CBO TESTIMONY

Statement of
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Mr. Chairman, I appreciate this opportunity to appear before you today. My comments focus on deficit reduction options affecting Social Security, illustrating both the likely budgetary effects of such measures and their distributional impacts. These options will appear in the Congressional Budget Office's (CBO's) annual volume entitled *Reducing the Deficit: Spending and Revenue Options*, which will be released next week. Before turning to the options themselves, I will briefly review CBO's budget outlook for the next decade.

THE BUDGET OUTLOOK

Although CBO projects little change in the total federal deficit over the next several years, we also foresee that by 1996 the deficit will again begin to rise. If policies continue unchanged for the next decade, the total deficit will climb from $310 billion in 1993 to more than $650 billion in 2003, or from 5.0 percent of the nation's output to about 6.8 percent (see Table 1).

This pattern by itself would be troubling enough. But combined with historically low private savings rates, these deficits jeopardize the future living standards of virtually all U. S. citizens. The United States has already become a net borrower rather than net creditor in world financial markets, and continued low levels of national savings will further hinder this country's

TABLE 1. THE BUDGET OUTLOOK THROUGH 2003 (By fiscal year)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
						In Billions of Dollars					
Outlays											
On-budget	1,186	1,226	1,285	1,345	1,423	1,516	1,610	1,711	1,823	1,946	2,080
Off-budget	267	281	289	298	310	323	333	344	354	366	377
Total	1,453	1,507	1,575	1,643	1,733	1,839	1,943	2,055	2,178	2,312	2,458
Revenues											
On-budget	825	879	934	981	1,021	1,071	1,112	1,155	1,200	1,249	1,300
Off-budget	317	336	356	376	393	411	427	445	464	484	504
Total	1,143	1,215	1,291	1,356	1,414	1,482	1,540	1,600	1,664	1,733	1,804
Deficit											
On-budget	361	347	351	365	402	445	498	556	623	697	780
Off-budget	-51	-56	-67	-78	-83	-88	-94	-102	-110	-118	-127
Total	310	291	284	287	319	357	404	455	513	579	653
						As a Percentage of GDP					
Outlays											
On-budget	19.2	18.8	18.8	18.7	18.9	19.3	19.7	20.0	20.5	21.0	21.5
Off-budget	4.3	4.3	4.2	4.1	4.1	4.1	4.1	4.0	4.0	3.9	3.9
Total	23.5	23.2	23.0	22.8	23.0	23.4	23.7	24.1	24.5	24.9	25.4
Revenues											
On-budget	13.4	13.5	13.6	13.6	13.5	13.6	13.6	13.5	13.5	13.5	13.4
Off-budget	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Total	18.5	18.7	18.8	18.8	18.7	18.8	18.8	18.7	18.7	18.7	18.7
Deficit											
On-budget	5.9	5.3	5.1	5.1	5.3	5.7	6.1	6.5	7.0	7.5	8.1
Off-budget	-0.8	-0.9	-1.0	-1.1	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3	-1.3
Total	5.0	4.5	4.1	4.0	4.2	4.5	4.9	5.3	5.8	6.2	6.8
Memorandum: Gross Domestic Product	6,173	6,508	6,855	7,202	7,543	7,873	8,192	8,537	8,901	9,280	9,674

SOURCE: Congressional Budget Office.

NOTE: Off-budget includes Social Security and Postal Service.

efforts to remain competitive in world markets by making it more difficult to finance public and private investments in our physical and human capital.

The most straightforward approach for enhancing national savings and for increasing long-run economic growth is to reduce the federal deficit. Although deficit reduction may dampen the economic recovery that now appears to be taking hold, a more stimulative monetary policy could cushion growth in income and employment from the effects of deficit reduction measures.

Of course, though the ailment is easily diagnosed, there are no painless remedies. Deficit reduction requires slowing the growth of spending, raising revenues, or both. Significant and credible deficit reduction will not come from rejecting relatively weak claims on federal resources, but rather from thoughtful changes in major federal programs and tax policies, perhaps even including modifications in Social Security benefits and revenues.

Including Social Security in any discussion of deficit reduction options always generates controversy. Its size and popular support, as well as its financing mechanism and trust fund status, often lead individuals to argue that it should be excluded from budget considerations. In fact, the one-fifth of government outlays and more than one-quarter of government revenues represented by Social Security are legally outside the official budget of the United States government. However, because the fiscal impact of federal spending and tax decisions relate more closely to overall federal activities, not just those on-budget, CBO and the Office of Management and Budget (OMB) continue to present the total deficit as well as the on-budget and the off-budget totals.

Those who would put Social Security options on the table argue that excluding Social Security from a deficit reduction package makes cutting the deficit more difficult, and would require that other components of the budget be more severely cut if specific budget targets are to be attained. Moreover, exempting Social Security makes it easier for advocates of other programs to claim they deserve similar treatment, thereby making consensus on deficit reduction more difficult to achieve.

Excluding Social Security from deficit reduction can also distort the perception of the relative merits of other options. For example, the Congress will probably consider a number of options that would increase the out-of-pocket health care costs of Medicare enrollees, most of whom are also Social Security recipients. These Medicare changes may have a greater impact on certain low-income enrollees than would proposals affecting Social Security COLAs or the taxation of Social Security benefits.

OPTIONS FOR REDUCING COLAS IN SOCIAL SECURITY AND OTHER NON-MEANS-TESTED BENEFIT PROGRAMS

One general strategy for achieving budget savings in major entitlement programs is to reduce or eliminate the annual benefit increases, often referred to as cost-of-living adjustments (COLAs), designed to maintain the purchasing power of benefits in the face of inflation. In its forthcoming deficit reduction volume, CBO presents three options that would affect COLAs for all non-means-tested cash benefit programs. All three options would exempt means-tested programs from COLA reductions and thereby protect the low-income families receiving these benefits from any income losses from the COLA restrictions. One option would also limit Social Security COLAs only for recipients with benefits above a certain level.

Eliminating the fiscal year 1994 COLA would save about $6.9 billion in 1994 and about $49.4 billion over the 1994-1998 period (see Table 2). These estimates assume that the link between the Social Security COLA and the annual increase in the maximum earnings limit subject to Social Security and Medicare taxes would be severed and that the wage bases would continue to rise with average wages. Another option would limit the COLAs for the next five years to two-thirds of the increase in prices, reducing federal expenditures by an estimated $47.6 billion over the next five years. Cutting the COLAs to 2 percentage points less than the inflation rate would reduce federal spending over the next five years by about $100.3 billion. The net impact of the reductions in Social Security COLAs, including offsets in other programs, account for about 75 percent to 80 percent of the total savings.

The interactions between Social Security COLAs and spending in other programs deserve some discussion. For individuals receiving both Supplemental Security Income (SSI) and Social Security, for example, the monthly income is essentially the SSI benefit level plus the $20 disregard for unearned income (in this case, Social Security benefits). If COLAs on SSI remain unchanged, the income of SSI recipients is unaffected if Social Security COLAS are reduced or eliminated, though the share of their income from SSI rises and that from Social Security falls. Consequently, in COLA options exempting means-tested programs such as SSI and Food Stamps,

TABLE 2. RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate COLAs for One Year			
Social Security/ Railroad Retirement	6.6	9.0	8.9	8.7	8.3	41.5
Other Non-Means-Tested Programs	1.7	2.3	2.4	2.4	2.5	11.3
Offsets in Means-Tested Programs and Medicare Premiums	-1.5	-0.8	-0.4	-0.4	-0.4	-3.4
Total	6.9	10.5	10.9	10.7	10.4	49.4
			Limit COLAs to Two-Thirds of the CPI Increase for Five Years			
Social Security/ Railroad Retirement	2.2	5.1	7.9	10.8	13.7	39.7
Other Non-Means-Tested Programs	0.6	1.3	2.1	2.8	3.7	10.5
Offsets in Means-Tested Programs and Medicare Premiums	-0.1	-0.2	-0.4	-0.8	-1.1	-2.6
Total	2.7	6.2	9.5	12.9	16.3	47.6
			Limit COLAs to the CPI Increase Minus 2 Percentage Points for Five Years			
Social Security/ Railroad Retirement	4.4	10.5	16.8	23.1	29.3	84.1
Other Non-Means-Tested Programs	1.2	2.8	4.4	6.0	7.8	22.1
Offsets in Means-Tested Programs and Medicare Premiums	-0.3	-0.6	-1.1	-1.7	-2.3	-5.9
Total	5.3	12.7	20.1	27.4	34.8	100.3
			Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years			
Social Security/ Railroad Retirement	0	0.7	1.8	2.8	3.8	9.1

SOURCE: Congressional Budget Office.

NOTE: Reductions in Social Security spending or increases in Social Security taxes would reduce the total federal deficit and the amount of federal borrowing from the public. These savings would not be counted, however, under the pay-as-you-go provisions of the Budget Enforcement Act of 1990.

spending in means-tested programs rises to offset some of the savings in the non-means-tested programs.

A somewhat different interaction occurs with regard to Medicare premiums for the Supplementary Medical Insurance (SMI) portion of that program. First, the estimates assume that the existing provision in law (sometimes referred to as the hold-harmless provision) that prevents an increase in the SMI premium from reducing the Social Security check received by the beneficiary would continue to apply. Thus, even though the monthly SMI premium will rise from $36.60 in 1993 to $41.10 in January 1994, eliminating the next COLA in Social Security would result in most Medicare beneficiaries not having to pay the premium increase next year. The hold-harmless provision does not affect the premiums paid by Medicare enrollees who pay quarterly or those whose premiums are paid by a third party such as Medicaid. Under a one-year COLA freeze, however, the monthly Medicare premiums of most beneficiaries would eventually return to their levels under current law with the 1995 Social Security benefit increase.

In contrast, the offsets in Medicare premiums for the options limiting COLAs for five years have two components. First, they have much smaller hold-harmless effects than the COLA freeze option because most Medicare beneficiaries would still see a larger rise in their cash benefit than the premium increase. Even those with small Social Security benefits would pay at least a portion of the premium increase. Second, beginning in 1996, SMI premiums are scheduled to increase at the rate of the previous year's Social Security COLA. Therefore, limits on the COLA increases after 1994 would reduce the SMI premium increases as well.

INCREASED TAXATION OF SOCIAL SECURITY BENEFITS

The other major options directly affecting Social Security recipients would increase the taxation of benefits. The Social Security Amendments of 1983 made a portion of Social Security benefits subject to federal income taxes for the first time. Current law includes in adjusted gross income (AGI) the lesser of one-half of Social Security benefits or one-half of the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security benefits) over a certain amount. The thresholds are $25,000 for single returns and $32,000 for joint returns. Because these thresholds are fixed over time, nominal growth in income will increase the percentage of recipient households who pay tax on some of their benefits. The Joint Committee on Taxation projects that the percentage of recipient families who will pay taxes on their Social Security benefits will grow from 23 percent in 1994 to 30 percent in 1998.

Two ways of increasing taxation of Social Security benefits are to increase the fraction of benefits included in AGI, or to eliminate or reduce the thresholds. The CBO deficit reduction volume includes both variations. One option would increase the taxable portion of Social Security benefits to 85 percent. This increase would accord Social Security benefits for workers with high earnings an income tax treatment similar to that used for contributory pensions, in which the individual's contribution is exempt from taxation when the pension benefits are paid. This percentage would be more generous for most workers than the contributory pension standard because most workers' contributions are less than 15 percent of their expected benefits. The Social Security Administration argues that it would be administratively too burdensome to calculate precise ratios for each worker, however.

If the taxable percentage were increased to 85 percent while maintaining the current thresholds, federal revenue would increase by an estimated $2.8 billion in 1994 and $31.5 billion over the 1994-1998 period (see Table 3). If the thresholds were eliminated and the taxable percentage raised to 85 percent, the comparable estimates would be $10.6 billion and $112.5 billion, respectively--or about four times as large as when the current thresholds are retained.

TABLE 3. INCREASE TAXATION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Retain the Current Income Thresholds					
Increase the Fraction of Benefits Included in Adjusted Gross Income to Tax up to 85 Percent of Benefits	2.8	6.0	6.8	7.5	8.3	31.5
	Eliminate the Income Thresholds					
Tax 50 Percent of Benefits	3.9	9.8	9.9	10.0	10.0	43.6
Tax 85 Percent of Benefits	10.6	24.1	25.0	25.9	26.9	112.5

SOURCE: Joint Committee on Taxation.

The budgetary effects of options affecting COLAs and the increased taxation of benefits often have different patterns of savings over time. COLA restrictions imposed for one year or for several years produce annual deficit reductions that soon begin to decline and eventually to disappear as beneficiaries affected by the COLA limitations die or otherwise leave the benefit rolls. They also affect recipients differently depending on when the recipients become eligible for benefits. This effect occurs because COLA limitations only affect those people who are eligible to receive benefits in the years when COLAs are restricted. For example, eliminating the 1994 COLA, without altering the benefits for those becoming eligible in 1994 or later, would create disparities by leaving those newly eligible relatively better off. Combining a COLA freeze with a reduction in the benefits of those who become eligible in the future would eliminate this disparity while also ensuring an ever-growing budgetary effect. The taxation options have this growing effect inherently because revenues rise automatically as total benefits increase. Moreover, with the options that retain the current thresholds, savings climb at a faster rate than benefits as a larger and larger portion of the beneficiary population sees its nominal income rise above the fixed-dollar thresholds.

DISTRIBUTIONAL EFFECTS: A COMPARISON OF ELIMINATING THE 1994 COLA AND INCREASING THE TAXATION OF BENEFITS

CBO has analyzed the impact of two options on the after-tax distribution of income of Social Security recipients. Those options are skipping the 1994 COLA and increasing the taxation of Social Security benefits while retaining the current-law thresholds. (Table 4 displays the results of these simulations for recipient families ranked by quintiles of family income).

On average, eliminating the 1994 COLA would reduce after-tax incomes for families receiving Social Security by an estimated $278 in that year, or 0.9 percent of income. Families in the lowest income quintile would lose an estimated $158 in 1994, about 2.0 percent of their after-tax income; the recipients in the highest quintile are estimated to lose $326 per family in 1994, about 0.4 percent of income. Families in the second highest quintile would feel the largest dollar impact--an estimated $335 loss in 1994.

Increasing the proportion of Social Security benefits subject to the income tax from 50 percent to 85 percent, for those people already having some portion of the benefits taxed, would reduce after-tax income by about 0.5 percent in 1994 for all recipients. But it would lower by about 1.1 percent the after-tax income of those actually paying the increased taxes. More than three-quarters of Social Security beneficiaries would not have any increase in

TABLE 4. DISTRIBUTIONAL EFFECTS OF ELIMINATING 1994 SOCIAL SECURITY COLA AND INCREASING TAXATION OF BENEFITS TO 85 PERCENT

Recipient Families by Adjusted Family Incomes	Average Income (Dollars)	Income After Tax: Change in Dollars	Income After Tax: Percentage Change	Share of Savings (Percent)
	Eliminate 1994 COLA			
First Quintile	8,063	-158	-2.0	13
Second Quintile	16,567	-286	-1.7	26
Third Quintile	26,825	-324	-1.2	24
Fourth Quintile	38,691	-335	-0.9	21
Fifth Quintile	85,572	-326	-0.4	17
All Quintiles	29,748	-278	-0.9	100
	Tax 85 Percent of Social Security Benefits with Current Thresholds			
First Quintile	8,063	0	0	0
Second Quintile	16,567	0	0	0
Third Quintile	26,825	-7	-0.0	1
Fourth Quintile	38,691	-131	-0.3	15
Fifth Quintile	85,572	-896	-1.0	84
All Quintiles	29,748	-151	-0.5	100

SOURCE: Congressional Budget Office.

NOTES: Pretax family income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, and all cash transfer payments. Where families are ranked by adjusted family income (AFI), income also includes the employer share of Social Security and federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of ranking by AFI, income for each family is divided by the projected 1994 poverty threshold for a family of that size. Quintiles contain equal numbers of people. Families with zero or negative income are excluded from the lowest income category but included in the total.

Changes in individual income taxes, premiums, and entitlements are distributed directly to families paying those taxes and premiums or receiving those benefits. Changes in payroll taxes are distributed to families paying those taxes directly themselves or indirectly through their employers. Changes in federal excise taxes are distributed to families according to their consumption of the taxed goods or services. The reported tax, premium, or entitlement change reflects no change in taxpayer behavior and no change in real economic output.

tax payments in 1994, because the thresholds under current law would be unchanged in this option.

Not surprisingly, limits on COLAs tend to have relatively greater impacts on less affluent beneficiaries than do options that would increase the taxation of benefits. Although a significant portion of the poorest recipients are protected from any income loss because they participate in SSI, many do not, and still others who are not eligible for SSI are of modest means.

Consequently, 13 percent of the COLA savings are borne by beneficiaries in the lowest one-fifth of the income distribution, and the largest share of the impact would be felt by the next-lowest quintile. Because the current thresholds for the taxation of Social Security benefits effectively exempt more than three-quarters of recipients from paying additional taxes, options increasing the taxation of benefits that maintain those thresholds ensure that only the relatively more affluent recipients are adversely affected. As shown in Table 4, those recipients in the highest income quintile pay an overwhelming share of the increased taxes. Beneficiaries in the bottom three-fifths of the income distribution are, however, virtually unaffected. Lowering or eliminating the thresholds would spread the impacts to recipients who were less affluent as well, although the poorest beneficiaries would still be spared any loss in disposable income through the personal exemptions and standard deductions in the income tax code.

CONCLUSION

Virtually everyone agrees that something must be done to combat the massive federal budget deficits looming before us. Consensus on the appropriate strategy for disarming this threat is more elusive. With its forthcoming deficit reduction volume, CBO hopes to inform the debate on the merits and flaws of a wide variety of measures that might be included in a deficit reduction package. These are not recommendations but rather illustrations of potential budget options. It is within this context that we have presented options that would reduce Social Security COLAs and would increase the taxation of Social Security benefits.