Statement of
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Committee on Finance
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Mr. Chairman, it is a pleasure to be here today to discuss S. 2016, Senator Moynihan's proposal to reduce the Social Security payroll tax and return Social Security to a pay-as-you-go system. This statement tries to clarify a number of the issues underlying what has been a spirited, but somewhat confused, debate about the merits of alternative approaches to the financing of Social Security. It examines the following four issues:

- o   The ways in which current budget policy can enhance the nation's ability and willingness to support the increased costs of future Social Security benefits;

- o   The likely effects of S. 2016 on the economy;

- o   The impact of payroll tax reductions on the distribution of tax burdens and after-tax incomes of families; and

- o   Some programmatic factors that relate to the choice between pay-as-you-go and partial reserve financing of Social Security.

PAYING FOR THE BABY BOOM'S RETIREMENT

The only links between today's policies and the payment of tomorrow's retirement benefits are the effects of current actions on the size of the economy. After all, no matter how Social Security is financed today, the government will have to pay the retirement benefits of future generations by

claiming a share of the gross national product (GNP) that is produced then. It can do this either by raising taxes, or reducing other spending. Indeed, a permanent increase in taxes or reductions in other federal programs appears to be a certainty, since the retirement of the baby boom will mark the beginning of a permanent increase in the ratio of retirees to workers. Borrowing would be both an unwise and unsustainable response. The nation will be better able to bear these increased taxes or reduced government programs if overall GNP is as large as possible.

The primary way for the government to affect the size of the economy in the future is to take actions that add to national **saving--in** other words, to reduce its deficit. Reducing the federal deficit will increase national saving during the 20 or so years that remain before the baby boom begins to retire. Added saving will increase the productivity of the economy and the amount of income that will be available to be shared between future workers and the retirees. These improvements should make the reallocation of resources to retirees less of a strain on the working population of that time.

The reason for this is not that the share of GNP required for Social Security benefits will be smaller than would be the case if deficits persist. The share will not be smaller because increased productivity of the economy will generate higher wages and these in turn will result in increased Social Security benefits. As a result, the part of GNP that goes to retirees will grow just as fast as GNP as a whole will. But presumably a society with more

income is better able to devote a fixed share of its resources to retirees than one that is not so well off.

This argument suggests that reduced budget deficits will increase the nation's future ability to finance retirement benefits. But they may also affect its willingness to do so because lower deficits now will reduce the share of future tax revenues that will go to pay the federal government's interest costs. If deficits are cut, the federal government's interest payments in the next century will be reduced. Consequently, more government resources could be devoted to purposes that directly benefit future citizens and taxpayers. Hence, they may be more willing to reallocate resources to retirees than would a population that had to devote a significant portion of its tax payments to paying the debt-service costs of government services that had been consumed--but not paid for--by another generation.

Appropriate and Inappropriate Uses of Social Security Reserves

If deficit reduction is the primary way in which the government can act to ease the burden imposed by future increases in Social Security expenditures, the question becomes one of whether the increases in the Social Security surplus over the past six years have, in fact, acted to reduce the overall deficit. This question is unanswerable but has nonetheless sparked a lively debate.

Most commentators have jumped to the conclusion that the current growth of Social Security surpluses has encouraged larger deficits in the non-Social Security portion of the budget. They argue that sharper reductions in the federal deficit would have been more likely had the Social Security surplus not helped obscure the fact that the deficit in all other federal accounts combined has changed little since 1983. They feel that this represents a violation of a trust that was established at the time the 1983 amendments on Social Security were passed. In particular, a number of people are concerned that the Social Security surpluses have been allowed to "mask" the "true" federal deficit, and that the practice of investing Social Security reserves in Treasury securities is an illegitimate use of these resources to finance other activities of government.

There are several reasons to question this line of argument. First, we do not know how fast the deficit in the rest of the federal budget would have declined without the growing Social Security surpluses of the 1980s. It was well known that Social Security would generate large surpluses when the Balanced Budget Act's targets for the deficit were set. Had those surpluses not been a prospect, the targets in all likelihood would have been set higher. If they had not been, the gap between the targets and the actual deficits probably would have been **commensurately** larger. The reason the deficit has not been cut by more is not that the deficit targets were insufficiently ambitious or that the size of the problem, as measured by the total deficit, was not large enough to frighten the American public into demanding action.

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Rather it was that the steps needed to bring the deficit down were too painful and there existed little leadership or public support for such actions.

Moreover, it is difficult to make a case that the Social Security surplus has been hiding the deficit in the remainder of the budget since the Balanced Budget Act was passed in 1985. The Balanced Budget Act took Social Security off-budget precisely to highlight its importance to the overall deficit. Both CBO and OMB began explicitly showing figures on the Social Security surplus and the deficit in the rest of the budget in early 1986, and they have continued to do so ever since. The budget resolutions adopted by the Congress for the fiscal years following 1986 clearly indicated the size of the expected Social Security surplus and the projected deficit in the balance of the budget. If policymakers have chosen not to reduce the deficit in the non-Social Security budget more during that period, it has not been because that deficit has been hidden from view.

As this last argument suggests, efforts to lend still more prominence to the Social Security surplus could divert time and energy to what amounts to a procedural issue instead of attacking the substance of the problem before the **Congress--reducing** the federal deficit. Those interested in "unmasking" are trying to recast the dimensions of the budgetary problem in a way that will stimulate further action on the deficit. As others have observed, however, the procedure is not the problem; the problem is the problem. We have long known that further reductions in the federal deficit are needed, and

efforts to repackage its constituent parts only threaten to put off a serious effort to deal with it directly.

In addition, the Social Security surplus is not an accurate measure of Social Security's offsetting effects on federal borrowing. A significant component of the surplus is made up of transfers from other federal accounts. These transfers work to increase the apparent size of both the Social Security surplus and the non-Social Security deficit, as is shown in Table 1. In other words, the amount of surplus that the Social Security trust fund is generating independently of the rest of the government is less than it appears and, similarly, the size of the deficit that the non-Social Security budget is running independently of Social Security is less than it appears.

Finally, the notion that lending Social Security reserves to the Treasury represents a misuse of those funds reflects a misunderstanding of earmarked revenues in the federal budget. First, Social Security contributions are used for Social Security benefits; every dollar results in budget authority for the Social Security trust fund. But second, the U.S. Treasury always uses whatever cash is on hand to make payments before borrowing. Thus, when any fund shows a surplus, the excess cash is used to meet the Treasury's current obligations, whether the excess cash comes from Social Security contributions, gas taxes, or oil lease receipts. In that sense, the money is used for nonearmarked purposes. There is no sensible alternative to this procedure: should the Treasury borrow funds when it already has them?

TABLE 1.   SOCIAL SECURITY INCOME AND OUTLAYS (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Income						
Income from Public:						
Off-budget revenues	288	309	330	352	376	401
Intrabudgetary Income:						
Interest	16	22	27	34	42	50
Employer share of employee retirement	6	6	7	7	8	9
Taxes on benefits	4	5	5	6	6	7
Other	2	a/	a/	a/	a/	a/
Subtotal	28	32	39	47	56	66
Total Income	316	341	369	399	432	467
Outlays						
Payments to Public:						
Benefit payments	243	260	277	294	312	331
Administrative expenses	2	2	2	2	3	3
Subtotal	245	262	279	297	315	334
Intrabudgetary Payments b/	4	4	5	5	5	5
Total Outlays	250	267	284	301	320	339
Surplus						
As Conventionally Measured:		74	85	98	112	128
Less: Intrabudgetary Transfers (Net)	-24	-28	-35	-42	-51	-61
Surplus Excluding Intra-budgetary Transfers	42	47	51	56	61	67

SOURCE: Congressional Budget Office.

a.   Less than $500 million.
b.   Primarily interest paid to Treasury on normalized tax transfers and playment to Railroad Retirement.

Third, strictly speaking, the only way to avoid devoting earmarked receipts to other purposes is for the Treasury to have no need to spend any excess funds derived from the earmarked accounts. This means not only balancing the budget, but running an overall surplus. In other words, what some consider to be ill-advised uses of Social Security reserves will end when the government contributes to national saving rather than using it up.

This discussion helps show why the currently fashionable view that only the non-Social Security deficit can be viewed as the "true" federal deficit is wrong. The federal budget necessarily differs from business accounts. In particular, the chief importance of the federal deficit is in accounting for the federal government's use of private saving, rather than tracking operating profits and losses. In turn, the true measure of federal absorption of private saving is the deficit of the whole federal government (other than for federal investments), including Social Security.[1]

ECONOMIC IMPLICATIONS OF S. 2016

What would enactment of S. 2016 do to the economy? If the measure were enacted without offsetting reductions in the deficit, it could have adverse economic effects over both the short and long run. CBO has estimated that S. 2016 would increase the $138 billion baseline deficit by $40 billion in 1991

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1. These principles were clearly stated in 1967 by the President's Commission on Budget Concepts, a group of distinguished accountants, bankers, Members of the Congress, and economists.

and by greater amounts in later years (see Table 2). This figure is slightly lower than other estimates, partly because it incorporates an assumption that wage rates would increase somewhat in response to the reduction in the employers' payroll tax rate, thereby raising other tax revenues enough to offset a part of the direct revenue loss.

Short-Run Effects

Because the economy is operating close to its full capacity now, a significant reduction in payroll tax rates without offsetting deficit reductions elsewhere could harm the economy's performance over the next several years. A significant tax cut could increase total demand for goods beyond the economy's capacity to produce them, leading potentially to increases in both inflation and the trade deficit. The Federal Reserve would be likely to try to head off extra inflation by raising interest rates, which are already quite high by historical standards in inflation-adjusted terms. These higher rates could further reduce investment and complicate many problem areas, such as the cash-flow problems of developing countries and domestic corporations that are already heavily indebted, and could make resolving problems of the thrift industry more difficult.

TABLE 2.   BUDGETARY EFFECTS OF S. 2016 (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Off-Budget (Social Security)						
Baseline surplus	66	74	85	98	112	128
Changes:						
Payroll taxes	-5	-42	-58	-62	-67	-71
Interest	a/	-2	-6	-11	-17	-23
Total changes	-5	**-45**	-64	-74	**-84**	-94
Surplus, S. 2016	61	30	21	24	29	34
On-Budget (All Other)						
Baseline deficit	-204	-212	-221	-239	-242	-246
Changes:						
Income tax offset b/	1	4	6	6	7	7
FERS offset c/	a/	a/	a/	1	1	1
Interest	a/	a/	1	1	2	2
Total changes	1	5	7	8	9	10
Deficit, S. 2016	-204	-208	-214	-231	-233	-235
Total Budget						
Baseline deficit	-138	-138	-135	-141	-130	-118
Changes:						
Payroll taxes	-5	-42	-58	-62	-67	-71
Income tax offset b/	1	4	6	6	7	7
FERS offset c/	a/	a/	a/	1	1	1
Interest	a/	-2	-6	-10	-15	-20
Total changes	-4	-40	-58	-66	-75	-84
Deficit, S. 2016	-143	-178	-193	-207	-204	-202

SOURCE: Congressional Budget Office.

a.   Less than $500 million.
b.   Assuming that nominal GNP is held constant, a reduction in Social Security taxes would increase income and, therefore, increase income taxes. These estimates are net of increased income tax revenues.
c.   A reduction in Social Security taxes would automatically increase the tax rate for the Federal Employees Retirement System.

Long-Term Effects

In the longer term, significant increases in the federal deficit could exacerbate several current economic problems, such as low net investment, slow growth in productivity, and faltering competitiveness in international markets. A further increase in the federal deficit from a cut in taxes would divert more of our limited saving away from investment (including research and development) that could increase our productivity, competitiveness, and living standards. Competitiveness would also suffer if the higher interest rates that would accompany lower saving caused the dollar to appreciate on foreign exchange markets, making American goods more expensive, and foreign goods cheaper.

Some analysts have argued that reduced payroll tax rates for employers could help improve the competitiveness of American goods by reducing this component of labor costs, but this outcome seems unlikely. Most studies of the payroll tax conclude that the employers' share ultimately has little effect on employers' costs because it is absorbed by workers in the form of lower wages than they would otherwise get. This implies that reduced employers' rates would be met with offsetting increases in wage rates or additional fringe benefits. As a result, there might be little improvement in employers' costs, and therefore in the competitiveness of the goods that they produce.

A major impetus behind the current effort to reduce the payroll tax is the recent trends evident in the distribution of income and the **progressivity** of the tax system. Between 1980 and 1990, average adjusted real family **income--family** income divided by the appropriate poverty **threshold--of** the top fifth of families rose by **31.7** percent, while the average income of families in the bottom four income quintiles either rose much more slowly or actually declined in the case of the bottom income quintile (see Table 3). During this same period, the total federal effective tax rate of families in the top two income quintiles declined, while in the bottom three quintiles it rose (see Table 4). Although federal taxes in 1990 are more progressive than they were in 1985, they are less progressive than they were in either 1977 **or 1980.**

The increased reliance placed on social insurance payroll taxes is the major explanation for the reduced progressivity of the tax system. Lowering payroll tax rates over the next 25 years with no offsetting changes in other federal spending or taxes would ameliorate this situation somewhat. If the Balanced Budget Act deficit targets were adhered to, however, offsetting changes in spending or taxes would be required. Whether the end result would be to make federal taxes more or less progressive or the distribution of income more or less equal would depend on the nature of these offsetting measures. Among the many possible offsets to the **deficit-increasing** effects

TABLE 3.   AVERAGE ADJUSTED FAMILY INCOME (Income expressed as multiples of the poverty thresholds)

Quintile[a]	1977	1980	1985	1990[b]	Percent Change 1977-1990	Percent Change 1980-1990	Percent Change 1985-1990
Lowest[c]	0.95	0.86	0.80	0.84	-11.8	-3.2	4.5
Second	2.06	1.92	1.86	2.00	-2.7	4.3	7.3
Third	3.09	2.93	2.96	3.18	2.8	8.4	7.2
Fourth	4.34	4.17	4.35	4.70	8.4	12.6	8.0
Highest	8.70	8.61	9.83	11.34	30.3	31.7	15.3
Top 10 percent	11.46	11.39	13.39	15.76	37.6	38.4	17.7
Top 5 percent	15.22	15.42	18.65	22.52	48.0	46.1	20.8
TOTAL[d]	3.84	3.69	3.96	4.39	14.3	18.7	10.8

SOURCE: Congressional Budget Office Tax Simulation Model.

a.   Ranked by size of adjusted family income.
b.   Projected based on Internal Revenue Service and Census Bureau data, using CBO economic forecast.
c.   Excludes families with zero or negative incomes.
d.   Includes families with zero or negative incomes not shown separately.

TABLE 4.   TOTAL FEDERAL EFFECTIVE TAX RATES

Quintile[a]	1977	1980	1985	1990[b]	Percent Change 1977-1990	Percent Change 1980-1990	Percent Change 1985-1990
Lowest[c]	9.5	8.4	10.6	9.7	2.6	16.1	-8.1
Second	15.6	15.7	16.1	16.7	6.6	6.0	3.8
Third	19.6	20.0	19.3	20.3	3.6	1.2	5.1
Fourth	21.9	23.0	21.7	22.5	2.6	-2.2	3.6
Highest	27.1	27.3	24.0	25.8	-4.6	-5.5	7.4
Top 10 percent	28.7	28.4	24.4	26.4	-8.1	-7.3	8.2
Top 5 percent	30.5	29.5	24.5	26.7	-12.5	-9.5	9.0
TOTAL[d]	22.8	23.3	21.7	23.0	12	-1.0	5.9

SOURCE: Congressional Budget Office Tax Simulation Model.

NOTE: Federal taxes include the individual and corporate income taxes, social insurance taxes, and excise taxes.

a.   Ranked by size of adjusted family income.
b.   Projected based on Internal Revenue Service and Census Bureau data, using CBO economic forecast.
c.   Excludes families with zero or negative incomes.
d.   Includes families with zero or negative incomes not shown separately.

of a payroll tax cut, two--an increase in income tax rates and the imposition of a federal value-added (sales) tax (VAT)--are examined in this statement.

## Effects on the Distribution of Tax Burdens and After-Tax Incomes

If payroll taxes were reduced by $50 billion and not offset by increases in other taxes, the tax burdens--federal taxes as a percent of pre-tax incomes --of lower-income families would be reduced relatively more than those of middle- and upper-income families (see Figure 1). These results reflect the assumption that the employers' share of payroll taxes is ultimately paid by workers in the form of lower wages. The percentage decrease in tax burdens would range from 10.5 percent among the fifth of families with the lowest incomes to 3.4 percent among the families in the top income quintile.

While low-income families would receive the largest percentage decreases in taxes, the effect of these reductions on their disposable incomes would be considerably smaller because they pay relatively little of their income in taxes. Two-fifths of families in the lowest income quintile pay no payroll taxes, as compared with one-fifth in the next highest quintile, and 10 percent to 15 percent in the remaining quintiles. The average tax reduction among the one-fifth of families with the lowest incomes would be $81, while that received by the one-fifth of families with the highest incomes would be $974. The payroll tax reductions would raise the after-tax incomes of families in the lowest income quintile by 1.1 percent and the after-tax income of
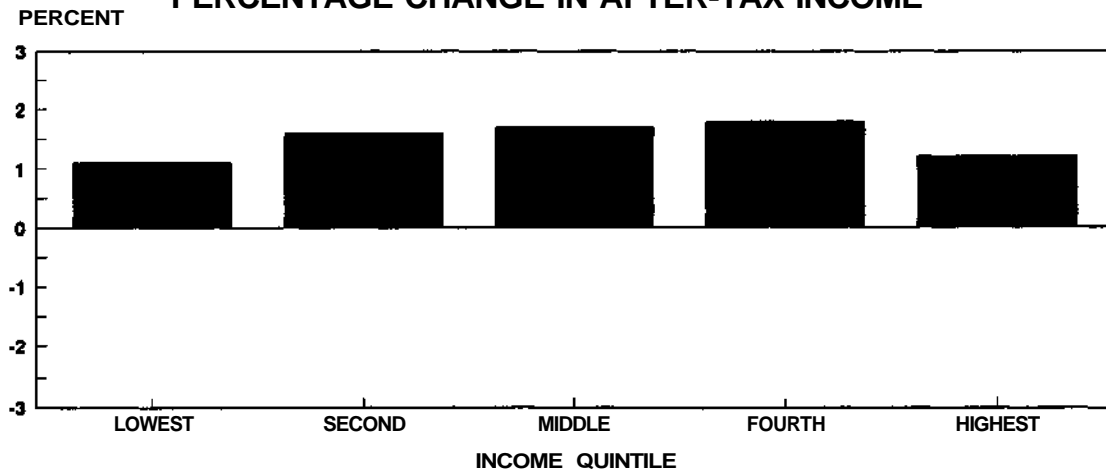
FIGURE 1. S. 2016

AVERAGE CHANGE IN TAXES
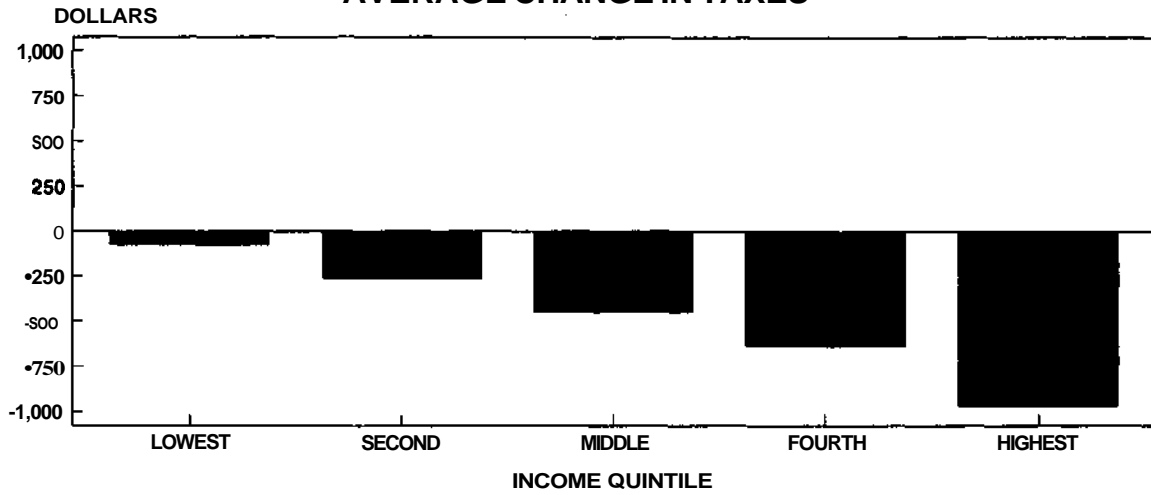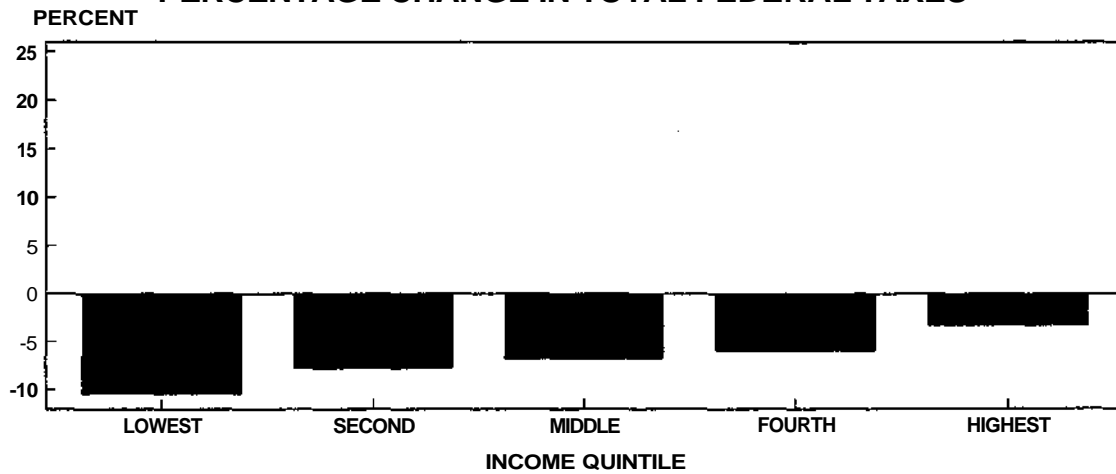
DOLLARS

INCOME QUINTILE

PERCENTAGE CHANGE IN TOTAL FEDERAL TAXES

PERCENT

INCOME QUINTILE

PERCENTAGE CHANGE IN AFTER-TAX INCOME

PERCENT

INCOME QUINTILE

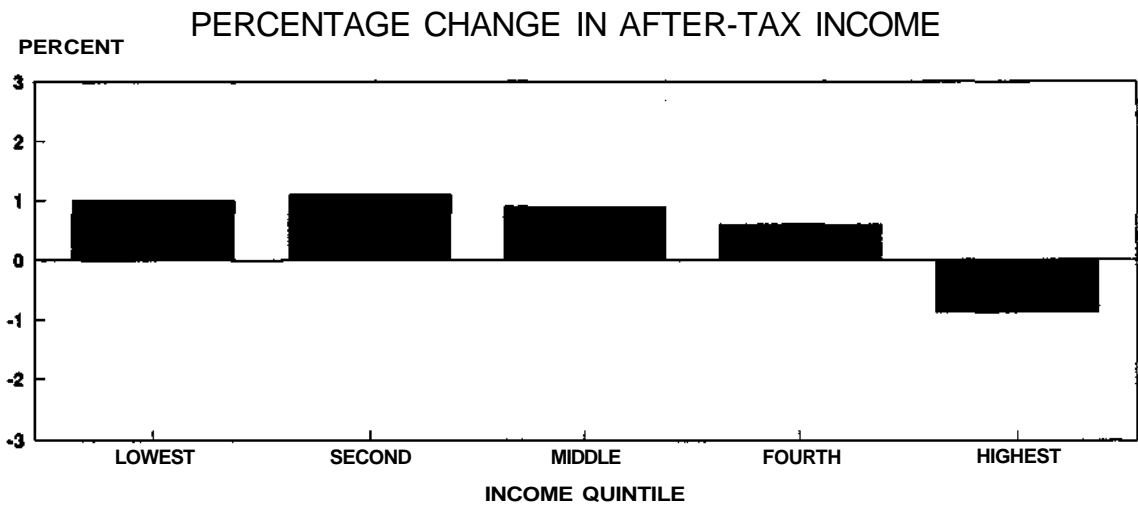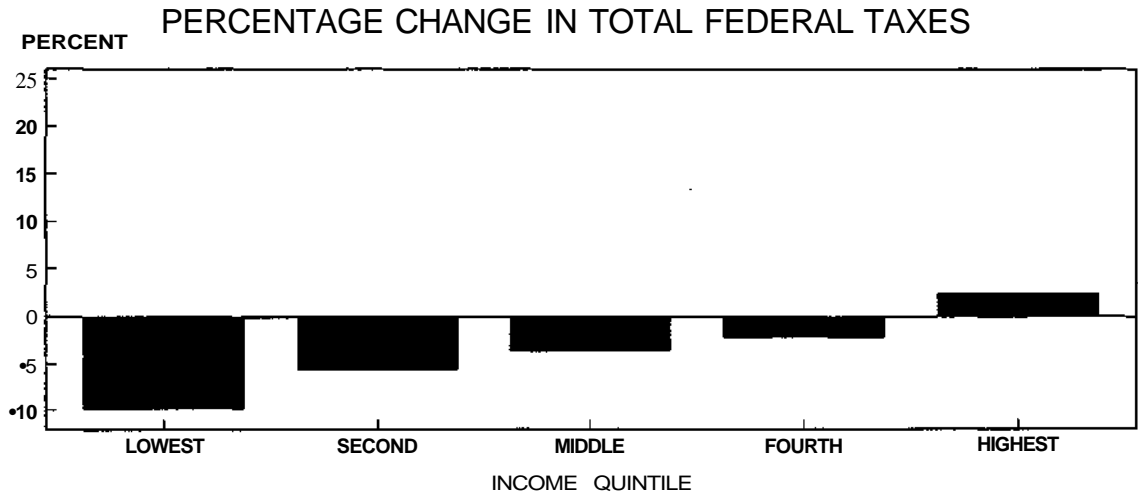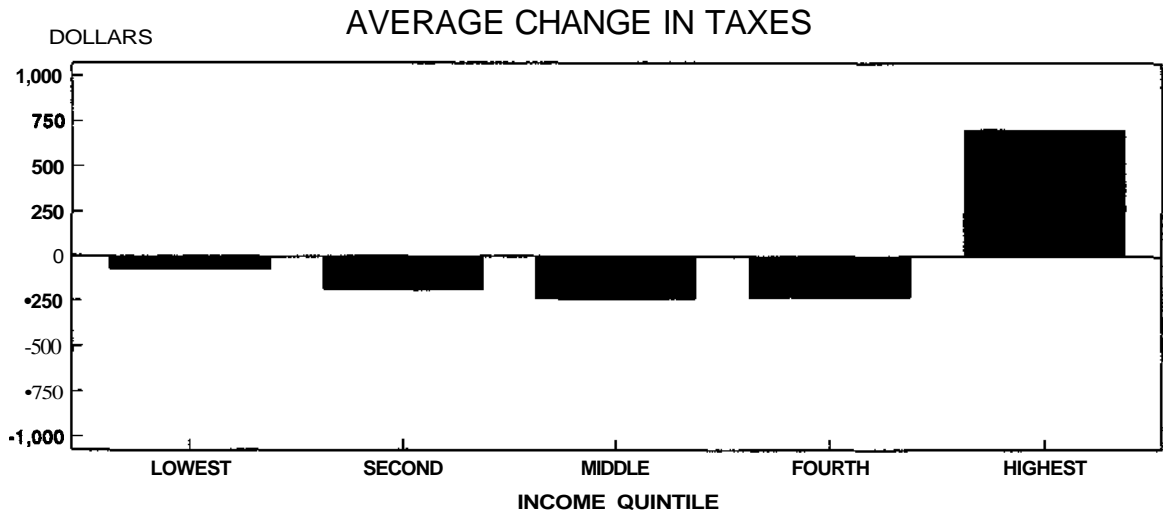SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

families in the highest income quintile by 1.2 percent. Thus, lowering payroll taxes would not appreciably increase the share of after-tax income received by low-income families.

Offsetting Increases in Income-Tax Rates

If the $50 billion in lost revenue from the payroll tax were replaced through a surcharge of about 10 percent on individual income taxes, the U.S. tax system would be more progressive (see Figure 2). About four-fifths of taxpayers would receive net cuts in taxes paid, with the size of the estimated cuts ranging from an average of $75 among the one-fifth of families with the lowest incomes to an average of $239 among the one-fifth with middle incomes. The one-fifth of households with the highest incomes would pay an average of $703 more in net taxes. These changes would lower the tax burdens of families in the bottom income quintile by almost 10 percent, while raising the tax burdens of families in the top income quintile by 2.4 percent. Moreover, the changes would move effective tax rates among different groups almost back to where they were in 1980.

At the same time, these amounts represent relatively small percentage changes in after-tax incomes. The relative change in after-tax incomes would, however, be progressive, ranging from a 1 percent increase among families

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FIGURE 2. S. 2016 WITH OFFSETTING INCOME TAX SURCHARGE

AVERAGE CHANGE IN TAXES

DOLLARS

INCOME QUINTILE

PERCENTAGE CHANGE IN TOTAL FEDERAL TAXES

PERCENT

INCOME QUINTILE

PERCENTAGE CHANGE IN AFTER-TAX INCOME

PERCENT

INCOME QUINTILE

SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

in the bottom quintile to a 0.9 percent decrease among families in the top quintile.

Replacing payroll taxes with income taxes would also change the distribution of taxes paid among different types of taxpaying households. The high-income elderly, most of whom do not pay Social Security taxes, would be more likely to pay higher net taxes than younger taxpayers. Elderly families in the one-fifth of the population with the highest incomes would face a net tax increase averaging $1,224 as compared with $703 for all families in the top quintile.

Effects of Imposing a Federal Value-Added Tax

If the revenue lost from lowering payroll tax rates were made up by imposing a value-added tax, it would make the tax system less progressive, as shown in Figure 3.[2] The impact of levying a value-added tax of a little over 3 percent would be to increase the net taxes of the two-fifths of families with the lowest incomes by between $22 and $147. The remaining families would receive net tax reductions of between $43 and $106. The one-fifth of families with the lowest annual incomes would face the largest net increase in taxes. Many of these households spend more than their annual income by borrowing or by
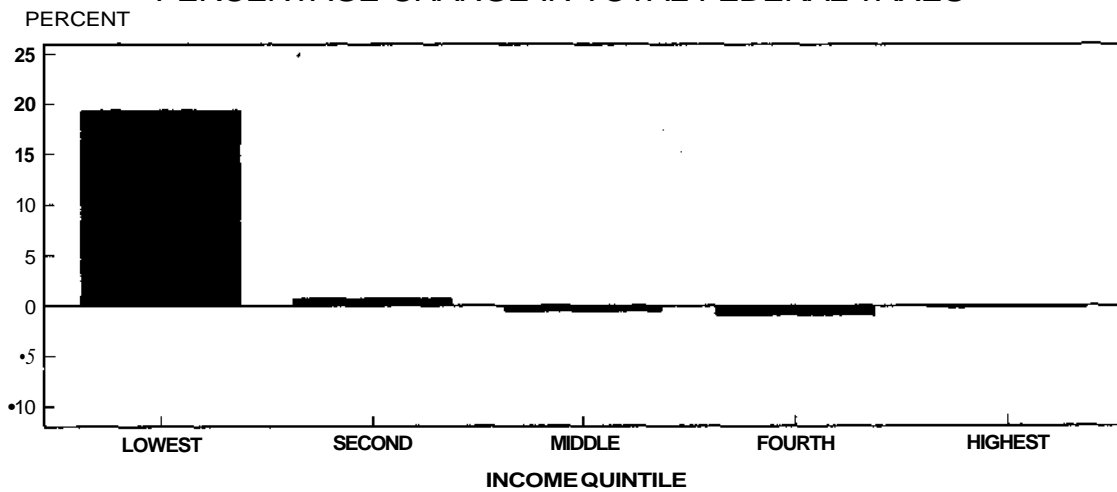
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2.   The simulations are for a VAT that excludes food purchased for home consumption, housing expenditures (including utilities), medical care, educational expenditures, and contributions to religious and charitable organizations. This VAT is similar to that proposed by Senator Hollings as a replacement for lower payroll taxes.

FIGURE 3. S. 2016 WITH OFFSETTING
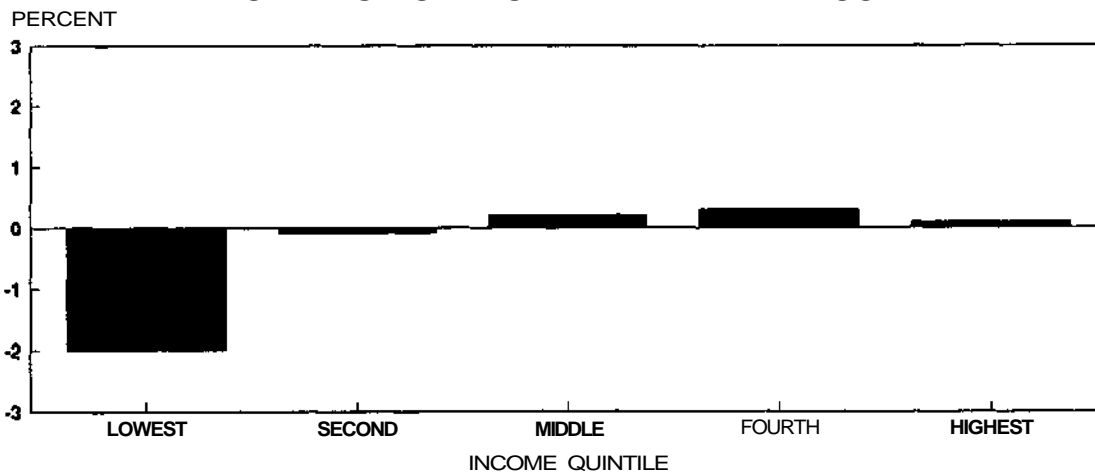# VALUE-ADDED TAX

AVERAGE CHANGE IN TAXES
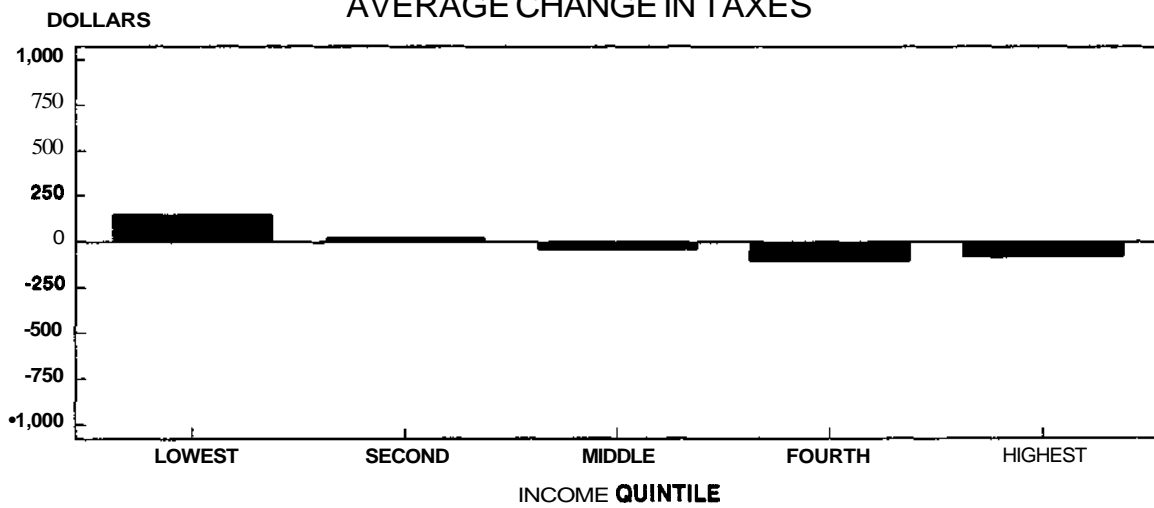
DOLLARS

INCOME QUINTILE

PERCENTAGE CHANGE IN TOTAL FEDERAL TAXES

PERCENT

INCOME QUINTILE

PERCENTAGE CHANGE IN AFTER-TAX INCOME

PERCENT

INCOME QUINTILE

SOURCE: CONGRESSIONAL BUDGET OFFICE TAX SIMULATION MODELS.

selling assets, as for example would be likely among the elderly. Households in such circumstances would pay relatively little in payroll taxes, and thus would receive little or no tax relief from lowering such taxes, but they would pay value-added taxes on their purchased consumption.

These changes would increase the tax burden of the one-fifth of families with the lowest annual incomes by 19.1 percent, while raising or lowering the tax burdens of the remaining families by small percentages. As in the case of increases in income tax rates, these changes in net taxes represent fairly small changes in the after-tax incomes of families. Unlike the income tax, they would be regressive, ranging from a 2.0 percent decrease in after-tax incomes among the one-fifth of taxpayers with the lowest incomes to a 0.1 percent increase among taxpayers in the highest income quintile.

While replacing payroll taxes with a VAT would make the present tax system less progressive, let me note that these measures overstate the increase in regressivity because a portion of families with low incomes in a particular year are not needy by other standards. Some households, for example, are able to sell assets to pay for spending that exceeds income. Value-added taxes would take up a larger share of the income of such households than it would of households that finance spending entirely from their annual income. In this case, value-added taxes would appear regressive, even though some families able to pay for spending out of existing wealth may not be needy.

A switch from payroll taxes to a VAT would also change the taxes paid by different types of households. It would increase net taxes paid by all older families, though the increase would be considerably less under a value-added tax than under a surcharge on the individual income tax.

The Administrative and Compliance Costs of Changing to Different Taxes

Changing the mix of taxes in the way described above would also affect the costs of administering the tax system, and the cost of complying with it. However, the effect is only likely to be significant when a new tax like the value-added tax is imposed. Based on a Treasury Department estimate for 1984, the administrative cost to government of instituting and collecting a value-added tax would be about $1 billion.

Effects on Incentives to Work and Save

The possible shifts among different types of federal taxes described above could also result in modest changes in the tax incentives affecting important economic decisions regarding how much to work and how much to save, though these changes are unlikely to have significant economic effects. Replacing $50 billion of payroll tax revenue with an income tax surcharge would slightly increase the marginal tax rate on income from saving and investment. However, changes in the after-tax return to saving do not seem

to have much effect on the amount that households save; thus, the small increase in marginal tax rates is unlikely to have much effect. The effects on incentives of substituting a value-added tax for the revenue lost from reducing payroll tax rates will probably have little perceptible effect on incentives to work or to save.

Other Alternatives

Reduced payroll taxes could be offset in many more ways than the two examples discussed above. Some people have suggested that higher gasoline taxes should be considered. A detailed discussion of this alternative is not included in my testimony largely because it could have far-reaching effects on the economy, which would require considerable analysis. In order to raise $50 billion in net revenue, it would be necessary to raise the gasoline tax by about 50 cents per gallon, an increase that is beyond the realm of U.S. historical experience. Preliminary simulations of the distributional effects of replacing $50 billion in payroll taxes with higher gasoline taxes, however, suggest that this alternative would be even more regressive than a VAT.

IMPLICATIONS OF S. 2016 FOR SOCIAL SECURITY FINANCING

The previous discussion of the overall economic, budgetary, and distributional implications of S. 2016 does not address the more narrow but equally important issue of how the nation should finance Social Security benefits.

S. 2016 has rekindled an old debate on Social Security financing. Should payroll tax rates be set so as to produce annual revenues approximately equal to annual outlays? Or should a reserve be built up, thereby establishing substantial interest earnings as an important source of financing?

Until 1972, tax rates were scheduled so that significant trust fund buildups would develop in the long run without subsequent legislative action. These substantial reserves never materialized, primarily because benefits were increased sufficiently to absorb the reserves before they could build up. As a result, the program was run on a de facto pay-as-you-go basis during the 1951-1972 period. The 1972 amendments, which indexed benefits to inflation, effectively legislated the pay-as-you-go structure. Five years later, the 1977 amendments reversed course and restored a significant trust fund buildup over the 1980-2010 period by moving a scheduled payroll tax increase from 2011 to 1990. For the first time, however, the long-range financing was not sufficient to meet anticipated program costs for the next 75 years, and the trust fund buildup was to be dissipated by 2030. This pattern of trust fund buildup and subsequent depletion (now projected to occur in 2046) was magnified by the Social Security Amendments of 1983.

S. 2016 would eliminate this pattern of reserve accumulation and depletion. The bill would establish a payroll tax rate schedule designed to result in total trust fund income sufficient to pay benefits and to maintain a one-year contingency reserve in the trust funds. Payroll tax rates would be

lower than under current law from now until 2014, and higher after 2019. In other words, the Social Security payroll taxes paid by baby-boom workers would be reduced while those levied on the relatively smaller cohorts of workers who follow them would be raised.

Evaluating Alternatives to Social Security Financing

Several important characteristics of the Social Security program and the underlying demographic trends help to focus the discussion of the program's financing. First, under current law, benefits depend on a formula based on earning records, not on tax payments. Thus, there is no direct link between the benefit a worker receives and the Social Security taxes the worker paid. Even if the payroll tax were halved, individuals would receive their payments so long as adequate spending authority (regardless of its source) resided in the trust funds. For example, if all income were provided to the Social Security trust funds through a transfer of general revenues rather than through the dedication of payroll taxes, benefit payments would be unaffected. Therefore, the difference in Social Security between S. 2016 and current law exists only with respect to the source of revenues, not to outlays.

Second, because both future benefits and the payroll tax base are indexed to wages, changes in economic growth do not substantially affect the balance between Social Security costs and income. Real wage growth translates relatively quickly into benefit payments. Although about 2 percent

more of GNP will have to be devoted to Social Security benefits in 2030 and thereafter compared with now, this increased share is little affected by the rate of economic growth. Thus, as a share of payroll or of GNP, the changes in Social Security resulting from faster or slower growth are smaller than generally imagined. For example, if real wages grow by 0.8 percent a year rather than 1.3 percent as is assumed in the "intermediate **II-B** assumptions" used by the Social Security Trustees, real wage levels in 2030 would be 18 percent lower. However, the fraction of GNP needed to pay benefits would increase by only 0.3 percentage points (from 6.68 to 6.94 percentage points). The required payroll **tax--under** a pay-as-you-go **approach--would** have to increase the payroll tax rate on both employers and employees by about 0.3 percent. As these figures show, the economic growth does relatively little to change the slice of the economic pie consumed by Social Security, but it has significant effects on the size of the whole pie to be carved up.

Third, under current demographic forecasts, the maturing of the baby boom does not represent a one-time swelling of the elderly's share of the population, but rather a permanent shift to a higher ratio of the aged population to the working-age population. If there is an economic logic in the accumulation of trust fund reserves, there is little such justification for dissipating those reserves given the underlying demographics. To avoid this depletion of the trust fund, a recent **Brookings** Institution study advocates scheduling future increases in tax rates. By building and maintaining Social

Security reserves, the study argues, each cohort of workers would be making more of a contribution to its own future retirement benefits.

Under current law, the tax rate needed to assure adequate funding of benefits in the year 2045 is identical to that proposed in S. 2016. Therefore, considering only the financing of the existing benefit structure and not economic growth, the real question when the baby boom retires is: what revenues will be increased or **what** spending will be reduced? According to the 1989 Social Security Trustees' Report, about 75 percent of benefits in the year 2030 will be supported through payroll tax revenues, 5 percent through income from the taxation of benefits, and 20 percent through interest payments on the trust fund reserves. Obviously, other federal revenues must be used to pay the interest. These revenues would equal about 1.3 percent of GNP, or an amount roughly equivalent to raising current corporate income tax revenues by two-thirds or personal income taxes by 15 percent. In contrast, S. 2016 relies almost totally on payroll tax and the taxation of benefits to support the program in 2030.

Financing Decisions and Future Benefits

Although there is no direct effect on benefits of moving back to pay-as-you-go financing, as is incorporated into S. 2016, other indirect effects may take place. First, some observers believe that a one-year contingency reserve is too small to weather severely adverse economic conditions such as those

experienced from the mid-1970s to the early 1980s. A larger reserve--perhaps 135 percent to 150 percent of annual **outlays--would** be necessary to ensure the timely payment of benefits under current law without an infusion from the general fund, at least if these conditions were to be repeated in the 1990s.

While the 1983 amendments provide for some safeguards against rapid depletion of reserves, the "stabilizer" provision does not kick in until the contingency ratio falls to 20 percent. The stabilizer mechanism itself may involve a reduction in annual **cost-of-living** adjustments, but only if the rate of inflation exceeds wage growth. In addition, such low reserves would probably encourage calls for tax increases or benefit reductions in order to restore adequate reserves.

Alternatively, current funding practices would result in substantial reserves over the next 30 years even if economic or demographic patterns were to worsen substantially. Thus, the reserve accumulation may provide significant protection for continuing benefits under current law, although it could inhibit making some desireable changes.

Second, when the retirement of the baby boom causes total benefits to rise in the next century, a pay-as-you-go system would entail a series of payroll tax increases as S. 2016 prudently schedules. At that time, workers might demand greater scrutiny of the Social Security benefit structure in

exchange for accepting these payroll tax hikes. In contrast, the accumulation of reserves expected under current law would provide spending authority for the trust funds for many years after Social Security costs exceed the program's tax revenues. In this respect, they delay the stage at which trust fund financing would force any reassessment of the benefit structure. But the baby boom's retirement will in any event lead to overall fiscal pressures on the federal government, requiring additional taxes or reduced spending.

Third, while a return to pay-as-you-go financing may increase the potential for future benefit adjustments, it may also create additional flexibility for adapting to changing conditions. Social changes--such as greater participation of married women in the labor force, expanded private pension participation, increased life expectancies, and the continued shift to service occupations--may make some restructuring of Social Security desirable. In addition, economic conditions can change. For example, if the 1990s were to mimic the 1970s, static or actually declining living standards of workers and their families might lead policymakers to reconsider the degree to which resources from the working population to the aged are redistributed as embodied in federal tax and spending policies. Although the financing problems of the late 1970s and early 1980s required the Congress and the President to agree to painful tax increases and benefit cuts, many of the changes--taxing benefits, extending coverage, imposing tighter limits on family benefits--could be justified both for programmatic reasons and on the grounds of overall equity and efficiency. Had the trust funds held significant reserves

as are projected for the next several decades, these sound policies might never have been carried out.

Fourth, in contrast to the trust fund buildup projected under current law, the one-year reserve levels envisioned under S. 2016 are sufficiently small to provide some restraint on increasing benefits. Many observers fear that the current projected trust fund surpluses may encourage an expansion of benefits that would further increase the aged's claim on future resources.

CONCLUSION

Large federal deficits combined with relatively low U.S. savings rates jeopardize the future growth in the standard of living for Americans. Without significant economic growth, future taxpayers may be both less willing and less able to support existing federal commitments including those for Social Security and Medicare. Therefore, S. 2016 raises the issues of not only how we structure our taxes to finance Social Security, but also what our overall commitments should be to savings, investment, and economic growth.

Social Security is woven deeply into the fabric of American society. The program affects roughly 133 million workers and over 39 million beneficiaries, with its payroll taxes accounting for more than one-quarter of total federal revenues and its benefits constituting one-fifth of total federal expenditures. Nearly two out of every five workers find their own **FICA** payments exceeding

their income tax liabilities, and about three-quarters face combined employee/employer payroll taxes that are greater than their income taxes. Over one-half of aged Social Security recipients depend on these benefits for the major share of their total income. Moreover, millions of other family members receive insurance protection against income lost with the retirement, disability, or death of a worker. These statistics highlight that any program changes, whether they alter benefit payments or the way the program is financed, deserve much careful study and debate.