipients in January 1986--would save about $5.1 billion in fiscal year 1986. Since the COLA would not have been given until the second quarter of that year, the savings in 1986 are smaller than in each of the subsequent four years (see Table 3). Total savings are estimated to be $33.8 billion over the 1986-1990 period.

TABLE 3. ESTIMATED OUTLAY SAVINGS OF OPTIONS TO REDUCE SELECTED CASH TRANSFER PROGRAMS, FISCAL YEARS 1986-1990 (In billions of dollars) a/

Option	1986	1987	1988	1989	1990	Cumulative Five-Year Savings
Freeze Social Security and Railroad Retirement Benefits						
Across-the-Board Freeze	5.1	7.1	7.3	7.2	7.1	33.8
Combine with Increase in SSI Guarantee	4.5	6.4	6.4	6.4	6.3	29.9
Freeze All Non-Means-Tested Cash Transfer Program Benefits b/						
Across-the-Board Freeze	6.5	9.1	9.3	9.3	9.2	43.3
Combine with Increase in SSI Guarantee	6.0	8.3	8.4	8.4	8.4	39.4
Exempt Social Security and Railroad Retirement Benefits Below Specified Threshold (COLA Cap) c/	2.5	3.4	3.5	3.5	3.6	16.5
Replace Social Security and Railroad Retirement COLA with Specified Flat COLA c/	1.5	2.1	2.1	2.2	2.2	10.2
Exempt Social Security and Railroad Retirement Beneficiaries with Benefits Below Specified Thresholds (Poverty COLA) c/	5.1	6.9	7.0	7.1	7.0	33.1

SOURCE: Congressional Budget Office.

a. See text for additional detail and cautions in interpreting findings. Details may not add to totals because of rounding.

b. The programs whose benefits would be frozen include Social Security, Railroad Retirement, Civil Service and Military Retirement, Veterans' Compensation, and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard.

c. Estimates are based on enactment of the option in time for it to take effect in December 1985. Enactment between mid-April and mid-June would result in some reduction in savings because of increases in administrative costs and in error rates. The Social Security Administration has indicated that later enactment would prohibit timely implementation.

This estimate provides a convenient benchmark against which to compare other options in which only the Social Security and Railroad Retirement COLA would be modified for one year. It is also used to compare options that would increase taxes paid by Social Security and Railroad Retirement recipients (see Section IV). Extending the freeze to the other non-means-tested programs (the third row of Table 3) would increase first-year savings by $1.4 billion to $6.5 billion and five-year savings by $9.5 billion to $43.3 billion.

If either a freeze on Social Security and Railroad Retirement benefits or a freeze on all non-means-tested program benefits was accompanied by increases in SSI guarantee levels (the second and fourth rows of Table 3), the budgetary savings would be about 10 percent smaller. The specific options examined here are estimated to cut first-year budgetary savings from a Social Security and Railroad Retirement benefit freeze, for example, from $5.1 billion to $4.5 billion and the five-year savings by $3.9 billion to $29.9 billion.

Each of the last three options would freeze benefits on all of the non-means-tested programs other than Social Security and Railroad Retirement and would modify the COLA for these two programs. Giving all Social Security and Railroad Retirement recipients the COLA only on the part of their benefits that did not exceed their poverty thresholds (the COLA Cap option) would reduce considerably the budgetary savings of a freeze,

because all recipients would be given at least a portion of the full COLA. The estimated five-year savings would be $16.5 billion, about $27 billion less than would result from freezing all non-means-tested programs.

Replacing the 1986 COLA on Social Security and Railroad Retirement benefits with a flat dollar amount (the Flat COLA option) would produce budgetary savings for the five-year period of $10.2 billion. All but $0.7 billion of the estimated savings would result from the freeze on the other non-means-tested programs. This option would save very little money, compared with any of the other options analyzed in this study, because the amount that would be given to Social Security and Railroad Retirement recipients is not far below the average COLA that would be provided under current policy. Moreover, many of these recipients would be given larger increases than they would have obtained under current policy.

Exempting from the one-year benefit freeze all Social Security and Railroad Retirement recipients whose benefits were under the poverty thresholds (the Poverty COLA) is estimated to save $33.1 billion over the five-year period--about $10 billion less than would be saved with an across-the-board freeze. Only the people whose benefits were below the specified amounts would receive any COLA increases, and no one would receive higher benefits than they would under current policy. Therefore, the estimated budgetary savings are larger than would be achieved by the preceding two options.

Estimated Effects on Beneficiaries

The budgetary savings that would be achieved by implementing any of the options reflect reduced incomes for the recipients. Estimates of the incidence of these reductions, however, are not directly comparable with the budgetary estimates. Estimates of budgetary savings are for fiscal years 1986 through 1990 and are based on the assumption that the option would be implemented in January 1986, whereas the estimated effects on beneficiaries are based on a sample of the population for 1983. Moreover, the data used for the recipient analyses did not include all of the programs that would be affected by a freeze. The estimates, therefore, should be interpreted as illustrative of what might occur if these options were adopted.

Two sets of estimates were made for each option. The first set provides information about how each of several groups of the elderly and nonelderly population would have been affected by the implementation of an option. What percentage of the total reduction in benefits, for example, would have been incurred by families whose incomes were already below the poverty threshold? How large would their losses have been? These estimates allow comparison of these options with the health premium and tax options examined in Sections III and IV.

Second, each option's effect on the distribution of income was calculated. Income from most of the cash transfer programs affected by the changes considered here is reported on the CPS and is used to determine a family's position relative to its poverty threshold. Thus--subject to the limitations enumerated above--changes in income can be simulated across families and individuals. The number of families and individuals who would be poor and the size of the poverty gap also can be simulated for each option.

Effects on Family Incomes. In order to examine the distribution of benefit reductions that would result from each option, each family in the CPS was classified according to whether it contained anyone age 65 or older and whether the family's total income was above or below the poverty threshold for its size. If above, then the family's income was further classified according to the extent to which its poverty threshold was exceeded. Those with incomes between their poverty threshold and 125 percent of the threshold will be referred to as "near-poor" and those with incomes above 125 percent of the threshold as "nonpoor." 16/ Finally, for ease of comparison across options, the number of families used to compute the percentage of recipient families that would experience loss of income is

16. In 1983, the poverty threshold for an elderly individual was $4,775 and the threshold for an elderly couple was $6,023. For nonelderly adults the thresholds were $5,180 and $6,697. Each year the thresholds are increased to reflect changes in the CPI. Thus, the real values of the poverty lines are constant.

always the number that receive benefits from any of the programs included in this section, even though only a portion of them would be affected under some of the options. When calculating average dollar losses, however, only affected families are included.

The incidence of the real benefit reductions that would result from a benefit freeze would mirror the distribution of the program benefits themselves, except for those people whose losses would be offset by increases in SSI or other cash assistance. 17/ Freezing Social Security and Railroad Retirement benefits would reduce the benefits of 22 million recipient families by an average of $220 for the year, which is 1.2 percent of the annual income of affected families (see Table 4). 18/ Approximately 8 percent of the losses would be incurred by recipients in poor families and

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17. Outlays for the programs not included in the CPS are less than 5 percent of total outlays for non-means-tested COLA programs. There would also be an offset for Veterans' Pensions, but that offset would be less than $10 million. Neither the budgetary estimates nor the estimated effects on recipients in this section take into account revenue reductions that would result from reductions in Social Security benefits among recipients who would be paying taxes on a portion of their benefits. This revenue offset would only affect recipients with adjusted gross incomes (including half of Social Security benefits) above $25,000 for individuals and $32,000 for couples. Taxation of benefits did not begin until 1984.

18. The only recipients who would not be affected would be the families that also receive SSI (or other cash assistance) benefits; their SSI benefits would not be subject to the freeze. These recipients would receive additional SSI benefits to offset their loss of other benefits.

TABLE 4. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS a/

Family Income Relative to Poverty Line	Percentage of Recipients in Group c/	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/		Average Loss	
			In Thousands	As Percentage of Families in Group c/	In Dollars	As Percentage of Average Income
All Families						
Total	100	100	21,810	84	220	1.2
Below Poverty Line	18	8	2,890	63	130	2.9
100-125 Percent	9	7	1,890	79	180	2.7
125-150 Percent	8	8	1,800	90	210	2.5
150-200 Percent	13	15	3,150	91	230	2.2
200-300 Percent	20	24	4,710	92	250	1.5
Over 300 Percent	33	39	7,370	87	250	0.7
Elderly Families						
Total	73	83	17,140	90	230	1.3
Below Poverty Line	11	5	2,080	69	130	3.1
100-125 Percent	7	6	1,510	83	180	2.9
125-150 Percent	6	6	1,490	94	210	2.7
150-200 Percent	10	13	2,550	95	240	2.4
200-300 Percent	15	20	3,740	97	260	1.7
Over 300 Percent	23	32	5,780	96	270	0.8
Nonelderly Families						
Total	27	17	4,660	65	180	0.9
Below Poverty Line	6	2	820	50	120	2.4
100-125 Percent	2	1	380	66	180	2.2
125-150 Percent	2	1	300	74	200	2.0
150-200 Percent	3	3	600	78	210	1.5
200-300 Percent	5	4	970	76	200	1.1
Over 300 Percent	10	6	1,590	64	190	0.5

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.

those affected would incur the largest percentage reductions in their total incomes (almost 3 percent). The largest absolute amounts of losses would be incurred by families with total incomes well above the poverty thresholds. Because these families are, on average, least dependent on Social Security, their losses as a percentage of average income would be least. Three-quarters of the families experiencing losses would be ones that contain elderly individuals, because the elderly are the main recipients of Social Security benefits.

Broadening the freeze to include other non-means-tested programs would have similar effects for low-income recipients, since few of them receive Civil Service or Military Retirement benefits (see Table 5). For the same reason, the share of total losses incurred by the poor would be decreased from 8 percent to 6 percent. The average dollar losses would be larger ($260 compared with $220)--in part because average federal retirement benefits are higher than average Social Security benefits, and in part because many of the recipients who would lose from a Social Security benefit freeze would also lose from a freeze on federal retirement benefits. 19/ Thus, almost 1 million of the 1.4 million additional families affected would be those with average incomes more than triple their

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19. About half of those who report receiving federal pensions also report Social Security benefits. About three-quarters of federal civilian pension recipients and virtually all military retirees ultimately will receive Social Security benefits.

TABLE 5. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON NON-MEANS-TESTED PROGRAM BENEFITS a/

Family Income Relative to Poverty Line	Percentage of Recipients in Group c/	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/		Average Loss	
			In Thousands	As Percentage of Families in Group c/	In Dollars	As Percentage of Average Income
All Families						
Total	100	100	23,200	89	260	1.3
Below Poverty Line	18	6	2,930	63	130	2.9
100-125 Percent	9	6	1,930	80	180	2.8
125-150 Percent	8	6	1,830	91	210	2.6
150-200 Percent	13	13	3,250	94	240	2.2
200-300 Percent	20	22	4,950	97	270	1.7
Over 300 Percent	33	47	8,310	98	340	1.0
Elderly Families						
Total	73	76	17,360	92	260	1.5
Below Poverty Line	11	4	2,080	70	130	3.1
100-125 Percent	7	5	1,520	83	180	2.9
125-150 Percent	6	5	1,500	94	210	2.7
150-200 Percent	10	10	2,560	96	240	2.4
200-300 Percent	15	17	3,780	98	270	1.8
Over 300 Percent	23	34	5,920	99	340	1.0
Nonelderly Families						
Total	27	24	5,840	82	250	1.1
Below Poverty Line	6	2	840	52	120	2.4
100-125 Percent	2	1	410	71	180	2.3
125-150 Percent	2	1	330	81	210	2.1
150-200 Percent	3	3	690	89	220	1.6
200-300 Percent	5	5	1,180	93	240	1.3
Over 300 Percent	10	13	2,390	96	330	0.8

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.

poverty thresholds, and the average loss for this income group would increase from $250 to $340.

Combining a freeze with the specified increase in SSI guarantee levels would considerably alter the incidence of its effects. In particular, families with incomes below the poverty thresholds, as a group, would incur no reduction in total benefits (see Tables 6 and 7). There would be considerable redistribution of benefits within the group of poor families, however. Two-thirds of the poor recipient families would lose benefits; in the aggregate, this loss would be offset by increases to the other third. For the entire income distribution, an estimated 3 million families would gain an average of $230 (2.4 percent of their income); almost all of the families who would lose benefits from either freeze would still lose. 20/

The remaining options examined in this section involve modifying a freeze on all non-means-tested programs with changes in the COLA for Social Security and Railroad Retirement benefits. Capping the COLA for Social Security and Railroad Retirement benefits at the poverty threshold

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20. The number of families who would lose is estimated to be slightly fewer (about 200,000) than would lose from the freeze because some families contain both SSI recipients and Social Security recipients; under the freeze, the latter group's losses were not offset by increases in SSI benefits. Note that these estimates are based on the CPS simulations and, therefore, do not take into account any increases in the number of SSI recipients that could result; moreover, errors in the number and family incomes of SSI recipients reported in the CPS would cause errors in these estimates.

TABLE 6. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS, COMBINED WITH SSI INCREASES a/

Family Income Relative to Poverty Line	Percentage of Net Loss Incurred by Group	Families Experiencing Losses b/				Families Experiencing Gains b/			
		Number		Average Net Loss		Number		Average Net Gain	
		In Thousands	As Percentage of Recipient Families in Group c/	In Dollars	As Percentage of Average Income	In Thousands	As Percentage of Recipient Families in Group c/	In Dollars	As Percentage of Average Income
All Families									
Total	100	21,590	83	220	1.2	2,880	11	230	2.4
Below Poverty Line	d/	2,840	61	130	2.9	1,610	35	230	4.9
100-125 Percent	5	1,850	77	180	2.8	470	19	230	3.2
125-150 Percent	8	1,760	88	210	2.6	180	9	240	2.4
150-200 Percent	16	3,120	90	230	2.2	220	6	250	1.9
200-300 Percent	27	4,670	91	240	1.5	190	4	230	1.0
Over 300 Percent	44	7,350	87	250	0.7	220	3	220	0.6
Elderly Families									
Total	87	16,980	90	230	1.3	1,660	9	230	2.6
Below Poverty Line	1	2,040	68	130	3.1	900	30	220	5.2
100-125 Percent	5	1,480	81	180	2.9	300	17	240	3.5
125-150 Percent	7	1,460	91	210	2.7	120	7	240	2.8
150-200 Percent	14	2,520	94	240	2.4	120	5	260	2.3
200-300 Percent	23	3,710	96	260	1.7	110	3	210	1.0
Over 300 Percent	37	5,770	96	270	0.8	100	2	200	0.5
Nonelderly Families									
Total	13	4,610	64	180	0.9	1,230	17	230	7.1
Below Poverty Line	-2e/	790	49	120	2.5	710	43	230	4.6
100-125 Percent	1	370	64	180	2.3	160	28	220	2.7
125-150 Percent	1	300	74	200	2.0	60	15	240	1.9
150-200 Percent	2	590	77	210	1.5	90	12	240	1.6
200-300 Percent	4	960	76	190	1.1	90	7	250	1.0
Over 300 Percent	7	1,590	64	190	0.5	110	5	240	0.6

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.
d. Less than 0.5 percent.
e. Total benefits received by the group would be increased.

TABLE 7. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON NON-MEANS-TESTED PROGRAM BENEFITS, COMBINED WITH SSI INCREASES a/

Family Income Relative to Poverty Line	Percentage of Net Loss Incurred by Group	Families Experiencing Losses b/				Families Experiencing Gains b/			
		Number		Average Net Loss		Number		Average Net Gain	
		In Thousands	As Percentage of Recipient Families in Group c/	In Dollars	As Percentage of Average Income	In Thousands	As Percentage of Recipient Families in Group c/	In Dollars	As Percentage of Average Income
All Families									
Total	100	22,980	88	260	1.3	2,860	11	230	2.4
Below Poverty Line	d/	2,870	62	130	2.9	1,610	35	230	4.9
100-125 Percent	4	1,890	79	180	2.8	470	19	230	3.3
125-150 Percent	6	1,800	90	210	2.6	180	9	240	2.4
150-200 Percent	14	3,210	93	240	2.2	220	6	250	1.9
200-300 Percent	24	4,920	96	260	1.6	180	4	230	1.0
Over 300 Percent	52	8,290	98	340	1.0	200	2	220	0.6
Elderly Families									
Total	78	17,200	91	260	1.5	1,640	9	230	2.7
Below Poverty Line	1	2,050	69	130	3.1	900	30	220	5.2
100-125 Percent	4	1,490	82	180	2.9	300	17	240	3.6
125-150 Percent	5	1,470	92	210	2.7	120	7	250	2.8
150-200 Percent	11	2,530	95	240	2.4	120	5	260	2.3
200-300 Percent	19	3,750	97	270	1.8	100	3	210	1.1
Over 300 Percent	38	5,910	98	340	1.0	100	2	200	0.5
Nonelderly Families									
Total	22	5,780	81	250	1.1	1,210	17	230	2.1
Below Poverty Line	-1e/	820	50	120	2.5	710	43	230	4.6
100-125 Percent	1	400	69	180	2.3	160	28	220	2.7
125-150 Percent	1	330	80	210	2.1	60	15	240	1.9
150-200 Percent	2	680	88	220	1.6	90	12	240	1.6
200-300 Percent	5	1,170	93	240	1.2	80	7	250	1.0
Over 300 Percent	14	2,380	96	320	0.8	100	4	240	0.6

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.
d. Less than 0.5 percent.
e. Total benefits received by the group would be increased.

would virtually eliminate the adverse effects of a benefit freeze on families below the poverty threshold and would reduce the losses for families just above the threshold as well (see Table 8). Fourteen million families would incur losses, averaging $150 per family. Only 1.2 million of the families incurring losses would be poor or near-poor; their losses would average only about $40 or $50 per family. The gains to recipients, however, relative to an across-the-board freeze, would be spread across the income distribution--both because all recipients would still receive increases and because nonpoor recipients whose benefits are below the poverty threshold would receive the full COLA. 21/

Replacing the COLA with a flat benefit increase would provide gains and losses throughout the income distribution, but the net result would be that the poor and near-poor would gain (relative to current policy) and the nonpoor would lose benefits (see Table 9). Because many nonpoor recipients also receive low benefits, 60 percent of the families that would experience gains are in the nonpoor categories. Moreover, the average losses among the nonpoor families that would experience reductions are lower than the

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21. Some or all of the increased benefits going to those with higher incomes could be recaptured through the tax system. Under current law, up to half of Social Security benefits--and thus half of any Social Security COLA--is taxable, so part of the COLA for such people would automatically revert to the government. More complex schemes that would specifically increase the taxation of COLAs could be devised to reduce the budgetary cost of protecting the poor and near-poor, but they would add further complexity to the revenue code.

TABLE 8. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON NON-MEANS-TESTED PROGRAM BENEFITS, MODIFIED BY A "COLA CAP" a/

Family Income Relative to Poverty Line	Percentage of Recipients in Group c/	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/		Average Loss	
			In Thousands	As Percentage of Families in Group c/	In Dollars	As Percentage of Average Income
All Families						
Total	100	100	14,390	55	150	0.7
Below Poverty Line	18	1	230	5	50	0.8
100-125 Percent	9	2	1,010	42	40	0.6
125-150 Percent	8	3	1,170	59	60	0.7
150-200 Percent	13	9	2,220	64	80	0.8
200-300 Percent	20	20	3,510	68	120	0.8
Over 300 Percent	33	66	6,250	74	230	0.6
Elderly Families						
Total	73	65	11,170	59	120	0.6
Below Poverty Line	11	d/	120	4	40	0.6
100-125 Percent	7	1	800	44	30	0.4
125-150 Percent	6	2	1,010	63	50	0.7
150-200 Percent	10	6	1,840	69	70	0.7
200-300 Percent	15	14	2,820	73	100	0.7
Over 300 Percent	23	41	4,590	76	190	0.6
Nonelderly Families						
Total	27	35	3,210	45	230	0.8
Below Poverty Line	6	d/	110	6	60	1.0
100-125 Percent	2	1	210	36	70	0.9
125-150 Percent	2	1	170	41	100	1.1
150-200 Percent	3	2	380	49	140	1.1
200-300 Percent	5	6	690	55	180	1.0
Over 300 Percent	10	25	1,660	67	320	0.8

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.

d. Less than 0.5 percent.

TABLE 9. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON NON-MEANS-TESTED PROGRAM BENEFITS, MODIFIED BY REPLACING THE SOCIAL SECURITY AND RAILROAD RETIREMENT COLA WITH A FLAT AMOUNT a/

Family Income Relative to Poverty Line	Percentage of Net Loss Incurred by Group	Families Experiencing Losses b/				Families Experiencing Gains b/			
		Number		Average Net Loss		Number		Average Net Gain	
		In Thousands	As Percentage of Recipient Families in Group c/	In Dollars	As Percentage of Average Income	In Thousands	As Percentage of Recipient Families in Group c/	In Dollars	As Percentage of Average Income
All Families									
Total	100	13,620	52	150	0.7	8,750	34	70	0.5
Below Poverty Level	-15 d/	200	4	50	0.8	2,660	57	80	1.9
100-125 Percent	-2 d/	990	41	30	0.5	780	32	70	1.0
125-150 Percent	1	1,100	55	60	0.7	670	34	70	0.8
150-200 Percent	7	2,030	59	80	0.8	1,100	32	70	0.6
200-300 Percent	21	3,290	64	120	0.8	1,480	29	70	0.4
Over 300 Percent	86	6,010	71	220	0.6	2,070	24	80	0.2
Elderly Families									
Total	65	10,510	55	120	0.6	6,290	33	60	0.5
Below Poverty Line	-10	100	3	40	0.6	1,950	65	70	1.8
100-125 Percent	-1	780	43	20	0.4	590	32	70	1.0
125-150 Percent	1	940	59	50	0.7	520	32	60	0.8
150-200 Percent	6	1,670	62	70	0.7	810	30	50	0.5
200-300 Percent	16	2,620	68	100	0.7	1,040	27	60	0.4
Over 300 Percent	53	4,400	73	190	0.6	1,390	23	70	0.2
Nonelderly Families									
Total	35	3,110	44	230	0.8	2,460	34	100	0.5
Below Poverty Line	-5	100	6	60	1.0	710	43	100	2.1
100-125 Percent	e/	210	35	60	0.9	190	33	90	1.0
125-150 Percent	e/	160	39	100	1.0	160	38	90	0.8
150-200 Percent	1	360	47	140	1.0	290	37	100	0.7
200-300 Percent	6	670	53	180	1.0	440	35	90	0.5
Over 300 Percent	33	1,620	65	320	0.8	680	27	90	0.2

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.

d. Total benefits received by the poor and near-poor in 1983 would increase by about $0.3 billion, and benefits received by the nonpoor would decrease by $1.6 billion, resulting in a net loss of $1.3 billion to be allocated across groups.

e. Less than 0.5 percent.

average losses under an across-the-board freeze. As noted previously, the budgetary effect of this option would be small because average Social Security and Railroad Retirement benefits would be virtually the same as under current law. That is, the Flat COLA would redistribute these benefits, but not change their average level. This approach, if used for many years, would substantially change the structure of Social Security benefits; its impact on the distribution of total benefits after only one year, however, would be small.

Most poor families also would be sheltered from a freeze on non-means-tested programs under the Poverty COLA option (see Table 10). As with the COLA Cap approach, this option would continue to provide COLAs to some nonpoor recipients who have low benefits. It would generate much higher budgetary savings, however, because no COLA would be provided to anyone whose benefits are above the poverty thresholds.

Impacts on Poverty. The seven options would have markedly different effects on the size of the poverty population and on the poverty gap (see Table 11). In 1983, about $47 billion would have been needed to raise the incomes of the 35 million poor people up to the poverty thresholds. The two across-the-board freeze options would increase that "poverty gap" by about $400 million and would push about 400,000 people below the poverty line.

TABLE 10. ANNUAL EFFECTS ON FAMILY INCOMES OF A ONE-YEAR FREEZE ON NON-MEANS-TESTED PROGRAM BENEFITS, MODIFIED BY A "POVERTY COLA" a/

Family Income Relative to Poverty Line	Percentage of Recipients in Group c/	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/		Average Loss	
			In Thousands	As Percentage of Families in Group c/	In Dollars	As Percentage of Average Income
All Families						
Total	100	100	14,860	57	300	1.4
Below Poverty Line	18	1	250	5	170	2.8
100-125 Percent	9	4	1,130	47	180	2.8
125-150 Percent	8	6	1,220	61	220	2.8
150-200 Percent	13	13	2,290	66	250	2.4
200-300 Percent	20	23	3,620	71	280	1.8
Over 300 Percent	33	53	6,370	75	370	1.1
Elderly Families						
Total	73	75	11,600	61	290	1.5
Below Poverty Line	11	d/	130	4	160	2.7
100-125 Percent	7	3	910	50	160	2.8
125-150 Percent	6	5	1,040	65	220	2.9
150-200 Percent	10	10	1,900	71	240	2.4
200-300 Percent	15	18	2,910	75	280	1.9
Over 300 Percent	23	38	4,700	78	360	1.1
Nonelderly Families						
Total	27	25	3,270	46	340	1.2
Below Poverty Line	6	d/	120	7	170	2.8
100-125 Percent	2	1	220	37	220	2.9
125-150 Percent	2	1	170	42	250	2.7
150-200 Percent	3	2	380	50	280	2.2
200-300 Percent	5	5	710	56	300	1.6
Over 300 Percent	10	15	1,670	67	400	1.0

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

c. The programs included to identify recipient families in group are Social Security, Railroad Retirement, Civil Service Retirement, Military Retirement, and Supplemental Security Income.

d. Less than 0.5 percent.

TABLE 11. EFFECTS ON POVERTY OF THE U.S. POPULATION OF SELECTED CHANGES IN COST-OF-LIVING ADJUSTMENTS FOR NON-MEANS-TESTED PROGRAMS a/

Option b/	Change In Poverty Gap (In billions of dollars)			Number of Additional Poor (In thousands)		
	All Families	Elderly Families c/	Nonelderly Families	Total	Elderly	Nonelderly
Freeze Social Security and Railroad Retirement Benefits						
One-year Freeze in Social Security and Railroad Retirement Benefits	0.4	0.3	0.1	420	280	140
Combine Social Security and Railroad Retirement Freeze with Increase in SSI Guarantee	d/	0.1	-0.1e/	300	190	110
Freeze All Non-Means-Tested Cash Transfer Program Benefits						
One-year Freeze in All Non-Means-Tested Program Benefits	0.4	0.3	0.1	420	280	140
Combine Freeze in All Non-Means-Tested Programs with Increase in SSI Guarantee	d/	0.1	-0.1e/	300	190	110
Exempt Social Security and Railroad Retirement Benefits Below Specified Threshold (COLA Cap)	d/	d/	d/	d/	d/	d/
Replace Social Security and Railroad Retirement COLA with Specified Flat COLA	-0.2e/	-0.1e/	-0.1e/	-60	d/	d/
Exempt Social Security and Railroad Retirement Beneficiaries with Benefits Below Specified Thresholds (Poverty COLA)	d/	d/	d/	80	d/	70

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. Includes Social Security, Railroad Retirement, Civil Service Retirement, and Military Retirement only.
b. See text for definitions of the options.
c. Elderly families are those with at least one member age 65 or over; elderly individuals are those age 65 or over.
d. Less than $50 million or 50,000 people.
e. The poverty gap would be reduced.

Combining a freeze with an increase in SSI guarantee levels would nearly eliminate the effect on the poverty gap and would reduce the number of individuals made poor by about 100,000. As previously discussed, these changes would result from raising the incomes of SSI recipients who were not affected by a freeze, moving some of them out of poverty. It would not mitigate the effects for the nearly 5 million poor and near-poor families whose benefits would not be offset by SSI.

Each of the other options would virtually eliminate the net effects of a freeze on the size of the poverty gap and on the size of the poverty population. In fact, the Flat COLA is estimated to reduce these numbers to below those that would result from no change in policy. The poverty gap would decline by about $200 million, and roughly 60,000 fewer people would be poor. Again, this is the net effect of changes in both directions; some poor and near-poor would lose benefits even though there would be an average gain.

III. INCREASES IN PREMIUMS OR COPAYMENTS FOR MEDICARE ENROLLEES

Federal spending for Medicare, which provides health benefits for about 30 million aged or disabled people, is expected to total about $71 billion in fiscal year 1985--equal to 7.4 percent of total federal outlays. Net outlays for Medicare (excluding offsetting revenue from premiums) are expected to increase at an average annual compound rate of 11.5 percent through 1990 under current law--faster than the rate of growth in federal outlays (7.9 percent) or in gross national product (7.8 percent). As a result, Medicare will absorb an increasing share of national resources unless further steps are taken to curtail this growth. Significant savings have already been realized as a result of changes made in previous years--especially limits on reimbursements to hospitals and physicians--but these reductions are reflected in the budget projections given above.

Although Medicare provides sizable benefits, enrollees still pay 35 percent to 40 percent of their health care costs. Medicare currently covers 97 percent of the elderly population and pays for 45 percent of their health care. 1/ The remaining health care costs include disallowed charges and

1. Medicare reimbursements cover about 50 percent of aged enrollees' health care costs, but these reimbursements are partly financed by enrollees' premiums.

noncovered services under Medicare--such as preventive care, medication, dental care, and extended nursing home care. Although other public programs such as Medicaid cover a portion of these costs, aged Medicare enrollees pay for one-fourth of their health care out-of-pocket and for an additional 10 percent to 15 percent of health care through premiums for Medicare and private health insurance. Estimates for 1984 indicate that these expenses averaged over $1,500 per elderly person, equal to about 15 percent of their average personal income. 2/ There is considerable variation, however. Nearly 40 percent of Medicare enrollees report so few health care expenditures that they do not exceed the $75 annual deductible under the Supplementary Medical Insurance (SMI) program.

SPECIFIC OPTIONS

The options discussed in this section would raise costs for Medicare beneficiaries, although the increases would affect almost all of them rather than being concentrated on heavy users of medical services. The specific options include the following:

- Increase the premium for SMI to cover 35 percent of costs, rather than the 25 percent of costs the premium covers under current law.

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2. There is insufficient information to estimate out-of-pocket and premium costs for disabled Medicare enrollees. Disabled enrollees are about 9 percent of the Medicare population.

- Increase the SMI premium to cover 30 percent of costs and increase the SMI deductible from its current value of $75 to $200, with future increases indexed to the Consumer Price Index (CPI).

- Introduce an income-related SMI premium by imposing a 1 percent surtax on the taxable income of SMI enrollees, with the additional tax liability limited so that no one's additional liability would exceed the subsidy value of SMI benefits.

- Impose a tax of 30 percent on the premiums that private insurance companies receive for "medigap" policies--that is, policies that are designed to supplement Medicare coverage by paying most required copayments under Medicare. (Policies that provide only catastrophic protection--by limiting the liability of the beneficiary for copayments to $1,000, for example--might be exempted from the tax.)

Increasing the SMI premium would reduce net federal spending for Medicare by shifting more of the costs to beneficiaries. It would do nothing to reduce unnecessary use of health services or to constrain price increases by providers, however, and could reduce enrollment for low-income people. To avoid this, some have suggested introducing an additional income-related SMI premium instead of increasing the current premium. Using the tax system for this would avoid having to set up complex new procedures to collect means-tested premiums from enrollees, but would complicate personal income tax forms.

An increased deductible would reduce federal expenditures by shifting costs to beneficiaries, but it might also reduce health costs overall by reducing demand for services somewhat. This effect would be small, however, since 75 percent of beneficiaries have supplemental coverage--

either through Medicaid or medigap policies--that insulates them from the immediate effects of higher required copayments under Medicare. Medigap premiums would increase over time to finance the higher cost-sharing, however.

It is estimated that revenues from a 30 percent tax on medigap premiums would compensate the Medicare program for additional spending that results from higher demand for medical services by holders of medigap policies. This tax could have several effects, but in each case it would reduce the federal budget deficit substantially. If, as seems likely, the tax was passed through to policyholders, the effective price of medigap policies would be increased accordingly, with the result that some current policyholders would discontinue their policies. Consequently, a larger proportion of Medicare beneficiaries would be affected by Medicare's cost-sharing provisions, resulting in reduced demand for services. This in turn would reduce Medicare reimbursements, thereby offsetting the reduction in medigap tax receipts. Although it is not known what proportion of current policyholders would discontinue their medigap policies, the deficit would be reduced whether the proportion was large or small. If it were large, most of the effect would be in reduced Medicare outlays; if few current policyholders discontinued coverage, however, most of the effect would be through medigap tax revenues.

Implementation Issues

There would be no administrative difficulty in implementing an increased premium or deductible in the SMI program because premiums are already collected under current law, and the agencies that process SMI claims already allow for a deductible in the program.

For the income-related premium, it would be necessary to modify current income tax forms. Further, it would probably be necessary for Medicare carriers to notify both SMI enrollees and the Internal Revenue Service of each person's SMI enrollment status during the tax year, especially if the tax was prorated for part-year enrollees.

Successful implementation of a medigap tax could require substantial cooperation from insurance companies. The tax could be collected directly from insurance companies based on premium income received for policies sold to Medicare enrollees that would pay any part of the deductible amounts or coinsurance under Medicare (up to some limit, such as $1,000 or $2,000). Companies could, if they chose, pass the tax on to policyholders as a surcharge on the premium.

METHODOLOGY AND LIMITATIONS

The estimates of budgetary savings assume that the proposals would be implemented on January 1, 1986, and are based on current program

data. 3/ In contrast, for the first three options, effects on beneficiaries were estimated using the March 1984 Current Population Survey (CPS), which reports incomes for calendar year 1983. The effect of taxing medigap premiums was estimated using the 1977 National Medical Care Expenditure Survey (NMCES), with dollar values inflated to 1983 to facilitate comparison with the other estimates. 4/

A major program offset--the interaction between Medicare and Medicaid--is incorporated into both the savings and the distributional estimates. The Medicaid program would pick up any increased premiums or copayments required under Medicare for Medicaid recipients, and this interaction reduces estimated budgetary savings for any given proposal. For the distributional estimates, the interaction reduces the impact on the lowest-income groups.

All of the limitations discussed in the previous section on changing cost-of-living adjustments for non-means-tested programs are applicable to the estimates discussed in this section. Income underreporting in the CPS

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3. The savings estimates for increases in the SMI premium incorporate the provision in current law that limits the increase in the monthly SMI premium for any person whose Social Security check would otherwise be reduced.

4. Income data were inflated by the rate of increase in family income between 1977 and 1983, while medigap premium costs were inflated by the rate of increase in per enrollee reimbursements under Medicare.

data would especially affect the distributional estimates for the option of introducing an income-related SMI premium. For this reason, two sets of estimates are given for this option--one using the unadjusted CPS data, and one using data adjusted for underreporting. (See Section IV for a discussion of the adjustment methods used.)

There are several additional caveats as well. First, the distributional estimates for the SMI premium and deductible increases assume that a person identified as a Medicare beneficiary is a recipient of SMI benefits, because eligibility for Hospital Insurance (HI) and SMI is not separately identified in the CPS. Eligibility for HI benefits is automatic for all Social Security recipients age 65 or over, while receipt of SMI benefits is contingent on paying a monthly premium. In 1983, nearly 99 percent of HI enrollees purchased SMI coverage.

Second, the effects on beneficiaries of an increase in the SMI deductible are estimated by assigning to all Medicare beneficiaries the average deductible paid. Although the actual deductible expense incurred undoubtedly varies among beneficiaries, the exact amounts for individuals cannot be estimated using CPS data, since the survey contains no information about medical use. Even available health expenditure survey data are inadequate for this purpose because they cannot accurately identify SMI-eligible

spending. It is unlikely, though, that average deductible amounts vary significantly among beneficiaries grouped by income category. 5/

Third, both the savings and the distributional estimates for the tax on medigap premiums are more uncertain than the other estimates, for several reasons. For one, these estimates are based on 1977 survey data rather than on the more recent CPS data used for the other estimates. In addition, Medicare enrollees in the survey were assumed to hold medigap policies if they had any private insurance coverage. Even in 1977, this assumption was probably not valid in all cases. It is less likely to be valid now, given recent legislative changes that have made Medicare the secondary payer for aged enrollees (up to age 69) who have health insurance coverage through their employment or that of their spouses. About 10 percent of people 65 or older are employed in any given month, although only half of these hold full-time jobs. Full-time employees are more likely to have insurance coverage through their employers, which may cover their spouses as well. To account

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5. What little variation there is occurs for the lowest income groups, whose average Medicare reimbursements--but not necessarily the average deductible--are somewhat higher than for upper-income groups. More than one-third of poor enrollees would not be affected by the proposed increase in the SMI deductible, because they are eligible for Medicaid and hence make no copayments out-of-pocket. Further, about 65 percent of aged enrollees who are not poor have medigap policies, which has the effect--through premium increases--of spreading the impact of increased copayments under Medicare across all medigap policyholders. Consequently, the approximation used to allocate the increased deductible is probably not misleading.

for the effect of the new legislation, the premium amounts calculated from the survey were reduced by 10 percent before estimating either revenues from the premium tax or the associated effects on Medicare enrollees.

ESTIMATED EFFECTS

This section discusses the effects on the budget and the effects on Medicare enrollees likely to result if the options discussed earlier were implemented.

Effects on the Federal Budget

Each of these options would reduce the federal deficit substantially over the five-year period 1986-1990 (see Table 12). Increasing the SMI premium to 35 percent of costs would generate nearly the same savings as the combined effect of raising the premium to 30 percent of costs and simultaneously increasing the deductible to $200. These options would reduce net federal outlays by more than $17 billion over the projected period, since SMI premiums are treated as negative outlays in the budget.

Additional revenues from a 1 percent surtax on taxable income would be $8.7 billion over the projected period, about half the savings resulting from either of the other premium options. Higher or lower revenues from an income-related premium could be generated, however, by varying the surtax rate.

TABLE 12. ESTIMATED EFFECTS ON THE FEDERAL BUDGET, FISCAL YEARS 1986-1990 (In billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Effect
Outlay Savings or Addition to Revenues						
Increase the SMI Premium to Cover 35 Percent of Costs	1.7	2.5	3.3	4.3	5.4	17.1
Increase the SMI Premium to Cover 30 Percent of Costs and Raise the Deductible to $200	1.7	2.7	3.5	4.4	5.4	17.7
Introduce an Income-Related SMI Premium by Imposing a 1 Percent Surtax on Taxable Income	0.5	1.8	2.0	2.1	2.3	8.7
Impose a 30 Percent Tax on Premiums for Medigap Policies a/	3.0	4.4	5.0	5.6	6.3	24.2

SOURCE: Congressional Budget Office using data provided by the Joint Committee on Taxation.

NOTE: See text for additional detail and cautions in interpreting findings. Details may not add to totals because of rounding.

a. A tax on medigap premiums would generate tax revenues from those who continue to purchase such policies, but would reduce Medicare outlays for those who respond to the tax by dropping their medigap policies.

A 30 percent tax on medigap premiums would have a greater impact in each of the projected years than the other options. The immediate effect would add to revenues, though, rather than reduce outlays. Some of the effect would shift from increased revenues to reduced Medicare outlays over time, however, if some policyholders discontinued coverage in response to the higher effective price for medigap policies. Reductions in the deficit could total about $24 billion over the five-year period.

Effects on Beneficiaries

The results presented in this section analyze the effects on families that would have resulted if the options discussed above had been implemented at the beginning of calendar year 1983. An income-related premium would have negligible effects on poor and near-poor families, since these families have little or no taxable income. The effects on the poor and near-poor would be smaller under the other options, on average, than for other families primarily because of the Medicaid program, which insulates about one-third of low-income Medicare beneficiaries from premium or copayment costs under Medicare. 6/ Further, since Medicaid makes their copayments, these Medicare beneficiaries have little reason to purchase medigap policies, and so would be less affected by a tax on medigap premiums.

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6. Those who purchase medigap policies (about 65 percent of aged Medicare enrollees) are also insulated from direct copayments under Medicare, but they pay those costs indirectly through higher medigap premiums.

Increase the SMI Premium from 25 Percent to 35 Percent of Costs. This option would increase the SMI premium for 1986 from $16.20 to $22.70 a month, or by $78 a year, for each enrollee. 7/ Overall, 87 percent of families with Medicare enrollees would be affected by an increase in the SMI premium. Only those who are also eligible for Medicaid--about 13 percent of all Medicare recipients in 1983--would be unaffected. The increase in the SMI premium would represent only 0.4 percent of family income for all families affected, however (see Table 13).

The option would affect a smaller proportion of poor recipient families than of higher-income families. Of families whose income is below the poverty line, 64 percent would pay the higher premium, while almost 96 percent of families whose income is more than three times the poverty line would be affected. Even at 300 percent of poverty, however, some families are eligible for Medicaid, for two reasons. First, some people eligible for SSI (and hence Medicaid) are included in larger nonpoor families. Second, some states provide Medicaid benefits to families that are "medically needy"--that is, families that have high medical expenses relative to income.

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7. The increase per enrollee would have been $60 a year if this premium increase had been implemented for 1983.

TABLE 13. EFFECTS OF INCREASING THE SMI PREMIUM TO COVER 35 PERCENT OF COSTS a/

Family Income Relative to Poverty Line	Percentage of Medicare Families in Group	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/ In Thousands	Number of Families Experiencing Losses b/ As Percentage of Families in Group	Average Loss In Dollars	Average Loss As Percentage of Average Income
All Families						
Total	100	100	18,440	87	80	0.4
Below Poverty Line	17	11	2,330	64	70	1.7
100-125 Percent	10	8	1,620	79	70	1.1
125-150 Percent	8	8	1,540	88	80	1.0
150-200 Percent	14	15	2,680	92	80	0.8
200-300 Percent	20	23	4,000	94	80	0.5
Over 300 Percent	31	36	6,270	96	80	0.2
Elderly Families						
Total	91	93	16,970	88	80	0.4
Below Poverty Line	15	10	2,050	65	70	1.7
100-125 Percent	9	7	1,450	79	70	1.2
125-150 Percent	8	7	1,420	89	80	1.0
150-200 Percent	13	14	2,490	92	80	0.8
200-300 Percent	18	21	3,680	94	80	0.6
Over 300 Percent	29	34	5,870	96	80	0.2
Nonelderly Families						
Total	9	7	1,470	78	70	0.4
Below Poverty Line	2	1	290	55	60	1.3
100-125 Percent	1	1	170	77	60	0.8
125-150 Percent	1	1	110	76	70	0.7
150-200 Percent	1	1	190	89	60	0.5
200-300 Percent	2	1	320	90	70	0.4
Over 300 Percent	2	2	400	92	70	0.2

SOURCE: Congressional Budget Office simulation based on March 1984 Current Population Survey.

a. See text for more precise definition of options and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

For those families affected, the average impact relative to family income would be greater for poor families than for higher-income families, but the largest average impact would represent only 1.7 percent of family income. Families below the poverty line would incur 11 percent of the increased costs under this option. These families make up 17 percent of all families with Medicare recipients, but they account for 4 percent of income received by Medicare families.

Increase the SMI Premium to 30 Percent of Costs and Raise the SMI Deductible to $200. Under this option, the SMI premium in 1986 would be $18.60 a month, or $29 more a year than under current law. The same families would be affected by the premium increase under this option as were affected under the first option. The average impact per family, however, would be slightly larger because of the increased deductible, although about 40 percent of Medicare enrollees would be unaffected by the increased deductible since they do not exceed the current deductible of $75 (see Table 14). The average increased expense for affected families would be about $100 per year, representing about 0.5 percent of family income. Although the average dollar impact would be smallest for low-income families, the impact relative to family income would be highest for this group. The largest impact would be on low-income elderly families who are not eligible for Medicaid, for whom the average additional $80 expense would represent 2.1 percent of family income. Some of these families would

TABLE 14. EFFECTS OF INCREASING THE SMI PREMIUM TO COVER 30 PERCENT OF COSTS AND RAISING THE SMI DEDUCTIBLE TO $200 a/

Family Income Relative to Poverty Line	Percentage of Medicare Families in Group	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/ In Thousands	Number of Families Experiencing Losses b/ As Percentage of Families in Group	Average Loss In Dollars	Average Loss As Percentage of Average Income
All Families						
Total	100	100	18,440	87	100	0.5
Below Poverty Line	17	11	2,330	64	80	2.0
100-125 Percent	10	8	1,620	79	90	1.4
125-150 Percent	8	8	1,540	88	90	1.2
150-200 Percent	14	15	2,680	92	100	0.9
200-300 Percent	20	23	4,000	94	100	0.7
Over 300 Percent	31	36	6,270	96	100	0.3
Elderly Families						
Total	91	93	16,970	88	100	0.5
Below Poverty Line	15	10	2,050	65	80	2.1
100-125 Percent	9	7	1,450	79	90	1.4
125-150 Percent	8	7	1,420	89	90	1.2
150-200 Percent	13	14	2,490	92	100	1.0
200-300 Percent	18	21	3,680	94	100	0.7
Over 300 Percent	29	34	5,870	96	100	0.3
Nonelderly Families						
Total	9	7	1,470	78	80	0.4
Below Poverty Line	2	1	290	55	80	1.5
100-125 Percent	1	1	170	77	80	1.0
125-150 Percent	1	1	110	76	80	0.9
150-200 Percent	1	1	190	89	80	0.6
200-300 Percent	2	1	320	90	80	0.4
Over 300 Percent	2	2	400	92	80	0.2

SOURCE: Congressional Budget Office simulation based on March 1984 Current Population Survey.

a. See text for more precise definition of options and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

incur larger losses, however, because they would have to pay the full increase in the deductible amount.

Introduce an Income-Related SMI Premium by Imposing a 1 Percent Surtax on Taxable Income for SMI Enrollees. This option would increase the tax liability for SMI enrollees with taxable income. The increased liability would be limited, however, so that no one's taxes would rise by more than the subsidy value of SMI benefits.

About 36 percent of Medicare families would pay some additional tax under this option, with the average increase in tax liability for those affected equal to $120 (in 1983 dollars). Virtually no poor or near-poor families would be affected by the surtax. Ninety-nine percent of the surtax would be paid by families whose incomes were at least twice the poverty threshold (see Table 15).

Estimates using CPS data adjusted for underreporting show that about 40 percent of Medicare families would be affected by this option. Using these estimates, the average loss for affected families would be $140, or about 0.5 percent of average income.

TABLE 15. EFFECTS OF IMPOSING A 1 PERCENT SURTAX ON TAXABLE INCOME FOR SMI ENROLLEES a/

Family Income Relative to Poverty Line	Percentage of Medicare Families in Group	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/ In Thousands	Number of Families Experiencing Losses b/ As Percentage of Families in Group	Average Loss In Dollars	Average Loss As Percentage of Average Income
All Families						
Total	100	100	7,550	36	120	0.4
Below Poverty Line	17	c/	10	c/	e/	e/
100-125 Percent	10	c/	30	1	e/	e/
125-150 Percent	8	c/	60	4	10	0.2
150-200 Percent	14	1	300	10	20	0.2
200-300 Percent	20	7	1,850	43	30	0.2
Over 300 Percent	31	92	5,300	81	150	0.5
Elderly Families						
Total	91	92	6,880	36	120	0.4
Below Poverty Line	15	c/	d/	c/	e/	e/
100-125 Percent	9	c/	10	1	e/	e/
125-150 Percent	8	c/	50	3	10	0.1
150-200 Percent	13	1	230	9	20	0.2
200-300 Percent	18	5	1,630	42	30	0.2
Over 300 Percent	29	86	4,960	81	150	0.5
Nonelderly Families						
Total	9	8	670	35	110	0.4
Below Poverty Line	2	c/	10	1	e/	e/
100-125 Percent	1	c/	10	5	e/	e/
125-150 Percent	1	c/	20	10	e/	e/
150-200 Percent	1	c/	60	28	30	0.2
200-300 Percent	2	1	220	64	60	0.3
Over 300 Percent	2	7	350	80	170	0.5

SOURCE: Congressional Budget Office simulation based on March 1984 Current Population Survey.

a. See text for more precise definition of options and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. Less than 0.5 percent.
d. Less than 5,000 families.
e. Too few families to estimate accurately.

Impose a Tax of 30 Percent on Medigap Premiums. If a tax on medigap premiums were imposed, and the tax was passed through to policyholders, about 62 percent of families with aged Medicare enrollees would be affected either because of higher costs for medigap coverage or because of more copayments for health care if they discontinued their medigap policies (see Table 16). Estimates are given only for aged Medicare enrollees, since there were too few disabled enrollees with private insurance coverage in the sample to give reliable results. The average increase in costs for medigap policyholders would be about $310 in 1983 dollars, or about 1.5 percent of family income.

About 8 percent of the total loss under this option would be incurred by poor families, for whom the average cost would be $210, or 7.5 percent of their average income. Two-thirds of the total loss would be borne by families whose incomes are at least twice the poverty threshold, but costs for these higher-income families would represent between 1 percent and 2 percent of their average incomes.

TABLE 16. EFFECTS OF IMPOSING A 30 PERCENT TAX ON MEDIGAP PREMIUMS a/

Family Income Relative to Poverty Line	Percentage of Medicare Families in Group	Percentage of Total Loss Incurred by Group	Number of Families Experiencing Losses b/		Average Loss	
			In Thousands	As Percentage of Families in Group	In Dollars	As Percentage of Average Income
Elderly Families c/						
Total	100	100	10,410	62	310	1.5
Below Poverty Line	18	8	1,230	41	210	7.5
100-125 Percent	10	5	900	52	180	3.0
125-150 Percent	6	5	660	60	250	3.3
150-200 Percent	14	15	1,570	68	300	2.9
200-300 Percent	18	21	2,080	67	320	2.1
Over 300 Percent	34	46	3,970	70	370	1.0

SOURCE: 1977 National Medical Care Expenditure Survey, with dollar values inflated to 1983.

a. See text for more precise definition of options and for cautions in interpreting the findings. All numbers have been rounded.

b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.

c. No results are given for nonelderly families because there were too few nonelderly Medicare families in the sample to give reliable estimates.

IV. TAXATION OF INCOME

Until recently, all Social Security and Railroad Retirement benefits were excluded from the federal income tax. 1/ Although the Social Security Amendments of 1983 changed the federal income tax status of Social Security and Railroad Retirement, only about 10 percent of beneficiaries in these programs currently must include some portion of benefits in federal adjusted gross income. 2/ In addition, most beneficiaries of these programs enjoy other tax advantages, principally an extra personal exemption and the tax credit for the elderly. The tax status of benefits from Social Security and Medicare, as well as these two tax provisions, could be revised to achieve reductions in the federal deficit that are comparable to the

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1. References in the text to "Railroad Retirement" apply only to Tier I benefits.

2. Employer contributions to Social Security, Railroad Retirement, and Medicare are business expenses and therefore are deducted by employers in calculating taxable income. In addition, the federal income tax does not regard employer contributions for these programs as income paid to employees while they are working. Hence, employer contributions are said to come from "before-tax" income.

   In contrast, employee contributions are not deductible from wage and salary income in the calculation of potential individual income tax liability and, therefore, are said to come from "after-tax" income. (The federal income tax does contain, however, an Earned Income Credit for low-income taxpayers that is often justified as a partial offset for Social Security employee payroll contributions.) Premiums for Supplementary Medical Insurance (SMI) also are made from after-tax income.

reductions that would be achieved either by revising the cost-of-living adjustment in Social Security and Railroad Retirement, or by increasing Medicare premiums or deductible amounts.

As with the revisions in the cost-of-living adjustment or some of the increases in Medicare charges discussed in Sections II and III, submitting Social Security and Railroad Retirement benefits to greater taxation would lower the disposable incomes of the beneficiary populations; that is, the after-tax value of the benefits would be lower. Because the income tax has a progressive rate structure, however, the income of lower-income beneficiaries would be affected less--and the income of higher-income beneficiaries would be affected more--under the options examined in this section than would occur as a result of eliminating a cost-of-living adjustment for all beneficiaries.

BACKGROUND

The Social Security Amendments of 1983 (Public Law 98-21) introduced limited taxation of Social Security and Railroad Retirement benefits. Under the 1983 act, higher-income beneficiaries must include in their adjusted gross incomes (AGI) certain benefit amounts. 3/ Benefits are not

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3. See the Introduction for a discussion of the tax status of Social Security and Railroad Retirement before passage of the 1983 act.

taxed unless the sum of (a) income that is otherwise includable in AGI, (b) nontaxable interest income, and (c) one-half of Social Security or Railroad Retirement benefits exceeds certain thresholds: $25,000 for an individual tax filer, or $32,000 for married joint filers. The amount of benefits included in adjusted gross income is the lesser of (a) one-half of benefits, or (b) one-half of the amount by which combined income (that is, other AGI items, nontaxable interest, and one-half of benefits) exceeds the relevant threshold. Thus, no more than one-half of benefits are includable in adjusted gross income. The effect on an individual's or couple's tax liability depends on both the amount of benefits included in AGI and the taxpayer's marginal tax rate.

As a result of these thresholds, approximately 90 percent of the beneficiary population currently pay no taxes on their benefits. Because the thresholds are not indexed for inflation, however, an ever greater percentage of benefits will become subject to taxation over time as benefits and income from other sources rise relative to the fixed thresholds. Under the long-term inflation assumptions of the Social Security system, by the middle of the next century almost all beneficiaries whose other income at least equals the zero bracket amount in the income tax (in 1985, $2,390 for an individual and $3,540 for a married couple) will find half their benefits subject to tax.

In contrast, federal Civil Service Retirement, Military Retirement, and other federal employee pensions are taxed under the general income tax rules applicable to pension income. If the employee contributed nothing from after-tax income to help fund the pension (that is, a noncontributory pension), then all payments from it are fully taxable. If the employee contributed from after-tax income (a contributory pension), then a portion of the pension is excluded from taxation during each year of payout. 4/

A pension recipient might be able to offset a portion of the tax liability on the pension or other income with the tax credit for the elderly or disabled. For lower- and middle-income elderly taxpayers who receive below-average amounts of Social Security benefits, the credit currently reduces their tax to levels that are comparable to what they would pay if Social Security made up a greater fraction of their total income. 5/

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4. The excluded amount is that portion of the pension payment that represents the payment multiplied by a fraction that equals the ratio of the employee's contributions to the total amount of the expected lifetime payments from the pension. If, however, within the first three years of the pension's payout, a pension beneficiary will receive an amount that equals or exceeds after-tax contributions to the plan while an employee, then a special rule provides that the recipient first must exclude from adjusted gross income an amount equal to those contributions and then include all subsequent pension payments.

5. The tax credit for the elderly or the disabled is available both to people 65 or older and to those under age 65 who are totally and permanently disabled and receiving disability income from their employer. The credit is equal to 15 percent of a defined "base

(Continued)

Under current law the elderly do not include in their AGI the value of Medicare benefits in excess of HI contributions made during working years and current premiums for SMI. This is consistent with the exclusion from AGI of employer-paid health insurance premiums for workers.

Finally, the elderly benefit from the tax provision that provides an extra personal exemption for taxpayers age 65 and over. The exemption is now equal to $1,040, but this amount is indexed to changes in the Consumer Price Index.

SPECIFIC OPTIONS

Five specific tax options are considered here:

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5. (Continued)
amount." For those age 65 or over, the initial base amount is $5,000 for an individual filer or when only one member of a couple filing a married joint return is 65 or older, and $7,500 when both members of the couple filing a joint return are 65 or older. (Those under age 65 are limited to the minimum of these initial base amounts or their taxable disability income.) The $5,000/$7,500 initial base amounts are reduced by (1) the full amount of any nontaxable pension or disability income--principally Social Security and Railroad Retirement benefits; and (2) one-half of the taxpayer's adjusted gross income in excess of $7,500 for an individual filer, or in excess of $10,000 for a married joint filer. As a result of these provisions, the tax credit does not exist for single taxpayers whose Social Security or Railroad Retirement benefits exceed $5,000 or whose other income exceeds $17,500. For married joint filers, the credit has no effect if their benefits exceed $7,500 or their other income exceeds $25,000. In 1982, 483,000 tax filers, half of them nonelderly, claimed the credit. The average credit was $272.

- Eliminate thresholds and continue to tax one-half of Social Security and Railroad Retirement benefits.
- Tax up to 85 percent of benefits with current law thresholds.
- Tax up to 85 percent of benefits with thresholds that are lower than under current law.
- Tax a portion of the insurance value of Medicare.
- Repeal the extra personal exemption for the aged.

Under the first option, the current $25,000 and $32,000 thresholds above which benefits are phased into adjusted gross income would be eliminated; 50 percent of all Social Security and Railroad Retirement cash benefits would be included in AGI. 6/ The argument for continuing to exclude 50 percent of benefits is that employers and employees each pay for half of benefits, and the employee's contribution has already been taxed as individual income.

The second option would retain the $25,000 and $32,000 thresholds of current law but would increase to 85 percent the amount of Social Security and Railroad Retirement benefits that could be included in adjusted gross income. This option, as well as the next one, is consistent with the view

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6. If the tax treatment of Social Security were made more stringent, complementary changes in the tax credit for the elderly also might be in order, especially in light of the historical reasons for the credit's existence. No attempt was made in this analysis, however, to specify what those changes might be.

that federal income tax treatment of Social Security should be more similar to that of private and public employee contributory pensions--that is, payments should be included in adjusted gross income to the extent that they exceed contributions from previously taxed income.

The 85 percent figure derives from analyses by the Social Security Administration's Office of the Actuary that have examined the ratio of projected employee contributions to projected future lifetime benefits for workers now entering the labor force. That ratio is 17 percent for male workers who will always earn at the maximum wage level for Social Security payroll contributions and who will never have any dependents. If the general rule for taxing private or public employee contributory pensions is applied to this hypothetical person, then 83 percent of his benefits would be included in his adjusted gross income during retirement. 7/ The Office of the Actuary also estimates that, for all people reaching age 20 in 1984, the total of lifetime Social Security employee contributions will be about 7 percent of what their total lifetime Social Security benefits will be. If the tax treatment of private contributory pensions were strictly applied to Social Security benefits, beneficiaries on average would have to include 93 percent of their benefits in adjusted gross income, although in some cases the exclusion would be greater and in other cases less. Setting case-by-case exclusions would be difficult to administer, however, so an exclusion of 15

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7. For this analysis 83 percent was rounded up to 85 percent.

percent was applied to all benefits. Because a 15 percent exclusion approximates the "correct" exclusion for the hypothetical worker who will pay the most contributions relative to the benefits he will receive, its application to other beneficiaries would be relatively generous compared with what would happen if the private pension analogy were strictly applied. 8/

The third option also would increase to 85 percent the amount of Social Security and Railroad Retirement benefits that could be included in adjusted gross income, but it would simultaneously decrease the thresholds above which benefits are phased in, to $20,000 (for an individual filer) and $25,000 (for married joint filers).

The fourth option would require Medicare beneficiaries to include in their adjusted gross income 50 percent of the insurance value of Hospital Insurance (HI) benefits and 75 percent of the insurance value of Supplementary Medical Insurance (SMI) benefits. (This analysis assumes that any attribution of Medicare to individuals would be based on the program's insurance value to all enrollees rather than actual reimbursement in

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8. In addition, because payroll contributions were lower for current beneficiaries compared with those for future beneficiaries, any exclusion rule applicable to future generations--for example, either a 50 percent or an 85 percent maximum on includable benefits--constitutes a relatively generous tax treatment for today's beneficiaries when compared with its application to future retirees.

particular cases.) The argument for including one-half of the HI insurance value is the same as that advanced for taxing only one-half of Social Security or Railroad Retirement cash benefits; that is, the employee's contribution has already been taxed, but the employer's has not. The logic of including 75 percent of the SMI insurance value follows from the fact that approximately one-quarter of that program is financed from premiums paid by participants, with the remaining three-quarters financed from general revenues. For 1985, includable insurance values would be approximately $780 for Hospital Insurance (one-half of the full HI insurance value of $1,565) and $510 for Supplementary Medical Insurance (three-quarters of the full SMI insurance value of $680). The combined amount is nearly $1,300 for each individual enrolled in HI and SMI. 9/

The fifth option would eliminate the extra exemption for the elderly and the blind.

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9. Other variants of this proposal to tax Medicare insurance values have been discussed. Some alternatives would phase in the inclusion of both HI and SMI insurance values over a set of thresholds like the ones that now apply to Social Security cash benefits. Another set of alternatives would focus exclusively on the inclusion of SMI insurance values in adjusted gross income, again with and without a phase-in over a set of thresholds.

Implementation Issues

In contrast to some of the options discussed in Section II, it does not appear that implementation of the taxation options would cause any significant new burdens on the Social Security Administration, beyond those already imposed by the 1983 amendments. Inclusion of Medicare in adjusted gross income, however, might require that additional information be supplied to taxpayers and the Internal Revenue Service by the Department of Health and Human Services. Moreover, the options would impose some additional administrative burdens on the Internal Revenue Service, both because the number of tax filing units would increase, resulting in additional demands for taxpayer assistance, and, in the case of Medicare taxation options, because there would be one more item in the tax base subject to potential underreporting. These extra administrative burdens are not likely to be severe, however, and any necessary changes probably could be implemented within a short time period.

The tax options would, however, increase the paperwork for taxpayers. The computation of Social Security tax liability and thresholds under current law adds some complication to tax forms. Options that would eliminate the thresholds would end this computation for some taxpayers and substitute a straightforward one-line item--taxable benefits. In contrast, options that would lower thresholds, without eliminating them, would require more taxpayers to make the computation. All of the tax options would result in an

increase in the number of elderly people liable for tax, and thus would impose compliance burdens on this new group of taxpayers.

METHODOLOGY

Different data bases and methods were used to estimate the revenue and distributional effects of these taxation alternatives.

Revenue Estimates

The revenue estimates were provided by staff of the Joint Committee on Taxation, using a data base that consists of tax return information onto which Social Security benefits have been imputed based on information from the Current Population Survey (CPS). These revenue estimates do not assume any accompanying changes in the tax credit for the elderly. Any changes in the credit, however, would not significantly affect the aggregate revenue estimates shown here.

Distributional Analyses

In order to provide estimates of the effects on beneficiaries that would be generally comparable to the ones prepared for the expenditure options presented in Section II, the five tax options were simulated on the March 1984 CPS, which reports 1983 incomes. The simulations were done with the federal income tax module of the Benefit and Tax Simulation

(BATS) model, developed by staff of the Assistant Secretary for Planning and Evaluation, Department of Health and Human Services.

The CPS provides no information on the federal income tax status of individuals. As a consequence, the BATS model assigns a tax filing status based on each individual's characteristics. For example, all married people with a spouse in the same household are assumed to file jointly; all people who are not married or have no spouse currently residing in the same household, and whose household includes an unmarried child (or other relative with adjusted gross income of less than $1,000), are assumed to file as heads of household; and all others are assumed to file as single individuals.

Adjusted gross income is constructed as the sum of wages and salaries, self-employment income, interest, rents, dividends, and pensions as reported on the CPS. Unemployment Insurance and Social Security, also as reported on the CPS, are added to AGI according to the appropriate tax treatment under current law or one of the proposed changes.

A total for itemized deductions is imputed to each tax filing unit based on an analysis of units with comparable income and demographic characteristics from the public use tape of the 1979 Statistics of Income (that is, tax return information). Each unit is assigned a probability that it will itemize and an amount reflecting a cross-classification by AGI; a

number of exemptions; and a number of special exemptions for age, sex, and filing status. Unlike other tax simulations using the CPS and this model, the analysis presented here does not correct for underreporting of income.

In order to reflect where the benefit taxation thresholds--current law or revised--stand in the income distribution of 1986 in the context of a data base that reports 1983 incomes, the thresholds were deflated by the ratio of the annual CPI-U index for 1983 to that index for 1986, as estimated by the Congressional Budget Office. Thus, the 1986 threshold of $25,000 becomes $22,123 in the estimate for 1983. In all other respects--for example, tax rates--1986 tax law provisions are used.

Finally, although the tax credit for the elderly is in the model, no changes were made in the credit's specifications for purposes of these CPS simulations.

LIMITATIONS

The limitations discussed in Section II also apply to analysis of the tax options. (See, for example, the discussions concerning poverty measures, limitations of the data from the CPS, and the use of 1983 information to portray 1986 effects.)

The underreporting of certain kinds of income--especially rents, interest, and dividends--in the CPS is a particularly serious problem for the analysis of the taxation options, because it understates both the number of elderly families who would be taxed under the options examined here and the amount of their increased tax liability. The underreporting problem is especially important for the analysis of options that involve the thresholds at which benefits become subject to taxation. Consequently, for this part of its analysis of estimated effects on beneficiaries, the CBO compared the results from simulations that do not correct for underreporting of income with results from other simulations that have made upward adjustments for rent, interest, and dividends for all tax units that include an elderly person and that report such income on the CPS. 10/ This comparison is discussed in detail at the end of this section (see also Table 23).

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10. The rents, interest, and dividends of all tax units with an elderly person were increased by 60 percent. For units whose total AGI reported on the CPS was $75,000 or more (incomes above $75,000 are coded as $75,000 on the CPS), property income was increased by an additional 45 percent and earned income was increased by 35 percent.

    These adjustment factors were designed to make income and taxes estimated with the CPS more nearly comparable to income reported to the Internal Revenue Service. (The adjustment factors, though applied to 1983 incomes, were based on a comparison of 1982 incomes reported on the CPS and 1982 tax return information; 1982 is the most recent year for which information is available from the IRS' Statistics of Income (SOI) series.) Without these adjustments, the estimated number of tax-paying units with positive tax liability and at least one elderly person is 19 percent lower using the CPS than the correspond-

(Continued)

ESTIMATED EFFECTS

The remainder of this section outlines the effects of the five taxation options described earlier. As mentioned above, the reported revenue results and the estimated distributional effects are drawn from different data bases using different simulation models.

Effects on the Deficit

Over the 1986-1990 projection period, the greatest amount of revenues--$36.1 billion--would result from repealing the $25,000 and $32,000 thresholds in current law and, thus, requiring all beneficiaries to include one-half of benefits in adjusted gross income (see Table 17). This option would have a somewhat greater effect on the deficit than the $33.8 billion reduction from eliminating the cost-of-living adjustment for 1986 Social Security and Railroad Retirement benefits.

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10. (Continued)
ing estimate from tax return (SOI) data. The total income of taxpayers who claim the elderly exemption is simulated to be almost one-third below that on the SOI, and property income is 46 percent too low. Taxes estimated on the CPS for elderly taxpayers are 44 percent too low if no adjustments are made. With the adjustments, the simulated number of taxpayers who claim the elderly exemption, their aggregate property income and total income, and the total taxes they pay are 6 percent to 8 percent below SOI values. Deceased and institutionalized taxpayers not included in the CPS sample probably account for most of the remaining discrepancy.

The second option would increase the maximum amount of benefits includable in adjusted gross income to 85 percent but would retain the $25,000 and $32,000 thresholds in current law. This option would raise $19.3 billion, or about three-fifths of what would be raised by eliminating the 1986 COLA in Social Security and Railroad Retirement.

TABLE 17. ESTIMATED INCREASED REVENUES FROM INCOME TAXATION OPTIONS, FISCAL YEARS 1986-1990
(In billions of dollars)

Option	1986	1987	1988	1989	1990	Cumulative Five-Year Revenues
Eliminate Thresholds for Inclusion of Benefits in Adjusted Gross Income (AGI)	2.2	7.3	8.0	9.0	9.6	36.1
Include up to 85 Percent of Benefits Above Threshold in AGI	1.0	3.4	4.1	5.0	5.8	19.3
Lower Thresholds and Increase Percentage of Benefits Included in AGI	1.6	5.5	6.2	7.2	7.9	28.4
Include 50 Percent of Value of HI and 75 Percent of SMI in AGI	1.1	3.9	4.4	5.0	5.7	20.1
Repeal Extra Exemption for the Aged	1.0	3.0	3.0	3.1	3.2	13.3

SOURCE: Congressional Budget Office using data provided by the Joint Committee on Taxation.

The third option--increasing to 85 percent the maximum amount of benefits includable in adjusted gross income above benefit taxation thresholds of $20,000 (for individual filers) and $25,000 (for married, joint filers)--would raise $28.4 billion in revenues, about $5 billion less than would be saved by eliminating the 1986 COLA in Social Security and Railroad Retirement. The fourth and fifth options would raise $20.1 billion and $13.3 billion in new revenues, respectively.

In comparison to savings from the proposals to reduce expenditures, revenues from taxation options would be lower in the initial fiscal years and higher in the later years. This different flow results in part from the lag between the initial accrual of increased tax liabilities in calendar year 1986 and tax filings for that year in the spring of 1987. In addition, revenues would rise under the two alternatives that increase taxation of Social Security benefits over benefit taxation thresholds, just as they do under current law, because the growth in nominal income steadily reduces the proportion of benefits exempted as a result of those thresholds. Finally, in contrast to the cost-of-living options, greater taxation of benefits would affect those who will become eligible for benefits in 1986 and later years.

Because the effects of the proposals that would increase the taxation of cash benefits or would tax Medicare insurance values would not decay over time, they could have a substantial effect on the long-term balances of

the Social Security and Medicare trust funds if, as under current law, the income tax revenues raised by the increased taxation were deposited in the trust funds. The increased balances in turn would reduce the need for the federal government to borrow from the public and, hence, would reduce the deficit as much as if the additional income tax revenues simply had stayed with the Treasury and had never been credited to the trust funds. To the extent that the Social Security system might go into actuarial surplus as a result of the enactment of one of these alternatives, consideration could be given in the future to lowering scheduled payroll taxes. In the context of deficit reduction efforts, however, a concomitant lowering of payroll taxes would void any positive effect in narrowing aggregate federal deficits.

Effects on Beneficiaries

The distributional effects of the five tax options are shown in Tables 18 through 22 and discussed below. These options would not affect all beneficiaries, however. For many with low incomes, inclusion of more benefits in adjusted gross income would still leave their income below the sum of the zero bracket amount and the personal exemptions (including the exemptions for the aged).

The first option, which would eliminate thresholds, would have a relatively high impact on taxpayers between 200 percent and 300 percent of poverty, because this group generally falls below the current thresholds (see

Table 18). Some higher-income beneficiaries would not be affected by the first option, since they already pay taxes on 50 percent of their benefits (that is, their modified AGIs are already considerably above current thresholds). About 82 percent of the beneficiary units between 200 percent and 300 percent of poverty would be affected, and their increase in taxes would average $320, or 2.2 percent of before-tax income. None of the other taxation options would affect this group as much as this one. On the other hand, eliminating the thresholds would simplify a complicated calculation for many beneficiaries, especially those above the threshold levels, as to what amount of their Social Security benefits is includable in AGI.

In contrast to the first option, the second and third options would have the least effect on the lower portion of the income distribution (see Tables 19 and 20). These options would retain thresholds, but increase to 85 percent the maximum amount of benefits that could be included in adjusted gross income. (The second option retains the thresholds at their current levels of $25,000 and $32,000. The third option lowers the thresholds to $20,000 and $25,000.) In 1986, neither option would affect families or unrelated individuals whose income was below 150 percent of the poverty threshold. The second option would affect fewer families between 150 percent and 300 percent of poverty than the third option, because the latter would set lower thresholds for taxation of benefits. In both cases, the number of affected families below 300 percent of poverty would represent

TABLE 18. EFFECTS OF TAXING ONE-HALF OF SOCIAL SECURITY CASH BENEFITS WITHOUT THRESHOLDS a/

Family Income Relative to Poverty Line	Percent of Total Loss Incurred by Group	Total Recipient Families in Income Class (in thousands)	Average Loss For All Recipients		Recipient Families Experiencing a Loss (in thousands)	Average Loss for Those Experiencing a Loss	
			In Dollars	As Percent of Average Income		In Dollars	As Percent of Average Income
All Families b/							
Total	100	23,520	190	1.1	11,320	400	2.0
Below Poverty Line	c/	3,890	e/	d/	50	90	1.1
100-125 Percent	c/	2,190	10	0.1	120	120	1.5
125-150 Percent	1	1,910	20	0.2	290	130	1.3
150-200 Percent	6	3,270	80	0.7	1,630	160	1.5
200-300 Percent	28	4,810	270	1.7	3,960	320	2.1
Over 300 Percent	65	7,450	390	1.2	5,280	550	2.0
Elderly Families							
Total	81	18,400	200	1.2	8,660	420	2.1
Below Poverty Line	c/	2,800	e/	d/	f/	g/	g/
100-125 Percent	c/	1,750	e/	d/	10	g/	g/
125-150 Percent	c/	1,570	e/	d/	80	60	0.6
150-200 Percent	3	2,640	50	0.5	1,160	120	1.3
200-300 Percent	22	3,810	260	1.7	3,140	320	2.2
Over 300 Percent	55	5,840	430	1.3	4,270	590	2.1
Nonelderly Families							
Total	19	5,110	170	0.9	2,660	330	1.6
Below Poverty Line	c/	1,090	e/	0.1	40	90	1.1
100-125 Percent	c/	440	30	0.4	110	120	1.5
125-150 Percent	1	340	90	0.9	210	150	1.6
150-200 Percent	3	630	190	1.4	470	250	2.0
200-300 Percent	6	1,000	290	1.5	820	350	1.9
Over 300 Percent	9	1,610	260	0.7	1,010	410	1.3

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. Less than 0.5 percent.
d. Less than 0.05 percent.
e. Less than $5.00.
f. Less than 5,000 families.
g. Too few families to estimate accurately.

TABLE 19. EFFECTS OF TAXING 85 PERCENT OF SOCIAL SECURITY BENEFITS WITH THRESHOLDS OF $25,000 AND $32,000 a/

Family Income Relative to Poverty Line	Percent of Total Loss Incurred by Group	Total Recipient Families in Income Class (in thousands)	Average Loss For All Recipients		Recipient Families Experiencing a Loss (in thousands)	Average Loss for Those Experiencing a Loss	
			In Dollars	As Percent of Average Income		In Dollars	As Percent of Average Income
All Families b/							
Total	100	23,520	50	0.3	2,540	480	1.1
Below Poverty Line	0	3,890	0	0.0	0	0	0.0
100-125 Percent	0	2,190	0	0.0	0	0	0.0
125-150 Percent	0	1,910	0	0.0	0	0	0.0
150-200 Percent	0	3,270	0	0.0	0	0	0.0
200-300 Percent	c/	4,810	e/	d/	20	g/	g/
Over 300 Percent	100	7,450	160	0.5	2,520	480	1.1
Elderly Families							
Total	80	18,400	50	0.3	1,900	520	1.2
Below Poverty Line	0	2,800	0	0.0	0	0	0.0
100-125 Percent	0	1,750	0	0.0	0	0	0.0
125-150 Percent	0	1,570	0	0.0	0	0	0.0
150-200 Percent	0	2,640	0	0.0	0	0	0.0
200-300 Percent	c/	3,810	e/	d/	f/	g/	g/
Over 300 Percent	80	5,840	170	0.5	1,890	520	1.2
Nonelderly Families							
Total	20	5,100	50	0.2	640	380	0.9
Below Poverty Line	0	1,090	0	0.0	0	0	0.0
100-125 Percent	0	440	0	0.0	0	0	0.0
125-150 Percent	0	340	0	0.0	0	0	0.0
150-200 Percent	0	630	0	0.0	0	0	0.0
200-300 Percent	c/	1,000	e/	d/	20	g/	g/
Over 300 Percent	20	1,610	150	0.4	630	380	0.9

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. Less than 0.5 percent.
d. Less than 0.05 percent.
e. Less than $5.00.
f. Less than 5,000 families.
g. Too few families to estimate accurately.

TABLE 20. EFFECTS OF TAXING 85 PERCENT OF SOCIAL SECURITY BENEFITS WITH THRESHOLDS OF $20,000 AND $25,000 IN 1986 a/

Family Income Relative to Poverty Line	Percent of Total Loss Incurred by Group	Total Recipient Families in Income Class (in thousands)	Average Loss For All Recipients		Recipient Families Experiencing a Loss (in thousands)	Average Loss for Those Experiencing a Loss	
			In Dollars	As Percent of Average Income		In Dollars	As Percent of Average Income
All Families b/							
Total	100	23,520	100	0.6	4,000	570	1.5
Below Poverty Line	0	3,890	0	0.0	0	0	0.0
100-125 Percent	0	2,190	0	0.0	0	0	0.0
125-150 Percent	0	1,190	0	0.0	0	0	0.0
150-200 Percent	c/	3,270	e/	d/	10	g/	g/
200-300 Percent	1	4,810	10	d/	90	280	1.0
Over 300 Percent	99	7,450	300	0.9	3,900	580	1.5
Elderly Families							
Total	80	18,400	100	0.6	3,020	600	1.6
Below Poverty Line	0	2,800	0	0.0	0	0	0.0
100-125 Percent	0	1,750	0	0.0	0	0	0.0
125-150 Percent	0	1,570	0	0.0	0	0	0.0
150-200 Percent	c/	2,641	e/	d/	f/	g/	g/
200-300 Percent	c/	3,810	e/	d/	30	200	0.7
Over 300 Percent	80	5,840	310	0.9	2,990	610	1.6
Nonelderly Families							
Total	20	5,110	90	0.5	980	460	1.2
Below Poverty Line	0	1,090	0	0.0	0	0	0.0
100-125 Percent	0	440	0	0.0	0	0	0.0
125-150 Percent	0	340	0	0.0	0	0	0.0
150-200 Percent	c/	630	e/	d/	10	g/	g/
200-300 Percent	1	1,000	20	0.1	60	310	1.1
Over 300 Percent	19	1,610	270	0.7	910	470	1.2

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. Less than 0.5 percent.
d. Less than 0.05 percent.
e. Less than $5.00.
f. Less than 5,000 families.
g. Too few families to estimate accurately.

only a very small fraction of the beneficiary population, and virtually all of the new revenues would come from those whose incomes exceeded 300 percent of poverty. The third option, however, would affect approximately 1.4 million more families or individuals above 300 percent of poverty, and those affected would experience a greater loss in disposable income--about $580, or 1.5 percent of before-tax cash income, compared with $480, or 1.1 percent of income for the second option. On the other hand, the third option would raise approximately 50 percent more revenue over the projection period than would the second.

Either set of thresholds in options two and three is sufficiently high so that, even in 1990, virtually all the incremental revenue burden would continue to come from those above 300 percent of poverty, despite the diminishing protection of the thresholds.

Because the 1983 value of Medicare benefits that would be included in income would be roughly the same as a personal exemption in 1983, the fourth and fifth options would have essentially the same distributional pattern, especially among people over age 65 (see Tables 21 and 22). This pattern also closely resembles that which would occur under the first option. In 1986, two-thirds to four-fifths of the new revenue would come from those whose incomes exceed 300 percent of poverty; 16 percent to 28 percent from those between 200 percent and 300 percent of poverty; and 7 percent

TABLE 21. EFFECTS OF TAXING 50 PERCENT OF HOSPITAL INSURANCE AND 75 PERCENT OF SUPPLEMENTARY MEDICAL INSURANCE WITH NO THRESHOLDS a/

Family Income Relative to Poverty Line	Percent of Total Loss Incurred by Group	Total Recipient Families in Income Class (in thousands)	Average Loss For All Recipients		Recipient Families Experiencing a Loss (in thousands)	Average Loss for Those Experiencing a Loss	
			In Dollars	As Percent of Average Income		In Dollars	As Percent of Average Income
All Families b/							
Total	100	21,160	110	0.6	9,070	260	1.0
Below Poverty Line	c/	3,650	e/	d/	10	g/	g/
100-125 Percent	c/	2,050	e/	d/	30	g/	g/
125-150 Percent	1	1,750	10	0.1	140	100	1.1
150-200 Percent	4	2,910	30	0.3	690	120	1.2
200-300 Percent	18	4,260	100	0.6	2,660	160	1.1
Over 300 Percent	77	6,530	270	0.8	5,530	320	1.0
Elderly Families							
Total	93	19,270	110	0.7	8,280	260	1.0
Below Poverty Line	c/	3,140	e/	d/	f/	g/	g/
100-125 Percent	c/	1,830	e/	d/	10	g/	g/
125-150 Percent	c/	1,600	10	0.1	100	80	1.1
150-200 Percent	3	2,700	30	0.3	590	120	1.2
200-300 Percent	17	3,910	100	0.6	2,410	160	1.1
Over 300 Percent	73	6,100	280	0.8	5,170	330	1.0
Nonelderly Families							
Total	7	1,890	80	0.5	790	200	0.8
Below Poverty Line	c/	520	e/	0.1	10	g/	g/
100-125 Percent	c/	220	10	0.2	20	g/	g/
125-150 Percent	c/	150	40	0.4	40	130	1.3
150-200 Percent	1	210	60	0.4	100	130	1.0
200-300 Percent	2	350	120	0.7	250	170	0.9
Over 300 Percent	4	430	210	0.6	360	260	0.7

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over.
c. Less than 0.5 percent.
d. Less than 0.05 percent.
e. Less than $5.00.
f. Less than 5,000 families.
g. Too few families to estimate accurately.

TABLE 22. EFFECTS OF ELIMINATING THE EXTRA EXEMPTION FOR THE ELDERLY IN 1986 a/

Family Income Relative to Poverty Line	Percent of Total Loss Incurred by Group	Total Elderly Families b/ in Income Class (in thousands)	Average Loss For All Elderly Families		Elderly Families Experiencing a Loss (in thousands)	Average Loss for Those Experiencing a Loss	
			In Dollars	As Percent of Average Income		In Dollars	As Percent of Average Income
Total	100	20,010	100	0.6	8,510	230	0.9
Below Poverty	0	3,280	0	0.0	0	0	0.0
100-125 Percent	c/	1,860	e/	d/	10	f/	f/
125-150 Percent	c/	1,630	e/	d/	100	60	0.3
150-200 Percent	3	2,740	20	0.2	540	100	1.0
200-300 Percent	16	3,990	80	0.5	2,350	130	0.9
Over 300 Percent	81	6,510	240	0.7	5,520	280	0.8

SOURCE: Congressional Budget Office simulations based on the March 1984 Current Population Survey.

a. See text for more precise definition of option and for cautions in interpreting the findings. All numbers have been rounded.
b. Unrelated sub-families and unrelated individuals are each defined as separate families in this analysis. Elderly families are those with at least one member age 65 or over. Nonelderly families would not be affected.
c. Less than 0.5 percent.
d. Less than 0.05 percent.
e. Less than $5.00.
f. Too few families to estimate accurately.

or less from those whose incomes are below 200 percent of poverty. Again, the largest dollar loss—about $300—would be experienced by those in the highest income group, but the losses in all income groups would average about 1 percent of before-tax income.

Some of these results show an effect on those whose incomes appear to be below income tax entry levels and, in some instances, below the poverty thresholds. Because of the double personal exemption and the zero bracket amount, tax entry levels exceed the poverty thresholds for elderly couples and individuals. Some elderly people, however, live with nonelderly relatives, and some of these multigeneration families containing several tax filing units may be below the poverty line, even though the elderly individual or couple within that family has income above the poverty threshold for one or two people. Further, tax entry levels are not high enough under current law to exempt nonelderly families and individuals near the poverty threshold from income tax liability, especially if previously nontaxable benefits became includable in adjusted gross income.

In Table 23, the results reported earlier in Tables 18 through 22 are compared with the results of additional simulations in which income on the CPS has been increased to approximate the income reported in the SOI (see page 92). In all cases, the number of families affected would be greater when income adjusted for underreporting is used in the CPS simulations.

TABLE 23. RESULTS FROM SIMULATIONS USING INCOME AS REPORTED ON THE CPS COMPARED WITH INCOME ADJUSTED TO APPROXIMATE SOI TOTALS

	Unadjusted Income			Adjusted Income		
		Average Loss for Those Experiencing a Loss			Average Loss for Those Experiencing a Loss	
	Families Experiencing a Loss	In Dollars	As a Percent of Average Income	Families Experiencing a Loss	In Dollars	As a Percent of Average Income
Eliminate Thresholds for Inclusion of Benefits in Adjusted Gross Income	11,320	400	2.0	11,520	410	2.0
Include up to 85 Percent of Benefits Above Thresholds in Adjusted Gross Income	2,540	480	1.1	3,340	550	1.1
Lower the Thresholds and Increase Percentage of Benefits Included in Adjusted Gross Income	4,000	570	1.5	4,970	620	1.5
Include 50 Percent of Value of HI and 75 Percent of SMI in Adjusted Gross Income	9,070	260	1.0	9,910	280	1.0
Repeal Extra Exemption for Elderly and Blind	8,510	230	0.9	9,330	250	0.8

SOURCE: Congressional Budget Office estimates based on the most recent information available from the Current Population Survey (CPS) and the Statistics of Income (SOI). All figures report estimated incomes for 1983.

Use of adjusted income in the simulations most noticeably affects the estimates for the two options that would retain thresholds for Social Security and Railroad Retirement benefit taxation, but would increase the proportion of benefits includable in AGI to 85 percent. For the option that would preserve thresholds at their present levels, the estimate of the number of families affected increases by 31 percent, with a corresponding increase of 14 percent in the estimate of their extra tax liability. For the option that would lower thresholds as well, the estimate of affected families rises by 24 percent and the estimate of extra tax liability by 9 percent. Despite these increases, the results for the losses as a percent of income are virtually the same whether adjusted or unadjusted income is used in the simulations. This is because the estimate of increased tax liabilities and the estimate of incomes are affected by the adjustments in comparable ways.

V. COMPARISON OF OPTIONS

Sixteen approaches to reducing net expenditures for selected entitlement programs--either by directly cutting benefits compared with current law or by increasing the tax liabilities of recipients--have been examined in this study. This section summarizes their budgetary effects and their effects on recipients.

The estimated budgetary savings from reducing retirement and disability benefits (relative to current policy), increasing Medicare premiums and copayments, and increasing tax revenues--along with the distribution of the effects across income groups--are presented in Table 24. For the reasons provided throughout the text, these numbers should be considered only as illustrative of the effects from implementing these options. In addition, individual members of each group could be affected quite differently from the average impact for the group. Finally, each estimate is subject to a number of limitations. In particular, the budgetary effects are estimated as if each option were implemented in January 1986, whereas the distributional analysis was conducted with data from an earlier year, usually 1983. Moreover, depending on the date of enactment, it might not be possible to implement some of the options examined here in time to reduce the 1986 budget deficit.

TABLE 24. AMOUNTS AND SOURCES OF BUDGETARY SAVINGS

Option [b]	Fiscal Years 1986-1990 Budgetary Savings [a] (in billions of dollars)	Distribution of Effects on Recipients in 1983 (in percents)				
		Poor [c]	100%-125% of Poverty Line	125%-200% of Poverty Line	200%-300% of Poverty Line	Over 300% of Poverty Line
One-Year Benefit Freeze Options						
Freeze Social Security and Railroad Retirement program benefits	33.8	8	7	23	24	39
Combine Social Security and Railroad Retirement freeze with increase in SSI Guarantee	29.9	[d]	5	24	27	44
Freeze all non-means-tested program benefits	43.3	6	6	19	22	47
Combine freeze on all non-means-tested programs with increase in SSI guarantee	39.4	[d]	4	20	24	52
Exempt Social Security and Railroad Retirement benefits below a specified threshold (COLA Cap) [f]	16.5	1	2	12	20	66
Replace Social Security and Railroad Retirement COLA with flat COLA [f]	10.2	-15[e]	-2[e]	8	21	86
Exempt Social Security and Railroad Retirement beneficiaries below a specified threshold (Poverty COLA) [f]	33.1	1	4	19	23	53
Medicare Options						
Increase SMI premium to 35 percent of costs [g]	17.1	11	8	23	23	36
Increase SMI premium to 30 percent of costs and increase deductible [g]	17.7	11	8	23	23	36
Introduce an income-related SMI premium	8.7	[d]	[d]	1	7	92
Impose a 30 percent tax on Medigap policies	24.2	8	5	20	21	46
Taxation of Benefit Income Options						
Eliminate thresholds for inclusion of benefits in adjusted gross income	36.1	[d]	[d]	7	28	65
Include up to 85 percent of benefits above threshold in AGI	19.3	0	0	0	[d]	100
Lower the thresholds and increase percent of benefits included in AGI	28.4	0	0	[d]	1	99
Include 50 percent of value of HI and 75 percent of SMI in AGI	20.1	[d]	[d]	4	18	77
Repeal extra exemption for the aged	13.3	0	[d]	3	16	81

SOURCE: Budgetary savings based on CBO baseline; distribution of savings based on tabulations of the March 1984 Current Population Survey, which reports incomes for calendar year 1983. See text for more detail and cautions in interpreting the findings.

a. Budgetary savings estimated for fiscal years 1986-1990; distributional effects are for calendar year 1983.
b. See text for definitions of options.
c. Poor families are those with incomes below Census poverty thresholds.
d. Less than 0.5 percent.
e. Total benefits received by the poor and near-poor in 1983 would increase by about $0.3 billion, and benefits received by the nonpoor would decrease by $1.6 billion, resulting in a net loss of $1.3 billion to be allocated across groups.
f. Benefit levels for all other non-means-tested programs would be frozen. See the footnote on implementation in Section II, page 41.
g. The distributions of effects of these options are identical because it is assumed that per capita deductible expenditures do not vary by income group.

Freezing Social Security and Railroad Retirement benefits for one year would generate budgetary savings of $33.8 billion over the 1986-1990 projection period. The 3 million poor families whose benefits would be reduced (relative to current policy) would account for 8 percent of the total losses. This is slightly less than the share of Social Security and Railroad Retirement benefits received by this group (9 percent) because SSI (or other cash assistance programs) would protect some of them. The average annual loss for the poor--$130--would equal almost 3 percent of their total family incomes. Seven percent of the losses would be incurred by families between 100 percent and 125 percent of the poverty threshold; 23 percent by families between 125 percent and 200 percent of the threshold; 24 percent by families between 200 percent and 300 percent of the poverty threshold; and the remaining 38 percent by families with incomes above 300 percent of the poverty threshold.

Omitting the COLA for one year on benefits from all non-means-tested cash transfer programs would increase five-year budgetary savings by $9.5 billion, to $43.3 billion. Nearly all recipients in the additional programs subject to such a benefit freeze have family incomes well above poverty thresholds.

Combining either of the across-the-board freezes with an increase in SSI guarantee levels would reduce five-year budgetary savings by about $4

billion and would eliminate losses for the poor as a group. This effect, however, would result from raising benefits for SSI recipients relative to current law--not from reducing the losses of those who would receive lower benefits under either freeze option. For example, about 1.6 million poor families containing SSI recipients would gain an average of $230, whereas the 3 million poor families who would lose from a freeze on Social Security and Railroad Retirement benefits would still lose an average of $130. In terms of aggregate payments to poor families, these two effects would offset one another.

The other three modifications would freeze benefit levels for non-means-tested programs other than Social Security and Railroad Retirement, but would vary in their treatment of Social Security and Railroad Retirement recipients. Consequently, part of the budgetary savings ($9.5 billion over five years) for each approach would come from lower benefits for civil service and military retirees, with virtually no adverse effect on the poor because only 1 percent of federal retirees are in this income group.

All three of these options would concentrate losses on the nonpoor, but they would have substantially different budgetary effects. The Flat COLA would concentrate losses almost entirely on families with incomes at least double the poverty threshold, but would save relatively little--$10.2 billion over five years, only $0.7 billion more than the savings from reducing the

COLA for other non-means-tested programs--because low-benefit recipients throughout the income distribution would be given higher benefits than under current law, and all recipients would receive some portion of the currently scheduled COLA. 1/ The COLA Cap and the Poverty COLA options would each concentrate the losses on nonpoor families, with the Poverty COLA generating substantially more budgetary savings--$33.1 billion compared with $16.5 billion--because many recipients would receive no COLA.

The first two options that would increase Medicare premiums and copayments would each produce five-year budgetary savings that are about half of the estimated savings from freezing Social Security and Railroad Retirement benefits ($17.1 billion and $17.7 billion). Poor recipients would incur a larger share of the losses than they would under this freeze option (11 percent, rather than 8 percent). Their share would nonetheless be smaller than their percentage of the Medicare population--17 percent--because Medicaid would pay the increased premiums and deductible amounts for about one-third of them.

The option that would introduce an income-related SMI premium would generate about half the additional revenues ($8.7 billion) that would result

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1. About 1.2 million poor and near-poor families would lose benefits, but their total losses would be smaller than the gains that would be experienced by 3.5 million other poor and near-poor families.

from the other two premium options. Revenues from an income-related premium could be increased or reduced, however, by altering the 1 percent tax rate used for this option. Essentially, none of the poor or near-poor would be affected by an income-related premium, while these groups would incur nearly 20 percent of the losses if the current SMI premium was increased to 35 percent of costs.

The option to impose a 30 percent tax on medigap policies would save $24.2 billion over the five-year period. Assuming that the tax would be passed through to policyholders, each income group would incur either higher health insurance costs (because they continued their policies) or higher copayments (because they dropped their policies). The distribution of these higher costs would be similar to the distribution of losses from freezing Social Security and Railroad Retirement benefits.

The five tax options examined here would produce revenues of between $13.3 billion and $36.1 billion over the five-year period. Eliminating the thresholds for inclusion of Social Security and Railroad Retirement benefits in adjusted gross income would produce the most revenue--slightly more than the budgetary savings that would result from freezing benefits from these programs.

Virtually all of the increased revenues that would result from implementing any of the tax options would be generated by higher taxes on nonpoor families. For example, if the thresholds for inclusion of benefits were eliminated, families with incomes between 200 percent and 300 percent of the poverty thresholds would incur 28 percent of the additional taxes, while families with incomes over 300 percent of poverty thresholds would incur 65 percent. Under the other tax options, the share of increased taxes that would be incurred by those with incomes between 200 percent and 300 percent of poverty would be lower, while the share incurred by the highest-income group would be larger.

Unlike the COLA options, the effects on the deficit from the Medicare options and the taxation options would not diminish over time as the affected population died or left the beneficiary rolls. Instead, future beneficiaries would face higher premiums and a higher degree of taxation on their benefits than that scheduled under current law. By contrast, unless a permanent adjustment is made in the formula used to calculate initial Social Security benefits that would parallel a benefit freeze, the savings from a freeze would eventually disappear.

It might be possible to combine options--for example, freeze all non-means-tested program benefits other than Social Security and Railroad Retirement and include up to 85 percent of Social Security and Railroad

Retirement benefits above current thresholds in taxable income. The budgetary and distributional effects of implementing more than one option concurrently have not been examined. In this particular example, the budgetary savings should be additive ($9.5 billion plus $19.3 billion), and few of the poor would be affected. In contrast, combining options that would both reduce Social Security benefits and increase taxation on these benefits would produce total budgetary savings less than the sum of the separate options.

In short, the 16 options examined in this study illustrate two basic strategies for achieving budgetary savings in Social Security, Medicare, and other entitlement programs. One strategy would spread the income losses or increased costs across almost the entire recipient population. Examples of this approach include the two across-the-board benefit freeze options and the two options that would increase the current SMI premium. In each case, some low-income recipients would be automatically protected--SSI recipients in the case of the freeze options, and Medicaid participants in the case of the Medicare options.

The other strategy essentially would focus the losses on fewer recipients--therefore either achieving smaller budgetary savings or requiring those affected to incur larger losses. The modified COLA options illustrate approaches that are specifically designed to protect low-benefit recipients.

The income-related SMI premium option and the other options that would operate through the personal income tax system would automatically concentrate the losses on recipients with higher incomes, because few poor elderly families are subject to the income tax.