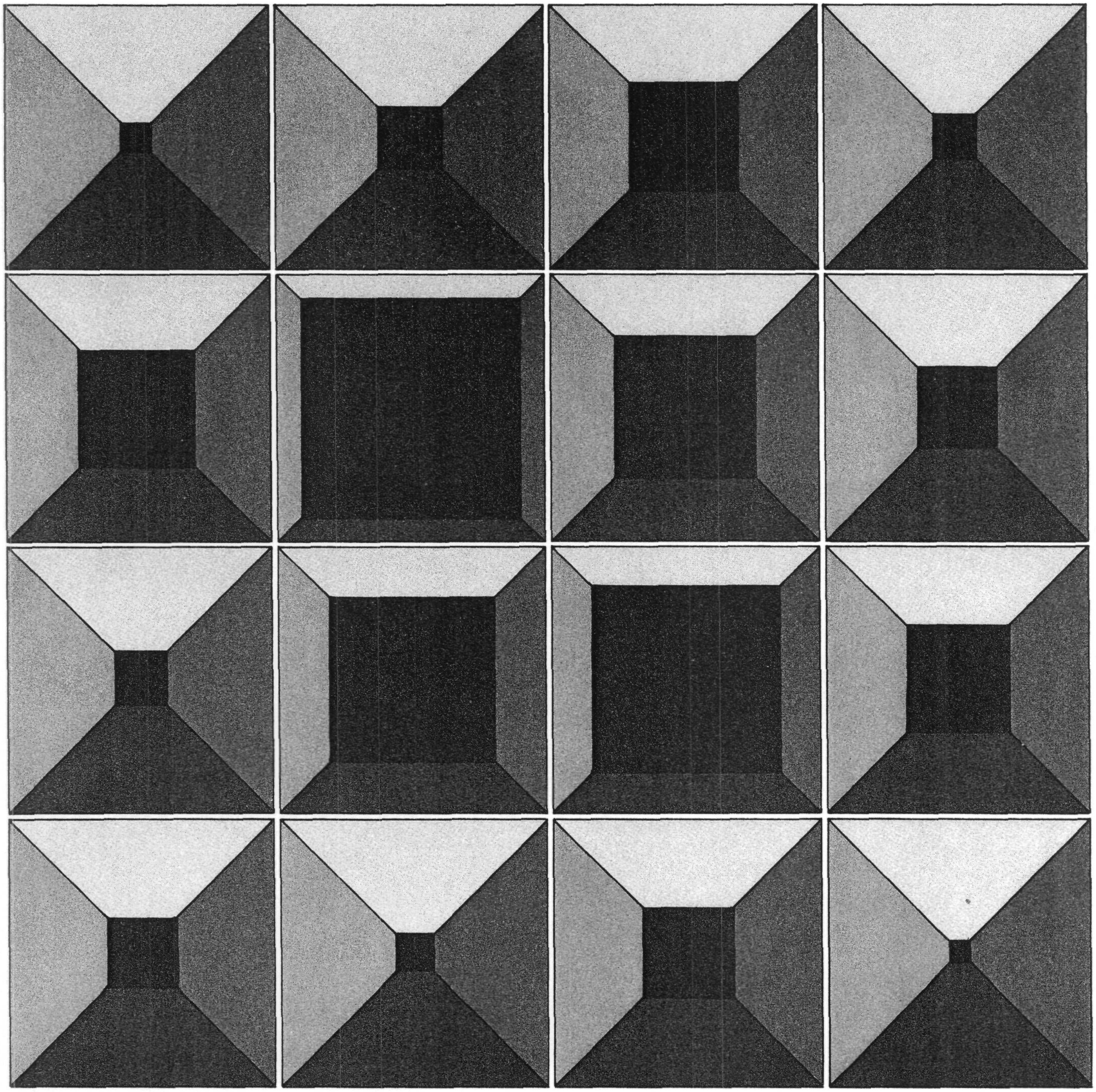
A CBO STUDY

Paying for Social Security: Funding Options for the Near Term

February 1981

Congress of the United States
Congressional Budget Office



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NOTE

In some tables, details may not add to totals because of rounding.

PREFACE

By the start of next year, the trust fund that finances the Social Security benefits of retired workers, their dependents, and survivors--the Old Age and Survivors Insurance (OASI) fund--will encounter a cash flow problem. The system's two other trust funds, which cover Disability Insurance (DI) and Hospital Insurance (HI) payments, should remain relatively sound, however. A wide variety of options are available to the Congress to remedy the OASI fund's immediate difficulties. Short-term choices range from various ways of altering the accounting mechanisms of the trust funds, to reducing benefit amounts, to increasing revenues into the system. Undertaken at the request of the Senate Budget Committee, this study focuses on short-run financing issues only. Since the paper concentrates primarily on the trust fund situation, it does not give estimates of all possible budgetary effects that could result from implementing any of the various options. Similarly, farther-reaching issues affecting Social Security's prospects 30 or 40 years hence present different analytical problems and must be considered in another forum. In keeping with CBO's mandate to provide objective and nonpartisan analysis, this paper offers no recommendations.

The paper was written by Stephen Chaikind of the Human Resources unit of CBO's Budget Analysis Division and by Hyman Sanders of the Tax Analysis Division, under the supervision of James L. Blum, Charles Seagrave, and James M. Verdier. Many persons assisted in the preparation of the study. Within CBO, they include Malcolm Curtis, Robert Dennis, David Delquadro, Lawrence DeMilner, G. William Hoagland, Sherri Kaplan, Patricia Ruggles, and Eric Wedum. Valuable contributions were also made by various staff members of the Social Security Administration, the House Committee on the Budget, the Congressional Research Service, the Joint Committee on Taxation, the U.S. Department of the Treasury, and the House Committee on Ways and Means and its subcommittee on Social Security. The authors particularly acknowledge the contributions of Johanna Zacharias, who edited the manuscript and offered many other important suggestions, and of Barbara Bakari, who typed the many drafts and prepared the paper for publication.

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Director

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CONTENTS

TABLES

TABLES (Continued)

73-780 0 - 81 - 2

SUMMARY

According to projections made by the Congressional Budget Office, the Old Age and Survivors Insurance (OASI) trust fund, the largest of the three funds that finance the Social Security system, will encounter financial difficulties during the first part of fiscal year 1982. Similar projections have been made by the Social Security Administration's actuaries. By the end of that year, the OASI fund is projected to have just over $7 billion in reserve (see Summary Table 1). The other two funds, Disability Insurance (DI) and Hospital Insurance (HI), however, are projected to be in a much stronger position for the 1981-1986 period. Although the relative strength of the DI and HI funds does not in itself remedy the OASI fund's anticipated problem, it does open a variety of choices for Congressional action.

THE RANGE OF AVAILABLE OPTIONS

The 97th Congress has a number of approaches it could take to ensure the soundness of the three trust funds that finance the Social Security system. The options examined in this study fall into three categories:

- Changing the trust fund accounting methods. Such approaches would involve borrowing among the three trust funds, merging the funds, or further realigning the portions of payroll tax revenues earmarked for each of the funds. (One such realignment was enacted last year.) They would not alter either the amount or timing of benefits or the tax rates currently legislated. At a minimum, taking such actions would give the Congress time to consider further measures.

- Modifying benefit amounts. This could be accomplished by changing the method used to adjust (that is, index) benefits for inflation or by making certain benefit cuts.

- Finding additions or alternatives to the payroll taxes that finance the system. The use of general revenues to finance part of Social Security is one option in this category. Additional payroll tax increases, as have been enacted in the past, is another.

SUMMARY TABLE 1. CBO PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOME, AND BALANCES, TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

Trust Fund	1981	1982	1983	1984	1985	1986
OASI						
Outlays	122.6	141.4	158.7	178.0	199.3	222.6
Income a/	117.8	129.0	143.0	159.1	181.9	203.7
Balance b/	19.7	7.4	-8.2	-27.1	-44.5	-63.5
DI						
Outlays	17.5	19.6	21.0	22.7	24.8	27.5
Income a/	12.6	21.9	26.4	30.0	37.7	44.4
Balance b/	2.8	5.2	10.6	17.9	30.9	47.7
HI						
Outlays	27.9	34.1	38.7	44.7	51.9	59.9
Income a/	31.9	38.3	43.2	48.4	55.5	65.5
Balance b/	18.5	22.7	27.2	30.8	34.4	40.1

NOTE: Minus sign denotes a deficit.

a/ Includes tax receipts, interest, and certain general fund transfers.

b/ Balances as of end of fiscal year.

The Constraints of Current Law

Under current law, benefits for each of the Social Security programs can be paid only from the specific trust fund of that program. Because of timing differences between the revenue inflows and the benefit payments, trust fund balances at the start of each fiscal year should be at least 9 percent of that year's anticipated outlays. Because the OASI trust fund's reserves in the early months of fiscal year 1982 will probably fall to a critical level, while the reserves of the DI and HI trust funds will not, there will be a cash flow problem only in the OASI fund. The OASI balance, according to CBO, is seen to be 14.0 percent of outlays by the start of fiscal year 1982, falling to 4.7 percent by the start of the next year (see Summary Table 2). The assets of the DI and HI funds, however, continue to grow as a percent of outlays.

SUMMARY TABLE 2. CBO PROJECTIONS OF TRUST FUND BALANCES AT START OF YEAR AS A PERCENT OF OUTLAYS, TO FISCAL YEAR 1986

Trust Fund	1981	1982	1983	1984	1985	1986
OASI	20.0	14.0	4.7	a/	a/	a/
DI	43.9	14.4	24.6	46.7	72.2	112.1
HI	51.9	54.2	58.6	60.8	59.5	57.5

a/ Negative balance.

THE CAUSES OF THE PROBLEM

The OASI fund's current difficulties are occurring despite increases in the tax rate and the maximum amount of earnings subject to the payroll tax (that is, the tax base) legislated in the Social Security Amendments of 1977. Before the amendments were enacted, both the OASI and DI trust funds were expected to be depleted by the early 1980s. The recurrence of the problem in the OASI trust fund that the 1977 amendments were designed to correct is the result of a combination of economic circumstances and structural features of the system. Together, these forces have acted to reduce revenues into and to increase outlays from the OASI trust fund. The major factors leading to OASI's current problem are:

- o High rates of inflation;
- o Low productivity growth and declines in real wages;
- o Growth in and anticipated continuation of high unemployment rates; and
- o Allocation of what appears in retrospect to have been too large a share of the payroll tax to the DI and HI trust funds in the 1977 amendments.

The difficulties leading to the passage of the 1977 amendments came about because declining real wages and high unemployment rates during the 1974-1975 recession reduced payroll tax receipts into the trust funds below their projected levels, while high inflation rates and large ad hoc benefit increases accelerated payments from them. In addition to the overall tax increase legislated in 1977, the Congress also earmarked a larger share of the overall payroll tax for the DI trust fund at the expense of the OASI fund, since at the time, DI was the fund thought to be most at risk. Subsequent events slowed the growth rate of the DI program, enabling that trust fund to increase its balances substantially. Without new legislation, however, DI reserves cannot be reallocated to assist the OASI trust fund.

In 1979 and 1980, generally high inflation rates attributable in part to large increases in oil prices and record high interest rates combined to depress real income growth. This decline in real incomes again limited the growth in revenues to the trust funds. In addition, high rates of inflation led to large automatic cost-of-living adjustments in benefits, further drawing down or limiting increases in the trust funds' reserves.

The U.S. economy experienced a mild economic downturn concentrated in the first half of 1980, followed by a moderate recovery in the latter part of that year. A weak recovery is expected in the first half of 1981. The higher unemployment resulting from the slowdown will further weaken the trust funds, because fewer workers will contribute payroll taxes, and because more older workers will elect to retire earlier. Even with a mild economic upturn, however, the expected persistence of high inflation rates over the next few years and the slow growth of real income will further stimulate growth in outlays while limiting revenues to all three funds.

SHORT RUN OPTIONS

Various actions are available to the Congress to ensure that the OASI fund has adequate reserves to meet all its obligations. Some of these options, taken alone, would shore up the trust funds only for an additional year or two; others, alone or in combination, would guarantee adequate reserves for longer periods.

Accounting Changes

Neither benefit payments nor scheduled tax rates would be affected by any option confined to changes involving the accounting mechanisms of the three funds. If economic conditions turn out to be better than current forecasts show--with rates of unemployment and inflation lower than are now anticipated--accounting changes alone might be sufficient to ensure OASI's adequacy over the 1981-1986 period. According to CBO's projections, however, if accounting adjustments only are made, other changes will be needed by 1984 to ensure that all three trust funds continue to have sufficient reserves.

Interfund Borrowing. The Carter Administration's budgetary proposal for fiscal year 1981 contained a plan that would allow any Social Security trust fund to borrow from the others as the need arose; the borrowing fund would make repayment when it could. The 1982 proposed budget again contained a similar general plan. Advocates of this approach hold that it would preserve the identity, and hence the Congressional "accountability," of the three separate trust funds. Although considered by the 96th Congress, this plan was not adopted.

Under current economic projections, if the OASI fund borrowed only from the DI trust fund, OASI reserves would be adequate for another three to six months. After this time, further borrowing would have to come from the HI trust fund to cover all OASI benefits into 1984, since all three funds combined would have enough reserves to meet all anticipated outlays during this period. By the start of 1985, estimates based on current economic assumptions indicate that other measures would be needed.

According to CBO's projections, the balances of the OASI and DI funds together would exceed 9 percent of both funds' projected outlays through fiscal year 1981 and into fiscal year 1982 (see Summary Table 3). In fiscal year 1982--the first year interfund borrowing would be needed--some $6.9 billion would have to be borrowed by the OASI fund from the DI and HI funds. To maintain adequate OASI balances through 1983, the minimum amount of borrowing needed would be $24 billion. By mid-1984, borrowing would involve other sources.

SUMMARY TABLE 3. CBO PROJECTIONS OF OASI, DI, AND HI AGGREGATE TRUST FUND BALANCES AT START OF YEAR, AS A PERCENT OF OUTLAYS, TO FISCAL YEAR 1986

Trust Fund	1981	1982	1983	1984	1985	1986
OASI and DI	23.0	14.0	7.0	1.2	a/	a/
OASI, DI, and HI	27.7	21.0	16.1	12.0	7.8	6.7

a/ Negative balance.

Realignment of Payroll Taxes. Another way the Congress can respond to a short-run deficit while maintaining the separate identities of the three trust funds is to realign the currently scheduled payroll tax rates among the funds and increase the share earmarked for the OASI trust fund. The 96th Congress adopted a measure of this sort as Public Law 96-403, with the aim of giving the next Congress time to examine Social Security issues in greater detail.

Merging the Trust Funds. Merging all three trust funds into one new fund, which would serve as a repository for all payroll tax receipts, is another alternative available to the Congress. This option, however, could lead to some loss of Congressional control in monitoring the status of the three programs, although maintaining a separate accounting system for each program could offset this disadvantage.

Benefits Changes

A wholly different approach to strengthening the trust funds' positions is embodied in choices that would reduce program outlays. Most of these would involve modifying the way annual cost-of-living benefit increases are calculated. A few would effect some benefit cuts.

Modifying the Annual Cost-of-Living Benefit Increase. To keep Social Security benefits abreast of inflation, they are adjusted (indexed) annually to reflect rises in the cost of living. At present, the yearly adjustments in OASI and DI benefits are automatic, and the measure according to which benefits are adjusted is the Consumer Price Index (CPI). Critics of the CPI have argued, however, that this index measures inflation improperly, at times overstating the cost-of-living rises that affect most people and thus leads to excessive Social Security benefit increases.

A way of limiting outlays from the Social Security trust funds therefore could be to select a different index--one that compensates for the CPI's flaws--to compute yearly benefit adjustments. Under this approach, benefits would still be altered to allow for inflation, while appreciable savings to the trust funds could be realized.

One such indexation modification that has been proposed would use the Commerce Department's personal consumption expenditure (PCE) "chain index", which could save the trust funds roughly $11 billion by 1986 if it were adopted in 1981. The Labor Department's "modified rental equivalent," which substitutes costs of rented housing for the homeownership component in the CPI, could yield a projected savings of approximately equal amounts by the end of fiscal year 1986. Savings resulting from these indexes are not certain if they were first implemented in 1982, however.

Another option suggested would limit the Social Security cost-of-living adjustment to the lower of a wage or price index. This option would enable beneficiaries to maintain their position relative to active workers in times of falling real wages, but maintain their real standard of living when real wages are rising. It would, however, result over time in lower real benefits for recipients.

Placing some limit on the yearly benefit increase generated by the CPI is also an option. Such a cap would be similar to the one placed by the President on federal pay raises. Limiting the Social Security cost-of-living increase to 67 percent (two-thirds) of the CPI's increase, for example, would alone generate nearly enough savings to ease the OASI funding short-run problem.

Cuts in Certain Benefits. A number of benefit cuts have been proposed in past budgets. These include eliminating the minimum, lump-sum death and certain parents' benefits and phasing out student benefits. These proposals have never been accepted by the Congress. Enacting them would, however, help the OASI trust fund's short-term financial problem, and if combined with other actions, could go somewhat farther to securing the trust fund's position.

Revenue Modifications

There are a number of revenue changes that the Congress could adopt to assist the trust funds. One possibility would be to allow borrowing by the Social Security system from the general fund in times of economic stress. Other options would involve further payroll tax increases or the introduction of income tax revenues either directly or indirectly to support the three trust funds.

General Fund Borrowing. One way of ensuring the solvency of the trust funds without resorting to explicit tax changes would be to permit Social Security to borrow funds from the U.S. Treasury. Such an option would avoid tax increases or benefit cuts. It could, however, increase pressures on the federal budget, forcing cuts in other areas or adding to the size of the deficit.

Payroll Tax Changes. The various ways of raising Social Security revenues to assist the OASI fund include a number of tax changes. One would follow past practice by raising the payroll tax rate for employers, employees, and self-employed persons. A permanent increase of 0.5 percent above currently scheduled rates would alone just barely raise the revenues that the OASI fund will need by 1986; a more substantial increase of 1.0 percent would

73-780 0 - 81 - 3

provide the system with a quite ample cushion. A second approach would involve eliminating the ceiling on wages subject to the payroll tax and taxing all earnings instead. This would provide some but not all of the added revenues the OASI fund will need. A third possibility would involve changing the tax liability for self-employed persons, whose earnings are now taxed at roughly three-fourths of the combined employer and employee rate, to the full employer/employee rate.

To lessen the inflationary and other restrictive economic effects of a payroll tax increase, such an increase could be accompanied by an income tax credit or deduction. A bill introduced in the 97th Congress (S. 44) would allow employees and employers a refundable 10 percent credit on their payroll tax contributions to offset the increases mandated by the 1977 amendments for 1981 and 1982. Credits to offset further increases could also be refundable and could be proportional to an individual's total payroll tax contribution.

General Revenue Financing. The 1979 Social Security Advisory Council recommended reallocating the HI share of the tax rate among the OASI and DI trust funds, along with reducing the overall payroll tax rate. The plan would call for financing HI from earmarked income tax revenues. Financing only HI program benefits from general revenues has been justified on the grounds that such benefits are not related to lifetime payroll tax contributions and therefore need not be paid for from a separate fund financed by a payroll tax. Such a tax change would help reinforce the OASI fund.

Alternatively, to assist the trust funds, the Congress could decide to forego the income tax reductions it has periodically enacted in the past to offset inflation-induced increases in tax liabilities. Some portion of the revenues maintained by keeping taxes at their present rates could be earmarked for the OASI trust fund.

SEVERAL OPTIONS IN COMBINATION

Taken alone, most of the options outlined above offer limited potential to solve the OASI trust fund's financing problem. But if several actions were taken simultaneously, the fund's prospects could be markedly improved. Combining any one of the three accounting changes, for example, with one of the possible modifications in the indexing mechanism would put the OASI fund in a secure position through the end of fiscal year 1986 under current projections. Similarly, the adequacy of the OASI fund could be assured by enacting a 0.5 percent payroll tax increase above currently scheduled rates, while at the same time reapportioning part of the DI share of payroll tax revenues to the OASI fund.

LONGER RUN ISSUES

Of the longer-run Social Security issues on the Congressional agenda, at least one item--universal coverage--could have ramifications for both the immediate and the more distant future. Expanding the system to require participation by civilian federal workers and some state and local government employees now exempted from the system could augment the payroll tax's revenue base. A quite different approach that would more gradually affect the trust funds' position would be to tax Social Security benefits according to the graduated schedules that now apply to other income. Doing so could increase income tax payments made by beneficiaries whose total retirement incomes are larger, and the resulting revenues could be earmarked for the trust funds.

CHAPTER I. INTRODUCTION

Nearly four years ago, in response to concern over developing problems in the Social Security trust funds, the Congress passed the Social Security Amendments of 1977 (Public Law 95-216). This legislation raised both future tax rates and the maximum amount of a person's total earnings on which these rates must be paid. For the most part, the increased revenues resulting from the amendments were channeled into two of the three trust funds that finance the system: the Disability Insurance (DI) and Hospital Insurance (HI) funds. Both of these funds had been experiencing extremely rapid increases in spending in the preceding years. At the time of the amendments' passage, it was generally felt that the newly legislated tax increases would be sufficient to ensure the fiscal viability of the Social Security system for the ensuing 30 years.

In the interim, however, unexpected economic developments--particularly rapid inflation and low real wage growth--have radically changed the program's prospects. According to projections made by both the Congressional Budget Office and the Social Security Administration's actuaries, the Old Age and Survivors Insurance (OASI) fund--the largest of the system's three trust funds--will experience a cash flow problem during fiscal year 1982. Thus, the Congress will have to address the Social Security system's financing situation once again to ensure that the reserves in the OASI trust fund remain above a critical level. Because the HI and DI trust funds are expected to remain strong, however, a number of short-term solutions to the OASI fund's problem are readily attainable.

SHORT TERM PROJECTIONS

As part of its regular reports to the Senate and House Committees on the Budget, CBO estimates outlays from and income to the Social Security trust funds. The periodic estimates of the financial status of the Social Security system are based on CBO's forecasts about the behavior of the economy as a whole. Despite differences in forecasting methods, economists and actuaries generally concur that, because of the poor performance of the economy in recent years, the near-term prospects of the OASI trust fund's finances are not good. The projected problem is serious only for the OASI trust fund, however; the DI and HI trust funds each should remain reasonably strong.

During the past session of Congress, Public Law 96-403 was enacted to reallocate some revenues from the DI to the OASI trust fund for calendar years 1980 and 1981. The purpose of this legislation was to give the Congress time to devise a plan to resolve the OASI fund's worsening financial status. By 1984, however, the sum of the three trust funds' combined reserves will be insufficient to meet all expected cash payments. Some action other than further realignment of the payroll tax revenues will be necessary in the coming five years.

Cash benefit payments from the Social Security trust funds are assured by the government; a number of alternatives are available that would maintain this assurance. This paper summarizes the short-term financing problem and some of the readily available solutions. If the Congress takes some action before the end of 1981, then, under current projections the system should be able to meet all its obligations in the near term.

CBO's present projections of the status of the trust funds rest on an assumption that there will be a steady though gradual improvement in the economy starting in calendar year 1981. It also assumes that the rates of inflation and unemployment will remain at levels higher than those that characterized previous economic upturns. The combination of rapid inflation, high unemployment, and falling real wages has been a major cause of Social Security financing problems in the past. If such economic circumstances do not coincide again, the system's financial condition should improve over current projections; if not, the opposite will occur.

In addition, these projections rest on the assumption that the payroll tax increases legislated by the 1977 amendments for 1981 and thereafter will be allowed to go into effect as scheduled. There is some interest in rescinding or rolling back the tax increase that went into effect on January 1, 1981. If such a course, but no other, were taken, the outlook for the trust funds could be markedly worse.

HOW THE SYSTEM WORKS

Social Security is financed by a payroll tax 1/ on earnings, with portions of its revenues earmarked for each of the trust funds. All persons who work in employment covered by the program pay a mandatory tax on their earnings up to a maximum dollar amount. Employers pay an equal tax rate for these workers. Under current law, as of 1981, the tax is levied at a rate of 6.65 percent of the first $29,700 of earnings for both the employer

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1/ Familiar to most covered workers by the designation F.I.C.A., Federal Insurance Contributions Act.

and employee. Table 1 summarizes the current payroll tax schedule. Self-employed persons pay at a rate of 9.3 percent, which roughly equals three-fourths of the combined employer and employee rate.

TABLE 1. CURRENT LAW SOCIAL SECURITY PAYROLL TAX RATES FOR EMPLOYERS AND EMPLOYEES AND TAXABLE EARNINGS BASES, BY INDIVIDUAL AND COMBINED TRUST FUNDS, 1979-1986

	Employee and Employer Rates, Each (in Percents)					
Year	OASI	DI	OASDI Combined	HI	OASDHI Combined	Taxable Earnings Base (in Dollars)
1979	4.330	0.750	5.080	1.050	6.130	22,900
1980	4.520	0.560	5.080	1.050	6.130	25,900
1981	4.700	0.650	5.350	1.300	6.650	29,700
1982	4.575	0.825	5.400	1.300	6.700	32,100 a/
1983	4.575	0.825	5.400	1.300	6.700	34,800 a/
1984	4.575	0.825	5.400	1.300	6.700	38,700 a/
1985	4.750	0.950	5.700	1.350	7.050	42,900 a/
1986	4.750	0.950	5.700	1.450	7.150	47,700 a/

SOURCE: Public Law 95-216.

a/ Automatic increase based on statutory formula and CBO's preliminary economic assumptions.

The Trust Funds and Pay-As-You-Go Financing

Social Security is funded on a pay-as-you-go basis, which makes the system particularly sensitive to economic fluctuations. For the most part, the annual flow of tax revenues into the trust funds is used to pay for the current outflow of benefit payments. No provision is made for accumulating the funds' assets at a level equal to anticipated payments. Rather, expected future payments are guaranteed solely by the government's power to tax. The role of the trust funds is to provide a reserve to cushion temporary shortfalls in revenues or unexpectedly large increases in outlays for benefits. Since nearly all workers now pay Social Security taxes, overall collections depend upon the aggregate nationwide level of earnings. A reduction in the growth rate of earnings results in a reduction in the growth of Social Security tax revenues. When unemployment rises or when income growth slows, the rate of increase in aggregate wages declines. Under these conditions, Social Security tax receipts can fall below projected levels.

Who Participates

At present, about nine out of 10 wage and salary earners and self-employed persons work in jobs covered by Social Security; most of the remainder are civilian federal workers, some state and local government employees, and persons working for certain not-for-profit organizations.

Benefits go to 35 million retired and disabled workers and to their dependents and survivors. Retired workers, their dependents, and their survivors receive benefits from the OASI trust fund, and disabled workers and their dependents from the DI trust fund. Hospital costs for the elderly and disabled are paid from the HI trust fund. 2/

To be assured of receiving Social Security retirement benefits, a worker must have accumulated a certain number of quarters in employment covered by the system. Under current law, the number of quarters of coverage increases each year until 1991, when the qualifying number will be 40 quarters for persons turning 62 in that year or thereafter. 3/

Disabled workers have a lower required number of quarters of coverage to be eligible for benefits, but they must meet a stricter test of recent work experience. For the young disabled worker under age 24, a minimum of six quarters of coverage within the last 12-quarter period is needed to qualify for benefits.

2/ The HI share of Medicare is financed by a portion of the payroll tax. Physicians' fees are paid from the Supplemental Medical Insurance (SMI) portion of Medicare. These are financed largely from general tax revenues, with only a small amount of expenditures covered by the premiums paid by beneficiaries.

3/ Prior to the Social Security Amendments of 1977, a quarter of coverage was defined as any quarter in which at least $50 in covered wages was earned. In 1981, under current law, each $310 in earnings in a year earns credit for one quarter of coverage, up to four quarters per year. This amount is now wage indexed and adjusted yearly.

How Benefits Are Determined

In order to calculate benefits, a worker's past earnings in covered employment are first adjusted for the growth in money wages since the income was earned (that is, wage indexed) and averaged over all years since 1951, less the five lowest years of indexed earnings. 4/ This computation determines his average indexed monthly earnings (AIME), which is then applied to a progressive benefit formula to derive the worker's primary insurance amount (PIA). The PIA is the benefit a 65-year-old retired worker receives, and it is the basis from which actuarial reductions or increases in benefits are made for early or delayed retirement and from which dependents' benefits are calculated. The formula to determine the PIA is progressive in that it gives persons with lower AIMEs proportionally higher benefits than it gives those with higher AIMEs. 5/

Indexation

To compensate for rises in the cost of living, OASI and DI benefit payments are directly indexed to--that is, they rise automatically with--the rate of increase in the Consumer Price Index (CPI). Each July, Social Security benefit payments increase by the change in the CPI from the first quarter of the previous year to the first quarter of the current year. Social Security benefits were increased 14.3 percent in July 1980, adding nearly $17 billion to outlays in fiscal year 1981.

PLAN OF THE PAPER

Chapter II of this paper presents projections, based on current law, of outlays, income, and trust fund balances for the three funds and details the background and causes of the current OASI problem. A number of short-term

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4/ Under the Disability Amendments of 1980 (P.L. 96-265), the number of years of low earnings disregarded in the calculation of benefits for young disabled workers was reduced. This does not affect the benefit calculations for most beneficiaries, however.

5/ The PIA formula for 1981 under the 1977 amendments is: 90 percent of first $211 of AIME, 32 percent of next $1,063 of AIME, and 15 percent of the remainder. There is a five-year "hold-harmless" transition provision for 1979 through 1983 in the 1977 amendments (applicable only to retired workers) that guarantees retirement benefits paid under this new computation formula not be lower than they would have been under the benefit formula previously in effect.

73-780 O - 81 -

financing options are reviewed in Chapter III, including accounting changes such as merging either two or all three of the trust funds, realigning the payroll tax rates among the funds, or allowing interfund borrowing. Other changes considered in Chapter III, such as allowing loans or outright grants from general revenues, or altering the rates of the payroll tax, would involve more basic changes in the structure and mechanics of the system. Beyond the short-run concerns of the OASI trust fund, there are longer-run Social Security issues the Congress will have to deal with in the future; some of these are briefly mentioned in Chapter IV.

BASIS OF THE ANALYSIS

The projected period examined in this paper covers fiscal years 1981 through 1986. The analysis is based in part on a methodology derived by CBO that takes into account recent Social Security program experience. The most recent projections of the elderly and disability-prone populations, and of the disability incidence rates (as determined by the Office of the Actuary at the Social Security Administration) serve as a basis for the estimated level of beneficiaries. In addition, the responsiveness of potential OASI and DI recipients to certain economic conditions affecting their employment and earnings prospects are taken into account, because such circumstances can influence a person's decision to retire.

Payroll tax revenues are projected using a set of econometric models developed by the Social Security Administration. These models estimate amounts of wages covered by Social Security based on information about the unemployment rates, wages and salaries, and proprietary incomes contained in the CBO set of assumptions about the economy, and on the payroll tax provisions that apply for specific years. Income to the trust funds (which is the funds' budget authority) includes the tax receipts, government transfers for certain statutory benefits, and interest income on trust fund assets.

Estimates of both expenditures and revenues are sensitive to underlying economic assumptions. In general, higher inflation leads to higher outlays as the result of the automatic cost-of-living benefit increase (the indexing feature of the Social Security program), and to higher tax receipts as wages rise. The increase in outlays as the result of continued inflation tends to be approximately the same as the increase in revenues, however. Higher unemployment increases outlays because, for many persons who are eligible for Social Security, retirement becomes an attractive alternative to searching for work or taking low-paying or uncertain jobs. Unemployment also lowers tax receipts, since fewer workers are paying the payroll tax. Even small increases in the level of unemployment can seriously diminish the trust fund balances.

The level of the Social Security trust fund balances needed to ensure the short-term solvency of the system is expressed in terms of the balance at the start of the year as a percent of that year's anticipated outlays. For example, if outlays for a given program are expected to be $120 billion over the course of a year, and that trust fund has a balance of $12 billion at the start of the year, the fund's balance as a percent of anticipated outlays is 10 percent. There is some debate about what is the appropriate OASI or DI balance as a percent of outlays to ensure that all benefits can be paid on time. If, however, balances at the start of a fiscal year fall below a level of 9 to 12 percent of that year's anticipated outlays, the fund's reserves might be inadequate at some point during that year to cover all monthly benefit payments, since one month's benefits come to more than 8 percent of the year's expenditures. Clearly, such a situation would result in a monthly cash flow problem for the program. This is the problem that both CBO and the Administration now foresee for the OASI trust fund.

Many analysts contend, however, that maintaining the trust fund at a 9 percent level of outlays--as some of the mixes of alternatives presented in this paper would do--is the bare minimum level that could be considered adequate, and it would not safeguard the system if the economy fluctuates even slightly. If the funds' reserves are to be maintained at higher proportions of anticipated outlays, then a number of options that yield more substantial revenues would have to be implemented.

CHAPTER II. THE SHORT-TERM OASI PROBLEM

Underlying the current financial difficulties of the Social Security trust funds is the system's general inability to respond well to the combination of economic conditions that prevailed in the mid-1970s and that recurred toward the end of the decade--high and rising rates of inflation and unemployment, and low and declining growth in real incomes. The system's vulnerability to such circumstances was evident before the passage of the Social Security Amendments of 1977, and it has again become conspicuous. In light of the moderate economic recovery now foreseen for 1981, a review of the system's past experience, as well as its anticipated needs and ability to meet those needs, can be useful.

BEFORE THE AMENDMENTS OF 1977 AND AFTER

The OASI trust fund entered the decade of the 1970s with reserves exceeding 100 percent of anticipated outlays (see Table 2). These reserves reflected high numbers of contributors relative to beneficiaries. The decline in the initially high trust fund reserves before 1970 was the result of increasingly more covered workers' beginning to collect benefits, and of certain liberalizations in eligibility for and amounts of benefits. The fall in the trust fund balance as a percent of outlays during the early 1970s was caused primarily by very large across-the-board ad hoc benefit increases (15 percent in 1970, 10 percent in 1971, and 20 percent in 1972). With the implementation of the automatic cost-of-living adjustment in 1975, the annual benefit increases have kept pace with, but have not exceeded, the rate of inflation as measured by the CPI.

The Social Security Amendments of 1977 came in response to much the same economic circumstances as now prevail. The round of rapid price increases and declines in real wages following the Organization of Petroleum Exporting Countries' (OPEC) oil embargo in 1973, compounded by the recession of 1974-1975, caused the trust funds' assets to decline during the

TABLE 2. PAST AND PROJECTED ASSETS OF THE OASI AND DI TRUST FUNDS AT THE BEGINNING OF YEAR, AS A PERCENT OF FISCAL YEARS' OUTLAYS: FISCAL YEARS 1960 - 1986

Fiscal Year	OASI	DI	Combined OASI and DI
1960	195	313	200
1965	123	151	126
1970	103	125	105
1971	101	142	105
1972	96	149	101
1973	83	135	89
1974	74	123	79
1975	67	103	71
1976	62	85	65
1977	50	56	51
1978	44	34	42
1979	34	31	34
1980	27	37	28
1981	20	44	23
1982	14	14 b/	14
1983	5	25	7
1984	a/	47	1
1985	a/	72	a/
1986	a/	112	a/

SOURCES: Social Security Administration and CBO.

a/ Negative balance.

b/ Decline reflects reallocation under P.L 96-403, enacted in 1980, of payroll tax revenues from DI to OASI for 1980 and 1981, with the entire reallocation being made during fiscal year 1981.

1974-1976 period. The OASI fund's balance fell from 83 percent of outlays at the start of 1973 to 50 percent at the start of 1977. The DI trust fund declined from 135 percent of outlays at the start of 1973 to 56 percent by the start of 1977. 1/ This steady erosion continued even though there were major tax increases in 1971 and 1973, as well as increases in the taxable maximum wage base every year after 1971.

Before the amendments' passage, CBO projected that the OASI and DI funds combined would be depleted by fiscal year 1982, with the DI trust fund failing by 1979. Even if there had been a realignment of the OASI and DI tax rates then in effect, the combined assets of the OASI and DI trust funds would not have been able, prior to the passage of the 1977 act, to meet all monthly payments by as early as 1981. 2/

In addition to the large increase in revenues they generated, the 1977 amendments yielded a net savings in outlays, estimated at the time to be more than $500 million in fiscal year 1979 and to total $10 billion by the end of 1983. The major savings feature of the amendments was a provision to correct the technical "overindexing" flaw implemented at the time cost-of-living benefit increases were automatically indexed to rises in the CPI. This "decoupling" provision took effect in June 1979 for all new disability awards. It will be fully effective for all new benefits to retired workers by 1982.

Thus, high automatic and ad hoc benefit increases, high rates of inflation and unemployment, low or negative real wage growth, and increasing income replacement rates, as well as some administrative factors, have affected the OASI trust fund adversely in the past, and many of these factors threaten to do so in future.

1/ The DI trust fund was further tapped by a large influx of recipients attributable to some loosening of administrative procedures and to the implementation of the Supplemental Security Income (SSI) program and Black Lung program for disabled coal miners. This rapid decline in the DI trust fund has been reversed in the last two years, partly by tighter administrative procedures and lessening pressures of the SSI and Black Lung programs. In addition, the reversal in the DI fund's decline may be attributable partly to the lower benefits resulting from the decoupling provision in the 1977 amendments, and to a number of benefit reducing provisions in the Disability Amendments of 1980 (P.L. 96-265).

2/ Under the provisions of the Social Security Amendments of 1977, increases in the payroll tax rate are scheduled at the start of 1982, 1985, 1986, and 1990. See Chapter I, Table 1.

THE PROJECTED OASI PROBLEM

Because current law stipulates that benefits for any Social Security program may be paid only from that program's specifically earmarked trust fund, there must be assets in each fund at the start of any month to cover all anticipated monthly benefit payments. Otherwise, some benefits, scheduled for payment on the third day of each month, will be delayed. Under current estimates, CBO projects this to occur only in the OASI program; the relatively stronger status of the DI and HI trust funds has no direct bearing on OASI's solvency. 3/

CBO projects that, by the start of fiscal year 1982, the balance in the OASI fund will fall to 14.0 percent of the estimated $141.4 billion needed for that year's outlays (see Table 3). Approximately $7 billion is projected to remain in the fund by the end of fiscal year 1982--4.7 percent of the next year's anticipated outlays. 4/ During 1983, the OASI fund is anticipated to be depleted. This represents a steep drop in the balances from the more than 34 percent level of OASI outlays at the start of fiscal year 1979. Additional income raised by scheduled tax increases is not projected to reverse the decline in the OASI balance, which is likely to continue falling as a percent of outlays through 1986. 5/

At the same time, however, the DI trust fund appears to improve its position substantially through 1986, with DI's level of reserves increasing to 112 percent of outlays by then. HI's balance will remain at approximately 50 to 60 percent of outlays over the period.

3/ Technically, the HI trust fund can continue meeting benefit payments with less than one month's anticipated expenditures on reserve, since that fund makes payments throughout the month. It is assumed here, however, that maintaining the HI balance at a 9 percent level is desirable, although the HI trust fund alone never approaches this low level during the period under study.

4/ The most recent Administration estimates available are contained in the Carter Administration's proposed budget for fiscal year 1982. These estimates show that, under current law, the OASI trust fund would fall to approximately 15 percent of outlays at the start of fiscal year 1982 and to 6 percent of outlays one year later.

5/ The decline in the trust fund balance could be reversed by 1990, though only under the assumption of no further serious downturns in the business cycle.

TABLE 3. CBO'S PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES a/, AND BALANCES, TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

	1981	1982	1983	1984	1985	1986
	Old Age and Survivors Insurance					
Outlays	122.6	141.4	158.7	178.0	199.3	222.6
Income	117.8	129.0	143.0	159.1	181.9	203.7
Year End Balance	19.7	7.4	-8.2	-27.1	-44.5	-63.5
Start of Year	(As a Percent of Outlays)					
Balance	20.0	14.0	4.7	b/	b/	b/
	Disability Insurance					
Outlays	17.5	19.6	21.0	22.7	24.8	27.5
Income	12.6	21.9	26.4	30.0	37.7	44.4
Year End Balance	2.8	5.2	10.6	17.9	30.9	47.7
Start of Year	(As a Percent of Outlays)					
Balance	43.9	14.4	24.6	46.7	72.2	112.1
	Hospital Insurance					
Outlays	27.9	34.1	38.7	44.7	51.9	59.9
Income	31.9	38.3	43.2	48.4	55.5	65.5
Year End Balance	18.5	22.7	27.2	30.8	34.4	40.1
Start of Year	(As a Percent of Outlays)					
Balances	51.9	54.2	58.6	60.8	59.5	57.5

SOURCE: Based on CBO's preliminary economic assumptions.

NOTE: Minus sign denotes a deficit.

a/ Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, and certain general fund transfers.

b/ Negative balance.

73-780 O - 81 -

CAUSES OF THE PROBLEM

In much the same manner as before the passage of the 1977 amendments, economic growth slowed dramatically in 1979, registering only an 0.8 percent real increase by the end of calendar year 1979; this represented a sharp drop from the previous year's growth of 4.8 percent. Three causes underlay the 1979 slowdown: increased OPEC oil prices, record high interest rates, and generally high inflation. At present, these factors continue to depress real income growth.

Meanwhile, the CPI rose 12.8 percent in 1979 and by an equal rate during fiscal year 1980--the most rapid continuous increase since World War II. Price increases, however, were not uniform in the various components of the CPI. Energy prices jumped dramatically. Large increases were also recorded in home purchase and financing costs, food, and health care. More moderate rises occurred in wearing apparel, household furnishings, entertainment, and transportation costs (excluding gasoline). Money wages, however, rose less than prices, leading to a decline in real average earnings in 1979 and 1980.

Thus, the resulting decline in real average earnings over the past two years has limited the growth in revenues to the trust funds. Because of indexation, high rates of inflation alone mean that future automatic benefit increases will be large. Although revenues tend to increase with inflation by approximately the same amount as outlays, and the trust fund balances tend to remain relatively constant in their absolute dollar amounts, they tend to decline as a percent of outlays. Each additional percentage point increase in the CPI currently adds more than $1.3 billion per year to OASI and DI outlays. In addition, indexed--that is, larger--benefits, once implemented, are paid in each succeeding year, and the rises are compounded in subsequent years, further drawing down the trust funds in the future.

Anticipated Economic Effects

The economy exhibited a mild recession concentrated in the first half of 1980, followed by a stronger-than-expected recovery in the latter half of the calendar year. CBO's projections assume that this recovery will weaken somewhat during the first half of 1981 and then gain momentum. Real GNP declined 0.1 percent in fiscal year 1980, and it is expected to rise by roughly the same percent in 1981. 6/ CBO's trust fund estimates for 1981 reflect the

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6/ See CBO, The Economic Outlook at Midyear 1980, A Report to the Senate and House Committees on the Budget (July 1980). The assumptions used in this analysis have been revised to reflect intervening economic developments.

actual Social Security benefit increase of 14.3 percent payable in July 1980, and a projected benefit increase of approximately 12 percent in July 1981. The unemployment rate is assumed to rise somewhat from its present level of 7.4 percent to nearly 8 percent by the end of 1981.

Even with some improvement in the economy, the reserve positions of the trust funds are expected to weaken in the next two years. High levels of unemployment are expected to put more pressure on the trust funds, as fewer workers contribute payroll taxes, and as a number of older workers retire sooner than they would have were the labor market stronger. Outlays too are sensitive to economic deterioration, in part because high inflation and unemployment make retirement an attractive alternative in poor labor market conditions. As inflation erodes real earnings and as employment prospects diminish, increasing numbers of persons over age 62 elect to retire, increasing the number of beneficiaries and their dependents collecting benefits. 7/

SOCIAL SECURITY'S SENSITIVITY TO ECONOMIC VARIATION

In reality, economic conditions may vary from those assumed. To illustrate the sensitivity of the trust funds' balances to differing economic circumstances, this section examines two alternative economic scenarios and their effects on the trust funds.

Higher Unemployment

The first illustrative path examined supposes the unemployment rate to rise one percentage point higher by the end of 1981 than is now assumed and to remain at that higher level through 1983. Under these circumstances, the OASI trust fund would be in a considerably worse position than is now forecast, since higher levels of unemployment would significantly reduce revenues while somewhat increasing outlays. Under this one-percent-higher unemployment path, the OASI fund's deficit would be $9.7 billion larger than

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7/ A number of studies have demonstrated the sensitivity of the number of beneficiaries to economic conditions. See for example, Lawrence Thompson and Paul Van de Water, The Short Run Behavior of the Social Security Trust Funds and Appendices, Technical Analysis Paper No. 8, Office of the Assistant Secretary for Planning and Evaluation, U.S. Department of Health, Education and Welfare, July 1976; John Hambor, An Econometric Model of OASDI; Studies in Income Distribution, Social Security Administration, Office of Research and Statistics, November 1978. See also a forthcoming CBO paper on an econometric model of the Social Security system.

is now assumed by the end of 1983, and the DI fund's balance would also fall $2 billion below currently projected levels. A combined OASDHI fund, too, would decline to less than 8 percent of outlays by the end of 1983.

Higher Inflation

The second alternative path assumes that the inflation rate rises for one year to a level one percentage point higher than in the base path and continues rising at a rate one percentage point higher than under the base path. This would result in annual cost-of-living benefit increases of about 13 percent starting in July 1981 instead of the 12 percent increase now projected. Under this one-percent-higher inflation scenario, both the OASI and DI trust funds' balances would remain at about the same absolute dollar levels as under the base path projections. But balances as a percent of outlays could fall to levels lower than those now projected. Whether or not they would depends on the cause of inflation. Inflation resulting from higher labor costs would affect the trust funds less adversely than would, say, inflation caused by rising oil prices. This is because rises in labor costs are more directly reflected in Social Security tax revenues than are such external factors as oil price increases.

Although these economic effects are most detrimental to the OASI trust fund, the DI trust fund would also suffer in any period of combined high inflation and high unemployment by having the growth of its reserves slowed. The reason the DI trust fund can remain sound in generally adverse economic conditions is that, besides increasing the overall payroll tax rates in the 1977 amendments, the Congress also earmarked a larger share of the total payroll tax rate for the DI fund. Subsequent events have slowed the rate of growth in the disability program, however, enabling the DI trust fund to improve its balances substantially. In addition, the Disability Insurance Amendments of 1980 (Public Law 96-265) will result in additional large savings in benefit payments from the DI trust fund.

This surplus in the DI trust fund, however, cannot be reallocated to the OASI fund without new legislation. And, as the following chapter makes clear, even a combined OASDI trust fund would dip below the critical level of reserves during 1982. Thus, the increased allocation of revenues into the DI trust fund enacted in 1977 and savings resulting from the 1980 disability legislation have only drawn more immediate attention to the OASI trust fund's short-run financing problem.

Cyclical Economic Behavior

The higher inflation and higher unemployment paths are meant to illustrate the effect of one isolated change in the economy. In reality, variations in inflation, unemployment, or real growth can and do occur in combination, moving in the same or in opposite directions as the economy progresses in some cyclical pattern.

The estimates underlying this analysis do not assume a cyclical economic pattern beyond 1982. Once the immediate economic situation is determined, the usual practice in formulating economic assumptions is to "trend out" the relevant economic variables beyond the current period. The economic assumptions now used to estimate the status of the Social Security trust funds project that the economy will recover from the current downturn, and that, after a recovery, no cyclical declines in or expansions of real economic growth will recur.

To see what effect continuing cyclical variations would have on the Social Security trust funds, the Social Security Administration's actuaries have projected the financial status of the funds under two alternative cyclical paths. 8/ The actuaries estimated one cycle in which real GNP grew faster in 1981 than had been assumed for their base projections. This cycle, called a "fast-recovery" scenario, had approximately the same rates of inflation and unemployment for 1981 as in the base set of assumptions. A second, "slow-recovery" cycle had real GNP declining in 1981, while unemployment and inflation were initially higher in 1981 than under the base path. Both cycles exhibited increases and decreases in real GNP, unemployment, and price growth over the remaining years of the forecast, as well as economic conditions that are sometimes higher or lower than in the base period's economic path. (This is what is meant by cyclical behavior.)

The scenarios show that, with any set of plausible economic assumptions, the current problem for 1982 and 1983 in the OASI and a combined OASDI fund appears virtually the same. The longer-term outlook for a combined OASDI funds remains poor. It could worsen considerably if the economy should follow the slow-recovery cyclical path, but under the fast-recovery scenario, balances could improve in some years. By 1990, though, under the fast-recovery path as well as under the slow-recovery path, a combined OASDHI fund would be in a worse financial state than under the base forecast.

8/ See U.S. Congress, Subcommittee on Social Security of the Committee on Ways and Means, Social Security and Economic Cycles (November 12, 1980), committee print.

CHAPTER III. POSSIBLE SOLUTIONS FOR THE NEAR FUTURE

To ensure that the OASI trust fund continues to have adequate reserves, the Congress must take some legislative action within the next year. A number of short-term measures are available that go beyond the payroll tax increases that went into effect on January 1, 1981. Some approaches involve only accounting changes; these would affect neither benefit payments nor scheduled total tax rates. Other short-term options would require more basic changes. These could include changing the method of adjusting benefits for the cost of living, increasing payroll taxes or turning to general revenues to relieve pressure on the trust funds. A quite different set of approaches affecting benefits would involve lowering or taxing them.

The effectiveness of such short-term options varies. Taken alone, most would require further legislative action shortly after they are implemented. All would depend on the behavior of the economy in future years. And none address the longer-term issues that may arise from problems in the design of the system itself. Short-term measures could, in any event, assure present retirees and persons now approaching retirement age of receiving the benefits they expect, and they could give the Congress time to consider more fundamental actions for the longer term. Further, they could help dispel public misapprehensions about the solvency of the system as a whole.

RECENT LEGISLATION--REALIGNING THE PORTIONS OF THE PAYROLL TAX

One accounting change has already been made. During the past session, to forestall the OASI trust fund's financial problems through 1981, the Congress passed legislation to realign the portions of payroll tax revenues flowing to the OASI and DI trust funds for 1980 and 1981. Public Law 96-403 increased the portion of the payroll tax rate earmarked for the OASI fund from 4.33 percent to 4.52 percent in 1980 (retroactive to January 1, 1980) and from 4.525 percent to 4.7 percent in 1981, at the same time reducing the DI portion of the tax by equivalent amounts. Tax revenues into the HI fund were unaffected by the statute.

The net effect of the legislation will be to postpone the expected cash flow problem of the OASI trust fund by approximately one-half year. Without the reallocation, OASI trust fund revenues would have been $7.4 billion lower in 1981 and still another $1.3 billion lower in 1982.

OTHER ACCOUNTING CHANGES

Under current economic assumptions, further accounting changes similar to those provided in Public Law 96-403 would enable all cash benefit payments to continue into 1984, because the total amount on reserve in all three trust funds will be adequate until then. Such options in this category include further realigning the payroll tax portions earmarked for the trust funds, allowing borrowing between the funds (as proposed by the Carter Administration in its budgets for fiscal years 1981 and 1982), and merging the three funds into one combined OASDHI trust fund. None of these measures, if taken alone, would obviate the eventual need for further assistance to the OASI fund.

A combined fund comprising OASI and DI only would only help OASI meet its obligations for an additional three to six months. Such a course would have to be supplemented before the end of 1982. A merger of all three funds into an OASDHI fund would go somewhat farther, providing an adequate balance through 1984. By 1985, however, the balance of an OASDHI fund would fall below 9 percent of anticipated outlays, and the decline is likely to continue in subsequent years (see Table 4). Combined reserves of all three funds are estimated to fall to 7.8 percent of outlays by 1985 and to remain at approximately this level through 1990. With the aggregate balance at such a low level, the need for further Congressional actions could arise again soon.

TABLE 4. PROJECTIONS OF SEPARATE AND COMBINED TRUST FUND BALANCES AT THE START OF YEAR, AS A PERCENT OF OUTLAYS, TO FISCAL YEARS 1986 AND 1990

Trust Fund	1981	1982	1983	1984	1985	1986	1990
OASI	20.0	14.0	4.7	a/	a/	a/	a/
DI	43.9	14.4	24.6	46.7	72.2	112.1	263.6
HI	51.9	54.2	58.6	60.8	59.5	57.5	49.7
OASDI	23.0	14.0	7.0	1.2	a/	a/	a/
OASDHI	27.8	21.0	16.1	12.0	7.8	6.7	8.3

SOURCE: Based on CBO's preliminary economic assumptions.

a/ Negative balance.

It should also be noted, as discussed in Chapter II, that the assumptions underlying the estimates presented here suppose that a cyclical pattern in the economy will not recur over the period 1982-1990. Accordingly, if the combination of high inflation rates, falling or low real wage growth and high unemployment did recur during this period, then the trust funds' short-term problems would probably worsen. Indeed, the sensitivity analysis given in Chapter II shows that, with slightly higher unemployment rates than are now assumed, the balance in a combined OASDHI fund would fall below 8 percent of outlays by the start of 1984 (compared to 12.0 percent under current law), making interfund borrowing alone insufficient to ensure continued timely payment of benefits beyond then. If, on the other hand, the economy experiences rapid growth and slow price increases, then the funds would be in better shape than is now projected. Since recent history has shown a pattern of economic fluctuations, the projections presented here probably give an optimistic picture. Further, the HI fund has an actuarial imbalance: on its present course, its reserve ratio will begin to fall in the late 1980s, and it is projected to be depleted by the end of this century.

Interfund Borrowing

In its 1981 budgetary proposal, the Carter Administration put forth a plan allowing the three Social Security trust funds to borrow from one another when the balance in any one fund falls below a certain level. (A similar though less explicit plan is also contained in the Carter Administration's 1982 proposed budget.) The intent of the proposal was to divert tax revenues from the DI fund (and possibly the HI fund) to the OASI fund without having to increase payroll taxes further. Repayment to the lending fund was to be made when possible, with interest.

As the result of the payroll tax reallocation enacted by the 96th Congress, borrowing by the OASI fund from the DI fund only is no longer feasible according to CBO's estimates. Permitting OASI to borrow from HI as well should be sufficient, though, for an additional two to three years. As Table 4 shows, the OASI fund falls below 5 percent of outlays by the start of fiscal year 1983, while a combined OASDI fund falls to 7 percent of outlays by the start of 1983 and becomes negative a little more than one year later. Interfund borrowing between the three funds to maintain both the OASI and DI funds above the critical level would totally deplete the HI fund during 1985.

To maintain a minimum balance of 9 percent of outlays at the start of each fiscal year, the OASI trust fund would need to borrow a total of nearly $160 billion over the 10-year period 1981 through 1990. However, only about $40 billion of this sum can come from the DI and HI trust funds in 1982, 1983, and through part of 1984 before their combined financial status is jeopardized. Starting in 1984, as a result of the timing of the problem, the loans from the HI fund to the OASI fund would have to be supplemented by approximately $7 to $10 billion from other sources to maintain all three trust funds' integrity. Over the full 10-year period, approximately $113 billion of the $160 billion needed by the OASI fund can be lent by the DI fund and another $42 billion from the HI fund without these balances' falling below 9 percent of outlays.

Table 5 details the total amount of borrowing CBO projects the OASI trust fund would need each year. During fiscal year 1982, for example, $6.9 billion dollars would have to be transferred to the OASI fund in order to maintain the flow of OASI cash benefit payments. 1/ An additional $17.4 billion would be needed before the end of fiscal year 1983. Table 6 shows that in the first year of borrowing, only $3 billion could come from the DI fund before its balance too falls to a critically low level. The remaining needs would have to be met by the HI trust fund.

Under the Carter Administration's original plan for interfund borrowing, such borrowing would be allowed when the balance of any one fund fell below what was deemed a critical level. The critical level proposed was up to 25 percent of the preceding 12 months' outlays. 2/ The amount of borrowing permitted could vary, but it could not exceed the amount that would raise the borrowing fund's balance to 25 percent of the preceding 12 months' outlays. Repayment, with interest, would be required; it would begin when the balance of the borrowing fund exceeded 30 percent of outlays for the preceding 12 months. According to the plan, the authority to borrow would expire in the year 1991.

CBO estimates that, if the OASI trust fund borrowed enough to maintain a balance at the beginning of the fiscal year equal to 25 percent of the previous year's outlays, roughly $10 billion would have to be borrowed by the start of fiscal year 1982 and $17 billion by the start of fiscal year 1983. Beyond that, the DI and HI trust funds could not support this borrowing plan without additional revenues.

Realigning the Tax Rates or Merging the Funds

Results identical to those achieved by interfund borrowing can be accomplished by further realigning the portions of the payroll tax designated for each trust fund. Increasing the OASI fund's share by roughly one-half of

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1/ These transfers would have to be made during the year shown in the text, but for analytical purposes, it is assumed in the tables that they are credited at the start of the next fiscal year.

2/ Section 101 of H.R. 6652 (96th Congress, 2nd Session).

TABLE 5. PROJECTED BORROWING NEEDED TO MAINTAIN THE OASI TRUST FUND RESERVES AT START OF EACH FISCAL YEAR AT 9 PERCENT OF THAT YEAR'S OUTLAYS, TO FISCAL YEAR 1990: IN BILLIONS OF DOLLARS a/

Fiscal Year	Total OASI Outlays	Trust Fund Balance at Start of Year Under Current Law	Total Amount Needed by Start of Year b/	Borrowing Needed by Start of Year b/ c/
1981	122.6	24.6	11.0	d/
1982	141.4	19.7	12.7	d/
1983	158.7	7.4	14.3	6.9
1984	178.0	-8.2	16.0	17.4
1985	199.3	-27.1	17.9	20.8 e/
1986	222.6	-44.5	20.0	19.5 e/
1987	248.2	-63.5	22.3	21.3 e/
1988	275.5	-86.0	24.8	25.0 e/
1989	305.1	-107.3	27.5	24.0 e/
1990	334.8	-128.9	30.1	24.3 e/
Cumulative Borrowing, 1981-1990				159.2

SOURCE: CBO estimates.

a/ Assumes that this borrowing can be obtained from DI or HI trust funds. During 1984, however, the HI trust fund balance is projected to fall below critical levels, and other revenue sources will have to be found.

b/ Total transfers needed by start of year. These transfers will have to be made, however, during the preceding fiscal year to ensure timely payment of all benefits.

c/ See Table 6 for source of these loans.

d/ No need for borrowing projected.

e/ Hypothetical. HI trust fund balance would fall to very low levels in 1984 and become negative during 1985 if all of these transfers were made.

TABLE 6. PROJECTED AMOUNT AND SOURCE OF POSSIBLE INTERFUND BORROWING NEEDED BY START OF YEAR TO MAINTAIN OASI TRUST FUND AT 9 PERCENT OF ANTICIPATED OUTLAYS, TO FISCAL YEAR 1990: IN BILLIONS OF DOLLARS

Fiscal Year	Amount Needed by OASI Fund Before Start of Year a/	Amount Borrowed by OASI Fund from DI Fund b/	Amount Borrowed by OASI Fund from HI (or Other Source)
1983	6.9	3.3	3.6
1984	17.4	5.3	12.1
1985	20.8	7.1	13.7 c/
1986	19.5	12.7	6.8 c/
1987	21.3	16.6	4.7 c/
1988	25.0	19.6	5.4 c/
1989	24.0	22.6	1.4 c/
1990	24.3	25.9	d/

SOURCE: CBO estimates.

a/ Transfers must be made in preceding year, but for analytical purposes entire amount shown as the amount needed by the start of year.

b/ This borrowing scenario assumes that the transfers would first be made from the DI fund, and any additional transfers would then be made from the HI fund. It assumes that the DI fund's balance never falls below 9 percent of outlays.

c/ Hypothetical. HI trust fund balance would fall to very low levels in 1984 and would become negative during 1985 if these transfers were made.

d/ DI fund could repay HI fund approximately $1.6 billion in this year.

one percent at some expense to the DI fund (0.15 percent) and to the HI fund (0.35 percent) would relieve the OASI fund's problem until 1984. Because they could involve repeated legislative action, however, such reallocations might be a less attractive accounting change than interfund borrowing, which could be carried out on an ad hoc basis for whatever period the legislation stipulated as the three funds' relative positions shift.

A merger of the trust funds to raise OASI's reserve balance could have the same advantage of flexibility as interfund borrowing. On the other hand, critics of both these approaches have argued that a merger, in particular, is a less desirable solution because it could limit the Congress' control over the three trust funds' outlays. By tending to obscure the visibility of the separate programs' accounts, such an amalgamation could create difficulties in identifying the causes and effects of internal fluctuations. This problem could be solved, however, by continuing to maintain three separate accounting systems.

MODIFICATION OF BENEFIT INDEXATION

Modifying the indexing formula used to raise Social Security benefits each year to keep pace with inflation is another way to relieve the pressure on the OASI trust fund. Since 1975, benefit payments have been indexed to increase automatically with rises in the CPI. Under current law, whenever the average rise in the CPI from the first quarter of the previous year to the first quarter of the current year is greater than 3 percent, benefits are raised by the actual first-quarter-to-first-quarter inflation rate. This benefit increase is first credited to the recipients' June benefit, payable in July. The June 1980 benefit increase was 14.3 percent--considerably more than the 7.33 percent average annual increase over the 1975-1979 period. CBO's current projections show an average annual increase from 1981 to 1986 of approximately 9.6 percent (see Table 7 later in this chapter).

The specific index used to compute the cost-of-living benefit increase is the CPI series for urban wage earners and clerical workers. This index measures changes in the price of a fixed "market basket" of commodities and reflects the purchasing patterns of less than 40 percent of the U.S. population. The overall index is a weighted average of the price changes of the commodities in the market basket, with the weights having been determined by consumers' 1972-1973 expenditure patterns.

The acceleration in the rate of inflation over 1979 and 1980 has raised concern that this particular measure of inflation may be overstating the actual increase in the cost of living. The apparent distortion results primarily from the "homeownership cost concept" used in the CPI. This concept treats houses like any other item--that is, as though they were "consumed" in the year they were bought. In fact, the services rendered by a house are consumed over its entire lifetime. Furthermore, a share of a house's purchase price can be viewed as an investment good, rather than as a consumer good. In the past several years, while housing prices have risen substantially, a comparable increase in rental costs has not occurred. In addition, mortgage interest rates have risen sharply over the past two years, leading to a large increase in this component of the CPI. As a result, recorded housing price rises reflect the increase in shelter use costs, the increase in investment value, and the higher mortgage costs. The inclusion of total house prices in the CPI thus overstates the rise in shelter costs during periods of rapid increase in housing values or mortgage interest rates.

Such overstatements in computing the effects of inflation can be extremely costly in government outlays. The 14.3 percent increase for June 1980 will add nearly $17 billion to outlays in fiscal year 1981 alone. For each one percentage point increase in the CPI in the future, more than $1.3 billion in benefits each year are paid to OASI and DI beneficiaries. In addition, these increased benefits accumulate in successive years, as higher annual inflated levels of benefits are paid and as future cost-of-living increases are compounded on these higher levels. This sensitivity of benefit payments to changes in the CPI means that relatively small problems or errors in the CPI, or other measures of the cost of living, can seriously worsen the financial prospects of the Social Security trust funds.

There are other flaws in the CPI as well that may justify the shift to a modified way of indexing benefits. The CPI has been criticized on several counts: for its failure to account for shifts in consumer buying patterns in response to changing commodity prices, for its failure to adjust adequately for changes in the quality of goods and services, and for its lack of relevance for particular subgroups in the population such as the elderly, who are the primary recipients of Social Security benefits. These problems, however, or others of similar magnitude, affect some other price indexes as well. The CPI is a readily available and accepted price index. The questions to be considered are: What is the function of the index chosen, and what index could best serve that function? These issues are complex and can only be pointed to here. 3/

There are several alternatives the Congress might consider to modify the method of indexing Social Security benefits and, in doing so, to save the system large sums of money over the next five years. In order to compensate for improper measurement of the weights of various components in the index, such as housing costs or the substitution of relatively cheaper goods in the market basket, an alternative index could be used. Or, the Congress could modify--from time to time and in an ad hoc way--the measure of the cost-of-

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3/ For further discussion, see Statement of Lawrence DeMilner, Congressional Budget Office, before the Task Force on Inflation of the House Committee on the Budget, December 14, 1979; and forthcoming CBO study on the CPI and alternative measures of inflation.

living increase that the CPI stands for. Tables 7 and 8 (below) summarize the effects of alternative approaches to modifying the Social Security benefit indexing mechanism.

The "Rental Equivalent" Modified Index

One solution to the housing treatment in the CPI is to tie benefit increases instead to a modified price index that uses a rental equivalent for housing costs. This approach was suggested in the 1982 Carter Administration budget. This modified "rental equivalent index" is now being published by the Bureau of Labor Statistics (BLS). It measures the cost of living in an owner-occupied house by the amount that equivalent accommodations would cost on a rental basis. All of the other components of this index, however, are the same as those in the CPI. This index, if it were implemented for the June 1981 benefit increase, would save an estimated $11 billion over the period 1981-1986 (see Table 8). If it were first implemented for the June 1982 benefit adjustment, however, it could raise costs over the period, since projections of falling interest rates could mean that the annual increase in the modified index will be higher than that for the CPI in 1982. If this index were implemented in place of the CPI in 1981, there would still be a need for interfund borrowing or some other short-run option over the 1981-1986 period. 4/

It should be noted that estimates of the potential savings from the use of this index, and the others discussed below, are highly uncertain. These indexes can fluctuate in ways that are difficult to forecast. Results such as those presented here must therefore be interpreted as tentative.

The PCE Chain Index

Some analysts see merits in using the Personal Consumption Expenditure (PCE) "chain index" in place of the CPI as an adjustment mechanism. The PCE chain index has roughly the same coverage as the CPI and uses a rental-equivalence measure for housing costs. The PCE chain index also uses current consumption patterns as weights instead of the 1972-1973 patterns used in the CPI.

As can be seen from Tables 7 and 8, the immediate substitution of the PCE for the CPI in determining the annual Social Security cost-of-living increase would also help with the short-run financing problem. Current

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4/ This and the following discussion on indexation assume that all of the savings from both the OASI and DI programs generated from various indexing options can be allocated to the OASI fund.

projections show the yearly PCE increases at approximately the same levels as the rental equivalent index. A June 1981 cost-of-living increase using the PCE index is estimated to be 10.3 percent, 1.7 percent below the expected increase of 12.0 percent if the CPI were used. This would save more than $2.4 billion by 1982. On the other hand, the relationship could reverse in future years; if so, no savings might occur. The PCE would not entirely eliminate the need for other options to help solve the short-term problem. 5/

A Price-or-Wage Index Adjustment

Another option is to limit the annual cost-of-living increase either to the rise in the CPI or to a wage index, whichever is lower over the given period. A modified approach of this type was presented by the National Commission on Social Security in its preliminary recommendations. Their proposal would also allow a "catch up" increase in benefits to compensate for past limits on benefit increases that occurred in times of falling real wages. This compensation would be made in subsequent periods when wages begin again to rise faster than prices. The catch up is not assumed in the analysis presented here, however.

During the two most recent recessionary periods, average money wages have not grown as fast as prices; that is, the real purchasing power of workers has declined. Over the last recessions, Social Security benefits have been protected against this decline in real purchasing power, since the automatic benefit increases have been greater than the growth in money wages. This relationship occurred during the 1974-1975 recession and was repeated during the current economic slowdown.

The savings to be realized from indexing benefits according to the lower of wage or price growth is substantial. If benefit increases were limited to the lower adjustment mechanism, savings of $26 billion would accrue to the trust funds by 1986. There would also be added interest income resulting from these higher balances.

Chosing the lower of a wage or price index would prevent retirees from gaining relative to active workers in times of falling real wages. It would also maintain retirees' real levels of benefits in times of rising real wage, although if benefits were previously indexed to wages, this would be at a new lower level of real benefits. Because wages over the working life of an individual are anticipated to increase faster than prices for most years,

5/ The difference between the PCE chain index and the CPI is also extremely difficult to forecast; the results presented should be understood as tentative.

indexing benefits to the lower of wages or prices would result in a slow decline in the relative position of Social Security recipients compared to current law price-indexed benefits.

Capping the Annual Cost-of-Living Adjustment

Another possibility is for the Congress to continue to allow indexation with the CPI, but explicitly to review the increase each year. This option could operate in a manner similar to the current Congressional review of the President's determination of the federal pay raise. A Social Security benefit increase based on the CPI would be established by the end of April each year. The increase could automatically become the rate of the benefit increase unless the Congress wished to adjust it, and this approach would explicitly permit the adjustment.

The Congress might, for example, want to limit, or "cap," the cost-of-living increase at 67 percent or 85 percent of the CPI in each year in the 1981-1986 period. 6/ The effects of these choices, as well as the resulting savings, are shown in Tables 7 and 8. The 67 percent cap, commencing in 1981, would yield savings of more than $96 billion over the 1981-1986 period for the OASI and DI trust funds together. Even though this option would yield large yearly savings in the out years, the OASI fund would need additional money in the more immediate future. Thus, this option alone would not immediately generate enough money to solve the funds' short-term problem entirely. However, these savings would put the fund in a position to meet its obligations through the end of the 1981-1986 period. The 85 percent cap would save more than $44 billion.

Although caps of 67 percent or 85 percent on CPI increases in benefit payments are somewhat arbitrary, a number of precedents and justifications can be cited. The President sometimes caps federal pay raises, for example. The actual pay increases differ from what are thought to be fair comparibility increases. In 1980, the Advisory Committee on Federal Pay determined that the October 1980 raise should average 13.5 percent. The actual pay raise was 9.1 percent, 67 percent of what it might have been. This is one limit that could be applied to Social Security, although the cap on federal pay raises undoubtedly would be different in the future.

6/ The 67 and 85 percent caps should be understood as examples of potential limits and the savings resulting from them, and not as suggestions of what an exact cap, if any, should be.

TABLE 7. ESTIMATED RATES OF INCREASE OF ALTERNATIVE SOCIAL SECURITY BENEFIT INDEXING MECHANISMS, TO 1986 a/: IN PERCENTS

	(Increase by End of First Quarter)					
Year	CPI (Current Law)	Rental Equivalent Modified Index	PCE Chain Index	Hourly Earnings for Non-Farm Workers	67 Percent Cap on CPI	85 Percent Cap on CPI
1981	12.0	10.3	10.3	9.1	8.0	10.2
1982	8.9	9.9	9.9	9.1	6.0	7.6
1983	9.4	9.0	9.0	9.3	6.3	8.0
1984	9.3	9.1	9.1	9.5	6.2	7.9
1985	9.2	9.2	9.2	9.5	6.2	7.8
1986	8.9	8.8	8.8	9.5	6.0	7.6
Average Annual	9.61	9.38	9.38	9.33	6.45	8.18

SOURCE: Based on CBO's preliminary economic assumptions.

NOTE: Index figures shown here are intended solely as illustrations for comparison.

a/ Percent increases in first-quarter index from that of preceding year.

There may be substantial economic consequences of denying across-the-board limits on cost-of-living increases. In times of high rates of inflation, the full benefit adjustment may hamper efforts to slow the continued growth in prices. A relatively large increase in spending would fuel additional price increases; caps of the type discussed above would tend to help slow the rate of growth of prices. However, the amount of the cap would be determined annually by the Congress, reinstating an ad hoc component to future cost-of-living adjustments. (Although these arguments directly relate to the 67 or 85 percent cost-of-living limits, they can apply equally to the other ways of limiting the benefit increase.)

TABLE 8. ESTIMATED ANNUAL AND CUMULATIVE SAVINGS TO OASI AND DI TRUST FUNDS FROM ALTERNATIVE BENEFIT ADJUSTMENT MECHANISMS, TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

Year	OASDI Outlays Under Current Law	Rental Equivalent Modified Index	PCE Chain Index	Lower of Price or Wage Index	67 Percent Cap on CPI	85 Percent Cap on CPI
1981	140.1	-0.5	-0.5	-0.9	-1.3	-0.6
1982	160.9	-1.9	-1.9	-3.8	-6.3	-2.8
1983	179.7	-1.2	-1.2	-4.4	-11.4	-5.2
1984	200.7	-2.0	-2.0	-5.1	-17.8	-8.2
1985	224.0	-2.4	-2.4	-5.6	-25.3	-11.7
1986	250.1	-2.8	-2.8	-6.3	-34.1	-16.0
Cumulative		-10.8	-10.8	-26.1	-96.2	-44.5

SOURCE: Based on CBO's preliminary economic assumptions.

NOTE: Minus sign denotes amount of yearly savings.

Opponents of such limits argue that incomes of Social Security recipients are below those of persons still in the work force; many retired Social Security beneficiaries are already less able to cope with increases in the cost of living. Although many recipients have some additional income from sources other than Social Security, such income rarely increases with inflation. Thus, even with fully indexed Social Security benefits, the total incomes of many recipients do not keep pace with the cost of living. Furthermore, this change would mean abandoning a commitment made by the Congress in 1972 to protect the elderly and disabled fully from the impact of inflation, however it is measured. Finally, reductions in Social Security indexing would lead to increased spending for other federal programs that are means tested. For example, expenditures for Supplemental Security Income or food stamps would rise, offsetting some of the spending reductions in Social Security. These outlays would not, however, come from the Social Security trust funds.

REDUCTION OR ELIMINATION OF CERTAIN BENEFITS

Options to modify Social Security benefits have been included in recent budgetary proposals of the Carter Administration. Although many of these cuts may be desirable for other reasons, none would generate enough savings to reverse the projected short-run OASI deficit. They could, however, serve a useful purpose if enacted in combination with other measures.

Options involving the cancellation of certain benefits include phasing out students' and certain parents' benefits and eliminating the minimum and lump-sum death benefits (see Table 9). These payments continue to come from the OASI and DI trust funds, despite the creation and expansion of other government programs more directly targeted toward the groups now eligible for these benefits. Some of these awards are not directly tied to tax contributions. Furthermore, changing labor-force patterns of women may have made obsolete some Social Security provisions. Many such benefits could, in addition, be rescinded quite quickly.

Both the Ford and the Carter Administrations recommended phasing out Social Security post-secondary student benefits, which are payable to unmarried dependents between the ages of 18 and 22 who are full-time students. (Nonstudent child dependents' benefits stop at age 18.) The entitlement was created in 1965 legislation and since that date the Congress has greatly expanded other forms of student assistance since 1965. In particular, the Basic Education Opportunity Grants (BEOGS) program has been implemented. Phasing out the Social Security benefit would thus eliminate some duplication of aid. There would be, however, some offsets in these savings to the general budget as a result of taking this option, since there will be some additional BEOGS payments to compensate lower-income recipients of Social Security student benefits.

In his 1980 budget, President Carter proposed phasing out the survivor benefits for parents of children aged 16 and 17. In addition, eliminating the minimum benefit for new beneficiaries, and the lump-sum death benefit for surviving families was also proposed. None of these proposals was enacted by the Congress.

Survivors' benefits for parents are paid until their children reach age 18. If the parents' benefits (but not the children's) were discontinued when the dependents turned 16, annual savings to the trust funds would exceed $500 million by 1986. Such a change would be based on the assumption that parents--primarily mothers--of children aged 16 or 17 are not homebound and can join the labor force. At present, however, more than half of all women whose youngest children are older than 13 are already in the work

TABLE 9. PROJECTED SAVINGS FROM REDUCING OR ELIMINATING CERTAIN SOCIAL SECURITY BENEFITS, TO FISCAL YEAR 1986: IN MILLIONS OF DOLLARS

Benefit Change	1982	1983	1984	1985	1986
Phase Out Student Benefits	650	1,235	1,820	2,480	2,710
Phase Out Survivor Benefits for Parents of Children Aged 16 and 17	25	90	500	525	535
Eliminate Minimum Benefit	65	135	160	205	225
Eliminate Lump Sum Death Benefit	400	410	420	435	450
Cumulative Savings	1,140	1,870	2,900	3,645	3,920

SOURCE: CBO estimates.

force. On the other hand, many such women have no recent work experience and may not be able to find jobs, especially in times of high unemployment. Furthermore, for those who are employed, many have low incomes, especially relative to previous total family incomes.

When a worker has been employed intermittently in jobs covered by Social Security, the benefit he would receive under the present benefit computation method could be very low. To compensate for the low benefits, the Congress had stipulated that there be a minimum monthly benefit. Under the 1977 Social Security Amendments, this minimum amount was frozen for most new retirees at $122 per month (except for certain special minimum benefits).

Although most persons receiving the minimum are women whose labor-force attachment covered only part of their potential working lives, many retirees who spent most of their working careers in noncovered employment, typically in government, also receive the minimum benefit. Some in the group who are eligible for the minimum benefit have earned pensions under other programs. Proposals have been put forth to eliminate this minimum benefit completely for newly retired workers. Persons actually in need could be directly protected by Supplemental Security Income (SSI) and other assistance programs; elimination of the minimum benefit could therefore lead to significant increases in spending elsewhere in the budget.

A lump-sum benefit (to a maximum of $255) is paid to survivors of deceased retired and disabled workers. This benefit goes either to the family, or, in the case of no immediate surviving family, to the institution or agency last caring for the beneficiary. The benefit is meant to defray part of the cost of burial, although the maximum payment allowed has not been increased since 1954. Proposals to eliminate this benefit could save approximately $400 million in fiscal year 1982. If this proposal created a financial hardship on some low-income families, the SSI or other assistance programs could serve as an alternative source of aid.

Proposals to cut or phase out benefits of any sort would inevitably give rise to controversy. These benefit options may, however, be programmatically desirable in the short run. They could help--to a limited degree--with the short-run financing problems and could save significant sums of money in the longer term. However, only larger benefit reductions or limits on the amount of future benefit increases could ensure the trust funds' short-term solvency without creating needs for concurrent tax increases or accounting changes.

INCREASING REVENUES TO THE TRUST FUNDS

As an alternative to accounting changes or benefit reductions, payroll taxes could be raised further, or revenues could be introduced from outside sources to maintain the trust fund balances at an adequate level. There are a number of ways to do this. The Congress might grant Social Security the authority to borrow from the federal Treasury when economic conditions are depressed. These loans could be repaid later, when the trust funds have a surplus. Alternatively, these general Treasury monies might be regarded as a form of countercyclical federal aid that would not have to be reimbursed.

Another option might be to finance all three trust funds, or the HI fund separately, with individual and corporation income tax receipts. A portion of income tax revenues could be earmarked for Social Security and used to replace part of payroll tax collections. Alternatively, payroll taxes could be raised still further, and credits for payroll tax contributions could be used to offset income tax liabilities.

Countercyclical Borrowing

Most proposals involving lending from the federal Treasury suggest using a measure such as the unemployment rate as a trigger mechanism. 7/ Such schemes have the advantage of avoiding payroll tax increases precisely when payroll tax revenues have slackened because of an economic slowdown. A drawback to most of these approaches, however, is the length of time for which these loans are likely to remain outstanding. In this respect, borrowed funds, because they are unlikely to ever be fully repaid, would resemble outright grants.

Another shortcoming to using the unemployment rate as a trigger to permit borrowing is the change in recent years in the definition of full employment. A decade ago, an unemployment rate of 5.5 percent reflected an economy operating far below peak capacity. Now, changes in the composition of the labor force indicate to some analysts that an unemployment rate between 5 and 6 percent can be defined as full employment. Further shifts in demography, or simply in definition, would limit the usefulness of any single economic indicator as a trigger for countercyclical borrowing.

Finally, whether funds from outside the system were transferred on a loan basis or as outright grants, the inevitable effect of borrowing would be either a reduction in the amount of money available for other federal programs or an expansion of the deficit. In the past, the Congress has found it difficult to slow increases in expenditures, since a large fraction of federal outlays (including Social Security) are regarded as relatively "uncontrollable". If other federal programs are not cut accordingly, the federal deficit would grow, in turn triggering a rise in the price level. This could cause Social Security expenditures to rise still further. If such an outcome were to be avoided without other federal program cuts, the Congress might have to turn to other sources for increased Social Security revenues.

Payroll Tax Increases

In keeping with past practice, a way to assist the OASI trust fund would be to raise either the payroll tax rate or the maximum taxable wage base over and above the increases now in effect and scheduled for future years according to the 1977 amendments. Ensuring that the trust fund balances remain above 9 percent of future outlays would require a payroll tax rate increase of at least 0.5 percent above current rates starting in 1982, or eliminating the ceiling on the taxable maximum wage base, and earmarking all the additional revenue for the OASI trust fund.

7/ For a similar recommendation, see Social Security Financing and Benefits, Report of the 1979 Advisory Council on Social Security (December 1979), pp. 51-54.

A payroll tax increase of 0.5 percent, which would bring the scheduled 1982 rate from 6.7 to 7.2 percent for both employers and employees, would raise Social Security revenues by a total of more than $25 billion in fiscal years 1982 and 1983 (see Table 10) and by more than $80 billion over the period 1982-1986. These new monies, however, would be just barely adequate to put the OASI fund in a position to meet its obligations. If instead the rate were raised by a full of 1.0 percent, the added revenues would double, giving the system a greater cushion against economic shocks.

Removing the ceiling on taxable earnings and taxing all earned income would achieve roughly the same result by 1986 as instituting a 0.5 percent payroll tax increase if the additional revenues were directed to OASI. Critics of this approach contend that persons whose incomes now markedly exceed the taxable wage base would bear a disproportionate share of the cost of Social Security. In response to this argument, some analysts have suggested that the ceiling be lifted off only the employers' share of the tax. This proposal is justified on grounds that employers can deduct their tax liabilities as business expenses, whereas employees have no such advantage. Such a compromise measure would generate roughly $34 billion in new payroll tax revenues through 1986, which is still short of what the OASI fund is assumed to require. 8/

Altering the tax treatment of self-employed persons, whose present payroll tax rate of 9.3 percent is set midway between the employees' and the total employer/employee rates, is another possibility. Raising the levy on self-employed persons to match the full employer/employee rate (13.4 percent in 1982) could generate $20 billion in new revenues through 1986. 9/

An Offsetting Tax Credit

Increases in the payroll tax have drawn objections as having both inflationary and restrictive economic effects. An increase in the employers' share of the Social Security tax would raise a firm's labor costs and thus

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8/ Because employers' payroll tax payments could be deducted against corporations' income tax liabilities, however, corporation income tax revenues would decline.

9/ The Carter Administration made such a proposal to deal with the so-called "independent contractor" issue, in which certain employers attempt to reduce their F.I.C.A. tax liabilities by not claiming employees as such but by defining them rather as providers of purchased services. Self-employed persons would have been permitted to deduct half of their contributions against their income tax liabilities.

could contribute to the higher levels of prices and unemployment. Many analysts believe that the employer-paid portion of a payroll tax increase, to the extent that it is not offset by lower wages or lower employment, would eventually be reflected in higher prices for goods and services. In the context of Social Security in particular, such inflationary effects have direct bearing on outlays, inasmuch as they would inevitably be reflected in benefit amounts. Increases in the employees' share of the tax would tend to cut into disposable income, causing a decline in aggregate demand that, in turn, might result in higher unemployment. 10/

To lessen the detrimental effects of a tax increase but at the same time meet the projected deficit in the OASI fund in 1982, the Congress could increase the payroll tax but moderate the impact by enacting an income tax credit or a deduction for payroll tax contributions. A bill introduced in the 97th Congress, S. 44, is intended to do approximately this. To help offset a rise of almost 10 percent in the payroll tax in 1981 and 1982, S. 44 would provide a refundable income tax credit of 10 percent for employer and employee payroll tax contributions made in those years. 11/ (The amounts by which such a credit would lower income tax revenues, if it were enacted on a permanent basis, are given as a note to Table 10.)

When likened to other kinds of income tax cuts, the credit proposal would direct a larger portion of the income tax reduction toward low-income taxpayers and would favor industries with higher labor costs. Because of its tie to Social Security coverage, certain portions of the taxpaying public would not realize any benefits from the credit--most notably Social Security beneficiaries themselves. An estimated 5 to 6 million taxpayers over age 65 might be left out of the cut. The 10 percent of the working population not covered by Social Security would also not benefit.

The earned income credit (EIC) was enacted (in 1975) to help offset the effect on low-income taxpayers of higher payroll taxes. A payroll tax credit could be viewed as an extension of the EIC, offering similar work incentive effects. The full effect of the credit's work incentive features would be felt by persons whose entire earnings fell below the Social Security income ceiling--the great majority of wage-earners.

10/ Such an outcome, however, would mitigate an increase's inflationary effects. For analysis of the effects of the payroll tax on different spheres of economic activity, see CBO, Aggregate Economic Effects of Changes in Social Security Taxes (August 1978).

11/ Unlike many other kinds of tax credits, credits in excess of income tax liability for a "refundable" credit are paid in cash.

A drawback to the credit is the complexity it would add to the income tax structure. For most taxpayers, this problem could be mitigated by incorporating the credit into withholding schedules. For low-income persons, however, experience with the refundable EIC has shown that low-income people who would not normally file tax returns might fail to take full advantage of the credit's refundability provision. Further difficulties might arise in devising a method for reimbursing state and local governments and not-for-profit organizations for contributions made on their behalf.

General Revenue Financing of HI

Both the 1979 Advisory Council on Social Security and the National Commission on Social Security have proposed a reduction in the overall payroll tax rate, to be achieved by financing HI out of earmarked individual and corporation income tax revenues. Of the three Social Security programs funded by the payroll tax, HI has been singled out for removal from the payroll tax framework because its benefits are unrelated to a person's past earnings. Unlike the expected benefits a person receives under OASI or DI, which are closely tied to the level of past contributions, HI expenditures are based exclusively on the need for medical care. In addition, a precedent has already been established for such a change by the funding of the other portion of Medicare, Supplemental Medical Insurance, some two-thirds of which is now financed from general revenues.

Financing HI from a surtax on income tax liabilities earmarked for HI would allow part of the HI share of the payroll tax to be shifted to the OASI and DI portions of the tax rate and part to be used for a reduction in the overall payroll tax rate. Table 10 shows the amount of additional payroll tax revenue the OASI and DI funds would receive if HI were entirely financed by income tax collections while the overall payroll tax rate was held at its 1981 level until 1986. (A bill, H.R. 1018, introduced in the 97th Congress, would achieve a similar result by funding half of HI from general revenues and setting the combined OASDHI rate at 6.55 percent.) Like the tax credit described above, this approach would neutralize the potentially adverse effects of future payroll tax increases by replacing payroll tax contributions with income taxes. On the other hand, workers not covered by Social Security, as well as current beneficiaries, would be required to pay for a portion of the program. As with the tax credit, labor costs would decline as the payroll tax rate fell, thus providing employers with greater incentive to hire additional employees. A surtax might also result in fewer administrative problems, since the procedures for determining tax liability would not change. This approach, unlike a payroll tax increase, would also tend to benefit low-income taxpayers more than more affluent people by guaranteeing a tax cut for low-income taxpayers.

TABLE 10. PROJECTED EFFECTS OF REVENUE CHANGES TO ASSIST THE OASI TRUST FUND, a/ TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

Change	1982	1983	1984	1985	1986
Increasing Payroll Tax by 0.5 Percent b/	10.0	15.6	17.5	19.5	21.8
Eliminating the Ceiling on Taxable Earnings b/	5.4	16.9	18.5	19.6	21.0
Raising the Self-Employed Tax Rate to the Full Employer/Employee Rate c/	0.8	3.9	4.4	5.0	5.7
Reallocating the HI Portion of Payroll Tax Rate to OASDI d/	24.9	38.5	43.2	39.7	40.7
Inflation-Induced Income Tax Revenues e/	11.9	39.0	75.1	121.0	179.1

SOURCE: Joint Committee on Taxation and CBO estimates.

NOTE: Proposed changes assumed effective January 1, 1982. Figures do not include any revenue offsets that might result from a payroll tax change. Most of these offsets are likely to come from changes in income tax payments.

a/ Assumes current law. For estimated amounts needed, see Table 5.

b/ As an offset to these payroll tax increases, a refundable 10 percent credit would reduce income tax revenues over the period by the following yearly amounts: $12.1 billion, $19.7 billion, $22.1 billion, $25.7 billion, and $29.4 billion.

c/ Disregards income tax reduction caused by deductibility provision for half of payroll tax contributions.

d/ Calculated by transferring a portion of HI rate to OASI and DI and fixing the combined OASDI rate at the current 6.65 percent rate.

e/ Based on currently scheduled tax rates. Assumes allocation of a portion of inflation-induced increases in revenues to go to OASI fund.

Inflation-Induced Increases in the Income Tax

During periods of inflation, federal income taxes tend to rise more rapidly than individual incomes because of the federal income tax code's progressive features. 12/ Under current policy, for example, additional individual income tax receipts attributable to inflation in a single year are likely to grow from $11.9 billion in 1982 to $179.1 billion in 1986 (see Table 10). In the past, the Congress has acknowledged these unlegislated tax increases by enacting periodic tax cuts designed in part to offset inflation's effects. If it seems advisable to forego or reduce the size of these income tax cuts, a portion of the resulting revenues could be directed to the trust funds by either earmarking them or making general revenue transfers. Many advocates of the Social Security program express a preference for allocating the funds explicitly, because they feel that this transfer arrangement would be more binding. They argue, in addition, that earmarking gives administrators greater control over program expenditures, although evidence from the DI and HI programs suggest that specific earmarking has little effect on program costs.

A shift in the method of funding Social Security would affect the overall distribution of the federal tax burden. Under current law, the payroll tax in 1981 is levied at a fixed rate on all wages and salaries up to the specified earnings ceiling of $29,700. The average payroll tax rate on adjusted gross income therefore remains fairly constant for incomes below the wage limit and declines for incomes above it (see Table 11). The distribution of individual income tax liabilities, on the other hand, is fairly progressive; the fraction of income collected in taxes rises with income, in accordance with ability to pay.

How taxpayers in different economic circumstances would fare under a combined income and payroll tax to finance Social Security is uncertain. For example, the Congress could decide to obtain additional revenue by doing without an inflation-offsetting tax cut and assigning the increases in individual income taxes to Social Security, as outlined above. Between 1967 and 1977, the Congress enacted income tax cuts that tended to overcompensate low- and middle-income persons for inflation. If the Congress decided to forego this kind of tax reduction in the future, the resulting distribution of individual income and Social Security taxes then would be roughly similar to the effects of the existing system. The Congress would be foregoing an income tax cut benefiting mainly low- and middle-income taxpayers but averting an alternative tax increase that would have fallen mainly on those same taxpayers.

12/ For a detailed discussion of inflation's effects on individual income tax liabilities, see CBO, Indexing the Individual Income Tax for Inflation (October 1980), Chapter II.

TABLE 11. COMPARISON OF THE DISTRIBUTION OF THE SOCIAL SECURITY PAYROLL TAX AND OF THE INDIVIDUAL INCOME TAX UNDER CURRENT LAW, BY INCOME CLASS

Income Class (in Dollars)	Payroll Tax Contributions: Percent of Total Paid by Each Income Class	Payroll Tax Contributions: As a Percent of Adjusted Gross Income	Income Tax Liability As a Percent of Adjusted Gross Income
Below 5,000	3.2	7.5	0.7
5,000 - 10,000	7.5	5.5	5.4
10,000 - 15,000	10.3	5.7	9.9
15,000 - 20,000	12.6	6.0	12.2
20,000 - 30,000	27.7	6.0	14.1
30,000 - 50,000	29.4	5.5	17.1
50,000-100,000	7.7	3.4	23.5
100,000-200,000	1.3	1.7	32.5
Over 200,000	0.3	0.7	39.9
	Total 100.0	Average 5.2	Average 15.9

SOURCE: Joint Committee on Taxation.

The Revenue Act of 1978, however, reversed the distributional pattern of the previous 10 years by providing relatively greater tax benefits to upper-middle- and high-income taxpayers. Foregoing this kind of tax cut and transferring the additional tax revenue to Social Security would effectively make the combined income and payroll tax more progressive, since a payroll tax that would fall primarily on low- and middle-income taxpayers would be averted by denying a tax cut to higher-income taxpayers.

SOME OPTIONS IN COMBINATION

As emphasized above, some revenue or benefit options alone would probably be insufficient to ensure benefit payments throughout the coming five years. Some, such as the accounting changes outlined early in this chapter, would allow benefits to be paid for an additional two or three years before other action is needed. Other options taken together, though, could be sufficient to relieve the system's financial difficulties for longer periods.

If the Congress selected any of the accounting changes to ease the OASI fund over its immediate critical period, further infusions of $3.5 billion and $4 billion would be needed in fiscal years 1984 and 1985. An additional $1 to $2 billion would be needed by 1987. After that, the OASI fund should be able to meet its obligations through 1990. In interpreting these estimates, however, one must assume that the economy will behave in the manner now anticipated. If there is a repetition of past cyclical behavior, even these additional monies could prove inadequate.

All four benefit reductions discussed above, combined with one of the accounting changes, could generate enough savings to ensure continued and timely payment of benefits. Combining accounting changes with any of the options involving the indexing mechanism could offer the same assurance. A combination of capping benefit increases at 67 percent of the CPI and of a one-percentage-point increase in the payroll tax would provide a larger trust fund cushion against unanticipated events.

CHAPTER IV. CHANGES FOR THE LONGER TERM

A number of options that would entail more fundamental changes in the structure of the Social Security system have been put forth. Several of these plans could at least help in solving OASI's short-term financing difficulties, although drawbacks accompany the advantages of each. The discussion below focuses on two such structural changes: that all paid workers participate in the Social Security system (that is, requiring universal coverage), and that OASI and DI benefits be treated as taxable income.

UNIVERSAL COVERAGE

Universal coverage, as the term implies, would require that Social Security coverage be extended to workers now excluded from the system--about 10 percent of the labor force. 1/ In the past, efforts to mandate universal coverage have been sparked by two concerns. First, persons whose work experience includes a mix of employment in jobs both covered and not covered by Social Security might fail to qualify for retirement benefits altogether, because of lack of coordination between different retirement systems. Second, other persons might receive overly generous Social Security payments on top of other retirement benefits; this could occur because the Social Security benefit formula is structured to provide a more generous return to persons making smaller contributions, and it does not distinguish between workers with low lifetime wages and those employed only part of their working lives in covered positions.

More recently, increases in the Social Security tax rate and base have caused a number of state and local government employers to opt for withdrawal from the system. These actions have increased pressure to alter the elective nature of the program for state and local government workers (as well as for certain workers in not-for-profit organizations), especially since many government workers who would leave the system have earned

1/ For analysis and data, see Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage For Employees of Federal, State and Local Governments and Private, Non-Profit Organizations, (March 1980). Also see reports of the 1979 Advisory Council on Social Security and the interim report of the National Commission on Social Security.

sufficient credits in covered employment to entitle them to Social Security benefits upon retirement. But the legal complexities of requiring state governments to pay taxes for a federal program have inhibited the development of proposals to include noncovered employers.

A number of ways of incorporating noncovered workers have focused on civilian federal employees. One option would be immediately to include all such federal workers, but without merging the Civil Service Retirement (CSR) fund with Social Security's funds. Such an approach, if implemented, would raise Social Security's tax revenues by about $6.8 billion in fiscal year 1982, and by a total of $54.6 billion through the end of fiscal year 1986. Though not stipulated in the proposal, retirement credits and contributions could be transferred between the Social Security and CSR trust funds, with civil service retirement benefits still being paid out of the CSR fund. Most of these payments now are appropriated from general revenues, and they would continue to be so.

Other proposals designed to broaden coverage take a more incremental approach. One such option, advanced by the 1979 Advisory Council on Social Security, would incorporate only newly hired employees of federal, state, and local governments and not-for-profit organizations. A more limited option would bring only newly hired federal workers into the system. Proponents of such gradual approaches point to them as ways to minimize the administrative complexities of merging various retirement systems and of extending "hold-harmless" protection to older employees. 2/ The principal arguments against such options are that these approaches would be unfair to federal workers; and, in addition, their potential impact on the short-run financing problem of the Social Security system would be too slight and would take too long to be felt.

The Advisory Council's recommendations do not address the administratively complex questions of integrating the two retirement systems' benefit levels, establishing eligibility requirements, or setting employee contribution rates. Nor do they consider the potential effects on the CSR fund. With assets exceeding $70 billion in 1981, the CSR fund now appears strong. But without compensatory revenue provisions, incorporating civil service workers into Social Security would diminish the CSR fund's income. The effect of implementing this option would be to transfer part of Social Security's current problem to the civil service retirement system.

2/ Hold-harmless provisions are designed to tide over beneficiaries of old, superseded aid programs while new plans are being implemented.

TAXATION OF BENEFITS

Administrative rulings made by the Internal Revenue Service in the early stages of the program have served as a basis for treating Social Security benefits as tax-exempt income. In the 1940s, however, retirement income supplemented by Social Security was far lower than it is today. In view of the currently projected difficulties in the Social Security trust funds, some observers have suggested shifting a portion of the payroll tax burden to beneficiaries themselves by taxing some part of OASI and DI benefits, rather than lowering the level of benefits across the board or raising Social Security taxes on the current generation of workers. The income tax revenues collected on benefits could be assigned to the trust funds, although an allocation mechanism would have to be developed.

Several variations of this proposal have been advanced. These include taxing half of all benefits or taxing the benefits of recipients whose total retirement incomes exceed certain levels. The rationale for taxing half of the benefits is twofold. First, employees already pay income taxes on the portion of their earnings that is also subject to Social Security taxes; employers' contributions are treated as a tax-deductible business expense and therefore escape taxation. Thus the half of OASI and DI benefits financed by employer taxes could be treated as taxable income. Second, the 1979 Advisory Council on Social Security found that, if the tax rules now applying to private pensions were also applied to Social Security, considerably more than half of all OASI benefits would be taxed, although the portion that would be taxed would vary.

Taxing half of benefits would very roughly approximate the present tax treatment of pension income and would avoid certain administrative complexities. By including Social Security benefits as part of taxable income, benefits would be taxed according to the ability-to-pay criteria that determine the federal income tax schedule. Households that are more dependent on Social Security income would have to forego a smaller portion of this income than would more affluent taxpayers. Analysis of this proposal's effect on OASI beneficiaries' tax liabilities shows that about 60 percent of current recipients would have paid roughly $17 more if the provision had been implemented in 1980 (see Table 12). More well-to-do beneficiaries would have experienced considerably larger tax increases, however--people with incomes between $50,000 and $100,000 would pay more than $1,000 in additional taxes per year. In the aggregate, though, taxing half of benefits would generate relatively small amounts of new revenue compared with the present needs of the Social Security system. For example, it is estimated that, in 1982, including half of OASI payments as part of taxable income would result in about $6.7 billion in additional revenues. By 1986, this figure would approach $13.4 billion.

TABLE 12. INCOME TAX LIABILITIES OF OASI RECIPIENTS UNDER CURRENT LAW AND TAX INCREASES RESULTING FROM TAXATION OF HALF OF OASI BENEFITS IN 1980, BY ADJUSTED GROSS INCOME CLASS

Income Class a/ (in Dollars)	Percent of All OASI Beneficiaries Filing Returns	Average Income Tax Liability Under Current Law (in Dollars)	Average Tax Increase Attributable to Tax on Half of OASI Benefits for 1980 (in Dollars)
Less than 4,000	59.9	-4 b/	17
4,000-10,000	20.1	214	305
10,000-20,000	13.1	1,440	443
20,000-30,000	3.8	3,446	594
30,000-50,000	2.3	6,891	751
50,000-100,000	0.7	17,697	1,070
Above 100,000	0.1	42,967	1,963
Total	100.0	Average 677	Average 178

SOURCE: Congressional Budget Office estimates.

a/ Includes income from OASI benefits.

b/ Liability is negative because of refundability provisions of earned income credit.

A more limited approach would be to tax half the benefits only for persons whose incomes rise above certain stated limits. The amounts of revenue to be generated by these kinds of proposals, though, would be considerably smaller than taxing half of all benefits. For example, if Social Security benefits were treated according to rules that apply to unemployment compensation, the additional revenue resulting from the tax would amount to \$1.6 billion in 1982 and \$4.6 billion by 1986. 3/

OTHER LONG TERM POSSIBILITIES

Certain other issues could arise over the next decade that might affect or be affected by potential short-term solutions to the trust fund problem. These could involve altering the benefit formula, implementing a multi-tiered benefit structure, increasing the retirement age, and adopting earnings sharing among married persons. In addition, some thought might be given over the next decade to a gradual lowering of the replacement rate for new beneficiaries.

These are among issues the Congress will want to bear in mind when deliberating about the short-run options for Social Security. Alone, however, none could remedy the short-run financing problem of the system.

3/ Under a provision of the Revenue Act of 1978, for individuals with adjusted gross incomes above \$20,000 and for joint returns with incomes greater than \$25,000, unemployment compensation benefits are included as part of taxable income.

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