SOCIAL SECURITY OVERSIGHT: SHORT-TERM FINANCING ISSUES

HEARING

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TUESDAY, JUNE 16, 1981

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, D.C.

The committee met, pursuant to notice, at 2:37 p.m., in room 5302, Dirksen Senate Office Building, Hon. John Heinz presiding.

Present: Senators Heinz, Cohen, Chiles, Bradley, and Burdick.

Also present: John C. Rother, staff director and chief counsel; E. Bentley Lipscomb, minority staff director; Larry Atkins, professional staff member; Ann Gropp, communications director; Kathleen M. Deignan, minority professional staff member; Robin L. Kropf, chief clerk; Nancy Mickey, clerical assistant; and Eugene R. Cummings, printing assistant.

OPENING STATEMENT BY SENATOR JOHN HEINZ, CHAIRMAN

Senator HEINZ. The hearing of the Special Committee on Aging will come to order.

Today's hearing is the first of several this committee will hold on the problems of assuring adequate financing to meet current and future obligations in the social security system.

Social security has been our most successful and popular Federal program. For more than 40 years, without fail, benefit checks have been sent out on time, matched by payroll tax contributions to the system. This system of pay-as-you-go financing has helped make it possible for the average worker to receive a favorable return in benefits on his contributions to the system. However, pay-as-you-go financing has also made the system dependent upon public confidence in the capability of the system to continue to provide adequate benefits in the future.

We meet today because of a problem in the social security system. It is a problem with financing the system over the next 5 years, and over the next 75 years. But most importantly, it is a problem with public confidence in the solvency of the system and in the commitment of Government to meet future benefit obligations. This erosion of public confidence is the most serious of all threats to the solvency of the social security system. Without the willingness of workers to contribute from earnings today to protect themselves in the future, there could be no social security program.

While the administration's recent pronouncements that the social security system is on the verge of collapse have helped to highlight the problems we face in financing the system, they have also furthered this erosion in public confidence. These warnings of

imminent failure, accompanied by proposals for major, immediate changes in benefits, have unnecessarily caused extreme anxiety and anger among current beneficiaries and among those nearing retirement age. The immediate problem with financing social security is critical but manageable. Older Americans and contributing workers should be reassured that the social security system can meet its obligations in the near future without major changes in the program.

Today, we will hear from the experts about the actual dimensions of the short-term problem, given current economic forecasts. The short-term problem is the most immediate problem and the one which Congress must resolve this year. In later hearings, the committee will focus on early retirement and the implications for social security, on options for responding to the short-term financing problem, and on long-term financing issues.

The immediate financing problem was not anticipated when Congress passed the Social Security Amendments of 1977. At that time, payroll tax rates and the taxable earnings base were set to increase on a schedule starting in 1979, with major increases in the payroll tax rate in 1985 and 1990. Based on economic forecasts at the time, these revenue increases were to place the OASI and DI programs on a sound financial footing until sometime next century. By 1987, trust fund reserves were to have built up to nearly 60 percent of estimated benefit payments for the year.

These 1977 economic forecasts have proved to be overly optimistic. Since then, inflation and unemployment have been higher, and real wage growth has been slower than anticipated. As a result, payouts from the combined OASDHI trust funds have increased by nearly 50 percent, and the ratio of reserves to payouts has dropped from 52 percent in 1977 to an estimated 29 percent in 1980.

If current economic trends continue, the combined trust funds can be expected to drop below the level required to meet cash-flow requirements sometime in the mid-1980's. While scheduled payroll tax increases and improving demographic balances should begin to improve the condition of the combined trust funds after 1985, there is a need to guarantee sufficient reserves to meet the system's obligations over the next few yers.

There is considerable confusion about the magnitude of the shortfall over the next 5 years. Differences in estimates of the shortfall result from the variations in the economic forecasts used, and disagreement over the amount of cushion needed in the reserves to buffer against economic fluctuation.

Before this committee can begin reviewing the options for providing the necessary cushion in the trust funds, it must have a clear understanding of the amount of cushion needed, and the cost to the system of providing that cushion. It is particularly important in this climate of overstatement and overreaction that we clearly set before this committee and the public the facts about the short-term financing problem in social security.

We have four distinguished witnesses with us today to provide us with a range of estimates, and some background on the factors which affect these estimates of the short-term problem.

Before I call on them, I would like to yield to my ranking member and distinguished Senator from Florida, Senator Chiles.

STATEMENT BY SENATOR LAWTON CHILES

Senator CHILES. Thank you, Mr. Chairman.

I want to congratulate you on holding this hearing. I think it most timely now that we begin to look at the pieces of the problem that we are now dealing with, and I think this looking at the short-term problem is, of course, the first place to start. I concur in your statement. I think that it is as you have set forth.

It seems that much of the attention has been on the short-term problem, and that is not the most serious problem we have in social security. It is one that is manageable and this Congress is going to be able to take care of that. But I note some of the cries of alarm that have gone out, to the extent that the system will be bankrupt next year, and I think that has gone a long way to cause some of the anguish on the part of our senior citizens, reading comments like that by some people that are in authority. I think we should be able to say as a committee that the system is not going to go bankrupt. It is based on the full faith and credit of the U.S. Government, and that full faith and credit has been good since 1936 in the social security system. It has been good for a little longer than that in our history, and it is certainly going to be good next year.

It is a question of us selecting the kinds of policies or a combination of policies that will take care of the short-term deficit. I hope and trust that this Congress is also going to deal with the long-term problem, because I think that is one that is much more serious and ultimately one that over a period of years will undermine the confidence of the system unless we come up with a system or means of correction that will be credible and that everyone can understand is going to give us a viable system.

I again want to welcome the witnesses that are here. I would at this time submit my prepared statement and ask that it be included in the record. Also, Senator David Pryor, who could not stay for the hearing, asked me to submit his statement for the record.

Senator HEINZ. Without objection, those will be included in the record.

[The statements of Senators Chiles and Pryor follow:]

PREPARED STATEMENT OF SENATOR LAWTON CHILES

I welcome these hearings and I thank Senator Heinz, as chairman of the committee, for giving us this opportunity to further examine our social security legislative options. This is a continuing effort. This hearing today, on short-term financing issues, and on Thursday, on early retirement, will allow us to examine in more detail subjects which were brought before us last year when the committee held a series of hearings on "Social Security: What Changes Are Necessary?"

After last year's hearings I came to the conclusion that social security needed a major overhaul if it was to continue at all. It became clear that Congress must act immediately—this year—to avert a short-term funding crisis. It was also clear to me that unless we acted on social security's long-range funding problems very soon, we would soon find ourselves in another crisis situation. Another threat of bankruptcy will loom in 20 short years.

As a result of those hearings I introduced the Social Security Reform Act of 1981, S. 484, in February. My bill is designed to solve both the short-term cash-flow crisis and the serious long-term deficit facing the system.

To solve the short-term problem, my bill authorizes interfund borrowing when any one of social security's three funds falls below 25 percent of one year's outlays. Since the trust funds will still face a deficit in the 1984-85 period even with interfund borrowing, however, my bill also modifies the minimum benefit provision and phases out the student benefit program.

My proposals differ from those of the administration and from the actions recently taken by the Senate Finance Committee in that they would not affect any current recipients in any way.

To avert the long-term funding crisis in social security, my bill proposes a gradual phasing-in of a raise in the retirement age for full social security benefits from 65 to 68, beginning in the year 2000. The age would increase by 1 month for each 4 months until age 68 is reached in the year 2012. The age for reduced benefits would increase in a similar manner, from 62 to 65.

There is no painless way to approach the long-term deficit facing social security. I made that decision after considering the options—to cut benefits, to raise social security taxes more, or to raise the eligibility age. I believe raising the eligibility age is the most positive approach to solving the long-term deficit. It recognizes the improved health and economic contributions of older workers. Younger workers will have ample time to plan for the change—30 years if we act now.

The House Social Security Subcommittee recently voted to move in this direction, and I look forward to Senate consideration of the long-range funding problem soon.

My bill also contains a number of incentives for the older worker. It would: (1) Remove the earnings limitation for retirees over 65; (2) eliminate the payroll tax for workers after 65, as well as their employers; and (3) remove age 70 or over as the permissible age for mandatory retirement in the private sector.

It is not easy to be in the position of advocating changes in basic social security entitlements—particularly as a member of this committee and as a Senator of the State with the largest concentration of social security beneficiaries in the Nation.

It appears that others feel the same way. I still have the distinction of being the only Member of the U.S. Senate with my name on a major reform bill.

But I know that we cannot insure social security for the near future and for the next century by standing still and saying, "No change."

I believe that the combination of measures advocated in my bill balances the necessary "tough medicine" with assurances of the future dignity of all older Americans. I have talked a great deal with Florida constituents about my bill, and I find that they agree.

From my discussions with Secretary Schweiker, I know that he agrees with me that we must face the long-range problems now. The administration's recent proposals recognized this fact. I disagree with their approach—the plan cut way too deep, far too soon, and chose to cut benefits rather than raise the eligibility age—but I welcome their entry into the social security debate.

The administration has asked for a bipartisan approach to solving social security's problems. I think that my bill offers such an alternative.

During a recent meeting between Secretary Schweiker and some of my colleagues here in the Senate, it appeared that our options are narrowing. We seemed to have general agreement on some issues. The administration is dead set against the use of general revenues, we cannot raise the social security tax rate again, and the public seems to be telling us, in response to the administration's proposals, that they don't want to have current social security benefits significantly cut. I think that leaves us with the approach I have advocated in my bill.

Again, I welcome the opportunity provided by this hearing to thoroughly examine the first item on our agenda—solving the short-term cash-flow problem.

As one of our witnesses this morning, Henry Aaron, has said before this committee before: The short-term funding problem is "critical but not serious," while the long-term funding problem is "serious but not critical."

The short-term problem is "critical," according to Mr. Aaron, because it will be upon us so soon. But it is not so serious, because there is little doubt that Congress will act soon and because there are a number of actions we can take.

This hearing this morning should help us make those decisions.

Statement of Senator David Pryor

I am proud to have the opportunity to participate today as the Senate Special Committee on Aging begins a series of hearings to examine the future financing of the social security system.

It certainly goes without saying this group of hearings could not have had more timely scheduling—over the last 3 years or so we have become increasingly aware of the need to modify the social security system so as to insure its short- and long-term financing. Most recently there has been a flurry of front page news articles about the poor financial health of the system and about proposals for bailing it out.

On May 18, I had the privilege of chairing a hearing of the Special Committee on Aging in Rogers, Ark. Just as an aside, I'd like to tell you that my home State of Arkansas is second only to Florida in the percentage of the population over the age

of 65. And Rogers is in the center of one of the fastest growing centers of elderly population in the Nation.

The goal of our hearing was to examine the effects of proposed social security reform on the elderly still in the work force, those who were not working, and on retirement income. As it happened, President Reagan had just released his package for social security reform less than a week before the hearing. Needless to say, we had a great turnout at the hearing, despite threatened heavy thundershowers. It is true that there was definite widespread concern and confusion over the effects of the administration's package.

But more than that, I was greatly impressed by the degree to which those present understood the problems the system was facing, the alternatives available to us, and the desire they had to be a part of the decisionmaking process. I have found that this interest has continued in the form of telephone calls, letters, and telegrams to my office, as well as in discussions, as I travel throughout Arkansas.

As I mentioned earlier, this hearing will launch a series of hearing which will each deal with one aspect of the financing of the social security system. This first hearing will examine short-term financing problems. We know that this is an issue of a critical nature. Current projections threaten depletion of the old-age and survivors insurance fund late this year or early in 1982. Interfund borrowing would buy about 1 year's time on that projection.

The committee has scheduled two additional hearings on related topics. I am hopeful that, at the conclusion of these hearings, we will have gathered together the information we need to make some sound and responsible decisions on future directions we should take.

I want to commend our able chairman, Senator Heinz, for his efforts in scheduling these hearings. I'm sorry that I will be unable to stay for the entire hearing, as I am scheduled for an Ethics Committee meeting, but look forward to reading the testimony of our distinguished witnesses as the transcript becomes available.

Senator HEINZ. Senator Cohen.

STATEMENT BY SENATOR WILLIAM S. COHEN

Senator COHEN. I have a somewhat lengthy statement I would like put in the record. But I would like to mention that I think this is the proper forum to examine the issue of social security financing rather than on the Senate floor a few weeks ago, where a rather heated exchange took place. The phrase was used then that "it would be a breach of faith" for the Congress to remain silent in the face of an administration proposal. My own response was, it would be a breach of faith if we were to try to politicize the social security system.

I want to commend you, Mr. Chairman, for holding these hearings, but I think it is important that there be either a nonpartisan or certainly a bipartisan support for examination of changes in the system that we recommend.

I think it is important that we try and light a candle of constructive change rather than engage in cursing one administration proposal to deal with the problem in the short-term and, indeed, long-term financing issues.

I want to commend you for holding the hearing in an atmosphere where we can examine these diligently.

Senator HEINZ. Thank you very much.

Without objection, your entire statement will be made a part of the record.

[The prepared statement of Senator Cohen follows:]

PREPARED STATEMENT OF SENATOR WILLIAM S. COHEN

Mr. Chairman, one of the major issues which confronts the 97th Congress is the question of how best to maintain the short- and long-range fiscal stability of the social security system. Last year, the Special Committee on Aging conducted a number of hearings on social security financing. I am pleased that today we again

will be examining the short-term financing problems which have finally caught up with us.

For the millions of Americans participating in social security, these hearings and the legislation we must surely consider will have a profound significance. Only 4 years ago, Congress approved legislation which, we believed, would solve the problems with the system. Here we are today, facing what we have long known—that the social security system financing shortfalls can no longer be ignored.

There isn't a single person in this room whose life will not be affected by the actions the Congress will take to restore solvency to the social security system. Every one of us has relatives and friends whose very livelihood is enhanced or even sustained by social security. All of those who are affected will be watching and listening as we struggle with the problems before us.

In my own State, over 10 percent of the population (140,000 people) relies on social security in one form or another. Some of these individuals who have written and called my office in the last few weeks are frightened and concerned about the future of social security, and, as a result, their own future well-being. Their economic security is threatened by every move we will make.

We owe it to them and to all the American people to take the steps necessary, however complex or controversial, to insure the future strength of the system in the least painful, yet economically responsible manner.

For most of us, whatever our views, this will involve painful choices. None of the proposals put forward is completely without fault—increasing social security taxes, allowing the medicare portion to be paid by general tax revenues, cutting back benefits, changing cost-of-living computations, taxing half the benefits, or providing universal coverage.

These hearings will provide an important forum for early consideration of some of the alternatives before us. They will, I hope, be a prelude to development of thoughtful recommendations for legislative solutions to social security's problems. I look forward to hearing from all the witnesses on the need for these changes, and their economic projections for the future.

Senator Heinz, the chairman of the committee, deserves great credit for initiating efforts to conduct these hearings to help us all address a painful issue we will almost surely be asked to confront in the near future.

Senator HEINZ. Senator Burdick.

Senator BURDICK. Thank you, Mr. Chairman.

I yield the rest of my time to the witnesses.

Senator HEINZ. Thank you.

Let me ask Robert Myers, the Deputy Commissioner of Social Security for Programs, to come forward as our first witness.

STATEMENT OF ROBERT J. MYERS, WASHINGTON, D.C., DEPUTY COMMISSIONER FOR PROGRAMS, SOCIAL SECURITY ADMINISTRATION, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. MYERS. Thank you.

Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you today to discuss the financial condition of social security.

Social security is facing the most serious crisis in its 46-year history. Without some legislative change, the old-age and survivors insurance portion of the social security system will be bankrupt toward the end of 1982 and will be unable to meet its benefit commitments to 32 million people.

I will review the most recent projections of the social security trust funds and the implications thereof. I will then discuss the options available to prevent the impending crisis and describe the rationale for the administration's proposed solution to these problems. In designing these proposals, we were guided by the overriding principle of avoiding temporary stopgaps and instead making permanent changes to assure the financial integrity of social security, at least into the next century.

The following table shows, under present law, the estimated operations of the old-age and survivors insurance, disability insurance, and hospital insurance trust funds, based primarily upon Data Resources, Inc.'s pessimistic economic assumptions. This procedure is the most prudent for developing financing proposals.
[Table follows:]

ESTIMATED OPERATIONS OF THE OASI, DI, AND HI TRUST FUNDS UNDER PRESENT LAW, BASED ON PESSIMISTIC ECONOMIC ASSUMPTIONS

[Dollar amounts in billions]

Calendar year	OASI	DI	OASDI	HI	Total
Income:					
1980	$105.8	$13.9	$119.7	$26.1	$145.8
1981	122.7	17.0	139.7	35.3	175.0
1982	132.7	23.9	156.7	40.3	196.9
1983	143.0	27.1	170.2	44.7	214.8
1984	159.7	31.3	191.0	50.8	241.8
1985	184.9	41.0	215.9	59.2	285.1
1986	205.1	47.3	252.3	70.6	322.9
Outgo:					
1980	107.7	15.9	123.5	25.6	149.1
1981	126.7	17.9	144.6	29.4	174.0
1982	147.7	20.0	167.7	34.4	202.2
1983	171.5	22.4	193.9	40.5	234.4
1984	196.4	24.8	221.2	47.9	269.1
1985	222.6	27.4	250.0	56.2	306.2
1986	249.0	30.1	279.1	65.4	344.5
Net increase in funds:					
1980	−1.8	−2.0	−3.8	.5	−3.3
1981	−4.0	−.9	−4.9	5.8	1.0
1982	−15.0	3.9	−11.1	5.8	−5.2
1983	−28.5	4.8	−23.8	4.2	−19.6
1984	−36.8	6.5	−30.2	2.9	−27.3
1985	−37.7	13.6	−24.1	3.1	−21.0
1986	−43.9	17.2	−26.8	5.2	−21.5
Funds at end of year:					
1980	22.8	3.6	[1] 26.5	13.7	[1] 40.2
1981	18.8	2.7	[1] 21.6	19.6	[1] 41.2
1982	3.9	6.6	[1] 10.5	25.4	[1] 35.9
1983	(2)	11.4	(2)	29.6	[1] 16.3
1984	(2)	17.9	(2)	32.5	(2)
1985	(2)	31.6	(2)	35.5	(2)
1986	(2)	48.8	(2)	40.8	(2)
Assets at beginning of year as a percentage of outgo during year:					
1980	23	35	[1] 25	52	[1] 29
1981	18	20	[1] 18	47	[1] 23
1982	13	14	[1] 13	57	[1] 20
1983	2	30	[1] 5	63	[1] 15
1984	(2)	46	(2)	62	6
1985	(2)	65	(2)	58	(2)
1986	(2)	105	(2)	54	(2)

[1] Assumes interfund borrowing is in effect.
[2] Trust fund is exhausted, and so benefits could not be paid.

Mr. MYERS. The OASI trust fund will have cash-flow problems by the latter part of next year. Under the administration's economic assumptions, such problems will also occur in 1982, although deferred a few months. This fund would run an annual deficit under the pessimistic assumptions mounting to $37 billion or more in each year, after 1983. Even if, as we have proposed, the OASI trust fund could borrow from the DI or HI trust funds to meet the

deficit, the combined funds would be exhausted in late 1983. While interfund borrowing may be a valuable interim device, it only postpones the problem by a year.

Without changes, the trust-fund deficit would, under the pessimistic assumptions, be $111 billion during the next 5 years. By "deficit," is meant the amount needed both to pay benefits and to maintain minimal fund balances.

Over the long term, the OASI and DI trust funds show a combined average deficit of 1.52 percent of taxable payroll under the intermediate-cost estimates in the 1980 trustees report. The equivalent lump-sum present value of this deficit is about $1.5 trillion.

The assets of the combined OASI and DI trust funds have fallen continually since 1974. The fund ratio—the assets on hand at the beginning of the year, expressed as a percentage of the outgo during the year—fell from 103 percent for 1970, to only 18 percent for 1981. The drawdown of the assets has masked the fact that outlays exceeded revenues each year after 1974.

These figures illustrate the damage that can be done to the balances in a short period by unanticipated downturns in the economy.

The element in the forecasts with the greatest effect is the projection of real growth in wages—that is, the excess of the increase in wages over that in the CPI. When wages do not keep up with inflation, increases in social security tax revenues do not keep pace with the increase in expenditures arising from automatic adjustment of benefits to prices. In 1977, it was assumed that real wages would grow by an average of 2.5 percent per year in 1977 to 1980. The reality, however, was that real wages actually declined by an average of 1.5 percent then.

Social security is financed on a pay-as-you-go basis; current contributions are used to pay current benefits. On the other hand, the security of private pensions is usually assured by sufficient reserves to fully fund them. Most people who have studied social security conclude that "full funding" is not necessary for assuring benefits to be paid, and is probably undesirable.

Full funding for social security is not necessary because the participation of future workers is required by law. It is undesirable because it would entail the accumulation of such large sums that social security would control a major part of the Nation's capital. If the program were on a fully funded basis, in the long run, the fund would equal about 1.7 times the gross national product.

Any discussion about maintaining appropriate trust-fund levels involves determining the assets that are adequate to provide a margin of safety against contingencies, so that benefits can be paid even when tax collections are temporarily reduced. An accepted measure of adequacy is the fund ratio—the ratio of the assets at the beginning of a year to the total outgo during the year. For the OASI and DI trust funds, if income is exactly equal to expenditures each month over the year, the fund ratio must be at least 9 percent to assure that there will be sufficient funds to meet current benefits. A considerably larger ratio is required to assure adequate funds to provide a margin of safety if economic conditions worsen.

The 1979 advisory council recommended a ratio of at least 75 percent. The National Commission on Social Security recommend-

ed that a ratio of 100 percent be developed over time. As a matter of prudence, I believe that a level of at least 50 percent is reasonable, and that once the financial integrity of the system is restored, such a fund ratio should be maintained.

The short- and long-run financing of social security are, as a practical matter, inseparable.

What we do for the short run has impact on the long run. The primary cause of the long-range financing problem is the anticipated demographic changes. Some 50 years from now, the Nation will have a very large retired population being supported by a smaller relative number of workers than at present. Intermediate projections indicate that, by 2030, there will be 2 workers per social security beneficiary, as compared with a ratio of 3 to 2 today.

This change will have a growing effect on social security. Despite cash-flow problems in near-future years, under the intermediate assumptions of the 1980 trustees report, OASDI will have an excess of income over outgo averaging 1.19 percent of taxable payroll over the next 25 years. The picture changes drastically when the World War II baby boom reaches retirement age. A deficit of 1.17 percent of payroll is shown for 2005–29, while for 2030–54, it is 4.58 percent.

These projections represent the best estimates of capable actuaries, based on the best information available. Despite many uncertainties, there is no doubt that a major demographic shift will occur in the next four decades. It is important to act now to assure the integrity of social security for the relatively larger aged population which will be present in the 21st century.

Restoring the system's financial integrity will not be easy, popular, or painless. There are really only three solutions available—restrain the growth of benefit outgo, increase payroll taxes, or turn to some other source of revenue.

The administration proposals overcome the serious financial problems by eliminating excessive incentives to claim benefits early, by removing penalties for continued work efforts, and by lessening the emphasis on the social-adequacy aspects of the system at the expense of its basic purposes. These proposals are our well-considered recommendations, although they are not immutable. We are prepared to work with interested parties to improve our proposals. However, we are committed to the following principles:

One, preserving the integrity of the system.

Two, holding down the tax burdens on current workers.

Three, eliminating the anomalous features and abuses.

Four, financing the permanent, ongoing benefit provisions solely from visible payroll taxes—and not from general revenues, which in reality, involve other hidden taxes.

The proposals would restore social security to program and financial soundness by:

One, encouraging workers to stay on the job at least until the traditional retirement age of 65.

Two, lowering future replacement rates by about 10 percent by moderating, for the next 6 years, the indexing in the initial benefit formula. This would adjust for benefit overliberalizations in the early 1970's, which substantially exceeded increases needed to keep pace with price changes.

Three, reducing the opportunity for windfall benefits—that is, relatively high benefits for persons who spend most of their working lifetime in noncovered employment and only a short time in covered work.

Four, relating disability benefits more closely to a worker's recent work history and medical condition.

Five, reducing the social-adequacy elements that duplicate other programs—and which have been overemphasized in recent years.

These reforms would have scarcely any impact on the 36 million beneficiaries now on the rolls or on the several million persons now aged 62 or over who are eligible for benefits but still working.

Assuming the enactment of these proposals, and those included in the administration's budget, social security will be actuarially sound in the short range and well into the next century. We can say this without qualifications concerning the state of the economy in the short run, because under the pessimistic economic conditions, the combined trust funds will not fall below 17 percent of annual expenditures. The program would be in much more favorable financial condition under estimates based on more realistic economic assumptions which reflect the effect of the administration's program for economic recovery.

It will be possible, even under the pessimistic economic assumptions, to aid the economic recovery by having a smaller tax-rate increase in 1985 than now scheduled and then, in 1990, to decrease tax rates below the current level. If the economy improves at a more rapid rate—as we anticipate it will under the President's program for economic recovery—the tax rates could be further reduced.

If strong actions are not now taken, social security faces financial insolvency, and the economic security of the millions of people who now receive benefits and the many more millions who expect to receive them in the future, will be threatened. Under our proposals, these future benefits will be paid, even under the pessimistic economic assumptions.

We recognize that there are other possible ways to deal with the financial problems of social security. We have already begun working with congressional leaders to develop mutually agreeable solutions to the financing crisis. While there may be room for debate over the specifics and details of our proposals, we strongly believe that any alternatives must meet our fundamental objectives, as mentioned earlier.

Senator HEINZ. Mr. Myers, thank you very much.

Let me ask you, in the course of your testimony you mentioned the pessimistic and relatively more optimistic economic assumptions.

What is the best economic forecast for Congress to use in gaging the scope of the short-term deficits or, for that matter, longer term deficits? Should we use the very pessimistic? Should we use the administration's optimistic, or something in between?

Mr. MYERS. Mr. Chairman, although the administration very strongly believes that, if its program is enacted, the assumptions in the President's budget will eventuate. However, the administration also strongly believes that, for planning social security over the short range, it is desirable to assume these pessimistic assumptions

so that, even with the worst coming to eventuate, the system will be viable. In fact, this yields the best of both worlds. If economic conditions turn out as we anticipate, the trust fund balances will build up to a much more adequate level.

On the other hand, if economic conditions are bad, the system will still have enough money to meet its benefit obligations in the short range.

For long-range planning, we believe in using the intermediate estimates; that is, blending in from the pessimistic assumptions in the short range over to the intermediate economic assumptions over the long range. This, we believe, is the best procedure for finance planning.

Senator HEINZ. As I understand what you just said, you believe that we should not use the pessimistic assumptions beyond the short term?

Mr. MYERS. That is correct, Mr. Chairman.

Senator HEINZ. There are three sets of forecasts that we have been presented with. One of those forecasts is the administration's pessimistic. Another is the CBO projections of February of this year, and the other is the administration's revised 1982 budget assumptions.

Why shouldn't we use the CBO numbers rather than the pessimistic assumptions inasmuch as the CBO projections are pretty pessimistic? They call for a higher level of unemployment than the administration calls for by substantial amounts. They call for a higher level of inflation for the next 5 years than the administration's economic plan calls for.

Why shouldn't we use the CBO projections rather than the so-called administration's pessimistic assumptions?

Mr. MYERS. Mr. Chairman, we believe that our so-called pessimistic assumptions are the proper ones to use because, as you pointed out, they are somewhat more pessimistic than the CBO. We believe what has happened in the past—for example, in connection with the cost estimates that were made for the 1977 amendments—we should have a sufficient margin of safety in the event that conditions do turn out pessimistically.

Senator HEINZ. Let's examine these pessimistic assumptions, because I do not think "pessimistic" is a strong enough word to describe them.

What they forecast is a rate of inflation of 12.8 percent this year, and it increases to 13.6 next year and then stays in the double-digit range in 1983 and 1984 at 11 percent.

With respect to unemployment, the right word would be "depressing," because you see unemployment rising to 8.3 percent this year, 8.7 in 1982; 9.7 in 1983, and that is getting pretty close to the definition of a depression, not a recession.

What kind of an economic catastrophe do these projections assume?

Mr. MYERS. Mr. Chairman, as to the level of price increases, what is really important—and as you brought out in your preliminary statement—is the real wage increase, the difference between the increase in wages and the increace in prices. I think that, certainly, our real wage increases of minus 2.3 percent in 1982, minus 1.1 percent in 1983, plus 1 percent in 1984, and about one-

half percent in the next 2 years, are certainly not overly pessimistic.

But I do want to emphasize that we believe this time we should make the financial projections for the short range on the basis where nothing will go wrong. There is very little chance it will. Obviously, it could get much worse if you assume the assumptions continue indefinitely into the future.

Senator HEINZ. We are following a 5-minute rule, and I say that it is also the early-bird rule, so I will recognize Senator Cohen.

Senator COHEN. What was the inflation rate factored into the administration's economic program?

Mr. MYERS. In our pessimistic estimate?

Senator COHEN. I want the pessimistic one.

Mr. MYERS. In the pessimistic assumptions, we assumed that the percentage increase in the CPI would be as much as 13.6 percent in 1982, and then gradually decreasing to 8.6 percent in 1986.

At the same time, we assume high wage increases, too.

Senator COHEN. Do you know whether or not the administration takes the same pessimistic projection for any other program?

Mr. MYERS. To my knowledge, it does not. The administration believes that if its economic recovery program is enacted, then the economy will be much better off.

But for this purpose, the intent was to assure that the program would be solvent for the short range, so that the benefits would be paid.

Senator COHEN. As I recall, the administration used an inflation figure of about 8 percent for defense calculations.

Mr. MYERS. In the budget, the assumption is 8.3 percent in 1982, and then gradually falling off to under 5 percent by 1985.

Senator COHEN. So why would we use an 8.2-percent inflation figure for Defense budget falling off to something considerably less than that, and yet you use something nearly double that for social security?

Why would you take the most pessimistic for social security and then propose changes that will certainly cause a great deal of social unrest, and then, on the other side—for another very large segment of the budget, you use a figure of 8 percent, declining to substantially less than that?

Why would you be so gloomy and pessimistic on social security and yet be so optimistic on Defense?

Mr. MYERS. Senator Cohen, solely for the reason of assuring that really, come the worst, the system will be able to pay benefits, and if things turn out much better, as we anticipate, the fund will be able to be built up to much more adequate level.

At the moment, the fund is at a relatively low level and decreasing rapidly. We want to assure that there is an adequate fund, so that, over the long range, benefit payments will be made.

Senator COHEN. But if you assume that the administration's economic proposals if, in fact, adopted, are going to produce certain results; namely, if you have a tax cut; if you have a reduction in spending; if you move toward a balanced budget in the short term, 3 or 4 years, to achieve those goals—why would you not take as an alternative, perhaps, a combination of some of the trust funds to get by that short-term problem with the least amount of social

dislocation and disruption. Then, relying upon the fact that if the economic programs are going to prove to be effective, we will have cured not only our short-term problem, but long-term problem as well?

Why take the most extreme for the short term rather than a more moderate approach to get by that time, with the least amount of social disruption?

Mr. MYERS. Senator, as you say, if you combine the funds, or in other words, had interfund borrowing and had favorable economic conditions, the fund could just barely get by the short term. Over the long term, there is still a problem, which does not come from economic conditions, but rather from demographic ones.

Over the short term, we strongly believe that we should hope for the best, but plan for the worst. Thus, there will not be the same dilemma we got into before when in 1977 the financing was arranged on the basis of the intermediate estimate.

Senator COHEN. Rather than deal with the issue of early retirement, what about the consideration that Senator Chiles and some Members in the House raised, of extending the retirement age from 65 to 68 beginning in 1990 so that you deal with the long-range problem of the demographic difficulties right away. Then, you really do not disrupt somebody's plans for retiring at 62, when that person, who is now 58 or 59, and whose health is failing, is told on short notice, he will be penalized for retiring early? Why not seek a solution that minimizes that kind of impact on the immediate future and plan for the long-range problems?

Mr. MYERS. You are quite correct that raising the retirement age gradually would help solve the long-range problem. But it would have no effect on the short range.

As to the proposal to sharply reduce benefits for early retirement, as I indicated, the administration put forth this proposal as part of its package. It is subject to negotiation as long as the objectives of the program are met and as long as sound financing is assured over the short range.

Senator HEINZ. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Myers, would you say that the reasons the 1977 projections proved to be wrong were because of higher inflation and greater unemployment?

Mr. MYERS. The principal reason, Senator Bradley, was the fact that, coupled with the higher price inflation, there were lower wage increases. The unemployment factor was an element, but only a minor one. The main thing that went wrong was that over the period since 1977, and especially beginning in 1979, prices rose more than wages. If wages had kept up with prices or had exceeded them by the small margin that usually has been the case in the past, there would be no financial problem at the moment. So it is really not the level of price inflation that caused the problem. It is the relationship between price inflation and wage increases.

Senator BRADLEY. What then is your rationale for not looking at the suggestion that has been made by a number of people that you tie the social security index to wages instead of to the CPI?

Mr. MYERS. The administration considered all of the various options for solving this financial problem and this particular pro-

posal was considered. However, it was not adopted because the President, in the campaign, had stated that he believed that full indexing should be continued.

Senator BRADLEY. I understand that. I understand the politics there. But can you tell me what is the substantive rationale for not addressing this indexation question? Second, if you are going to keep social security payments indexed, why would you choose to keep them indexed to the CPI and not wages? As you said, the last couple of years, if payments had been indexed to wages, there would have been much less of a financial strain on the system.

Mr. MYERS. What you just said is quite true. There was a study that indicated that the numbers would come out that way. But as to the rationale of the administration, recommending the continued indexing by the CPI, it is the belief that retired people should have their benefits kept up to date with the cost of living and that adequate financing of the system should be accomplished through other measures.

Senator BRADLEY. Given the present system, if you were not going to cut benefits, contrary to what the administration has suggested, at what rates of inflation, unemployment, and wages would the social security system run into financial difficulties?

Mr. MYERS. Actually, regardless of what happens, if you just look at the three trust funds separately, then no matter what economic conditions are, the OASI trust fund is going to run out of money next year.

Senator BRADLEY. You mean whether or not you borrow from the other funds?

Mr. MYERS. I said with no change in the law.

Senator BRADLEY. Take the combined system. If we do not want to make any of the cuts the administration proposed, at what inflation rate do you get into trouble?

Mr. MYERS. I cannot say that precisely.

Senator BRADLEY. Well, then, what is the administration's rationale for the cuts? Could you make a guess that maybe if inflation rises to 20 percent, for example, you do not need any of the cuts?

Mr. MYERS. The important element is whether wages will rise more rapidly than prices. For the combined system, if wages rose more rapidly than prices by 1½ percent per year, this would solve the problem.

Senator BRADLEY. So you are saying that one way we solve the social security system problem is to have a CPI at 20 percent a year. Then wage increases just have to be 21½ percent a year, and as long as wages increases are greater than CPI rises, that solves the social security problem.

Mr. MYERS. That would solve the social security problem, but it would create some others.

Senator BRADLEY. Quite a few. So let's assume that you are following the President's March 1981 budget projections that the CPI will rise by 10.5 percent in 1981, 7.2 percent in 1982, and 4 percent in 1986.

So with these rates of inflation, why do you need to cut benefits?

Mr. MYERS. Although the administration believes that this can be accomplished with regard to inflation, we still believe that we should play it safe and have a sufficient margin of safety by

making pessimistic assumptions. Thus, no matter what happens, we will be able to pay benefits. If things turn out right, we will be able to build the fund back to a safer level, so that, if there is a future depression, there will be an adequate fund to draw upon. We are skating awfully near the thin edge of safety now.

Senator BRADLEY. If you make the assumption of 13.6 percent in 1982 and 11 percent in 1984 or 1986, that would have very different implications for the rest of the budget.

Mr. MYERS. If those figures were used for the budget, yes.

Senator BRADLEY. Why do you suppose for social security there is a great deal of flexibility and the administration is willing to look at a pessimistic, optimistc, and most likely set of economic projections in order to take care of all possible contingencies. But, on the budget itself, on the general revenue side, we were told that this is it: There are only to be one set of assumptions. If you question those assumptions and even try to put any caution in there, that somehow or other you do not understand supply-side economics. What is the probability that we will realize the pessimistic assumptions?

Mr. MYERS. Mathematically, I do not think that probabilities can be assigned to this. I think the degree of accuracy in making economic forecasts in the past has been pretty low and, therefore, I think that we should be prudent.

Senator BRADLEY. Isn't that what you are doing when you are making an analysis of——

Mr. MYERS. No; I do not think so; because we are assuming what we think is the reasonably worst situation. If the situation happens that bad, we will still be able to pay benefits. If conditions are better, we will not only be able to pay benefits, but also be able to build the fund back to a prudent position.

Senator BRADLEY. Thank you, Mr. Chairman.

Senator HEINZ. Mr. Myers, let's assume for the sake of argument that the likelihood of any one of the three forecasts that we have discussed is eqully probable of coming true.

Now, if the administration's optimistic forecast, so-called, has a particular probability of becoming true, what kind of reserve ratio should we adopt? Let's pick 1986.

Should we shoot for a reserve ratio of 9 percent? That is the bare minimum, according to your testimony.

Should we shoot for one at 50 percent? That is what you said we would like to build up to.

Should we shoot for one in the middle?

What should we shoot for?

Mr. MYERS. Mr. Chairman, as to this matter, there is no complete actuarial analysis that is precisely correct. But certainly I would say that if there were a 9-percent ratio, the fund is going to be in trouble, because benefit outgo does increase during the year. If there were a 9-percent ratio at the beginning of the year, some time after the middle of the year, the fund would be out of money. I think that the absolute minimum fund ratio at the beginning of a year should be between 20 and 14 percent. The minimum really should not be less than 17 percent then, and over the long run it should be built up to 50 percent. I think that building up to 50 percent by 1986 would probably be too rapid. It should probably

take 10 years to get there, because that much money should not be withdrawn, as it were, from the economy.

Senator HEINZ. In 1986, what kind of number would you feel comfortable with?

Mr. MYERS. I think 25 to 30 percent at least.

Senator HEINZ. You would feel comfortable with that, given the optimistic forecast?

Mr. MYERS. Yes.

Senator HEINZ. Would you feel comfortable with that at the CBO forecast, about the same level, assuming an equal probability of any of these coming true?

Mr. MYERS. With the CBO forecast, it would be desirable to be that high, but if conditions were somewhat more pessimistic than the CBO forecast is, you probably could not get up that high.

Senator HEINZ. Where do you think you might be able to get to on CBO, 15 to 20?

Mr. MYERS. Probably something like that.

Senator HEINZ. Then under the pessimistic numbers where unemployment is at 1933 levels, you are looking at, what, for a 1986 ratio?

Mr. MYERS. The planning should be such that you really expect the ratio never to go much below 17 percent, and when it got down to the 12 to 14 percent range, if the experience turned out that way, it is waving a red flag that something ought to be done at once about it.

Senator HEINZ. That is very helpful. You say we should hope for the best but plan for the worst. One of the problems in planning for the worst is that it may require us to make some very, very deep cuts in social security benefits if we adopt that bit of advice; and you have proposed some very substantial cuts in social security benefits.

Suppose that in planning for the worst, we are wrong. What do you see as the consequences of that?

Mr. MYERS. If we had an adequate fund ratio now of 50 percent, or anywhere close to it, we would not be in this position of having to take the worst case assumptions and make benefit reductions to match them.

But if things do turn out, from an economic standpoint, much better than the pessimistic assumptions—and we think it is very likely they will—then we will have the beneficial effect of building up the fund, so that we will not be in this position again.

Senator HEINZ. Let me just, so there is no misunderstanding, read into the record unemployment rates assumed under the administration's pessimistic assumption: 1981, 8.3 percent; 1982, 8.7 percent; 1983, 9.7 percent; 1984, 9.1 percent; 1985, 8 percent, and finally, a breath of optimism in 1986, 7.4 percent, at which point we will either all be involuntary retired if this is true after having come up for reelection, or we will be past the problem.

Let me ask this one last question.

You propose actually reducing social security taxes in 1985 under your plan.

Mr. MYERS. That is correct.

Senator HEINZ. And as I understand it, if you take the optimistic assumptions, two things are true: No. 1, that you would reduce

expenditures $82 billion, and No. 2, that you would also reduce social security revenues into the fund by $40 billion over the period 1982 through 1986; is that correct, using the optimistic assumptions?

Mr. MYERS. The figure is correct as to the reduction in expenditures. However, as to the reduction in the taxes, I believe that your figure is based on a tax schedule that was constructed on the basis of using optimistic economic assumptions. In other words, that is what would have been legislated if we had used such assumptions, which we did not. Probably that presentation was a bit misleading. We never meant that those taxes would be recommended. We gave them as hypothetically what we would have done if we were absolutely certain that the budget economic conditions would eventuate.

Senator HEINZ. Yes; but assuming that you did recommend those and they did go into effect, is the number $40 billion an accurate projection in terms of reduced income to the fund?

Mr. MYERS. Yes; I believe that is correct.

Senator HEINZ. So under those optimistic assumptions, we would only have to save about—or fund alternatively about $40 billion to get reserves up to around 30 percent by 1986, if we did not cut social security taxes.

Does that sound right to you?

Mr. MYERS. Yes.

Senator HEINZ. We would be in 1986. We would have a very high reserve ratio, 30 percent. We would have a relatively modest amount of funding or saving to do, $40 billion between now and 1986. Social security in 1982–86 will outlay $1.2 trillion; $40 billion, divided by $1.2 trillion is something like 3 percent. So that is not an unmanageable amount.

The Senate Finance Committee has already recommended over that period of time a savings of between $20 and $25 billion. So I assume it would be fair to say, subtracting that from $40 billion, we would have a $20 billion nut to crack, assuming again the optimistic assumption, which we would all love to assume, even if Senator Bradley is not there quite yet on Reagan economics.

Very well.

Senator Cohen.

Senator COHEN. At what point do you begin to reduce the tax rate?

As I recall, you indicated it would take 10 years to build up this 50 percent funding ratio. That is about the same time you would like it to work. But you also indicate you would like to start reducing the tax rates. Which would you do first? Would you wait until you got to 50 percent, or would you reduce tax rates first?

Mr. MYERS. What we did, you might say, was a little of both. In the proposal, there would be a small reduction in the tax rate from 1985 to 1989, and about at that time, either slightly before 1990 or slightly after, the fund ratio would simultaneously build up to 50 percent. Then, more significant decreases in the tax rate could be put in, especially considering the fact that the 1990's are going to be a very low-cost period for the social security system. At that time, most of the retirees will have been born in the depres-

sion years of the 1930's when there were fewer births per year than there were in the 1920's or 1940's, and subsequently.

Senator COHEN. On page 9 of your prepared statement, I think you indicate the four basic objectives of the administration; and you point out, No. 3, eliminate the anomalous features and the abuses in the current system.

Which specific anomalies are you referring to?

Mr. MYERS. Among the anomalies I am referring to is, for example, that the maximum family benefit for a retirement case or a survivor case is higher than for a disability case. In fact, in a number of instances, the tax-free social security benefits are in excess of the net take-home pay that the worker had immediately before retirement or death.

Another anomaly, we believe, is the payment of student benefits when there are many other student grants available.

As to abuses, what I am referring to particularly is the so-called windfall portion of the benefits that certain people get who are in the system a short portion of their entire working lifetime and thus get very heavily weighed benefits.

Senator COHEN. What about the indexation? Was that an abuse or an anomaly, to tie the indexing of social security benefits to the CPI as opposed to something more realistic as far as wages were concerned?

Mr. MYERS. We did not consider that an anomaly because we believe that the benefits of the retired population should be kept up to date with price increases.

Senator COHEN. On page 10, when you say, this would be done, under item No. 2, "This would be done in order to adjust for benefit overliberalizations in the early 1970's, which substantially exceeded increases needed to keep pace with changes in the price level."

What did you mean by that?

Mr. MYERS. In 1969–72, there were three social security benefit increases—a 15-percent increase, a 10-percent increase, and a 20-percent increase—all across the board. The effect of those was to increase benefits by about 23 percent in real terms. In other words, the increase was that much more than the increase in prices. Part of that 23 percent excess was recovered in 1974 when there was legislation that increased benefits less than prices. Then in 1977, Congress deliberately decoupled the benefit structure so as to pay benefits in the future that were at a relative level 5 or 6 percent lower than those currently payable.

So, there was still left about a 10 percent or so excess increase in benefits over what they should have been increased in 1969–72.

Senator COHEN. But you do not consider it to be an excess benefit to tie the automatic cost-of-living increases to something higher than it actually is, as would be reflected as far as the wage scale is concerned?

Mr. MYERS. No; we believe that in the future as in the past, the benefit level in the 1960's should have been kept up to date with prices, both in 1969–72 and thereafter, and in the future.

Senator HEINZ. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Myers, as I understand it, roughly 70 percent of the social security recipients who retire early cite poor health as the reason for their retirement. Under your proposal, these early retirees would receive a reduction in benefits from 80 to 55 percent, a reduction of roughly one-third. I am curious what portion of the 70 percent who cite poor health as a reason for their early retirement will stay on the job under your proposal.

Mr. MYERS. Senator Bradley, as you realize, the reductions in benefits that you are talking about are for people who retire exactly at 62. These are smaller reductions for other early retirement.

As to this particular figure of 70 percent, frankly, I do not believe those surveys.

Senator BRADLEY. You do not believe that 70 percent that retire cite poor health?

Mr. MYERS. No; your citation is correct, but I believe that the surveys are wrong.

I think that, very often, when you go around and make a survey of people's opinions, you do not get the real facts of life.

Senator BRADLEY. You do not believe that they have poor health, even though they tell you they have poor health?

Mr. MYERS. That is correct.

I believe that many people say that they are in poor health as part of an alibi to stop working.

Senator HEINZ. On Thursday, we will be examining in some detail this entire area. I think the Senator knows that, and I wanted the audience to know.

Senator BRADLEY. Thank you, Mr. Chairman.

Let me get at this point, because this is fairly fundamental to much of the testimony we have heard in the Senate Finance Committee on these matters.

You say you have no evidence retirees cite poor health, but you believe that they do not have poor health. What is the evidence to show that they do not have poor health?

Mr. MYERS. I do not believe there is any evidence either way. I have been working in the social security field for 45 years, and I have carefully and extensively considered these opinion surveys, and I do not think that they really necessarily tell the facts of the matter. The only way in which you could tell if they were in poor health would be if there was a medical examination. If they were really in poor health, they would have applied for and been awarded disability benefits, so that they would receive a larger amount.

Senator BRADLEY. But in 45 years, you have done no actual checking?

Mr. MYERS. I do not think there is any real way of telling, without having a very expensive survey procedure that would involve a doctor going around with the survey staff and checking the people. If the people are really in bad health, they would have applied for disability and not received the 80 percent—or the proposed 55 percent—but rather a 100-percent benefit.

Senator BRADLEY. In the absence of any contrary fact, aside from belief and conviction about whether people are honest, you are faced with the fact that 70 percent do cite poor health. Now, some of those are going to have to remain working under the administration's proposal. What percent do you think?

Mr. MYERS. The estimates that our actuaries have made assume that a certain percentage of those who would otherwise have claimed reduced benefits will continue working but they do not break it down as between those in good health or those in poor health. The proportion runs roughly 20 to 25 percent.

Senator BRADLEY. So, if 70 percent of the early retirees cite poor health and 25 percent of those who would have retired will continue working under the administration's proposals, at least 5 to 10 percent, using your estimates, will continue working even in poor health.

Mr. MYERS. Undoubtedly, there will be people who are in poor health, and undoubtedly some will go on working. In fact, it may be better for them to be working than to be at home.

Senator BRADLEY. Is that another belief?

Mr. MYERS. Yes, it is a belief; because this is something that cannot be proved as a statistical fact.

Senator BRADLEY. But you believe that it is better that sick people work than stay home?

Mr. MYERS. In some cases, yes. Not in all cases, obviously.

Senator BRADLEY. Thank you very much.

Senator COHEN. Why is that better than having people work longer who are healthy?

Mr. MYERS. I would not say that it is better. Both situations are desirable. I think that, if people stay at work, they will tend to be healthier than if they retire. I think that this can often be shown that, sometimes, people who are forced to retire, by compulsory retirement, have their health affected. It is for this reason, in my opinion, that the Congress a few years ago wisely raised the minimum mandatory retirement age that could be imposed.

Senator COHEN. So you would not be adverse if Congress were to decide in terms of preferences that over the long run it would be more preferable or desirable to encourage people to work to the age of 68 or a minimum of 65?

Mr. MYERS. The administration has not recommended that. As with all other options, the administration is open to considering it.

Senator COHEN. As far as you are concerned, you have no objection to that? You feel it is better to work than to retire, in any event.

In view of the fact that we live longer, we are generally healthy, that we have lifted the mandatory retirement age limit as far as Federal workers, that that in itself would not be an objectionable recommendation as far as you are concerned?

Mr. MYERS. The administration certainly is in favor of encouraging people to work beyond age 65 and that is the reason for our recommendation of gradually, by 1986 at least, eliminating the earnings test so that people age 65 and over do not have disincentives to work.

Senator COHEN. Do you feel that most people who retire on disability are not really disabled?

Mr. MYERS. No, I would not say that. The people who retire on disability are disabled by a certain standard. Our various recommendations about restricting disability benefits deal with only certain groups. For example, we believe that disability should be determined as it was originally intended—solely on medical charac-

teristics and not taking into account such vocational characteristics as age and education. We believe that the determination should be solely on medical grounds.

Senator HEINZ. Mr. Myers, regarding the disability changes you proposed, you have suggested a longer recent work history.

Why is that a fair requirement?

Mr. MYERS. We believe that the present work requirement of essentially 5 years of work out of the last 10 years does not really show enough attachment to the work force. In other words, we believe that people who are to receive disability benefits should have had a more substantial attachment to the work force in the past 10 years, just as we also recommend the other requirement of having worked in 1½ years in the last 3 years.

Senator HEINZ. What is magic about 10 years as opposed to 5 years?

Mr. MYERS. Mr. Chairman, there is nothing magical about it. That is a period which was selected originally, and the original requirement was 5 out of 10 years. We believe that, because that is only half-time employment, it is not sufficient attachment to the labor force to produce eligibility for disability benefits. We believe that a better requirement is 7½ out of 10 years.

Senator HEINZ. Well, if you feel that way, why wouldn't you propose to make disability payments proportional to the length of work force attachment, as opposed to an all-or-nothing kind of approach?

Mr. MYERS. I agree that that is a possibility that can be considered. We considered various options, and we came out with this particular package.

As I said before, we are agreeable to considering various different alternatives now with interested groups that propose them.

Senator HEINZ. Well, that is, I suppose, fine. It does not really get at what I think I asked you, which is, it seems logically consistent, given the point from which you start, that you do not have to move the age of all or nothing from 5 to 10 years, but the logic of your position would be that benefits should be related to the amount of time in the covered work force.

The logical corollary of that would be to scale them rather than to simply cut them off.

Mr. MYERS. Mr. Chairman, I quite agree with what you have said being very logical. It is something we will consider. We had to come forth with a definite package. We came forward with the package as it is, but we will most certainly consider your suggestions.

Senator HEINZ. I have one personal question.

How old are you?

Mr. MYERS. I will be 69 my next birthday.

Senator HEINZ. You are doing what you said you would like people to do, which is to continue to work on past 62. We congratulate you.

Senator COHEN. What is your position as far as integrating the Federal employees into the social security system?

Mr. MYERS. The administration considered this along with all the other issues and did not recommend that there should be compulsory coverage of either Federal or State and local employees. The

issue that we did address in this respect is the one that I mentioned, about eliminating the windfall portion of the benefits. In other words, if people who work for the Federal Government and were not then covered, but later are under social security, either part time or after retirement, the proposal would continue the payment of benefits, but ones that are more proportional, rather than the heavily weighted benefits that go to people who have low average earnings.

Senator COHEN. I believe a commission was formed to study the question of integrating the Federal employees into the social security system.

Do I take it from your answer that the administration has made its own determination that that consideration will not be part of this administration's policy?

Mr. MYERS. Actually, Senator, as you may know, there were three commissions that studied this matter. One was assigned only this particular issue——

Senator COHEN. We have been assigning commissions for as long as I have been here.

Mr. MYERS. I suppose that you are referring to the Universal Social Security Coverage Study Group.

They looked at this question, but actually, as I understood their report, which was a little anomalous, they only said how it might be done. They did not come forward with a recommendation, although the chairman himself did say that there ought to be universal coverage. So, it was a rather fuzzy situation.

Senator COHEN. So it is not fuzzy as far as the administration is concerned. What is the position?

Mr. MYERS. The position of the administration at this point is that it is not recommending any extension of coverage—that is, the so-called universal coverage provisions. However, we are recommending the elimination of windfall benefits for those who are not covered during their working career and who receive pensions from noncovered employment.

Senator COHEN. Has it taken any position with respect to Federal employees who retire and then move into another Federal job?

Mr. MYERS. No; this is not within the scope of our responsibilities, although other parts of the administration might be looking into that.

Senator HEINZ. Two last questions.

The President's Commission on Pension Policy, which reported early this year, chaired, as I recollect, by the president of the Xerox Corp., recommended the taxation of social security benefits.

Does the administration go on record against the taxation of social security benefits?

Mr. MYERS. Mr. Chairman, I am not certain that the administration has actually gone on record on that matter, although I think that the President has spoken on the issue, being opposed to such taxation.

In any event, in our proposal, there is no provision whatsoever for making social security benefits subject to income tax.

Senator HEINZ. Mr. Myers, thank you very much for your statement. You have been very, very helpful.

Our next group of witnesses will be Dr. Henry Aaron, senior fellow of the Brookings Institution, Dr. Alice Rivlin, Director of the Congressional Budget Office, and James Swenson, chairman of the Committee on Social Insurance of the American Academy of Actuaries.

Let me welcome you all and taking people in alphabetical order, let me ask Dr. Aaron to go first.

STATEMENT OF HENRY J. AARON, PH. D., SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C., AND PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND

Dr. AARON. Let me begin by expressing my agreement with the statement read by the chairman at the beginning of the hearings. I think it sets exactly the right tone.

In contrast to Mr. Myers, I would like to emphasize the sharp distinction between the short- and the longrun financial problems. The short- and the longrun problems derive from completely different sources and require completely different solutions.

In a separate forum before the House, I testified on the administration's proposals and I would like to submit those remarks for the record.

Senator HEINZ. Without objection, your other remarks will be made a part of the record.[1]

Dr. AARON. The sharp distinction between the long- and the shortrun problems leads me to the conclusion that it is intellectually dishonest, although it may be politically expedient, to use the shortrun problems that the social security system faces as the basis for making changes in the system that are relevant more to the longrun problem. While it is nice to kill two birds with one stone, that is not usually possible if, as in the present case, the birds are flying far apart.

I believe that attention should be paid to both of these problems. As the chairman put it, the shortrun problem critically demands our attention. The longrun problem, potentially much larger, can be handled best if we address it now so that we can consider even those changes that require lengthy phase-ins. It is important to recognize, however, that these problems are separate and require quite different solutions.

Turning to the questions proposed by the committee, I prepared a table, which appears in my prepared testimony,[2] that summarizes the three forecasts to which the chairman made reference earlier in your questioning of Mr. Myers.

These forecasts refer to the trust fund balance at the end of 1986. As you can see, the differences among those numbers are rather striking. The OASI trust fund has a large deficit under all the economic assumptions, the administration's relatively optimistic assumptions, the CBO's February assumptions, and the DRI pessimistic assumptions. I might point out that DRI no longer adheres to those pessimistic assumptions. Subsequent events have been considerably more favorable than those that would have been consistent with the February scenario. So DRI's current "pessimistic"

[1] See page 29.
[2] See page 27.

assumptions are less pessimistic than the ones they had in February.

Second, the DI and the HI funds have large surpluses and accumulate large reserves by 1986.

Third, the economic assumptions have an enormous effect on the size of the surplus and the deficit.

And, fourth, whether there is enough money in the system as a whole depends on the economic assumptions. Combined reserves are sufficient if you take the administration's assumptions. They just barely fall short with the CBO's and you fall considerably short with DRI's assumptions.

Now, what do you make out of all of this? That is the purpose of these hearings.

The first thing is that it makes no sense whatsoever to look at the individual trust funds separately if one wants to get some sense of the overall size of the shortrun financing problem. Thus, the constant reference to OASI going bankrupt in 1983 or 1982, it seems to me, is not helpful in sharpening the issues. The social security actuaries, of whom Mr. Myers is, I think, one of the most distinguished, have all been scrupulous to warn users that the actuaries were preparing projections, not forecasts; extrapolations of the implications of the assumptions they employed, not predictions.

When the projections of reserves in one fund turn out unduly optimistic and those in another unduly pessimistic, we should take steps to even things out by reallocating revenues or by interfund borrowing, or both. To the extent that offsetting errors are responsible for the present problem, it would make no more sense to declare bankruptcy for social security than it would to declare oneself personally bankrupt, despite having a large savings account, because one had overdrawn one's checking account.

Having stated that the economic assumptions are important, let me turn to the question of what assumptions one ought to use and how big the problem really is.

My own view, shared by that of virtually all economists not bound by party discipline, is that the economic scenario employed by the administration is more optimistic in general and more favorable to the social security system in particular than is likely to occur.

Based on the administration's forecast, interfund borrowing or the reallocation of revenues is sufficient to keep the system moving along nicely for many years. But I do not think it would be correct to legislate in the confident hope that the favorable events that the administration forecasts will come to pass. There is too great a chance that things may turn out worse than they assume.

For symmetric but opposite reasons, I think one should disregard the assumptions based on the DRI pessimistic forecast. The chairman has pointed out the economic calamity implied by the unemployment rate, inflation, and, I might add, the GNP growth rate that underlie those assumptions. We would be in very deep trouble if those events came to pass.

But more particularly, those assumptions represent such highly improbable sets of events and the remedies that would have to be taken within the present legislative framework to deal with them

are so serious that I think one should contemplate instead, changes in the structure of social security to reduce its sensitivity to economic bad news.

Let me back up a bit and talk about the size of the reserve that it would be nice to have.

As chairman of the advisory council that produced that 75 percent trust-fund target, let me state what that reserve is supposed to achieve. It is supposed to permit continued payment of social security benefits with no increase in payroll taxes through a recession as large as the one we suffered in 1974 and without any changes in the structure of the social security system to reduce its sensitivity to shortrun economic events.

Well, what are the sources of that sensitivity?

I think there are two key areas that make the social security system very sensitive at the present time to bad news.

The first is that revenues are indexed to wage rates and benefits are indexed to prices. That means, as Mr. Myers pointed out, that whenever wages grow relatively less rapidly than prices, there is a sharp and immediate effect on the trust fund reserves.

Second, the system is sensitive to variations in the employment. The higher the rate of unemployment, the lower the revenues that are collected, and the higher the rate of benefit claims.

I think that Congress now faces a very important choice. If it acts to reduce the sensitivity of social security to the economic events I just mentioned, then few reductions in benefits other than those in the reconciliation resolution would be sufficient to set the system on sound financial footing for the next several decades.

The problems of the next century will remain, and those ought to be dealt with in the near future. But as I indicated earlier, those are different in character than the present system.

Now, let me illustrate the consequences would be of not doing anything to reduce the sensitivity of the system to economic events. It would be necessary to cut benefits by large amounts, perhaps not exactly along the lines proposed by the administration, perhaps not even close to the lines proposed by the administration, but nevertheless very large in total.

So you face a choice, it seems to me, of reducing the sensitivity of the social security to shortrun economic events, or of enacting large cuts in benefits or increases in taxes.

How is it possible to add flexibility to the system? There exist a variety of ways to do that. Among them are the following three:

First, it has been proposed to index benefits to the lesser of the rate of the growth of prices or of wages. I think that Congress should move to do that at the present time. Second, Congress has contemplated giving the trust funds authority to borrow from each other and from the Treasury if its reserves sink to unacceptably low levels. That is a second approach.

The third, it has been proposed to inject general revenues into the social security system in a carefully limited manner, either on a countercyclical basis along lines proposed in 1977 or to pay for part or all of medicare hospital benefits as proposed by the last two advisory councils and by the National Commission on Social Security.

My own view is that any of those changes would be desirable. The adoption of any one of them could have prevented the current shortrun problems of the system.

The alternative is to leave the system as it is, acutely sensitive to shortrun economic events. In that case, I think you would be driven to adopt relatively pessimistic assumptions, probably along the lines suggested in February by the CBO, which leads to the necessity of significant reductions in benefits.

Senator HEINZ. Before I call on Dr. Rivlin, those of us on the Finance Committee have a meeting at 4 o'clock with Secretary Regan and, unfortunately, I will have to leave and turn the meeting over to Senator Cohen. Let me apologize to our other two witnesses because I wanted very much to hear both of you. But unfortunately the tax bill is off and running and we have got to keep track of it.

So, Senator Cohen, thank you very much.

[Subsequent to the hearing, Senator Heinz submitted additional questions to Dr. Aaron. Those questions and Dr. Aaron's responses appear in appendix 2, items 1 and 2.]

Senator COHEN [presiding]. Thank you, Dr. Aaron. Your prepared statement will be inserted into the record at this point.

[The prepared statement of Dr. Aaron follows:]

PREPARED STATEMENT OF DR. HENRY J. AARON

Mr. Chairman, thank you for the opportunity to testify on the shortrun financing problems of the social security system. It is my understanding that you do want to go into the longrun problems that will affect the social security system early in the next century. These problems are traceable almost exclusively to demographic events—the decline in birth and death rates—that will boost costs of presently legislated benefits beginning around the year 2005.

These difficulties are almost completely independent from the shortrun financing problems caused by the recent failure of wages to rise faster than prices as has been customary in the United States. The slow growth of wages relative to prices is attributable largely to the failure of productivity growth to resume and the second round of OPEC price increases. The shortrun problems must be solved to assure that people now on the benefit rolls or soon to enter them will receive promised benefits.

Once this problem is solved, the social security system will face a period of 30 years during which the cost of the system, measured as a percent of the wage base used to finance it, will be less than it is today. Thus, a 30-year financial interlude, as well as the nature of the issues raised, separates the longrun and the shortrun problems facing social security.

This fact leads to the conclusion that it is intellectually dishonest, although it may be politically convenient, to use the shortrun problems that the social security system faces as the basis for making changes in the system that are relevant more to the longrun problem. While it is nice to kill two birds with one stone, that is not usually possible if, as in the present case, the birds are flying far apart. I believe that attention should be paid to both of these problems. The shortrun problem critically demands our attention. The longrun problem, potentially much larger, can be handled best if we address it now so that we can consider even those changes that require lengthy phase-ins. It is important to recognize, however, that these problems are separate and require quite different solutions.

Table 1 summarizes the trust fund projections of the administration based on its own economic assumptions, alternate administration estimates based on highly pessimistic economic conditions that DRI in February considered possible but unlikely, and CBO estimates based on economic conditions neither as favorable as the administration's nor as unfavorable as DRI's pessimistic assumptions.

The numbers in table 1 have three striking characteristics. First, the OASI trust fund has a large deficit under all assumptions. Second, the DI and HI trust funds have large surpluses. Third, economic assumptions clearly have an enormous effect on the size of the surplus or deficit in each of the funds. Fourth, whether the system as a whole has sufficient reserves through the end of 1985 to cover month-to-month

imbalances between income and outgo (estimated to be about 9 percent of next year's outlays) depends on one's economic assumptions. Under the administration's assumptions, reserves are sufficient; under CBO's they just fall short; under the DRI pessimistic assumptions, there is an overall deficit.

TABLE 1.—PROJECTED TRUST FUND SURPLUSES AND DEFICITS UNDER ALTERNATIVE ASSUMPTIONS IN 1986

[Dollars in billions]

Trust fund	Trust fund balance at end of year			Balance at start of year as percent of year's outlays during year		
	Administration assumptions	CBO assumptions	Pessimistic assumptions	Administration assumptions	CBO assumptions	Pessimistic assumptions
OASI	−$29.2	−$63.5	−$125.9	−12	−20	−34
DI	+50.9	+47.7	+44.2	+135	+112	+95
HI	+46.2	+40.1	+41.5	+71	+58	+58
Total	+67.9	+24.3	−40.3	+18	+7	−6
25 pct reserve at end of year	+70.2	+77.5	+83.9	+25	+25	+25

Sources: Administration assumptions—memorandum from Harry C. Ballantyne, dated Mar. 13, 1981. CBO assumptions—"Paying for Social Security: Funding Options for the Near Term," February 1981. Pessimistic assumptions—memorandum from Harry C. Ballantyne, dated Mar. 9, 1981.

What is one to make of all of this? The first thing is that it makes no sense whatsoever to look at the individual trust funds separately if one wants to get some sense of the overall size of the shortrun financing problem. The allocation of tax revenues to each of the funds reflects past congressional decisions based on actuarial projections of the cost of each program. These projections reflect the assumptions on which they are based and nothing more. The social security actuaries have been scrupulous to warn users that their projections were not forecasts, but merely the extrapolations of the implications of the assumptions they employed. When the projections of reserves in one fund turn out unduly optimistic and those in another unduly pessimistic, we should take steps to even things out, by reallocating revenues or by interfund borrowing or both. To the extent that offsetting errors are responsible for the present problem, it would make no more sense to declare bankruptcy for social security than it would to declare oneself personally bankrupt, despite having an overall surplus because one overspent on entertainment and underspent on other items.

My own view, shared by that of virtually all economists not bound by party discipline, is that the economic scenario employed by the administration is more optimistic in general, and more favorable to the social security system in particular, than is likely to occur. Based on that forecast, interfund borrowing or the reallocation of revenues is sufficient to keep the system moving along nicely for many years. Even if one thinks that the President's program should be supported as the one most likely to succeed, however, one can acknowledge that it would be imprudent not to plan for the possibility that things will turn out less well than its supporters hope. For that reason, I believe that one should not legislate for social security on the basis of those assumptions. There is too great a chance that events will be less favorable and that, in such an event, the Nation will confront another social security crisis in a couple of years and you will have to legislate amid such fear, possibly on the eve of the next Presidential election.

For symmetric, but opposite reasons, I think one should disregard the projections based on the DRI pessimistic assumptions. These assumptions imply something approaching economic calamity, unemployment averaging close to 10 percent for all of 1983 and averaging over 9 percent for all of 1984; inflation at 12.8 percent this year, and accelerating next year; and virtually no productivity growth through 1986. DRI is no longer using these assumptions in its pessimistic forecast variant because events have been more favorable than those in its February projection. While economic events as pessimistic as these are not inconceivable, they are most unlikely. The operative question today is whether Congress should slash benefits or raise taxes enough to keep the system financially sound even in the face of highly improbable economic events, or whether it should take other steps that would make the system more robust in the face of economic adversity.

If reserves were now sufficiently large to see us through an extended period of economic adversity, I believe that the correct set of economic assumptions to use would be ones that reflect our best forecast of the likely future course of the

economy. Reserves would obviate the need to raise tax rates in order to sustain benefits during periods when economic events were less favorable than those underlying our projections. That was the arrangement under which social security operated until a few years ago. Recent economic events, however, have depleted reserves so much that they now are inadequate unless the economy performs better than it is reasonable to expect. For that reason I believe that you should do your legislative planning on the basis of economic assumptions that are somewhat less favorable than our best guess of the future and build buffers into the system so that it is less sensitive to very bad economic news than it is today.

At present the social security system is highly sensitive to two kinds of economic bad news that have been prevalent in recent years. In the shortrun, revenues are indexed to wage rates and benefits are indexed to prices; when the usual excess of wage increases over price increases does not occur, the effect on the reserves is immediate and pronounced. The system is also sensitive to fluctuations in employment because employment levels are a major determinant of the wage base and have some effect on the number of benefit claims.

In our present position, Congress faces an important choice. If it acts to reduce the sensitivity of the social security system to these economic events, relatively small reductions in benefits or small increases in legislated tax rates will be sufficient to place the system on sound financial footing for the next several decades. The problems of the next century will remain and should be addressed soon; but as I indicated before, next century's problems are distinct from today's and call for different solutions. On the other hand, if no steps are taken to reduce the sensitivity of social security to shortrun economic adversity, there is a risk that economic events less favorable than our best forecasts will place the system in jeopardy again in the near future; only large tax increases or large benefit cuts for those now receiving or soon to receive them would absolutely preclude this unhappy possibility. These are really the only two choices you face. To make them specific, let me sketch illustrations of how you could pursue each.

Adding flexibility, small benefit and tax changes.—There exists a variety of ways to protect social security from unanticipated economic fluctuations.

First, the proposal to index benefits to the lesser of the rate of growth of prices or of wages has been widely discussed. I believe that it should be enacted now.

Second, Congress has contemplated granting the social security trust funds authority to borrow from each other and from the Treasury if reserves sink to unacceptably low levels. I am persuaded that this authority should be granted, provided that explicit arrangements are made for repayment of such borrowings when economic conditions warrant tax increases and certainly within a stipulated number of years. The purpose of borrowing authority is to prevent the need either to raise taxes or to cut benefits on short notice during recession or stagflation, not to provide a permanent subsidy to the social security system.

Third, I believe that it would be desirable to inject some general revenues into the social security system in a carefully limited manner, either on a countercyclical basis along lines proposed in 1977 or to pay for part or all of medicare hospital benefits as proposed by the last two advisory councils and by the National Commission on Social Security.

I support all three of these changes, but any one of them would suffice to enable the continuation of social security benefits and payroll tax rates at approximately their current levels and they would preserve the financial balance of the system even in the face of very unfavorable economic developments. If any one had been enacted in 1977, there would be no shortrun financial crisis today.

Let me stress that I do not think that enactment of such provisions should deter the Congress from weeding out low-priority benefits. I support elimination of the minimum benefit for new beneficiaries, the phasing out of student benefits, the replacement of the lump-sum death benefit with one under the SSI program, and the introduction of a general cap on the multiprogram benefits to prevent exhorbitant replacement rates. Such changes, combined with already legislated payroll tax rates and the buffers described above, would create a stable financial basis for the social security system for several decades.

Let me stress, also, that these provisions should not stand in the way of a plan to build up contingency reserves gradually in the years ahead. Already legislated tax rates will lead to the accumulation of such reserves beginning in 1986. But it will take time for such reserves to accumulate, and, until they do, it will be important to make sure that economic events, such as an OPEC price increase or a major crop failure, do not automatically produce a crisis in social security. Social security policy should not be made to a rhythm set in Riyadh or determined by meteorological cycles.

No added flexibility.—If Congress does not adopt any of the three buffers described above, much larger cuts in social security benefits or increases in payroll taxes will be necessary to preclude recurrence of another financial crisis if economic events are less favorable than the administration assumes. I can see no justification for raising payroll taxes now when we rightly are contemplating reductions in income taxes. I can see no justification for abrupt reductions in benefits that would affect those already receiving cash benefits or about to retire. At $379 per month in January, average newly awarded retirement benefits cannot be described as unduly generous.

Thus, Congress can create buffers to protect the social security system from shortrun economic events that should not influence social security policy but threaten to do so because reserves are depleted. If it does not do so it will either have to raise payroll taxes at the same time that it is cutting income taxes, or slash benefits for those now on or soon to enter the benefit rolls at the same time that it is cutting income taxes. Most of the benefit of either alternative will accrue to persons far better off economically than those paying payroll taxes or receiving social security benefits.

To return to the issue I posed earlier—how big is the shortrun social security financing problem—my answer is that its size is up to you. If you enact one or more of the buffers I described, what exists is not a crisis in any sense, but a job of legislative reform and of weeding out benefits that are of relatively low social value. In the face of the widespread fear and handwringing about the imminent bankruptcy of social security, such a statement may smack of Panglossian refusal to recognize the gravity of the situation. It is, in fact, recognition of the fact that a problem that needs a solution has one.

Statement of Henry J. Aaron, Ph. D.

Mr. Chairman, I should like to make the following six points regarding the President's proposed reductions in social security benefits:

The reduction in social security benefits sought by the administration in its budget amendments and May 12 announcement would reduce benefits by more than 23 percent. These cuts are more than twice as large as necessary to close the longrun deficit under current law. If one agrees with the administration's shortrun economic forecast, nothing other than interfund borrowing is necessary to deal with the shortrun financing problem.

The reduction in benefits for early retirees would leave those who retire at age 62 in 1987 with benefits 43 percent smaller than those payable under current law. No age 62 retiree in 1982, single or couple, would receive a benefit as high as the official poverty threshold. Moreover, the abruptness of the proposed implementation of the cuts would reduce benefits for millions of persons on the eve of their retirement.

The administration proposes to eliminate age, education, and experience as criteria for determining disability. Of those who apply for disability, more than 70 percent are now refused—up from 53 percent 6 years ago. Of those refused, 80 percent never work regularly again. Disability insurance is not unduly soft. On the basis of recent experience, there is no need to tighten the eligibility criteria.

The proposed increase in the required proportion of recent quarters applicants for disability insurance must have worked to be eligible for benefits would have major effects on the eligibility of women. For example, a woman who quits work to have a baby and returns to work on her child's third birthday never loses eligibility under current law. Under the new proposals, this women would lose eligibility when the child is 2 years old and would not regain it until 7 years after she returned to work.

The administration proposes to reduce replacement rates because they are higher today than they were in 1972. However, the average $359.25 benefit paid at the end of 1980 does not seem to be too generous to many people. Moreover, the size of the cut depends on the actual rate of inflation and wage growth; if prices and wages rise 3 percentage points more per year than the administration assumes, replacement rates will be cut 15 percent on the average.

Other methods of dealing with the short- and longrun problems of social security are at hand—correction of the overindexing of benefits in the recent past, use of general revenues to pay for part of medicare as urged by the last two advisory councils and the National Commission on Social Security, a gradual increase in the age at which unreduced benefits are paid starting in the year 2000, and taxation of part of benefits—and the time has come to extend social security coverage to all workers. These steps would improve the structure of social security, give beneficiaries fair warning of planned changes, and put the system on sound financial footing for the next 75 years.

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Senator COHEN. Dr. Rivlin.

STATEMENT OF DR. ALICE M. RIVLIN, WASHINGTON, D.C., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. RIVLIN. Thank you, Mr. Chairman.

In the interest of time, let me concentrate on the projections and the financial status of the social security fund. The statement also deals with options, but I will skip over that rather more briefly.

Based on the set of economic assumptions adopted by the Congress in the first concurrent resolution on the budget for fiscal year 1982, the Congressional Budget Office projects that at the start of fiscal year 1983, the balance in the old-age and survivors insurance fund—the largest of the three trust funds that finance the social security system—will fall to 9.2 percent of the estimated $157 billion in outlays for that year. These numbers are shown in table 1. (See page 34.) Approximately $1 billion will remain in the OASI fund by the end of that year; in the absence of legislative action, it will be depleted shortly thereafter.

The disability insurance trust fund, however, is projected to improve its position substantially through 1986, with reserves increasing to 132 percent of outlays. The hospital insurance fund's balance is projected to grow to over 80 percent of annual outlays over the period.

Although the problem with the OASI fund is serious, there is no question that action by the Congress will guarantee the continued payment of benefits on time to social security recipients.

Timing differences between revenue inflows and outlays for benefits require that trust fund balances at the start of each fiscal year be at least 9 to 20 percent of that year's anticipated outlays. Like Mr. Myers, I would feel more comfortable at the high end of that range. Of the three funds, only the OASI fund is expected to experience a cash-flow problem in the next 5 years, when its balance at the beginning of fiscal year 1983 drops below the 9-percent level of expected outlays.

Maintaining a trust fund balance at a minimum level of 9 percent of annual outlays should mean that, at the start of any month during the year, there will be a balance sufficient to meet that month's expenditures. This 9 percent is an absolute minimum, but not a desirable level at which to maintain the funds. My statement today will focus mostly on the options that are available to insure that the trust fund balances are maintained at that minimum level.

The OASI fund's current difficulties result primarily from social security's sensitivity to the economy. Trust fund revenues are primarily a function of aggregate earnings. When unemployment rises and earnings grow more slowly than expected, revenues fall below projected levels. For example, a sustained 1-percent rise in the unemployment rate over 3 years can diminish all three trust funds' balances by as much as $15 billion.

At the same time, benefit payments are sensitive to price level changes, because benefit amounts are indexed annually to changes in the Consumer Price Index. When inflation rates are high, benefit payments grow sharply. The recent combination of high inflation, relatively high unemployment rates, and low rates of growth

in real earnings has led to the deterioration in the trust fund balances.

Nearly 4 years ago, in response to similar economic circumstances, the Congress passed the 1977 Social Security Amendments. These amendments were thought to be sufficient to maintain the trust funds for the ensuing 30 years. The unforeseen recurrence of these adverse economic conditions means that the Congress again needs to take some action.

Senator COHEN. Could I stop you?

Why do you say they were unforeseen? Why do you not take Mr. Myers' view that we prepare for something that is not necessarily unthinkable but in all reality could take place?

If we had taken Mr. Myers' attitude—and I will deal with that in a minute with Mr. Aaron—would you have had the same recommendation for 1977?

Dr. RIVLIN. By unforeseen, I mean that those who put together those amendments thought that a combination of circumstances as adverse as they had just been through was unlikely to occur again.

Senator COHEN. And times have shown that they were not pessimistic enough.

Dr. RIVLIN. There is much to be said for Mr. Myers' point of view that, in general for the budget but particularly with respect to social security, one should tend to be pessimistic. Then if things are better, that is terrific and one can add to benefits perhaps in the future.

Senator COHEN. You agree with that underlying philosophy of Mr. Myers: Prepare for the worst and if it gets better we can reduce taxes or build up the reserves? But if things are as bad as they might be, then we are protecting our social security recipients.

You do not disagree with the philosophy?

Dr. RIVLIN. I do not disagree with the philosophy and I wish that had been done in 1977. We would not be in the hole we are in now.

Senator COHEN. But you are going to recommend a different option to pursue?

Dr. RIVLIN. I am not recommending anything. What I was going to say is, while I agree with the philosophy, there is a real question.

When you are in the hole you are in now, how fast can you move to a more desirable reserve ratio without giving up other things?

The current projections, shown in table 1, are based on the economic assumptions underlying the first concurrent resolution—that the rate of inflation will fall to 6.2 percent by 1983 and 4.2 percent by 1986, and that the unemployment rate will fall to 5.6 percent by the end of 1986. These assumptions, which are shown in table 2 (see p. 35) are similar to those of the administration. Like any economic forecast, they are uncertain and grow increasingly so as they go further into the future.

For this reason, it is frequently asked—what effect a different set of economic assumptions would have on the trust fund. CBO has constructed a set of internally consistent alternative assumptions for its analysis of the administration's 1982 budget request. Under these assumptions, also shown in table 2, the inflation rate declines, but not by as much as under the economic assumptions of

the first resolution, reaching 8.9 percent in 1983, and 7.1 percent by 1986. The unemployment rate falls to 7.2 percent by 1986.

Table 3 (see p. 35) compares the status of the three social security trust funds under these alternative economic assumptions with those used in the first resolution. The OASI trust fund will encounter cash-flow problems before the end of fiscal year 1982 under the alternative set of assumptions, and will become depleted by the end of fiscal year 1983. The DI and HI funds remain strong, however, under this path.

Both of these sets of economic assumptions forecast real economic growth in each year over the 5-year period; no further downturns in the business cycle are forecast. Yet, even with the economy growing at only slightly different rates, the difference between the economic assumptions results in a difference in the estimated combined trust funds' balances of $60 billion by the end of 1986. If real growth should continue at the levels that have occurred over the most recent past—that is, occasionally negative instead of at the higher levels projected under both sets of economic assumptions—the problem in the trust funds would worsen.

As you discussed earlier in the afternoon, a variety of options exist about what to do with this. One thing is to change the trust funds' accounting methods, combining them or allowing interfund borrowing, or changing the tax rates. Another is to modify the benefit amounts. A third broad set of options is to increase the payroll tax or to find another way of getting more revenue into the system.

These options are treated in my prepared statement. I will skip over those, in the interest of time, Mr. Chairman. We can come back to them in the questions, if you would like.

It is likely that one might want to take a look at several options in combination. Indeed, one by one they offer a limited potential to solve the OASI trust fund's financing problem. Accounting changes alone could entirely ease the short-run problem, at a minimum under optimistic economic assumptions, but would not do so with less optimistic ones. The OASI fund will certainly need additional funds within the coming 18 months. Accounting changes, given no further downturn in the business cycle, could allow continued payments 2 or 3 additional years before more changes could be needed. 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.

Thus far, I have talked about options in terms of their potential to enable the system just barely to maintain benefit payments with some minimum level of trust fund reserves. The Congress, however, may wish to consider building up the funds to a more adequate level. The trust fund balances can be viewed as contingency reserves to enable the system to absorb unexpectedly large differences between revenue and outlay flows that occur during reces-

sionary and other periods. Studies have shown that an adequate contingency reserve during these periods would require balances of between 60 and 100 percent of outlays at the start of the year. This level of reserves, it is argued, would be sufficient to maintain the system through a further economic downturn slightly more severe than that of the 1974–75 period without having to raise taxes or lower benefits until a recovery was underway.

The system will require a much larger sum of benefit reductions or revenue increases to build up such a reserve than needed just to maintain benefit payments under the current forecast. In addition to interfund borrowing, for example, added income or reduced outlays would have to add up to $80 to $130 billion under the two sets of economic assumptions to maintain the system at a combined 50 percent of yearly outlays by 1986.

Mr. Chairman, I would be pleased to answer any questions.

Senator COHEN. One quick question comes to mind.

You heard Mr. Myers testify that he would like to build up the trust fund to 50 percent as far as the ratio is concerned and at the same time reduce the tax rates and the payroll taxes.

Is it wise to pursue that course at the same time, simultaneously, to build up the reserve and at the same time reduce the tax rate; and should you try to treat one before the other?

Dr. RIVLIN. There is no firm answer to that one way or the other. It really depends on what other things you want to do.

In a period when one is reducing the income tax dramatically, there might be a less strong case for reducing the payroll tax or, alternatively, one might want to reduce the payroll tax faster and the income tax slower.

Senator COHEN. Isn't the social security tax considered to be less progressive as it is a flat rate as opposed to a progressive rate?

Dr. RIVLIN. Yes; it is certainly much less progressive than the income tax.

[Due to the fact that Senator Heinz had to leave the hearing before he had an opportunity to question Dr. Rivlin, he submitted questions in writing to Dr. Rivlin. Those questions and Dr. Rivlin's responses appear in appendix 2, items 3 and 4.]

[The prepared statement of Dr. Rivlin follows:]

PREPARED STATEMENT OF DR. ALICE M. RIVLIN

Mr. Chairman, I am pleased to appear before this committee to discuss short-term social security financing. In my remarks, I will address two major issues:

Current projections of the financial status of the social security trust funds; and

Short-run options to remedy the situation.

CURRENT PROJECTIONS OF THE TRUST FUND BALANCES

Based on the set of economic assumptions adopted by the Congress in the First Concurrent Resolution on the Budget for Fiscal Year 1982, the Congressional Budget Office projects that at the start of fiscal year 1983 the balance in the old-age and survivors insurance (OASI) fund—the largest of the three trust funds that finance the social security system—will fall to 9.2 percent of the estimated $157 billion in outlays for that year (see table 1). Approximately $1 billion will remain in the OASI fund by the end of that year; in the absence of legislative action, it will be depleted shortly thereafter. The disability insurance (DI) trust fund, however, is projected to improve its position substantially through 1986, with reserves increasing to 132 percent of outlays, while the hospital insurance (HI) fund's balance is projected to grow to over 80 percent of annual outlays over the period. Although the problem with the OASI trust fund is serious, there is no question that action by the

Congress will guarantee the continued payment of benefits on time to social security recipients.

TABLE 1.—PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES, TO FISCAL YEAR 1986

[In billions of dollars]

	1981	1982	1983	1984	1985	1986
Old-age and survivors insurance:						
Outlays	122.4	140.4	157.0	171.5	185.7	199.2
Income[1]	121.9	130.7	144.0	157.9	176.8	194.5
Year-end balance	24.1	14.4	1.3	−12.3	−21.2	−25.9
Start-of-year balance (as percent of outlays)	20.1	17.1	9.2	0.8	−6.6	−10.7
Disability insurance:						
Outlays	17.5	19.5	20.8	22.0	23.3	25.0
Income[1]	13.2	22.2	26.6	29.7	36.6	42.3
Year-end balance	3.4	6.1	11.8	19.6	32.9	50.2
Start-of-year balance (as percent of outlays)	44.0	17.6	29.3	53.9	84.0	131.7
Hospital insurance:						
Outlays	27.6	33.2	37.2	41.9	46.8	52.1
Income[1]	33.0	38.9	43.6	48.3	54.5	63.3
Year-end balance	19.9	25.7	32.1	38.5	46.2	57.4
Start-of-year balance (as percent of outlays)	52.5	60.1	69.0	76.6	82.3	88.6
Combined OASI, DI, and HI:						
Outlays	167.5	193.2	215.1	235.4	255.8	276.3
Income[1]	168.2	191.9	214.2	235.9	267.8	300.1
Year-end balance	47.5	46.2	45.2	45.8	57.8	81.6
Start-of-year balance (as percent of outlays)	27.9	24.6	21.5	19.2	17.9	20.9

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

Note.—Minus sign denotes a deficit.

Source: Based on economic assumptions underlying the First Concurrent Resolution on the Budget for Fiscal Year 1982.

The nature of the trust funds

Timing differences between revenue inflows and outlays for benefits require that trust fund balances at the start of each fiscal year be at least 9 to 12 percent of that year's anticipated outlays. Of the three funds, only the OASI fund is expected to experience a cash-flow problem in the next 5 years, when its balance at the beginning of fiscal year 1983 drops below the 9 percent level of expected outlays.

Maintaining a trust fund balance at a minimum level of 9 percent of annual outlays should mean that at the start of any month during the year there will be a balance sufficient to meet that month's expenditures. This 9 percent is an absolute minimum, but not a desirable level at which to maintain the funds. My statement today will focus mostly on the options that are available to insure that the trust fund balances are maintained at this 9 percent level of outlays.

Sensitivity to economic conditions

The OASI fund's current difficulties result primarily from social security's sensitivity to the economy. Trust fund revenues are primarily a function of aggregate earnings. When unemployment rises and earnings grow more slowly than expected, revenues fall below projected levels. For example, a sustained 1 percent rise in the unemployment rate over 3 years can diminish all three trust funds' balances by as much as $15 billion. At the same time, benefit payments are sensitive to price level changes, because benefit amounts are indexed annually to changes in the Consumer Price Index (CPI). When inflation rates are high, benefit payments grow sharply. The recent combination of high inflation, relatively high unemployment rates, and low rates of growth in real earnings has led to the deterioration in the trust fund balances.

Nearly 4 years ago, in response to similar economic circumstances, the Congress passed the 1977 social security amendments. These amendments were thought to be sufficient to maintain the trust funds for the ensuing 30 years. The unforeseen recurrence of these adverse economic conditions means that the Congress again needs to take some action.

The current projections shown in table 1, are based on the economic assumptions underlying the first concurrent resolution: That the rate of inflation will fall to 6.2 percent by 1983 and 4.2 percent by 1986, and that the unemployment rate will fall

to 5.6 percent by the end of 1986 (table 2). These assumptions are similar to those of the administration. Like any economic forecast, they are uncertain and grow increasingly so as they go further into the future. For this reason, it is frequently asked what effect a different set of economic assumptions would have on the trust fund projections. CBO has constructed a set of internally consistent alternative assumptions for its analysis of the administrations's 1982 budget request. Under these assumptions (also shown in table 2), the inflation rate declines, but not by as much as under the economic assumptions of the first resolution reaching 8.9 percent in 1983, and 7.1 percent by 1986. The unemployment rate falls to 7.2 percent by 1986.

TABLE 2.—ALTERNATIVE ECONOMIC ASSUMPTIONS, BY CALENDAR YEAR

	1981	1982	1983	1984	1985	1986
Real GNP (percent change, year over year):						
First resolution	2.0	4.2	5.0	4.5	4.2	4.2
Alternative	1.3	2.5	2.7	3.0	3.8	3.7
CPI (percent change, year over year):						
First resolution	11.1	8.3	6.2	5.5	4.7	4.2
Alternative	11.3	9.5	8.9	8.2	7.7	7.1
June social security benefit increase (percent):						
First resolution	11.2	9.3	6.6	5.8	4.9	4.4
Alternative	11.2	9.8	9.2	8.4	7.9	7.2
Unemployment rate (percent, annual average):						
First resolution	7.5	7.2	6.6	6.4	5.9	5.6
Alternative	7.8	7.9	7.8	7.7	7.5	7.2

Table 3 compares the status of the three social security trust funds under these alternatives economic assumptions with those used in the first resolution. The OASI trust fund will encounter cash-flow problems before the end of fiscal year 1982 under the alternative set of assumptions, and will become depleted by the end of fiscal year 1983. The DI and HI funds remain strong, however, under this path.

Both of these sets of economic assumptions forecast real economic growth in each year over the 5-year period; no further downturns in the business cycle are forecast. Yet, even with the economy growing at only slightly different rates, the difference between the economic assumptions results in a difference in the estimated combined OASI, DI, and HI trust funds' balances of $60 billion by the end of 1986. If real growth should continue at the levels that have occurred over the most recent past instead of at the higher levels projected under both sets of economic assumptions, the problem in the trust funds would worsen.

TABLE 3.—COMPARISON OF OASI, DI, AND HI TRUST FUND BALANCES AS A PERCENT OF OUTLAYS AT START OF YEAR UNDER FIRST RESOLUTION AND ALTERNATIVE ECONOMIC ASSUMPTIONS, BY FISCAL YEAR

	1981	1982	1983	1984	1985	1986
OASI:						
First resolution	20.1	17.1	9.2	0.8	−6.6	−10.7
Alternative	20.1	16.7	8.5	−1.7	−12.7	−21.4
DI:						
First resolution	44.0	17.6	29.3	53.9	84.0	131.7
Alternative	44.0	17.3	28.5	49.6	72.8	110.5
HI:						
First resolution	52.5	60.1	69.0	76.6	82.3	88.6
Alternative	52.5	59.0	65.8	68.6	67.8	67.4

SHORT-RUN OPTIONS

The Congress has a variety of actions it could take to guarantee the adequacy of the trust funds. These options fall into three broad categories:

Changing the trust funds' accounting methods.

Modifying benefit amounts, and

Increasing or finding alternatives to the payroll tax revenues that finance the system.

Many of these options have already been considered by the Senate Finance and House Ways and Means Committees in their submissions to the Budget Committees for the 1981 reconciliation bill, or in other bills, or have been suggested by the administration.

Accounting changes

I would first like to discuss three possible accounting changes:

Interfund borrowing among social security's three trust funds.

Realigning the payroll tax rates among the funds, and

Merging the three funds.

Neither benefit amounts nor the scheduled payroll tax rates would be affected by enacting any of these three accounting options. The first two of these three accounting options are implicit in the administration's plan for social security, and are spelled out in detail in the current financing bill before the Social Security Subcommittee of Ways and Means (H.R. 3207).

TABLE 4.—CBO PROJECTIONS OF OASI, DI, AND HI AGGREGATE TRUST FUND BALANCES AT START OF YEAR, AS A PERCENT OF OUTLAYS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS, TO FISCAL YEAR 1986

Trust fund	1981	1982	1983	1984	1985	1986
OASI AND DI:						
First resolution	23.1	17.2	11.5	6.8	3.5	5.2
Alternative	23.1	16.8	10.8	4.1	−3.2	−6.8
OASI, DI, and HI:						
First resolution	27.9	24.6	21.5	19.2	17.9	20.9
Alternative	27.9	24.1	20.5	15.7	9.8	7.1

Interfund borrowing.—Under both sets of economic projections, if the OASI fund borrowed only from the DI trust fund, OASI reserves would be adequate for another 3 to 6 months. After this time, further borrowing would have to come from the HI trust fund. The needed OASI borrowing would amount to $39 billion over the 1981 to 1986 period under the first resolution assumptions, and $66 billion based on the alternative assumptions. This amount of borrowing can be supported by the DI and HI funds under the former path, but $6 billion in additional income or benefit reductions would be needed by fiscal year 1985 to minimally meet the system's needs under the latter path.

Realinement of payroll taxes or merging the trust funds.—Similar results could be achieved by realining the way the payroll tax is apportioned among the three trust funds or by merging the funds into one new fund. The 96th Congress enacted a realinement measure for fiscal year 1981 (Public Law 96-403) with the aim of giving this Congress time to examine social security issues in greater detail. Merging all three trust funds into one new fund could lead to some loss of congressional control in monitoring the status of the three programs. Maintaining a separate accounting system for each program could offset this disadvantage, however.

Benefit changes

An alternative way of easing the cash-flow problem would alter benefits. Some choices in this category would involve modifying the way annual cost-of-living benefit increases are calculated. Other alternatives, involving selective benefit reductions, have been reported by the Senate Finance and by the House Ways and Means Committees in their reconciliation packages sent to the Budget Committees. If these packages become law, the trust funds, with interfund borrowing or the realinement of the payroll tax rate, should be able to meet cash-benefit payments without further action over the next 5 years under either set of economic assumptions.

Modifying the annual cost-of-living benefit increase.—To keep social security benefits abreast of inflation, they are automatically indexed annually to reflect rises in the CPI. These adjustments are costly; the increase in benefits resulting from the 14.3 percent June 1980, and 11.2 percent June 1981 automatic benefit increase, will add $19 billion to expenditures in fiscal year 1981. The indexing provision will add $18 billion in fiscal year 1982.

There are a number of rationales for modifying the way benefits are adjusted for inflation. Benefit increases might be capped at some percent of the CPI's growth rate, compensating for past increases in the replacement rate resulting from a technical flaw in the indexing mechanism. Such a limit could also be justified on the grounds that social security benefits have been increasing at higher rates than average earnings, improving the social security recipients' position relative to workers, or on the basis that housing costs have overstated the increase in the cost of living as measured by the CPI. Limiting the July 1982 social security benefit increase to 85 percent of the increase in the CPI, for example, would lower fiscal year 1982 social security outlays by about $0.5 billion. It would lower outlays in 1983 by much more since that would be the first full year the option was in effect. Outlays would be $2.5 billion lower under first resolution assumptions and $209 billion lower under the alternative set in 1983. Alternatively, the Congress may chose to look at another index by which to adjust benefits, such as a rental-equivalent CPI or a wage index. The impacts on Federal outlays of these options are very difficult to predict, however.

The House Ways and Means Committee sent to the House Budget Committee a reconciliation option that contained another type of indexing option—postponing the annual adjustment from July to October of each year, thereby putting these adjustments on a fiscal year basis. That provision, which offsets recipients' losses by giving one-half of the expected 1982 increase in July and indexes the October 1982 adjustment to a 14-month rise in the CPI, would save $1.7 billion in fiscal year 1982 and a total of more than twice that in the outyears. A variation of this option was announced by the administration in its latest social security financing plan, and would save $3.3 billion in fiscal year 1982.

Eliminating certain benefit payments.—Several options to reduce or phase out certain specific benefits have been proposed by past administrations. These options involve the phasing out of students' benefits, and the elimination of the lump-sum death benefit and the minimum benefit. One rationale for these proposals is that such benefits have recently been duplicated by other Federal programs more directly targeted toward recipient groups. These options have been included by the Senate Finance Committee in their reconciliation instructions. Along with provisions to tighten eligibility for disability insurance and a few other changes, the Senate Finance Committee bill would add over $2.5 billion in 1982 to the trust funds, and more than $25 billion over the 5-year 1982–86 period. Along with interfund borrowing, these options would be sufficient to insure benefit payments through 1986, maintaining the combined trust fund balances at over 12 percent of outlays in each year even under the alternative set of economic assumptions.

Revenue modifications

A number of tax changes could raise the revenues needed by the OASI fund. Among the possible revenue options, one would allow the social security system to borrow 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.

Payroll tax changes.—Congress could follow past practice by raising the payroll tax rate for employers, employees, and self-employed persons. An increase in currently scheduled rates of between 0.5 to 1 percent would alone raise the revenues that the OASI fund will need by 1986. Along with one of the accounting options, such an increase would provide the system with an ample trust fund reserve in the short run. 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. These tax credits could be refundable and would be proportional to an individual's total payroll tax contribution.

General revenue financing.—Both the 1979 Advisory Council on Social Security and the National Commission on Social Security have recommended reallocating the HI share of the payroll tax rate among the OASI and DI trust funds, while also lowering the overall rate. Various plans call for financing either all or one-half of HI from an earmarked portion of income tax revenues. Financing HI program benefits in this manner 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.

General fund borrowing.—Granting the social security system the power to borrow from the general fund would provide the system with an added cushion against more negative economic outcomes and would also help avoid some potential payroll tax increases or benefit cuts.

Both general revenue financing and general fund borrowing, however, have potential shortcomings. They could increase pressures on the Federal budget, forcing cuts

in other areas, forestalling reductions in the size of the deficit, or creating an upward pressure on income taxes.

Several options in combination

Taken alone, many of the options outlined above offer limited potential to solve the OASI trust fund's financing problem. Accounting changes alone could entirely ease the short-run problem, at a minimum, under optimistic economic assumptions, but would not do so with less optimistic ones. The OASI trust fund will certainly need additional funds within the coming 18 months. Accounting changes, given no further downturn in the business cycle, could allow continued payments 2 or 3 additional years before more changes could be needed. 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.

A more adequate reserve

Thus far, I have discussed options in terms of their potential to enable the system just barely to maintain benefit payments with some minimum level of trust fund reserves. The Congress, however, may wish to consider building up the funds to a more adequate level. The trust fund balances can be viewed as contingency reserves to enable the system to absorb unexpectedly large differences between revenue and outlay flows that occur during recessionary (and other) periods. Studies have shown that an adequate contingency reserve during these periods would require balances of between 60 and 100 percent of outlays at the start of the year. This level of reserves, it is argued, would be sufficient to maintain the system through a further economic downturn slightly more severe than that of 1974–75 without having to raise taxes or lower benefits until a recovery was under way.

The system will require a much larger sum of benefit reductions or revenue increases to build up such a reserve than needed just to maintain benefit payments under the currrent forecast. In addition to interfund borrowing, for example, added income or reduced outlays would have to add up to $80 to $130 billion under the two sets of economic assumptions to maintain the system at a combined 50 percent of yearly outlays by 1986.

Senator COHEN. Mr. Swenson.

STATEMENT OF JAMES R. SWENSON, WASHINGTON, D.C., CHAIRMAN, COMMITTEE ON SOCIAL INSURANCE, AMERICAN ACADEMY OF ACTUARIES

Mr. SWENSON. On behalf of the American Academy of Actuaries, I wish to thank you for the opportunity to discuss financing issues affecting the social security program.

I would like my prepared statement to be made a part of the record and I would like to summarize the statement.

Senator COHEN. Without objection, so ordered.[1]

Mr. SWENSON. It is apparent that legislation needs to be enacted to resolve the predicted short-term financing problems of the OASI portion of the program. The academy believes that it is equally important that long-term financing issues be addressed at the same time to help assure the financial viability of the program and to restore public confidence in the program.

The long-term financing problems pose an even greater challenge to the program. Since the social security program is an intergenerational transfer program, funded essentially on a pay-as-you-go basis, the demographic influences of increasing life expectancy combined with the post-World War II baby boom and subsequent baby bust will require substantial increases in future payroll tax

[1] See page 42.

rates. Official actuarial estimates predict OASDHI benefit costs ranging from 22 to 38 percent of payroll by the year 2030.

Since the financial viability of the program depends upon the willingness and capability of persons who are working to pay taxes sufficient to support promised benefits, those benefit promises must be kept at levels that are reasonable and affordable. This requires that significant long-term changes to the program be enacted so that future generations will not be faced with a burden they will be unable or unwilling to support. Such changes should be made now so that those affected will have adequate time to plan accordingly.

In this context, it is noted that the recent administration proposals were criticized because they produced more savings than needed to restore long-term financial balance to the OASDI program. While this is true, these additional long-term savings would be required to help offset the even larger deficits expected to develop in the hospital insurance program.

Returning to the short-term financing problems, there are a variety of alternatives available to solve these problems. Enactment of proposals permitting interfund borrowing would substantially alleviate the short-term problem. However, the margins protecting the program from adverse economic conditions would be inadequate and other changes are warranted as well.

Actuarial forecasts of the degree of the short-term problem largely depend upon the economic assumptions employed in those forecasts. At least three currently available forecasts have been prepared in 1981 by the Office of the Actuary and the actuaries employed in the Health Care Financing Administration. A number of other forecasts will soon be available when the 1981 trustees' report is released.

The three currently available forecasts are based upon: One, former President Carter's 1982 budget assumptions; two, President Reagan's 1982 budget assumptions; and three, DRI's February 1981, pessimistic economic assumptions.

If interfund borrowing were permitted among the three trust funds, short-term cash-flow problems would not develop based upon President Reagan's 1982 budget assumptions. However, cash-flow problems would develop in 1985 based upon former President Carter's assumptions and as early as 1983 based upon DRI's pessimistic assumptions.

My personal opinion is that former President Carter's economic assumptions are the most realistic of the three sets of assumptions. However, opinions will differ and while recent economic conditions are encouraging, it is impossible to accurately predict future economic conditions. In 1977, it would have been unrealistic to predict, as "best estimates," economic conditions as adverse as those that prevailed during the past 2 years.

Therefore, it is necessary to provide adequate margins to protect the program from the consequences of unexpected adverse economic conditions.

Senator COHEN. I do not understand. On the one hand, you say President Carter's is the most realistic. On the other hand, you say, past experience shows he was overly optimistic in 1977. Why do

you say we should call Carter's the most realistic and yet recent past history shows in fact they were not?

Mr. SWENSON. Thank you for giving me the opportunity to clarify that point.

Basically, you can make your best-estimate assumptions but it is obvious that it is impossible to accurately predict what economic conditions are going to prevail. There are many factors that will affect the economy. The Middle East and OPEC prices certainly have an enormous effect.

Given that fact, what I am suggesting is that former President Carter's 1982 budget assumptions appear to be the most realistic of the three sets of assumptions that I described, in my own personal opinion. However, I cannot state with certainty that those assumptions are indeed going to prevail and I will further state that in 1977, if I had been asked to predict assumptions, I would not have predicted assumptions as adverse as those that actually occurred within the past 2 years.

Senator COHEN. But you have been sensitized by recent events to say that even though Carter's projections seem to be the most realistic, the recent events cause you to prepare for the worst?

Mr. SWENSON. I think that is a reasonable course of action, and I think that it is reasonable to desensitize the program to economic conditions, as I will be discussing.

Relative to that point, safety-valve type provisions are highly desirable to protect the program from adverse economic conditions.

For example, if the 1977 Social Security Amendments had provided that benefit increases be based upon the smaller of wage or price increases, the program would not now be confronted with cash-flow problems. Unfortunately, tax revenues have failed to keep pace with CPI indexed benefit payments because of negative real wage growth. The CPI increase exceeded the average wage increase by 3.1 percent in 1979 and by 5 percent in 1980. This is the primary cause of the immediate cash-flow problems.

If future benefit increases were limited to the smaller of the wage or price increases, this would provide the program with substantial protection from adverse economic conditions. Under favorable conditions, such as those forecast by President Reagan's 1982 budget, benefits would continue to be fully indexed to CPI measured price increases. However, if economic conditions prove unfavorable, the benefit increases would be limited to wage increases, thereby providing protection when it is needed most.

For example, using the DRI pessimistic assumptions, the administration has indicated that $111 billion of additional taxes or benefits reductions would be required prior to the end of 1986 to continue to make benefit payments. The safety-valve provision would provide $35 billion of this total amount needed, according to projections made by the Office of the Actuary.

It is my personal opinion that the DRI pessimistic assumptions are not unreasonably pessimistic. As a matter of fact, none of the future DRI real wage loss assumptions are as great as the actual real wage losses that occurred in the last 2 years. In addition, it should be noted that since 1972 there has been only 1 year during which there was more than 1 percent real wage gain. Current

legislative changes should provide adequate reserve margins as well as safety-valve provisions.

A minimum reserve of approximately 8 percent of annual outlays is essential to meet cash-flow requirements. Additional reserves are needed to permit time for legislative action if actual economic conditions are worse than expected. Two advisory councils and the National Commission on Social Security have recommended reserve levels ranging between 75 to 125 percent of annual outlays.

These are reasonable long-range objectives for the program. They are not redundant when it is recognized that the reserve level was 80 percent in 1973 and had fallen to 24 percent as of the end of 1980.

It is not politically realistic to expect these reserve ratios to be attained during the next 5 years. Therefore, a judgment must be made about a politically feasible minimum reserve level. This minimum reserve recommendation is based upon the assumption of enactment of a safety-valve provision limiting benefit increases to wage increases when real wage losses occur.

Based upon actuarial forecasts employing from President Carter's 1982 budget assumptions, maintenance of this maximum reserve level would require approximately $65 billion of additional taxes or benefit reductions to be spread throughout the period from 1982 to 1986. Again, please realize that subsequent political action may be required to protect the program, but current enactment of legislation providing a safety valve and further producing these additional revenues or savings would allow sufficient time for such action. If you wish to reduce the probability of having to take subsequent political action, then current legislation should be based on pessimistic assumptions.

The current financing problems of the program illustrate the continuing need for independent, professional actuarial analysis. The Office of the Actuary and the actuaries employed in the Health Care Financing Administration are uniquely qualified to provide such analysis. They must be given the latitude to select a range of appropriate assumptions independent of official economic forecasts.

ERISA requires that valuations of private pension plans be certified by qualified actuaries. A similar actuarial certification is required for pension plans covering Federal employees.

In each situation, the actuary must certify that the assumptions used are reasonable in the aggregate, representing the best estimates of anticipated experience, and the methodology is proper. The American Academy of Actuaries recommends that the Social Security Act be amended to enable the public to enjoy the same benefit of professional actuarial certification for the social security program, and this recommendation has also been made by the National Commission on Social Security.

Attached to the formal testimony is a proposed amendment to the Social Security Act.

In conclusion, the academy hopes this testimony has been helpful, and we would welcome the opportunity to be of further assistance as you proceed with your important deliberations.

Senator COHEN. Thank you, Mr. Swenson.

[Due to the fact that Senator Heinz had to leave the hearing before he had an opportunity to question Mr. Swenson, he submitted questions in writing to Mr. Swenson. Those questions and Mr. Swenson's reponses appear in appendix 2, items 5 and 6.]

[The prepared statement of Mr. Swenson follows:]

Prepared Statement of James R. Swenson

Mr. Chairman and distinguished Senators of the committee, my name is James R. Swenson. I am the chairman of the Committee on Social Insurance of the American Academy of Actuaries. On behalf of the Academy, I wish to thank you for the opportunity to discuss financing issues affecting the social security program.

The American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. It includes members of three founding organizations—the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

Requirements to become a member of the Academy can be summarized under two broad headings—(1) education, and (2) experience. At the present time, the education requirements for membership can be satisfied by passing certain professional examinations given either by the Casualty Society or the Society of Actuaries or by becoming an "enrolled actuary" under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of 3 years of responsible actuarial work.

As of the end of 1980, the Academy membership exceeded 6,200. The Academy is unique as the national actuarial organization for actuaries in all areas of specialization. These actuaries have a variety of types of employment, including insurance organizations, consulting firms, academic institutions, and government. A large majority of those individuals who have satisfied the education and experience requirements of the Academy have, in fact, joined the Academy.

The Academy is active in the development of guides to professional conduct and standards of practice required of members in their professional practice. The Academy is also active in government relations, liaison with other professions, and public relations.

Actuarial science involves the evaluation of the probabilities of uncertain future events, often over long periods of time, and the financial impact which these events involve. The computation of financial values for insurance and pension programs in both public and private sectors is a major application of actuarial techniques.

The actuarial nature of the financing arrangements for social security has been recognized since the inception of the program in 1935. In recognition of the extreme importance to society of maintaining the financial integrity of the social security system the Academy formed its Committee on Social Insurance several years ago. The committee includes some of the most eminent actuaries in the United States with a wealth of experience in both public and private insurance and pension programs.

Since I am representing a professional organization comprised of individuals who hold diverse political views, this statement will not generally favor or oppose specific legislative proposals. Instead, the statement will discuss the actuarial projections involving the social security program to assist you in your important deliberations.

It is apparent that legislation needs to be enacted to resolve the predicted short-term financing problems of the OASI portion of the program. The Academy believes that it is equally important that long-term financing issues be addressed at the same time to help assure the financial viability of the program and to restore public confidence in the program.

While the short-term financing problems of the program require immediate action, the long-term financing problems pose an even greater challenge to the program. Since the social security program is an intergenerational transfer program, funded essentially on a pay-as-you-go basis, the demographic influences of increasing life expectancy combined with the post World War II baby boom and subsequent baby bust will require substantial increases in future payroll tax rates. Official actuarial estimates predict OASDHI benefit costs ranging from 20 to 30 percent of payroll by the year 2030. The cost of medicare's supplementary medical insurance program, which is financed primarily by general revenues, will require an additional intergenerational transfer equal to approximately 2½ percent of payroll by that year.

Since the financial viability of the program depends upon the willingness and the capability of persons who are working to pay taxes sufficient to support promised benefits, those benefit promises must be kept at levels that are reasonable and affordable. This requires that significant long-term changes to the program be enacted so that future generations will not be faced with a burden they will be unable or unwilling to support. Such changes should be enacted now so that those affected will have adequate time to plan accordingly.

In this context, it is noted that the recent administration proposals were criticized because they produced more savings than needed to restore long-term financial balance to the OASDI program. While this is true based upon the intermediate assumption projections made in the 1980 trustees report, these additional long-term savings would be required to help offset the even larger deficits expected to develop in the hospital insurance program.

Returning to the subject of this hearing, namely the short-term financing problems, there are a variety of alternatives available to solve these problems. Enactment of proposals permitting interfund borrowing would substantially alleviate the short-term problem. However, the margins protecting the program from adverse economic conditions would be inadequate and other changes are warranted as well.

Actuarial forecasts of the degree of the short-term problem largely depend upon the economic assumptions employed in those forecasts. At least three currently available forecasts have been prepared in 1981 by the Office of the Actuary and the actuaries employed in the Health Care Financing Administration. A number of other forecasts will soon be available when the 1981 trustees report is released.

The three actuarial forecasts which have been released during 1981 are based upon: (1) Former President Carter's 1982 budget assumptions, (2) President Reagan's 1982 budget assumptions, and (3) DRI's February 1981 pessimistic economic assumptions. If interfund borrowing were permitted among the three trust funds, the projections indicate that short-term cash-flow problems would not develop based upon President Reagan's 1982 budget assumptions. However, cash-flow problems would develop in 1985 based upon former President Carter's 1982 budget assumptions and as early as 1983 based upon DRI's pessimistic assumptions.

My personal opinion is that former President Carter's economic assumptions are the most realistic of the three sets of assumptions. However, opinions will differ and it is impossible to accurately predict future economic conditions. In 1977, it would have been unrealistic to predict, as "best estimates," economic conditions as adverse as those that prevailed during the past 2 years.

Therefore, it is necessary to provide adequate margins to protect the program from the consequences of unexpected adverse economic conditions. The current margins are inadequate. Those margins should be large enough to permit adequate time for legislation to be enacted to maintain the financial viability of the program.

In addition, "safety valve" type provisions are highly desirable to protect the program from adverse economic conditions. For example, if the 1977 Social Security Amendments had provided that benefit increases be based upon the smaller of wage or price increases, the program would not now be confronted with cash-flow problems. Unfortunately, tax revenues have failed to keep pace with CPI indexed benefit payments because of negative "real wage" growth. The CPI increase exceeded the average wage increase by 3.1 percent in 1979, and by 5 percent in 1980. This is the primary cause of the immediate cash-flow problems.

If future benefit increases were limited to the smaller of the wage or price increases, this would provide the program with substantial protection from adverse economic conditions. Under favorable conditions, such as those forecast by President Reagan's 1982 budget, benefits would continue to be fully indexed to CPI measured price increase. However, if economic conditions prove unfavorable, the benefit increases would be limited to wage increases thereby providing protection when it is needed most.

For example, using the DRI pessimistic assumptions, the administration has indicated that $111 billion of additional taxes or benefit reductions would be required prior to the end of 1986 to continue to make benefit payments. Limiting the benefit increases would provide $35 billion of this total amount needed according to projections made by the Office of the Actuary.

The relative unpredictability of the economy indicates that more emphasis should be placed on actuarial projections based upon pessimistic assumptions. It should be noted that such projections indicated the potential for short-term cash-flow problems shortly after the 1977 amendments were enacted. Virtually no publicity was given to that fact at the time.

It is my personal opinion that the DRI pessimistic assumptions are not unreasonably pessimistic. As a matter of fact, none of the future DRI "real wage" loss assumptions are as substantial as the actual "real wage" losses that occurred in the

last 2 years. In addition, it should be noted that since 1972 there has been only 1 year during which there was more than a 1 percent real wage gain.

Current legislative changes should provide adequate reserve margins as well as "safety valve" provisions. Even with these margins and provisions, there is a good chance that subsequent legislative action would be required if "best estimate" forecasts are used as the basis for legislative action because of the unpredictability of the economy.

A minimum reserve of approximately 8 percent of annual outlays is essential to meet cash-flow requirements. Additional reserves are needed to permit time for legislative action if actual economic conditions are worse than expected. Two advisory councils and the National Commission on Social Security have recommended reserve ratios ranging between 75 to 125 percent of annual outlays.

These are reasonable long-range objectives for the program. They are not redundant when it is recognized that the reserve ratio was 80 percent in 1973, and had fallen to 24 percent as of the end of 1980.

It is not politically realistic to expect these reserve levels to be attained during the next 5 years. Therefore, a judgment must be made about a politically feasible minimum reserve level that would permit time for subsequent legislative action should it become necessary. It is my judgment that a minimum reserve level of 25 percent of annual outlays is essential to protect the program and its recipients. This minimum reserve recommendation is based upon the assumption of enactment of a "safety valve" provision limiting benefit increases to wage increases when "real wage" losses occur.

Based upon actuarial forecasts employing former President Carter's 1982 budget assumptions, maintenance of this minimum reserve level would require approximately $65 billion of additional taxes of benefit reductions to be spread throughout the period from 1982 to 1986. Again, please realize that subsequent political action may be required to protect the program, but current enactment of legislation providing a safety valve and further producing these additional revenues or savings would allow sufficient time for such action. If you wish to reduce the probability of having to take subsequent political action, then current legislation should be based on pessimistic assumptions.

The current financing problems of the program illustrate the continuing need for independent, professional actuarial analysis. The Office of the Actuary of the Social Security Administration and the actuaries employed in the Health Care Financing Administration are uniquely qualified to provide such analysis. They must be given the latitude to select a range of appropriate assumptions independent of "official" economic forecasts.

It should be noted that the Employee Retirement Income Security Act of 1974 (ERISA) requires that valuations of private pension plans be certified by qualified actuaries. A similar actuarial certification is required by Public Law 95-595 for pension plans covering Federal employees. In each situation, the actuary must certify that the assumptions used are reasonable in the aggregate, representing the best estimates of anticipated experience, and the methodology is proper. The American Academy of Actuaries recommends that the Social Security Act be amended to enable the public to enjoy the same benefit of professional actuarial certification for the social security program. This recommendation has also been made by the National Commission on Social Security.

Consistent with this recommendation, the board of directors of the American Academy of Actuaries has adopted the following resolution:

"Whereas actuarial projections and cost estimates based on work of the highest professional quality and integrity have been an important force for fiscal prudence in the historical development of social insurance programs; and

"Whereas the growth of these programs and their commitments to future generations of beneficiaries makes it more important than ever that these programs be managed in a fiscally prudent manner;

"Therefore, be it resolved that this organization believes that it is in the best interests of the public that, (1) the actuaries who are responsible for the projections and cost estimates be free to use their best professional judgment and expertise independent of pressures for political expediency, and (2) the actuaries ultimately responsible for their work be required to issue an opinion letter accompanying the appropriate annual report stating whether the actuarial assumptions used in the projections contained therein are, (a) in the aggregate reasonable taking into account the experience and expectations of the plan, and (b) represent their best estimates of anticipated experience under the plan."

Attached to this testimony is a proposed amendment to the Social Security Act.[1] This amendment would require a statement of opinion by the Chief Actuary of the Social Security Administration and the Chief Actuarial Officer of the Health Care Financing Administration that the techniques and methodology used in preparing the actuarial status of the trust funds and the cost estimates and the assumptions used with respect to such funds are reasonable and conform with generally accepted actuarial principles.

In conclusion, the Academy hopes this testimony has been helpful, and we would welcome the opportunity to be of further assistance as you proceed with your important deliberations.

Senator COHEN. Assuming that your recommended amendment to the Social Security Act were in fact passed and adopted by the Congress, would you certify the Reagan economic assumptions to be reasonable?

Mr. SWENSON. Well, I do not have to make that decision as I am not the actuary for the Social Security Administration.

Senator COHEN. Let me ask you personally.

Mr. SWENSON. If I were—I have given you my best estimate assumption; namely, the former President Carter assumption, and if I were being asked personally to certify the Reagan assumptions which I feel are overly optimistic, I would probably not be able to do so. But again this is a personal judgment and I cannot speak either for the Academy of Actuaries, or Dwight Bartlett, who is the current actuary.

Senator COHEN. In 1977, at that time, if this amendment had been in effect, and the academy or some actuary were asked to certify the Carter economic assumptions, I assume the conclusion would be they were reasonable, when in fact they turned out to be far too reasonable as far as the economic conditions that existed in that period of time; right?

Mr. SWENSON. Certainly history has proved them not to be realistic.

Senator COHEN. So ultimately what would your amendment have done in that case?

Mr. SWENSON. Well, what the amendment would do is require the chief actuary and the actuaries employed in the Health Care Financing Administration to use their own best judgment as to what appropriate assumptions are.

Senator COHEN. I assume they could have come to the conclusion in 1977 that these are in fact reasonable assumptions. You certainly would not have had any disagreement with them at that time. Assume I had called upon you to testify. You would have said, they are in fact reasonable. So how would it have changed the outcome of the current situation we find ourselves in as to whether that amendment was passed or not?

Mr. SWENSON. Actuarial certification would merely provide some safety to the public in the sense that the actuary would be free to choose a set of assumptions which are independent of political pressure.

However, I think that it is clear, as I indicated earlier in my testimony, that it is impossible to accurately predict future economic events. As a consequence, I believe that, as in the trustees report, where there are at least three sets of assumptions which are employed, the pessimistic alternative, the intermediate alterna-

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[1] See appendix 2, item 7, page 164.

tive and the optimistic alternative, it is important to pay attention to all three sets of assumptions.

I would agree with Dr. Rivlin and Mr. Myers that it is important to plan based upon the pessimistic assumptions, and if conditions prove to be better than those pessimistic assumptions would indicate, then there is some margin.

In addition, as I mentioned in the testimony, I believe that it is important to desensitize the program to the effect of economic conditions by providing a safety-valve-type provision.

Senator COHEN. Do you think the administration's economic assumptions are based on political factors?

Mr. SWENSON. I do not wish to characterize them as such and I certainly hope those economic assumptions prove to be realistic.

Senator COHEN. I gather indirectly, by implication, that the thrust of your amendment is to say that we should have economic assumptions being certified by professionals based upon their professional judgment without regard to political assumptions. That implies that in fact the current ones in your judgment or of that of your coprofessionals, are based on political factors.

Mr. SWENSON. Let me just say that it is my current judgment, political considerations notwithstanding, that the administration assumptions are overly optimistic, but I am certain that economists who have been making these projections feel they are based on proper and rational bases.

Again, opinions will differ. I believe it was Harry Truman that said that he always wanted to find a one-armed economist because they were saying on the one hand this and on the one hand that.

Senator COHEN. And I think someone else said that if you place economists end to end you would never reach conclusions.

Dr. Rivlin, what about your conclusion about the recommendation as far as certification? Does that pose any difficulty as far as you are concerned? Does it help?

Dr. RIVLIN. I do not think it would do any harm. It is always good to have another opinion. I do not think it would remove the Congress from the problem, which it will always have, of evaluating the opinions of the administration and others opinions about what is likely to happen to the economy.

Senator COHEN. Do you think it is, No. 1, either feasible or indeed desirable to separate out political factors in making judgments such as this?

Dr. RIVLIN. No, not in any formal sense. And I think all administrations tend to be optimistic. This is nothing peculiar to the current one.

Senator COHEN. In fact, there are political consequences to administrations that become unduly optimistic.

Dr. RIVLIN. Absolutely. And clearly there is a very large amount of uncertainty in any economic forecast. The events of the last few years have underlined that.

But we have always known that, and any administration has to hope that its programs will work and that unforeseen events will not have a negative consequence. So there is a tendency for an administration to look on the brighter side of the range of uncertainty. There is nothing wrong with that.

Senator COHEN. Let me ask you, is there, in fact, any psychological benefit—as far as professional economists are concerned—is there a psychological impact upon being optimistic and encouraging the commercial world, for example, to start investing based on certain optimistic assumptions?

Would that be undercut by a certification coming from an actuary that said that is nonsense; we find it nonsense and it would be much more bleak?

What is the impact of such an amendment in a political context with an administration—not with this one, but those down the line, since we are legislating for the future, to have such a certification?

Dr. RIVLIN. I had not thought about such a certification before. But my off-the-top-of-the-head judgment is that it would not in itself be a detriment. Because of the peculiar nature of social security, I think it is sensible for the Congress and the Government to look down the road a good, long way with social security, and to say, this is what we hope will happen to the economy. But quite frankly, we are not sure and we are going to budget for a worst case. Now, I do not think that will necessarily make the worst case come true, but it seems to me it is a prudent thing to do.

Senator COHEN. I think you indicated that if the budget reconciliation packages that were reported out of the Finance Committee and the Ways and Means Committee became law, that these provisions, combined with interfund borrowing, would satisfy the short-term problem without any further action; is that correct?

Dr. RIVLIN. That is correct on the basis of the minimum 9-percent reserve with what we have described as alternative assumptions, which are more pessimistic than the administration's. The combination of interfund borrowing and those changes which would be fairly drastic—they would reduce some benefits—would solve the problem for the short run.

Senator COHEN. And the short run; how long is that short run?

Dr. RIVLIN. We are talking about through 1986—that is, over in the next 5 fiscal years.

As Dr. Aaron pointed out, there is a serious longer run problem. That is a different problem that does not go away.

Senator COHEN. But it is your judgment that the reconciliation package plus allowing for the interfund borrowing would take care of the short-term needs?

Dr. RIVLIN. Yes.

Senator COHEN. Do you also agree with Dr. Aaron and Mr. Swenson that we should separate out the short and the long term? Mr. Myers said they were inseparable.

Dr. RIVLIN. I think it is important to think clearly about what particular problems you are dealing with. But that does not mean that we can neglect the longer run problem. The longer run problem is primarily a result of changes in demography, in the relative size of age groups. That is not what we are dealing with in the next 5 years. That is a different problem. But we need to think about both problems.

Senator COHEN. Dr. Aaron, just one basic question to you.

I noticed you went over the number of options you would support. Basically, there were three. No reference was made to the possibility of extending the retirement age from 65 to 68, which is

one proposal being considered in the House and I believe by at least one member of this committee.

What is your judgment on that?

Dr. AARON. The reason I skipped that was because of my focus on the shortrun problem. I was operating on the assumption that any change in the retirement age would require a lengthy phase in and would decrease the longrun problem. It would probably make sense at the present time to enact an increase in the age at which unreduced benefits are paid from 65 to 68, beginning no sooner than 2000, and gradually phased in after that.

However, if one moves in that direction, one needs to attend to a problem that also arises if one wants to reduce early retirement benefits. As Senator Bradley's question to Mr. Myers underscored, a lot of people, are suffering from serious physical problems. They need to retire. Consequently, if we extend the basic retirement age, we would need to take steps to provide a disability, unemployment insurance or early retirement benefit for workers over 65 but under 68 and hence not eligible for regular benefits under the new higher retirement age some such backup protection, more liberal than that provided under current programs, would be needed to protect those who retire under pressure, under duress.

Senator COHEN. I enjoyed your alliteration on page 8, "Social security policy should not be made to a rhythm set in Riyadh or determined by meteorological cycles."

Do you really think that you can devise a social security fund or system or any program, for that matter, for the immediate future that is independent from the rhythm set in Riyadh?

Dr. AARON. Substantially, yes.

As Mr. Swenson pointed out, had the provision been enacted in 1977 to index benefits for those now on the rolls for the lesser of wages and prices, you would not be holding these hearings today.

Senator COHEN. Let's assume we have a rather explosive Middle East situation. Suppose there is an immediate shutoff of oil. Suppose, as you have said on page 4, that the assumptions underlying the administration's proposal approach economic calamity, unemployment averaging close to 10 percent for all of 1983 and averaging over 9 percent for all of 1984, inflation at 12.8 percent this year and accelerating next year.

Is that really that unrealistic?

Dr. AARON. I fully agree that even the most careful planning cannot protect social security from worldwide economic catastrophe that would throw all our institutions into turmoil and require that we tinker with all of them.

I was alluding to the kind of events we have lived through recently, a continued increase in the real price of oil along the lines that has occurred in the last 5 or 6 years, recessions of the magnitude to which we have unfortunately become accustomed. I do believe it is possible through the kinds of buffers that Mr. Swenson and I mentioned in our my testimony to put the social security system in a situation where you do not have to legislate each time the unemployment rises or inflation unfortunately lifts up.

Senator COHEN. Am I correct in understanding that all three of you approve of this general approach of planning for the worst

case, but that you have different courses of action or options you would recommend?

Dr. Aaron, perhaps you would recommend an amendment as far as what actuaries should do in the future. But you basically agree that we should hope for the better if not the best and plan for the worst in order to get this back on track?

Dr. AARON. I would agree with that; but there is a harder question that comes after that. Once you acknowledge that you want to plan for the worst, you have to decide whether you want to cut benefits now so that a deficit will not occur even if bad economic news that is unlikely, happens to occur, or whether you want to enact buffers so that the system automatically adjusts. That is really the choice you face.

Senator COHEN. But you would support some reduction in benefits almost immediately if we change the indexation from CPI to the wage index? That is really a reduction almost immediately; isn't it?

Dr. AARON. I would list some other reductions, including some presented by the administration that seem to me to be worthy of consideration. Over the long haul——

Senator COHEN. Don't take the long haul.

Dr. AARON. You are quite right. This year, if you had the lesser of the CPI or the wage index, you would have a smaller index than present law provides.

Senator COHEN. Senator Heinz had a number of questions he wanted to pose to each of you, and since he is not here, I ask they be submitted in writing and, if possible, if you could respond in writing.

The committee will stand in recess until next Thursday.

[Whereupon, at 4:40 p.m., the committee recessed.]

APPENDIXES

Appendix 1

BRIEFING MATERIAL FOR HEARING

MEMORANDUM

TO: Members of the Special Committee on Aging
FROM: Committee Staff
RE: Short-Term Social Security Financing Issues
DATE: June 14, 1981

CURRENT CONDITIONS

- The Old Age and Survivor's Insurance (OASI) trust fund is expected to be exhausted by November, 1982

- If OASI, Disability Insurance (DI), and Medicare (HI) trust funds are combined:

  - With a rapid economic recovery, trust funds would be sufficient to cover payouts through 1982.

  - With a gradual recovery, trust fund balances would fall below 9%, producing cash flow problems, between 1985 and 1990.

  - With a slow and delayed recovery, trust fund balances would be insufficient to meet cash flow requirements by 1984 and would be exhausted by 1985.

- Payroll tax rate increases, already scheduled for 1982, 1985, 1986, and 1990, will help restore trust fund balances for OASI and DI in the late 1980's.

- Short-term problems are distinct from the long-term problem. Anticipated changes in demographics occurring after the late 1980's are expected to create surpluses in OASDI until about 2010 when long run imbalances will start to appear.

- The cause of the short-term problem has been unpredicted increases in expenditures and slowed growth in revenues, resulting from:

  - Inflation rates as high as 14.3% causing benefits to increase more rapidly than predicted.

  - Unemployment and slowed economic growth reducing payroll tax revenues and increasing the number of beneficiaries.

ORIGINS OF THE PROBLEM

As recently as 1970, the Old Age Survivor's and Disability Insurance (OADI) trust funds had on hand a reserve equal to one year's payout from OASDI, an amount then considered adequate to meet any unexpected changes in expenditures or income during the year. When Congress passed the 1972 Amendments to the Social Security Act, economic forecasts projected a continuation of the relatively high growth rates and low rates of price inflation which had been experienced during the 1960's. Under these conditions, revenues into the fund would adequately cover payouts, and trust fund reserves would remain sufficient for contingencies.

The 1972 Amendments increased social security benefits across-the-board by 20%, and initiated the price-indexing of benefits and a complex indexing method for computing the initial benefit. A technical error in the method of computing the initial benefit led to an "over-indexing" of initial benefit amounts for new beneficiaries. In addition, when price-indexing of benefits was initiated in 1975, annual inflation rates of around 10% began to fuel a rapid increase in payouts from the system. A recession in 1974-75 raised unemployment rates to their highest level since WWII, and slowed the growth in real wages, causing income to the OASDI program to fall below expenditures. Finally, Disability Insurance trust funds were being steadily eroded because of a continuing rapid increase in beneficiaries.

Beginning in 1973, the Board of Trustees of the OASDI program began to predict a deterioration in the financial condition of the program in both the immediate future and over the long run. By 1977, the Trustees Report predicted that the DI trust funds would be depleted by 1979 and the OASI trust funds by 1983. The long run deficit (75 year average) was predicted to reach 8.2% of taxable payroll, a dramatic increase from the .32% deficit predicted in the 1973 Report. By 1977 reserves in the OASDI trust funds had already declined to less than six months payout.

Congress moved in 1977 to correct the financial condition of the OASDI program. The 1977 Amendments to the Social Security Act increased the overall payroll tax rate beginning in 1979, increased the taxable earnings base, reallocated a portion of the Hospital Insurance (HI) payroll tax rate to OASI and DI, and resolved the technical problems in the method of computing the initial benefit amount (de-coupling). These changes were predicted to produce surpluses in the OASDI program beginning in 1980 and continuing over the next thirty years with reserves building up to seven months payout by 1987. The long run deficit in the OASDI program was to have been reduced from an average 8.2% to 1.46% of taxable payroll.11Again, however, the economy did not perform as well as forecasts had predicted. Annual increases in the Consumer Price Index have exceeded 10% since 1979, a rate sufficient to double payouts from the program over seven years. Real wage changes have been negative or near zero since 1977, and recently, unemployment rates have climbed to

about 7%. As a result, annual income to the OASDI program continued to be insufficient to cover expenditures. Trust fund balances declined from $36 billion in 1977 to an estimated $27 billion in 1980. Lower trust fund balances combined with rapidly increasing expenditures brought reserves down to less than three months payout by 1980.

The 1980 Trustees Report, the most recent report issued, predicted under its intermediate assumptions that OASDI combined reserves would drop to less than one month's payout by 1983, creating cash flow problems, and would be exhausted in 1984. The DI program by itself actually was adequately financed over the short and the long run. This was partly due to a steady decline since 1976 in the number of newly entitled beneficiaries for Disability Insurance. OASI, on the other hand, was projected to run into cash-flow problems in 1981 and to exhaust its reserves in 1982. The OASI program was expected to continue to show deficits into the 1990's until scheduled tax increases and improving demographics began to create surpluses and build up the reserves again. The reserve balance was expected to continue to grow until around 2010 when changing demographics would again begin to create deficits. Over the long term, the combined forecast for the OASDI program was similar to that for the OASI program alone. The long-run deficit for the OASDI program was forecast, according to intermediate assumptions, to average 1.52% of taxable payroll over 75 years.

Carter Administration mid-session projections for the social security system contained in the July, 1980 budget update were more pessimistic than the intermediate forecasts of the Trustee's Report. According to Carter projections, reserves of the OASI program would be exhausted by November, 1981 and combined reserves of the OASDI program would be depleted in mid-1982.

The 96th Congress responded to these forecasts by reallocating a portion of the DI tax rate to OASI for 1980 and 1981. This measure (signed into law as P.L. 96-403) was intended to buy time for the 97th Congress to resolve the shortage of funds in the OASI and DI programs.

The Hospital Insurance or Medicare (HI) program has had a somewhat different set of problems. Despite a doubling in HI expenditures between 1968 and 1980 due primarily to rapidly rising hospital costs, this program has been able to maintain reserve balances in the neighborhood of six months payout. Tax rate increases included in the 1977 Amendments will help increase the ratio of reserves to payouts into the mid-1980's, based on the intermediate assumptions used in the 1980 Trustees' Report. Thereafter, however, rising costs are expected to overcome increases in revenues, causing the HI trust fund to decline rapidly until it is exhausted sometime around 1994.

Combining the HI and OASDI program finances will improve the condition of the OASDI program temporarily. Under intermediate assumptions, the combined OASDHI reserves would decline to less than one month's payout in 1985 and 1986, but would not be exhausted. However, combining the finances of the program would cease to be beneficial to the condition of the OASDI program in the latter years of the 1980's.

SIZE OF THE SHORT-TERM DEFICIT

- The cumulative difference between income and expenditures over the five years from 1981 to 1985 may produce anything between a net surplus of $7 billion and a net loss of $76 billion for the combined OASDHI trust funds.
- To achieve trust fund reserves of three months' payout by the beginning of 1986 would require an increase of from $30.6 billion to $44.5 billion in trust fund balances over 1981 year end balances.
- Estimates of the amount of savings or revenues needed to maintain adequate trust fund balances between 1982 and 1986 vary as a result of differenct assumptions about economic conditions and suitable trust fund ratios. Current estimates range from $40 billion to $110 billion.

There is considerable disagreement about the amount of money that either needs to be saved from current social security programs or added to revenues to maintain the solvency of the combined OASDHI trust fund over the next five years. Estimates have ranged from less than $50 billion to more than $184 billion. The reason for this variation is that estimates of the "deficit" are based on subjective judgments about two factors:

1) the appropriate forecast for the economy over the next five years, and
2) the size of the cushion needed in the reserves to buffer against economic fluctuation in the near term.

In addition to variation resulting from differences over economic projections and reserve cushions, there is variation which results from whether or not the social security system is seen as a self-contained system entirely dependent on the payroll tax for financing, or a system with back-up financing from general revenues when reserves are low. If back-up financing is available, a smaller reserve cushion is necessary to guard against errors in ecomonic forecasting.

The basic issue behind this hearing is the amount of money that must be either saved from current programs or added to revenues to keep the social security system solvent in the near term if borrowing is permitted among the OASI, DI, and HI trust funds.

A secondary issue involved in arriving at this figure is the nature of the tradeoff between assurance that the system will remain solvent without further Congressional action after this year, and maintenance of the social security system with its present benefit and financing structure and replacement rates. Maintaining the present system involves a risk that marginal action taken to correct the projected deficit will not be sufficient. Making major changes in the system to assure sufficient reserves under the most pessimistic forecasts involves a risk that the economy will improve and these changes will have been unnecessary to assure the solvency of the OASDHI program.

Under optimistic or intermediate forecasts of the economy, the combined OASDHI programs will run deficits through at least 1985, but will not exhaust reserves. However, under intermediate assumptions reserves would drop to less than 9% of annual payouts after 1984, resulting in an inability to pay benefits on time. This depletion of reserves would be reversed beginning in 1986 or earlier, due to major scheduled increases in payroll tax rates in 1985 and 1990. After 1990, reserve ratios would rise above the danger point. Over the next thirty years the OASDI program would accumulate surpluses because of the increase in taxes and improved ratios of workers to retirees. In short, under optimistic assumptions there is no serious short-term financing problem. Under intermediate forecasts, the problem only becomes serious in 1985 and is corrected after 1990 by already legislated tax increases.

Under pessimistic forecasts of the economy, the combined OASDHI trust funds will encounter cash-flow problems in 1984 and be exhausted in 1985. Annual deficits will continue to increase throughout this period and beyond. Current pessimistic forecasts, however, have not been expanded beyond 1986.

Cost estimates of the savings or revenues needed to maintain the combined OASDHI programs through 1986 have only been provided for the Administration's 1982 budget and pessimistic assumptions. Under their 1982 budget assumptions, the total package of reforms, including a rollback of scheduled payroll tax rates, would save $82 billion. Without a payroll tax rate rollback, this figure would be substantially lower (we estimate savings would only have to be $40 billion). The proposed savings would keep trust fund reserve ratios above 21% and raise them to 30% of annual payouts by 1986.

Under the Administration's pessimistic assumptions, the total package of reforms would save $112 billion (we estimate savings would have to be $107 billion without tax rollback). These savings would keep trust fund ratios above 16% and raise them to 21% by 1986.

Cost estimates of the savings or revenues required to raise trust fund ratios to 40% by 1986 were developed by the Social Security Subcommittee of the House Ways and Means Committee, using the Administration's 1982 revised budget assumptions. The estimate of savings and revenues required was between $100 and $110 billion.

COST ESTIMATES FOR RESTORING TARGET TRUST FUND RATIOS BY 1986
(Amounts in billions)

Total Estimated Income 1981-85	Total Estimated Payout 1981-85	Net Change In Fund Balance 1981-85	Fund Ratio Target beginning 1986	Est. Increase In Fund Balance to meet 1986 target	Total Est. Savings Needed 1982-86
ADMINISTRATION REVISED 1982 BUDGET ASSUMPTIONS					
$1,106.3	$1,099.1	$ 7.0	30%	$45.0	$ 38.0
CONGRESSIONAL BUDGET OFFICE ASSUMPTIONS					
$1,076.7	$1,102.9	$-26.2	25%*	$36.5	$ 62.7*
ADMINISTRATION PESSIMISTIC ASSUMPTIONS					
$1,113.1	$1,188.9	$-75.8	21%	$30.7	$106.5

* An arbitrary fund ratio target was selected for CBO forecasts for purposes of illustration. CBO has not estimated costs or selected fund ratio targets.

ECONOMIC FORECASTS

- Projections of future costs and revenues for social security are extremely sensitive to near term economic forecasts because of automatic indexing of benefits and taxable earnings.
- In recent years, the economy has shown slower growth and higher inflation than predicted in intermediate forecasts. For this reason, current problems were not anticipated when Congress made changes to balance OASDHI in 1977.
- Three sets of economic forecasts are currently in use:
  - Administration revised 1982 budget assumptions (issued in February, 1981) forecast a rapid recovery for the economy with a strong growth trend over the next five years. Inflation is predicted to be at 4.2% and unemployment at 5.6% in 1986.
  - Congressional Budget Office projections (February,1981) forecast a steady but gradual recovery over five years, with inflation reaching 7.2% and unemployment 7.0% by 1986.
  - Administration pessimistic assumptions issued with the comprehensive social security reform proposals in May, 1981 predict a slow and delayed recovery. Current trends are expected to continue through 1983, followed by improvement leading to inflation of 8.6% and unemployment of 7.4% by 1986.

The size of the short-term deficit is heavily influenced by the economic forecasts for the near-term. It is usual to incorporate three sets of forecasts in projecting costs and income for the social security system: an optimistic, an intermediate, and a pessimistic set. It is also usual to follow the intermediate set in making policy decisions. However, in recent years, the economy has not performed as well as intermediate forecasts predicted. This has led analysts to question the use of intermediate range forecasts in developing social security policy.

Proponents of using pessimistic forecasts point out that Congress is again encountering a short-term financing problem it thought it had corrected in 1977. The only way to guard against this happening again is to use pessimistic assumptions to justify large savings in the current program. If the economy recovers, this savings will provide a larger cushion against future economic shocks.

The use of intermediate forecasts makes it possible to reduce the size of the savings required. However, there is also an increased risk of failing to solve the short-term problem.

One issue is whether it is reasonable to assume that the economy will recover steadily over the next five years. Using these assumptions and reducing the size of the savings needed carries with it a risk of error, and a risk that further savings will be needed in the near future. However, using assumptions of slow recovery to justify larger savings carries with it the risk that the changes made in the program will be more extreme than necessary.

A second issue is the duration of the short-term financing problem. Using intermediate forecasts leads to a projected recovery in five years and the portrayal of the short-term problem as temporary and contained. Under this scenario, it is possible to justify marginal savings to carry the system over two or three difficult years. Using pessimistic forecasts raises the question of how long the short-term problem could last. The longer the projected duration, the greater the necessity of substantial changes in the system to prevent the exhaustion of reserves.

Five year prognoses for the OASI, DI, and HI trust funds vary considerably depending upon forecasts for the economy in the near term. Both income and expenditures in social security are sensitive to fluctuations in the economy.

Income to the system from payroll taxes is dependent upon the total value of wages paid, the limit of taxable earnings, and the number of covered workers. Increases in unemployment or a decline in the rate of growth in wages reduces total receipts. It is estimated currently that a 1% increase in unemployment decreases payroll tax contributions by $3.4 billion.

Expenditures from the program are a function of the number of beneficiaries and the value of the benefits paid. In periods of high unemployment older workers retire at higher rates and seek entitlement for social security. In addition, there is a direct relationship between inflation and benefit payments because of the automatic indexing of benefit amounts to the CPI. It is estimated currently that a 1% increase in inflation adds $1.4 billion in benefits. Inflation, by increasing total payments from the system, also has the effect of reducing trust fund ratios if trust fund balances are not increasing at the same or higher rates.

The introduction of automatic indexing into the program has made projections of future costs and revenues particularly sensitive to near term fluctuations in the economy and, as a consequence, made the financial condition of the social security system much less predictable. Because of this sensitivity to economic conditions, the first point at issue in discussing the short-term financing problem is the choice of alternative economic forecasts.

One of the major causes of the current short-term financing crisis has been the inability in the past, particularly when major pieces of legislation have been enacted, to correctly anticipate near term economic trends. Economic forecasts in 1972 and 1977 used to define the effects of changes made in the system have since both proven to be overly optimistic (see chart below).

COMPARISON OF ESTIMATED & ACTUAL PERFORMANCE OF KEY ECONOMIC INDICATORS 1973 and 1977 FORECASTS

Calendar Year	CPI INCREASE Forecast 1973	CPI INCREASE Forecast 1977	CPI INCREASE Actual	REAL WAGE DIFFERENTIAL Forecast 1973	REAL WAGE DIFFERENTIAL Forecast 1977	REAL WAGE DIFFERENTIAL Actual	UNEMPLOYMENT Forecast 1973	UNEMPLOYMENT Forecast 1977	UNEMPLOYMENT Actual
1973	3.3	-	6.2	2.9	-	0.7	4.5	-	4.9
1974	3.3	-	11.0	2.9	-	-3.5	4.5	-	5.6
1975	3.3	-	9.1	2.9	-	-2.5	4.5	-	8.5
1976	3.3	-	5.8	2.9	-	2.5	4.5	-	7.7
1977	2.8	6.0	6.5	2.9	2.4	0.4	4.5	7.1	7.0
1978	2.8	5.4	7.6	2.3	2.7	0.5	4.5	6.3	6.0
1979	2.8	5.3	11.5	2.3	2.5	-3.1	4.5	5.7	5.8
1980	2.8	4.7	13.4	2.3	2.4	-4.2	4.5	5.2	7.6

As a result, the Congress has had to raise again, years later, a short-term financing problem it thought it had corrected in previous legislation. There is, obviously, no way forecasters using the hindsight of the tremendous economic growth and low inflation of the 1960's could have anticipated the combination of stagnation and inflation which occurred in 1974-75 and in 1978-1980. But it is also important to realize that intermediate and pessimistic forecasts of the past have proven to be optimistic in fact.

In 1980, the Annual Report of the Trustees of the Federal OASDI Trust Funds used three sets of assumptions about the economy to project costs and income for the system. Alternative I used "optimistic" assumptions: the downturn in the economy was assumed to be relatively short with increasing economic growth beginning in the last half of 1980. Alternative II used an "intermediate" set of assumptions: the recession which began in early 1980 was assumed to continue for about a year with a period of recovery following. Alternative III used "pessimistic" assumptions: a severe recession was assumed for 1980 and 1981, followed by a period of recovery beginning in the last half of 1981.

SELECTED ECONOMIC ASSUMPTIONS UNDER ALTERNATIVES I, II, AND III, CALENDAR YEARS

Calendar year	Average annual percentage increase in— Real GNP[1]	Average wages in covered employment	Consumer price index	Real wage differential[2] (percent)	Average annual interest rate[3] (percent)	Average annual unemployment rate (percent)
Alternative I:						
1980	.0	10.0	14.3	−4.3	10.8	7.0
1981	2.2	11.3	10.4	.9	10.5	7.3
1982	4.8	11.0	8.6	2.4	9.4	6.6
1983	5.0	9.3	7.3	2.0	8.1	6.0
1984	4.9	8.5	6.5	2.0	7.5	5.3
1985	4.8	7.7	5.7	2.0	6.8	4.6
Alternative II:						
1980	−.4	9.6	14.2	−4.6	10.5	7.2
1981	.4	9.5	9.7	−.2	9.9	7.9
1982	4.6	10.9	9.0	1.9	9.5	7.3
1983	4.6	9.9	8.6	1.3	9.2	6.6
1984	3.9	9.4	8.2	1.2	8.9	6.2
1985	3.6	9.1	7.8	1.3	8.5	5.9
Alternative III:						
1980	−1.7	9.9	16.6	−6.7	10.5	7.4
1981	−1.0	11.7	13.7	−2.0	10.0	9.1
1982	5.5	11.9	11.0	.9	10.0	8.0
1983	3.9	10.9	10.6	.3	10.0	7.3
1984	3.0	10.4	10.2	.2	10.0	7.0
1985	3.0	10.3	9.8	.5	10.0	6.8

[1] The total output of goods and services expressed in constant dollars.
[2] The difference between the percentage increase in average annual wages in covered employment and the percentage increase in the average annual CPI.
[3] The average of the interest rates determined in each of the 12 months of the year for special public-debt obligations issuable to the trust funds.

Since February, 1981 there have been three sets of forecasts used to estimate costs and income in the social security system in the near-term. The Administration's revised 1982 budget assumptions are the most optimistic of the set. They assume rapid recovery with a strong growth trend in the economy beginning in 1982 and lasting throughout the five year period from 1982 to 1986. Inflation is projected to slow to a rate of 4.2%, and unemployment is projected to drop to 5.6% by 1986.

Congressional Budget Office projections use an intermediate set of assumptions. They assume a gradual improvement in economic conditions over the five year period leading to an inflation rate of 7.2% and an unemployment rate of 7.0% by 1986. Growth is projected to be moderate and increasing over this period.

The Administration's pessimistic projections which were used in estimating costs and income for the recent proposal for comprehensive social security reforms are the most pessimistic. They assume a slow recovery with no real growth, high rates of inflation, and unemployment through 1983. Between 1984 and 1986, the economy is expected to improve somewhat, with a fairly strong growth trend accompanied by high but declining rates of inflation and unemployment. By 1986, inflation is projected to reach 8.6% and unemployment 7.4%.

SELECTED ECONOMIC ASSUMPTIONS
CURRENT FORECASTS
CALENDAR YEARS 1982-86

Calendar Year	% Change In Real GNP	% Change In average wages In covered unemployment	Consumer Price Index	Average annual unemployment rate (%)	Increase In benefits (%)
ADMINISTRATION'S REVISED 1982 BUDGET ASSUMPTIONS					
1981	1.1	-.6	11.1	7.8	11.6
1982	4.2	1.4	8.3	7.2	9.3
1983	5.0	2.4	6.2	6.6	6.6
1984	4.5	2.3	5.5	6.4	5.8
1985	4.2	2.2	4.7	6.0	4.9
1986	4.2	2.7	4.2	5.6	4.4
CONGRESSIONAL BUDGET OFFICE PROJECTIONS (February, 1981)					
1981	1.4	-1.2	10.9	7.7	11.9
1982	2.8	-0.6	9.5	7.6	9.7
1983	2.9	0.7	9.0	7.5	9.2
1984	3.3	1.6	8.3	7.4	8.6
1985	3.4	1.8	7.7	7.2	7.9
1986	3.5	2.0	7.2	7.0	7.4
ADMINISTRATION'S PESSIMISTIC ASSUMPTIONS					
1981	-0.1	-1.9	12.8	8.3	11.6
1982	0.7	-2.3	13.6	8.7	14.4
1983	0.7	-1.1	11.6	9.7	11.9
1984	4.4	1.0	10.9	9.1	11.4
1985	4.4	0.6	9.7	8.0	10.2
1986	3.4	0.5	8.6	7.4	9.0

These three sets of assumptions result in vastly different estimations of the operations of the combined OASDHI programs over the five year period. (See chart on next page) Under the Administration's budget assumptions combined trust funds remain adequate to meet program commitments, throughout this period, dropping to their lowest level in 1985 when reserves are sufficient to meet more than one month's payouts. Under the CBO assumptions, the combined trust funds drop below the level required to meet cash-flow needs in the programs sometime in 1984. After 1985, reserves begin to build up again. Under the Administration's pessimistic assumptions, the deficits in the combined programs grow larger throughout the five year period. By 1984, fund reserves are predicted to be insufficient to meet cash-flow needs for the system.

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ESTIMATED OPERATIONS OF THE OASDHI COMBINED TRUST FUNDS UNDER PRESENT LAW
UNDER ALTERNATIVE ECONOMIC FORECASTS
Calendar Years 1981-1986

(Amounts in billions)

Calendar year	Combined income	Combined outgo	Net change in funds	Combined assets year end	Reserve ratio
ADMINISTRATION'S REVISED 1982 BUDGET ASSUMPTIONS					
1981	$175.0	$174.1	$ 0.8	$ 41.0	23%
1982	197.0	198.0	-1.0	40.0	21
1983	218.3	220.5	-2.2	37.9	18
1984	240.4	242.3	-1.9	35.9	16
1985	275.6	264.3	11.3	47.3	14
1986	306.0	286.5	19.5	66.8	16
CONGRESSIONAL BUDGET OFFICE PROJECTIONS (February, 1981)					
1981	$162.3	$168.0	$ -5.7	$ 41.0	28%
1982	189.2	195.1	-5.9	35.3	21
1983	212.6	218.4	-5.8	29.6	16
1984	237.5	245.4	-7.9	21.6	12
1985	275.1	276.0	-0.9	20.8	8
1986	313.6	310.0	3.6	24.3	7
ADMINISTRATION'S PESSIMISTIC ASSUMPTIONS					
1981	$175.0	$174.3	$ 0.7	$ 41.8	24%
1982	196.9	202.7	-5.8	36.0	21
1983	214.7	235.1	-20.4	15.7	15
1984	241.6	269.8	-28.2	-12.6	6
1985	284.9	307.0	-22.1	-34.7	-
1986	322.5	345.3	-22.8	-57.5	-

RESERVE RATIOS

- The function of reserves is to meet cash flow needs of the system and provide a cushion to assure that benefits can be paid regardless of fluctuations in the economy.

- The size of the cushion needed is a subject of debate:

  - Definitions of an adequate reserve ratio have changed substantially in recent years: from 3 years' outgo in the 1940's to 1 years' outgo in 1970 to 60% or less of one years' outgo in the late 1970's.

  - Current definitions of an adequate reserve ratio for the next several years depend upon:

    - the expected duration of the lowest ratios (the extent to which low ratios are considered temporary);

    - the chance that economic forecasts used to predict income and costs for the system could prove to be optimistic;

    - the extent to which other sources of income are available for back-up financing in the event of unpredicted economic conditions.

There is a wide range of opinion on the ratio of trust fund reserves to annual payouts that should be maintained to help the social security meet contingencies. Some experts suggest that trust fund balances should be built up until a full years' estimated payouts are on hand. Others, recognizing that current imbalances in the system are likely to be temporary, suggest smaller fund ratios can be maintained in the near term until balances begin to increase naturally in the next decade.

The tradeoff in the reserve ratio issue is between cost and risk. High trust fund ratios would be extremely costly to develop in the near term. However, with low trust fund ratios there is a risk that balances will not be sufficient if there should be a severe recession over the next five years.

The basic issue is the definition of a sufficient reserve cushion for the near term.

In addition, there are questions of the relationship between economic forecasts, the duration of short term imbalances, the availability of backup financing from non-payroll tax sources, and the appropriate reserve ratio.

Finally, there is the need to distinguish between optimal reserve ratios and a minimal reserve ratio.

The function of reserves in the social security system has been to assure that adequate funds are on hand to meet benefit obligations in years when the payouts from the system exceed income. The actual amount of reserves needed at the end of a year varies in proportion to the amount of projected payouts anticipated from the system in the subsequent year. This ratio is the reserve ratio. There are essentially two components of the reserve ratio: the amount needed to meet the cash-flow requirements of the system, and the cushion. The minimal reserve ratio needed on hand at the beginning of the year to pay benefits on time is estimated to be between 9% and 15%. Nine percent represents one month's average payout from the system. The debate over reserve ratios, however, is really focused on the size of the cushion needed in the reserves.

Thinking about the size of the cushion needed in the reserves has changed substantially in the last few years. Historically, reserves in the OASDI programs have been quite large. In the early years of the program, the general rule was that reserves should be sufficient to meet three years' worth of payouts, and by the early 1950's the trust funds had built up to as much as five years of payouts. However, these reserves declined until, by 1970, only one year's payouts were on hand in the OASDI trust fund. In the early 1970's, a reserve ratio of from 75 to 125% of one year's payouts was considered adequate, but, in fact, the reserve ratio fell below 75% after 1975, and has continued to decline since. Still, experts have continued to suggest that reserves in the range of 60 to 100% of one year's outgo be maintained in the system. The 1979 Advisory Council on Social Security recommended that a reserve ratio of 75% be maintained unless countercyclical general revenue financing and borrowing were used, in which case the trigger for general revenue financing would be a 60% reserve ratio, and the trigger for borrowing would be a 25% ratio. The National Commission on Social Security recommended building reserves up to a level of one year's payouts.

Given the adverse economic conditions of the last five years and the continued erosion of trust fund balances, there has been an increased willingness to allow the system to get by with lower trust fund ratios. In part, this is because most near-term projections indicate that the current fiscal imbalance in the system is relatively short-lived, and that trust fund balances for OASDI will begin to build up again before 1990. In part, this is because of the tremendous costs that would be involved if the reserve ratios were to be quickly restored to the 60% level.

In the present context, the discussion has shifted to determining the minimum trust fund ratio required to keep the system operating over the next five years. The size of the cushion needed in this context is a function of three factors: 1) the chances that the economic forecasts used to estimate income and costs for the system will prove to be optimistic, 2) the number of years the system is expected to operate with this minimal cushion, and 3) whether the system is expected to rely entirely upon payroll taxes for financing, or whether there is some opportunity to dip into general revenues if actual economic conditions turn out to be worse than forecast. The greater the chances that the economic forecasts could be optimistic, the greater the cushion needed. The only way to reduce the size of the cushion and be assured that the system will not exhaust the reserves is to either choose pessimistic forecasts for the economy or establish some method of financing the system from general revenues if the worst assumptions are realized.

RESERVE RATIOS - ACTUAL AND PREDICTED
SELECTED CALENDAR YEARS 1950-84

OASI and DI

ASSETS AT THE BEGINNING OF THE YEAR AS A PERCENTAGE OF EXPENDITURES DURING THE YEAR FOR THE OLD-AGE, SURVIVORS AND DISABILITY INSURANCE PROGRAM, BY TRUST FUND, FOR SELECTED CALENDAR YEARS 1950-79, AND ESTIMATED FUTURE PERCENTAGES FOR CALENDAR YEARS 1980-84 UNDER THE INTERMEDIATE SET OF ASSUMPTIONS

Calendar year	Assets at the beginning of the year as a percentage of expenditures during the year		
	Old-age and survivors insurance and disability insurance trust funds, combined	Old-age and survivors insurance trust fund	Disability insurance trust fund
Past experience:			
1950	1,156	1,156	----------
1955	405	405	----------
1960	186	180	304
1965	110	109	121
1970	103	101	126
1971	99	94	140
1972	93	88	140
1973	80	75	125
1974	73	68	110
1975	66	63	92
1976	57	54	71
1977	47	47	48
1978	37	39	26
1979	30	30	30
Estimated future experience:[1]			
1980	24	23	35
1981	18	15	44
1982[2]	12	6	61
1983[2]	8	−2	84
1984[2]	4	−10	111

[1] In interpreting the estimates, reference should be made to the preceding section which describes the underlying assumptions.

[2] The OASI trust fund is depleted in late 1981 when assets become insufficient to pay benefits when due under alternative II. Since none of the income to one trust fund can be allocated to the other trust fund under present law, the figures for 1982-84 for the OASI trust fund and for the combined OASI and DI trust funds are theoretical.

HI

Ratio of assets in the fund at the beginning of the year to disbursements during the year for the Hospital Insurance Trust Fund

[In percent]

Calendar year:	Ratio
Historical data:	
1967	28
1968	25
1969	43
1970	47
1971	54
1972	47
1973	40
1974	69
1975	79
1976	77
1977	66
1978	57
1979	54
Projection:	
1980	53
1981	52
1982	65

CURRENT METHOD OF FINANCING SOCIAL SECURITY

The Social Security program is an earnings related system that is funded on a pay-as-you-go basis. All people who work in jobs under the program pay Social Security contributions (taxes) in order to provide insurance protection for themselves and their families against the risks of loss of income from work because of retirement in old age, disability or death, and against the risk of burdensome hospital care costs in the event of severe and extended disability. The financing provisions are intended to produce enough income to pay the benefits and administrative expenses of the program as they come due and to provide modest assets to serve as contingency reserves for use in temporary situations where program income might be less than outgo.

While the security of a private pension is usually "fully funded" the various advisory councils and other experts that have studied the program have concluded that full funding is not necessary to assure the payment of monthly benefits. It is not necessary because the participation of future workers in the system is required by law and future revenues are assured by the taxing power of the Government.

The major source of income to the Social Security system is the payroll tax paid by workers, their employers and the self-employed. About 114 million workers and their employers paid the tax in 1980 (about 90% of the workforce). The tax is a composite of three separate rates supporting: 1) the old-age and survivors insurance program, 2) the disability program; and 3) hospital insurance program. Each of the program -- OASI, DI, and HI has a separate trust fund to receive the taxes and to operate its own program. The financing of the system has been amended almost 20 times since the program began in 1937. Beginning with a tax rate on employee and employer each of 1% on earnings up to $3000 annually, the tax rate is now 6.65% of the first $29,700 of wages, a historical table of tax rates and earnings base is attached.

Historical table of payroll tax rates and earnings

Years	OASDHI tax rates and earnings base		
		tax rate (percent)	
	Earnings base	Employer and employee each	Self-employed
1937-49	$3,000	1.0%	--
1950	3,000	1.5	--
1951-53	3,600	1.5	2.25%
1954	3,600	2.0	3.0
1955-56	4,200	2.0	3.0
1957-58	4,200	2.25	3.375
1959	4,800	2.50	3.75
1960-61	4,800	3.0	4.5
1962	4,800	3.125	4.7
1963-65	4,800	3.625	5.4
1966	6,600	4.2	6.15
1967	6,600	4.4	6.4
1968	7,800	4.4	6.4
1969	7,800	4.8	6.9
1970	7,800	4.8	6.9
1971	7,800	5.2	7.5
1972	9,000	5.2	7.5
1973	10,800	5.85	8.0
1974	13,200	5.85	7.9
1975	14,100	5.85	7.9
1976	15,300	5.85	7.9
1977	16,500	5.85	7.9
1978	17,700	6.05	8.1
1979	22,900	6.13	8.1
1980	25,900	6.13	8.1
1981	29,700	6.65	9.3

OASDHI Combined
Scheduled Payroll Tax Rates and Projected Earnings Base
1982-1990

Year	Projected earnings base	Tax Rate (percent) Employer/ employee	Self-employed
1982	$32,100	6.70	9.35
1983	34,800	6.70	9.35
1984	38,700	6.70	9.35
1985	42,900	7.05	9.90
1986	47,700	7.15	10.00
1987	-	7.15	10.00
1988	-	7.15	10.00
1989	-	7.15	10.00
1990	-	7.65	10.75

FACT SHEET ON SOCIAL SECURITY

BENEFICIARIES

No. of Beneficiaries (OASDI) .... 35.6 million (Dec. 31, 1980

Retired workers and their dependents .... 23.2 million
Beneficiaries 62 and over .... 27.4 million
65 and over .... 23.8 million

Disabled beneficiaries and their dependents ...... 4.7 million

Children
Student children aged 18-21 734,000
Disabled children aged 18 and over 451,000

No. of New Benefits Awarded to Retired Workers .... 1.5 million (1978)

Receiving reduced benefits for early retirement .. 974,000 (68%)

BENEFITS

Average Monthly Benefit (Dec. 31, 1980

Retired Worker alone .... $ 333
Retired Couple 568

Minimum Benefit 122

TAXES

Contribution rates - OASDHI combined

	employer	employee	self-employed
1981	6.65%	6.65%	9.30%
1985	7.05	7.05	9.90
1990	7.65	7.65	10.75

Tax rates and maximum annual tax contributions:

	tax rate	taxable wage	max annual contr.
1937	1.00%	$ 3,000	$ 30
1950	1.50	3,000	45
1960	3.00	4,800	144
1970	4.80	7,800	374
1981	6.65	29,700	1,975

COVERAGE

Current workers: 90% in paid employment or Self-employment are covered or eligible for coverage in 1981

Retirees: 95% of the people reaching 65 in 1981 are eligible for benefits.

FINANCING

Operations - Calendar Year 1980
(in billions)

	Income	Outgo	Assets (12/81)
OASDI (combined)	$ 119.7	$ 123.5	$ 26.5
HI	26.1	25.6	13.7

Deficits:

Short-term (CY 1982-86):
Administration best case assumptions: $ 11.0 billion
Administration worst case assumptions: 110.8 billion

Long-term (75 year average cost - 1980 to 2055)
Average cost as a percent of taxable payroll 1.52%

Trust Fund Balances as a percent of expenditures:

	OASI	DI	OASDI (combined)	HI
1960	180%	304%	186%	----
1970	101	126	103	49%
1975	62	92	66	81
1980	23	35	25	52

INCOME OF THE AGED

Median Income (1978) of Families w/ Head 65 and over .. $ 10,124
w/ Head under 65 .. 18,939

Sources of Income for Families with Head 65 and over

Earned Income	48% of families with aged head
Social Security	90
Social Security only	6
SSI (Supplemental Security Income)	8
Annuities, Dividends, Rents	70

Poverty:

All persons 65 and over	14% of those 65+ were below poverty level
Very old (85 and over)	19
Black aged 65+	34
Aged living in families	8
Living outside family setting .	27

SOCIAL SECURITY FINANCING AND TAXATION

ISSUE BRIEF NUMBER IB80007

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ISSUE DEFINITION

After passage of the amendments to the social security program (Old Age, Survivors, and Disability Insurance -- OASDI) in December 1977, concern quickly mounted about the increases in both the tax rate and earnings base enacted with those amendments (P.L. 95-216, The Social Security Amendments of 1977). The new legislation was barely a few months old before there were serious discussions in the House Ways and Means Committee and Senate Finance Committee of whether and how to provide relief from the increases, which began in calendar year 1979. While some relief against the 1979 increase was provided in the Revenue Act of 1978 (enacted in November 1978) through reductions made in individual income taxes, concern continued to mount throughout the 96th Congress about even greater increases in the taxable earnings base in 1980 and 1981, and in the tax rate in 1981 and 1982.

The taxable earnings base was $25,900 in 1980 and increased to $29,700 in January 1981. The 1980 tax rate for employees and employers of 6.13% rose to 6.65% in January 1981 and will increase to 6.70% in 1982. The rate for the self-employed rose from 8.10% to 9.3% in January 1981 and will rise to 9.35% in 1982.

At the same time that concern mounted over these increases, financial forecasts indicated that current adverse economic conditions would cause one of the trust funds, Old Age and Survivors Insurance (OASI), to begin to have sh flow problems even with these increases beginning sometime in late 1981 .d to completely run out of reserves in 1982.

The 96th Congress took steps to alleviate this immediate problem by passing a measure (P.L. 96-403) allocating a share of Disability Insurance (DI) revenues to the OASI fund. This was a 2-year measure intended to give the 97th Congress time to make longer term improvements in social security financing this year. The most recent trust fund projections show that the assets of both the OASI and DI trust funds will be exhausted by mid to late 1982. In late March 1981, the Subcommittee on Social Security of the House Ways and Means Committee began marking up legislation to address the system's short and long range financial problems, as well as to meet the subcommittee's budget reduction requirements under the FY82 budget process. Before the Easter recess the subcommittee reached tentative agreement on more than 20 proposals to alter the program, which were subsequently aggregated into a single bill, H.R. 3207, introduced by Chairman J. J. Pickle.

On May 12, 1981, the Reagan Administration announced its 14-part plan to address the system's financing problems. These proposals were in addition to the Administration's budget proposals announced in February. Testimony from the Administration is expected to be given shortly with formal mark up of legislation to follow.

BACKGROUND AND POLICY ANALYSIS

CURRENT METHOD OF FINANCING THE SYSTEM

The major source of income to the social security system is the payroll tax. About 114 million workers and their employers paid the tax in 1980

(about 90% of the workforce). The tax is a composite of three separate tax rates supporting: (1) the old-age and survivors insurance program (OASI); (2) the disability insurance program (DI); and (3) the hospital insurance program (HI or part A of Medicare). (Part B of Medicare or supplementary medical insurance is also considered a social security program but is financed from premiums and contributions from the General Fund of the Treasury rather than from payroll taxes.)

Each of three components of the overall social security tax -- OASI, DI, and HI -- has a separate trust fund which receives all the taxes generated by its portion of the overall tax and which can use those funds only to operate its own program.

The three trust funds also receive payments from the General Fund of the Treasury for various limited expenditures from the trust funds which the Congress believes are more appropriately financed by general revenues. In addition, the three trust funds receive interest on their investments (which are interest-bearing obligations of the U.S. Government).

TABLE 1. Social security tax rates
(in percent)

	Employee-employer, each				
	OASI %	DI %	OASDI %	HI %	Total %
Calendar year:					
1980	4.52	.56	5.08	1.05	6.13
1981	4.700	0.650	5.35	1.3	6.65
1982-84	4.575	0.825	5.40	1.3	6.7
1985	4.75	0.95	5.7	1.35	7.05
1986-89	4.75	0.95	5.7	1.45	7.15
1990+	5.1	1.1	6.2	1.45	7.65

	Self-employment				
	OASI %	DI %	OASDI %	HI %	Total %
Calendar year:					
1979-80	6.2725	.7775	7.05	1.05	8.1
1981	6.7625	1.2375	8.0	1.3	9.3
1982-84	6.8125	1.2375	8.05	1.3	9.35
1985	7.125	1.425	8.55	1.35	9.9
1986-89	7.125	1.425	8.55	1.45	10.0
1990+	7.65	1.65	9.3	1.45	10.75

base

In 1980 the tax applied to the first $25,900 of an individual's earnings.

In January 1981 the maximum level rose to $29,700. These levels for 1980 and 1981 -- as well as the 1979 level of $22,900 -- were fixed in law by the 1977 Social Security Amendments. The earning base would have been lower if the pre-1977 law had not been changed. In future years the amount of earnings subject to the tax will rise depending on the increase in average earnings that occurs from one year to the next.

The table which follows shows the potential increases in the earnings base over the next 4 years, as reflected under the optimistic, intermediate and pessimistic assumptions in the 1980 Report of the Social Security Trustees:

TABLE 2. Annual earnings subject to social security tax

	1980 trustees report		
	Optimistic assumptions	Intermediate assumptions	Pessimistic assumptions
Calendar year:			
1981.........	29,700	29,700	29,700
1982.........	32,700	32,700	32,700
1983.........	36,300	35,700	36,600
1984.........	40,800	39,600	40,800
1985.........	45,300	43,500	45,300

Brief History of Payroll Tax Structure

Collection of payroll taxes began in 1937. Since that time, the financing of the system has been amended almost twenty times. Beginning with a tax rate on employee and employer each of 1% on earnings up to $3,000 annually, the tax structure remained constant until 1950 when the rate rose to 1.5% NOTE: Earlier increases had been scheduled, but legislation during the period precluded them from going into effect. In 1951, the earnings base increased for the first time to $3,600 annually, and the self-employed were brought under the system with a tax rate of 2.25%, i.e., 1.5 times the employee/employer rate. The employee/employer rate rose again to 2.0% in 1954. Coupled with many expansions and improvements in the system (the introduction of Disability Insurance and Medicare foremost among them), almost a dozen changes in the financial structure of the system have been made since the early 1950s. A summary of the year-by-year tax rate and earnings base since 1937 is provided in Table 3.

TABLE 3. Historical table of payroll tax rates and earnings

	OASDHI tax rates and earnings base		
		tax rate (percent)	
Years	Earnings base	Employer and employee each	Self-employed
1937-49	$3,000	1.0%	--
1950	3,000	1.5	--
1951-53	3,600	1.5	2.25%
1954	3,600	2.0	3.0
1955-56	4,200	2.0	3.0
1957-58	4,200	2.25	3.375
1959	4,800	2.50	3.75
1960-61	4,800	3.0	4.5
1962	4,800	3.125	4.7
1963-65	4,800	3.625	5.4
1966	6,600	4.2	6.15
1967	6,600	4.4	6.4
1968	7,800	4.4	6.4
1969	7,800	4.8	6.9
1970	7,800	4.8	6.9
1971	7,800	5.2	7.5
1972	9,000	5.2	7.5
1973	10,800	5.85	8.0
1974	13,200	5.85	7.9
1975	14,100	5.85	7.9
1976	15,300	5.85	7.9
1977	16,500	5.85	7.9
1978	17,700	6.05	8.1
1979	22,900	6.13	8.1
1980	25,900	6.13	8.1
1981	29,700	6.65	9.3

FINANCIAL CONDITION OF SYSTEM

Adverse Forecasts of the Mid-1970s

In 1970, the OASDI trust funds had reserves amounting to more than 100% of 1 year's expenditures; i.e., there was more than 12 months worth of benefits on hand for contingencies.

Beginning with its report of 1973, the Board of Trustees of the OASDI program repeatedly forecast a worsening financial situation for the programs both in the near term, i.e., for the late 1970s and early 1980s, and over the long run, i.e., until the middle of the next century. The 1975 report showed the DI program as having difficulty meeting its benefit obligations beginning in 1980. By 1977, the Trustees were reporting that DI reserves would fall to zero in late 1978 or early 1979; and similarly, OASI reserves would be used up by 1983.

As for the long run, the 1973 report showed a deficit equal to .32% of taxable payroll; the 1974 report showed a deficit of 2.98% of taxable payroll; by 1977, the projected deficit reached 8.2% of taxable payroll. The 1977 projected deficit of 8.2% of taxable payroll reflected an average shortfall in revenues of more than 40% of the costs of the program through the long range 75-year measuring period, 1977 to 2051. (In today's dollar values, 1% of taxable payroll is equal to approximately $12 billion annually -- although it should be noted that the "long range" deficit generally was attributable to shortfalls late in this century and early next century.)

Effect of the 1977 Amendments

With the passage of the Social Security Amendments of 1977, forecasts of the financial condition of the program improved significantly. At the time of enactment, the Social Security actuaries projected that the OASDI program would show a surplus through the next 25-year period. While annual deficits occurring in 1978 and 1979 would bring reserve balances down to a level equivalent to 25% of 1 year's outgo (a little more than 3 months worth of benefit expenditures), annual surpluses beginning in 1980 and continuing thereafter would bring reserve balances up to 59% of 1 year's outgo by 1987.

The improved short run outlook was brought about by legislated changes on the revenue side, estimated at that time to add some $80 billion in new revenues to the OASDI programs in the 1978-83 period, as well as changes in benefits resulting in net reductions of outgo of $7.5 billion during that same period.

The revenue increases were the result of (1) ad hoc increases in the taxable earnings base above the increases that would have occurred automatically, (2) a reallocation to OASDI of a portion of the already scheduled increases in the HI tax rate, (3) increases in the overall tax rate beginning in 1979, and (4) increases in the OASDI portion of the self-employment tax rate bringing it up to one and one-half times the employee rate.

The principal benefit changes affecting outgo included (1) revamping of the OASDI benefit formula to eliminate overcompensation for inflation in the future (referred to as the "decoupling" provisions), (2) modifications to the

retirement test, (3) correction of a major technical flaw in computing benefit increases for early retirees, (4) improvements in protection for divorced and widowed spouses, (5) limitations on the receipt of retroactive benefits, and (6) an offset against social security dependent's benefits for persons also receiving public pensions from non-covered employment.

According to the official estimates at the time the 1977 amendments were adopted, the amendments improved the long range financial condition of the program by reducing the projected deficit of 8.2% of taxable payroll to 1.46% of taxable payroll, representing an average revenue shortfall over the 75-year period of less than 10% of the cost of the program. Almost three-fourths of this improvement was brought about by the changes made to the benefit formula (decoupling).

Conditions as Reported in the 1980 Trustees' Report (June, 1980)

Each year, the Board of Trustees of the Social Security programs issues a report on the near and long term financial condition of the programs. This is the basic report, given to Congress and the public each year, providing a full scale actuarial evaluation of the financial condition of the social security system. (See CRS Report No. 80-114 for a detailed summary of 1980 Trustees' Report.) The latest report, issued in June 1980, contains future projections under three different sets of economic and demographic assumptions intended to show what would happen under optimistic, intermediate, and pessimistic circumstances. Projections under the intermediate assumptions are typically the ones used in considering the financial impact of new legislation. The 1981 Trustees Report is currently overdue, and is expected to be submitted to Congress shortly. It is uncertain as to what changes in the financial condition of the system will be reflected in the Report; however, major changes from last year's report are unlikely. Individual assumptions may be different, but the general financial projections hould be fairly close to those in the 1980 Report.

Under the intermediate assumptions, the 1980 report indicated that the OASI program would run into cash flow difficulty beginning in late calendar year 1981. This was due almost entirely to the recent adverse economic conditions -- high inflation which increases expenditures and rising unemployment which cuts down on receipts. Initially, this would be only a cash-flow problem in that the resources of the fund might not be sufficient on the normal payment date (usually the third of the month), but might be later on in the month. However, in 1982, the assets of the fund would be completely exhausted, and the incoming revenues would not cover expenditures for an extended period of time -- presumably until sometime in the 1990s when the future scheduled tax increases and favorable demographic factors would turn this situation around.

In 1993 OASI reserves would begin to accumulate once again, assuming the shortfalls in the previous years were overcome in some way (e.g., infusions of new revenues, reallocation of taxes among the trust funds, etc.): The reserve balance of the fund would grow continuously from that point on up to the year 2010 or so, when it would reach a high equal to 159% of one year's expenditures (more than 19 months worth of benefits would be in reserve). After that point the demographic impact of the post WW-II baby boom and the subsequent birthrate decline would begin to be felt, and sometime during the period between 2020 and 2025, OASI reserves would be exhausted and incoming taxes would begin to be insufficient to meet the benefit obligations. The average revenue shortfall during the subsequent period, 2030-2054, would be

equal to roughly 33% of the expenditures during that period. In summary, the financial problems facing the OASI program fall into two timeframes, 1980 through 1995 and 2025 through the remainder of actuarial valuation period, 2055.

In contrast, the report showed the disability insurance (DI) program to be more than adequately financed over the next 10 years, and in the long-run as well. The 1980 reserve level of 35% of estimated expenditures in that year was expected to rise to 142% by the beginning of 1985 and 442% by the end of the decade (i.e., almost 4 1/2 years worth of benefits would be on hand). The long range forecast showed reserves growing to nearly 30 years worth of benefits on hand by the year 2055. The average surplus over the 75-year period would be equal to 43% of the average cost of the DI program. While DI estimates are more volatile and subject to greater imprecision than those of the retirement program, the Trustees felt that the DI program was overfinanced by the 1977 Social Security Amendments, which allocated more of the system's overall tax revenues to the DI program, and has benefited from recent lower, more favorable disability incidence rates.

The hospital insurance program (HI-Part A of Medicare) similarly was reported to be adequately financed throughout the coming decade. Its 1980 reserves of 53% of current expenditures were expected to rise to 88% in 1988 and slide down to 73% in 1990. The longer range picture, however, which in the HI program is measured over a 25-year actuarial measuring period (ending in the year 2004), showed a significant financial imbalance.

Frequently, the financing of the social security programs is measured on a basis that combines the operations of the various trust funds. While the trust funds are required by law to be maintained on a separate basis, under which neither reserves nor tax revenues can be shuffled around, a combined forecast does give an indication of the overall solvency of the system given the tax structure under existing law.

When the operations of the OASI and DI programs were combined in the 1980 Trustees' Report, the favorable reserve situation of the DI trust fund created a slightly more favorable combined trust fund outlook than that for the OASI program alone. The combined reserves amounted to $30 billion at the beginning of calendar year 1980, and while they were expected to decline rapidly, cash-flow problems theoretically would not appear until 1983. The combined reserves would be exhausted in 1984. The combined trust-fund situation would remain inadequate until 1988, but would improve from then on and remain favorable until well into the next century. Then the impact of the demographic shift caused by the baby-boom would be felt, and sometime around the year 2030 the combined OASDI outlook would become inadequate, and remain that way through the remainder of the actuarial valuation period. The average combined long term deficit was estimated to be 1.52% of taxable payroll or 11% of the average combined costs of the two programs. The number of covered workers per beneficiary would fall from roughly 3.2 workers per beneficiary in 1980 to 1.9 workers per beneficiary in 2030.

In summary, the combined forecast for the cash programs -- OASDI -- parallelled to a large extent that of the OASI program, although the short range forcasts gave more time for corrective measures to be instituted.

Although it is the operations of the two cash programs which are combined most often to assess the financial status of the system, another approach which is sometimes used is to combine the operations of the two cash programs and the HI program. While these programs are different in purpose, all three

of them are supported for the most part by the social security payroll tax. Under this approach the overall adequacy of the financing of the progra supported by the entire social security tax can be measured. The 19.. Trustees' report showed the combined operations of the three trust funds through 1990. In contrast to the situation occurring in the OASI program by itself, and the situation arising when the operations of the OASI and DI programs were combined, this forecast for the three funds showed that they theoretically have sufficient financing throughout the decade. The combined reserves of the three funds would fall from a level of 29% of 1980 expenditures to a low of 16% of 1985 expenditures and then rise again to 35% of 1990 expenditures. While a reserve cushion of 16% of annual outgo would not represent a comfortable margin (given the volatility of the economy and other factors that impact on the balance between income and outgo to the system), if it actually did become the low point in the overall reserve condition of the three programs during the 1980s, the programs would be able to meet their benefit obligations without interruption.

The Trustees concluded their report with the following statement:

> The actuarial estimates presented in this report are based upon economic and demographic assumptions which are inevitably subject to considerable uncertainty. The assumptions and estimates that appear in this report were necessarily prepared before the most recent changes in the economy were known. Current evidence indicates that the economy has moved into a recession and is weakening rapidly. Therefore, revised short-range projections will probably be necessary in the near future as more information becomes available about the intensity of the changes in the economy. Over the longer term, uncertainty is of course an even more difficult factor. However, the Board believes that the long-range estimates presented in this report will remain useful for a longer period of time because they are less sensitive to changes in the short-range economic conditions.
>
> Over the short term the OASI trust fund will face financial strains requiring policy actions. Without such actions, the OASI fund would be depleted in late 1981 or early 1982, depending on the course of the economy. Reallocation of the tax rates between OASI and DI would postpone depletion until the latter half of 1982 or early 1983.

ACTION OF THE 96TH CONGRESS--REALLOCATING TRUST FUND RECEIPTS

The projections for the social security programs contained in the July, 1980 Carter budget update fell somewhere between the Trustee's Report intermediate and pessimistic forecasts. Reserves of the OASI trust fund would run out in November, 1981. Reserves of the two trust funds, OASDI, would run out in mid-1982. Reserves of the three trust funds combined would fall to a low of 8% of 1985 outgo -- a level too low to be considered safe. In other words, if all trust fund reserves were allocated to the three funds so that they would have equal reserve ratios, combined reserves would fall to a low of 8% of 1 year's outgo by the mid-1980s. Since reserves of 8% or 9% of 1 year's outgo is the absolute lowest level to assure monthly benefits can be paid,

the projected 1985 reserves was considered barely adequate to avoid cash-flow problems.

Given the trustees' cautionary note and the Carter Administration's mid-session 1980 projections, Congress found it necessary to reallocate a greater portion of tax receipts to the OASI trust fund, because of the reserve shortfall that would have arisen this year. H.R. 7670, as passed by the House and Senate, reallocated revenues from the DI program to the OASI program for calendar years 1980 and 1981. President Carter signed the measure on Oct. 9, 1980 (P.L. 96-403).

This reallocation of the tax rates eliminated the possibility of a financing deficiency through the end of 1981. (The measure re-shuffled the tax allocations to the two funds only for 1980 and 1981). This was intended to give the committees and Congress time this year to consider the various alternatives to solve the system's financing problems.

OUTGOING CARTER ADMINISTRATION PROPOSALS

The financial projections for the trust funds worsened after Congress took action last fall temporarily reshuffling tax receipts between the OASI and DI funds. The Carter Administration's FY82 5-year budget forecast, issued this past January, showed that the 2-year tax reallocation would still have its intended effects (keeping the system solvent through mid-1982), but the combined outlook for the three trust funds had deteriorated to the point where it was now unfavorable. The mid-session 1980 forecast had projected that the three funds combined would reach a low of 8% of one year's outgo in 1985. This past January's forecast shows the combined outlook for the three funds reaching a low of 1% of 1986 outgo.

Thus, even if Congress were to reallocate revenues permanently or permit interfund borrowing among the three trust funds, under the Carter assumptions such measures would not assure the financial soundness of the system for more than a few years. Additional steps would have to follow to either (1) raise aggregate revenues going to the system or (2) reduce future benefit obligations. This was in contrast to the Carter mid-session projections which showed that at the lowest point over the next decade there would still be one month's worth of benefits on hand. This would occur in 1985 after which the reserve balance of the three funds would improve. These mid-1980 projections suggested that a simple reallocation among the three trust funds would possibly avoid a financial shortfall for the programs throughout the 1980s. In January, 1980, the Carter Administration Administration had proposed the creation of a borrowing authority under which the OASI trust fund could receive loans from the DI and HI trust funds. Under the proposal, the borrowing authority would apply to all three of the trust funds, OASI, DI and HI. It would be triggered whenever the assets of one of the trust funds fell to a level of less than 25% of the outgo from that fund during the preceding 12-month period. The Managing Trustee (the Secretary of the Treasury) would have the discretion to determine from which of the other two funds the loan would be made (if not from both), as well as the amount of the loan. The loan would be repaid with interest whenever the assets of the borrowing trust fund reached a level of 30% or more of the outgo from that fund during the preceding 12-month period. The borrowing authority would expire in FY90.

The 96th Congress did not accept the proposal; however it was resubmitted

in the Carter Administration's FY82 Budget and is now being reconsidered by the House Ways and Means Committee.

The Carter Administration also recognized in its FY82 Budget that interfund borrowing would not provide a solution to the system's short-term problem. Although no specific recommendation was made, the Carter Administration outlined three options it considered acceptable:

1. Shifting one-half HI tax to the OASDI program and finance the revenue loss to HI through a general fund payment,
2. Allowing trust funds to borrow from the general fund,
3. Increasing the payroll tax.

CURRENT LEGISLATIVE MOMENTUM

The Social Security Subcommittee of the House Ways and Means Committee began to explore the system's financing problems and has actually conducted markup sessions on possible legislative remedies. In April 1981, just prior to the Easter congressional recess, the subcommittee tentatively approved more than 20 changes to the program. These proposals (among others) were then incorporated in H.R. 3207, introduced by the Subcommittee Chairman, Representative J.J. Pickle. The subcommittee began a formal markup in the first week of May 1981, but held up further action so that the Administration's proposals, announced on May 12, 1981, could be considered. The Administration is expected to give testimony shortly on its 14-point pl[illegible] to fix the system's financing difficulties. Markup sessions then woul[illegible] likely resume.

BASIC POLICY CHOICES FOR THE 97TH CONGRESS

This section of the issue brief is intended to give a basic overview of the options available to the Congress to address the financing issues confronting the social security system. The specific approaches proposed by Representative Pickle and President Reagan are discussed in detail after this overview.

Many proposals that would alter the financing provisions of the system can be associated with either improving the financial condition of the system or providing relief from the payroll tax. With the exception of the options specifically targeted for tax relief or to increase the payroll tax, the following discussion of financing options is not intended to be aligned with any one of these two major financing questions. The reader should recognize that new funding sources, expansion of coverage, and benefit reductions can be directed at either goal, or for that matter at both at the same time. For instance, recent proposals calling for use of general revenues have been motivated by both issues.

A. Making No Change in the Tax Policy Relating to Social Security

The question of whether payroll (social security) tax relief in a pur[illegible] sense should be provided in any form against the recent and upcoming increases in payroll taxes is largely an economic one, but there are other considerations.

The major arguments in favor of taking no action are that

(1) A reduction in payroll tax revenues would add to the potential Federal budget deficit (given no offsetting changes in other taxes or expenditures), increasing the amount the Government must borrow, and thus possibly keep the overall cost of money higher than it would otherwise be;

(2) A reduction in payroll taxes below existing levels would put more money in the hands of consumers than there would otherwise be, and thus aggravate or maintain the current high rate of inflation; and

(3) Given the deteriorating financial condition of the program, even a partial reduction of the scheduled tax increases would jeopardize the payment of benefits almost immediately;

The major arguments in favor of a tax reduction are that

(1) The payroll tax has become too conspicuous and too heavy a burden for most workers covered by the social security system;

(2) The scheduled increases in taxes will make the cost of labor greater relative to other factors of production (e.g., machines), and thus further aggravate the recent high rates of unemployment; and

(3) The scheduled increases in taxes will further increase the costs of goods and services in the economy, and thus further aggravate the already high rate of inflation.

B. <u>Leaving the Payroll Tax Structure in Place, But Making Offsetting Reductions in Income Taxes</u>

Another approach for tax relief is to allow the scheduled increases in the tax rate and earnings base to go into effect, but make offsetting reductions in income taxes. This would be similar to the action taken by the 95th Congress in the Revenue Act of 1978 when it reduced individual income taxes to offset the increases in 1979 payroll taxes, as well as the tax package reported by the Senate Finance Committee in the last Congress.

The major arguments in favor of this approach are that

(1) It avoids the appearance of breaking the tie between contributions to the system and benefit rights, which many would argue would come about by infusions of general revenues into the system; and

(2) It avoids further weakening of the financial condition of the programs at a time when concern is mounting that even the present law tax hikes may be insufficient to meet the benefit obligations of the near future.

The major arguments against this approach are that

(1) It would still leave the payroll tax in place and payroll tax withholding would not be altered; thus, the growth of the payroll tax would continue to be perceived as burdensome upon workers and employers, and pressure would continue to roll it back; and

(2) If the approach taken is an across-the-board reduction for all persons

paying income taxes, as was done in the Revenue Act of 1978, the tax cut would be given to many persons who are not covered by the social security system and thus are not subject to the recent and upcoming tax increases.

Under this approach, overall income tax reductions amounting to $15 billion in 1981 and $20 billion in 1982 would be needed to offset the aggregate new revenues arising from the social security tax increases. NOTE: An individual with annual earnings of $15,000 will have a payroll tax increase of 8% in 1981 over 1980. An individual with annual earnings of $30,000 will have a payroll tax increase of approximately 20% in 1981 over 1980.

Proposals of this nature were introduced by Representative Gephardt, H.R. 4990 and H.R. 7046 in the 96th Congress and H.R. 1809 in the 97th Congress. A similar bill, S. 44, was introduced by Senator Bradley in the 97th Congress. S. 44 and H.R. 1809 would provide for an income tax credit of 10% of annual payroll taxes for 1981 and 1982. The credit would be available for individuals for whom taxes are due and to those entitled to refunds. The credit would be provided on the employer's share, but would act to reduce the employer's income tax deduction for such payments currently allowed under the Internal Revenue Code. In contrast to the across-the-board approach taken in the Revenue Act of 1978, this approach limits the income tax reductions only to those who actually pay social security taxes.

C. New Sources of Revenue

In consideration of the 1977 amendments, the Congress rejected the approach of turning to the General Fund of the Treasury to meet the near term benefit requirements of the system, and adopted instead the more traditional approach of meeting the program's financial needs through an increase in the payroll tax rate and earnings base. Interest continues, however, in proposals to both shore up the financial condition of the system and/or provide tax relief through use of the General Fund or creation of new forms of taxation. A brief summary of these alternative revenue measures follows.

General Fund financing

Proposals for the use of general revenues as a source of financing for social security date back to the beginning of the program in 1935. Numerous attempts followed over the life of the program to introduce a major "government" or general revenue contribution to the system. While very limited uses have been made of general revenues, no major infusion has ever been enacted (except for the financing of SMI - Part B of Medicare). Interest in such an approach has been mounting again in recent years.

The 1975 Social Security Advisory Council recommended that no increases in the overall tax rates be made beyond those already scheduled in the law, and that the rates for the OASDI program be increased by gradually reallocating to it the portion of the overall tax rate scheduled to go to the HI program. Income lost to the HI program would be made up by infusions of general revenues as needed. In considering the Social Security Amendments of 1977 (H.R. 9346), the Congress did not adopt the idea.

The most recent (1979) Advisory Council also endorsed the infusion of general revenues into the HI program. This Council's approach differed from the prior Council's suggestion in that it would provide for a special allocation or earmarking of general funds in place of a portion of the

payroll tax now earmarked for HI. The remaining portion of the payroll tax earmarked for HI would be diverted to OASDI. A similar proposal made this past January by the National Commission on Social Security would shift half of the HI portion of the social security tax to the OASDI program with any deficiency in the HI program covered by an infusion from the General Fund. In addition, the Commission's proposal called for a 2.5% surtax to be added to the Federal personal income tax to make up for about one-half of the general revenues diverted to the HI program.

Another approach for the use of general funds in the system is the one approved by the House when it passed the 1977 amendments, under which standby authority for a loan from the General Fund of the Treasury would be created. The House-passed bill called for such a loan whenever the assets of either of the trust funds at the end of a calendar year amounted to less than 25% of the expenditures during that year. Repayment of the loan and imposition of additional taxes would be required under certain conditions. The provision was eliminated in conference.

Yet another approach, included in the Carter Administration's bill leading up to the 1977 amendments, is that whenever the economy takes a noticeable downturn, as indicated by an unemployment rate in excess of 6%, general revenues be provided to the system to make up for the payroll tax revenues lost because of the slump. An amount, estimated to be equal to the difference between the social security taxes actually paid and those that would have been collected for the year if unemployment had been no more than 6%, would be transferred from the General Fund of the Treasury to the trust funds. The plan was referred to as "countercyclical" general revenue financing. Neither the House nor Senate adopted this idea in their bills leading up to the amendments.

Numerous bills were introduced in the 96th Congress and similar ones are emerging in the 97th Congress proposing the use of general revenues to finance the system. A number renew the idea of the Federal Government as an equal partner in supporting the system, with the Government picking up a third of its costs. Others propose that some or all of the portion of the tax earmarked for HI be reallocated to OASDI or that the DI portion be reallocated to OASI and HI. General revenues would make up the loss. Still other bills would infuse general revenues into both HI and DI.

The reasons typically put forth for the proposal to have the Government share equally in the cost of program (by picking up one-third of its costs), are that (1) the payroll tax is a burden on the worker and has reached its limits as a source of financing, and (2) that various features of the program are socially oriented (the "minimum benefit," the weighting of benefits for low-income workers, dependents' benefits, etc.) and would be more appropriately supported by a general tax on the population.

The reasons made for approaches that would introduce general revenues into the HI and/or DI programs are (1) that these programs were late additions to the social security program, (2) that they are not an integral part of the system, which has as its principal purpose providing protection against the loss of earnings stemming from retirement or death, and (3) that their purposes are more socially oriented than those of the OASI program and thus better suited for support from a general tax on the population. A further argument made in regard to putting general funds into HI is that HI benefits, unlike those of the OASDI programs, are not related in any way to an individual's earnings or contributions as are cash benefits.

Although numerous arguments can be made against the notion of introducing general revenues into the system (some of which have already been mention in an earlier section of this report), the ones typically put forth are th: (1) most workers perceive their benefits as a matter of right acquired by their payroll tax contributions, and a large Government contribution might damage or weaken this acceptance of the system; (2) the close tie between new benefit liberalizations of the program and new taxes provides the system with a "fiscal brake" without which there would not be enough constraints to prevent major unrealistic benefit expansions; (3) the use of a general form of taxation to support the system would ultimately lead to a means-testing of benefits or a portion thereof; and (4) the use of general funds to meet a deficit is a "paper transaction" that does nothing to provide the needed additional funds but simply moves the deficit from the trust funds to the general funds.

Use of a value-added tax for social security

Over the past few years there has been some interest in the so-called "value added tax" (VAT) for purposes of financing a portion of the social security program. Although such interest has recently subsided, during the 96th Congress, Representative Ullman, then Chairman of the House Ways and Means Committee, introduced major tax reform bills incorporating a VAT (the Tax Restructuring Act of 1980, H.R. 7015, which made revisions to The Tax Restructuring Act of 1979, H.R. 5665, introduced earlier in the 96th Congress).

The tax would be imposed on the sales price of goods and services at ea stage of production and distribution. The actual amount of the sale to whi the tax would be applicable is the increment in the total value of goods and services added at each stage. In effect, it would be applied to the difference between the costs of materials that go into the production process and the selling price.

A VAT is similar to a sales tax in that it is a tax on consumption, but it differs from the sales tax in that it is levied at stages of production, manufacture, and distribution below the retail level. It has long been a major source of revenue for many Western European countries (e.g., France, Belgium, Germany, Italy, Netherlands, Sweden, and Great Britain).

Under former Representative Ullman's bill, a VAT would have been a replacement tax for a major portion of the income and payroll tax structures, not a new added form of taxation. His VAT, modeled after the one used in Germany, would have had an across-the-board 10% tax rate, but with exemptions of food, housing, medical costs, tuition, charities, mass transit, sales to government's, capital investments, and other such items.

With regard to the payroll tax, the bill would have rolled back the increase in social security tax rates that took effect in January 1981 and further reduced both the employer and employee share of social security taxes to 4.85%. Comparable reductions were proposed for the self-employed. Each of the three social security trust funds would have received funds directly from the VAT each month to maintain the trust funds at the level they would have been without the rollback.

Former Representative Ullman's proposal, if effective in CY81, would have reduced aggregate income and payroll taxes this year by an estimated $115 billion. Of this amount, $43 billion would be payroll tax reductions, $40

billion would be individual income tax reductions, and $32 billion would be business income tax reductions. The VAT would make up for these lost venues.

The major arguments for and against the VAT for the most part have not been directed at its social security implications, but at broader economic policy questions. This is reflected in the brief list of pros and cons which follows.

The arguments for:

(1) The VAT permits a reduction in the heavy, visible burden of income and payroll taxes; consequently, lower income persons would see a benefit in lower payroll taxes, while higher income persons and business would see advantages in lower income tax rates.

(2) Foreign experience with the VAT has shown it to be a stable revenue raiser.

(3) The VAT would give U.S. exports a competitive edge, and thus increase foreign sales at a time when increased exports are seen as a necessity in improving the value of the dollar abroad.

(4) The VAT would spur on capital formation by lowering the tax rates for higher income individuals and businesses that are more likely to invest, and

(5) The VAT has the potential to provide new revenues to the social security system, and avoid the upcoming cash flow problems.

The arguments against:

(1) Use of the VAT simply means shifting the tax burden and is not a real tax reduction; the VAT would tend to be regressive (that is, the burden would fall more heavily on low-income persons).

(2) The VAT would aggravate inflation (at least in the short-run) at a time when the cost of living already is growing at a fast pace.

(3) The VAT would break the direct link now tieing the worker's contributions to his social security benefits.

(4) Persons already retired would continue to pay for their benefits every time they make purchases.

Mandatory, universal coverage

As is the idea of using general revenues to finance the social security system, recommendations to mandate the coverage of government and other noncovered workers under the social security system are as old as the system itself.

Renewed interest in this idea arose when the House Ways and Means Committee proposed mandatory social security coverage of some six million jobs in Federal civilian, State, local, and nonprofit employment when considering the 1977 Social Security Amendments. The effective date of the provision was set for Jan. 1, 1982. An amendment introduced by Representative Fisher on the floor of the House, proposing deletion of the

provision, was accepted by the House. However, a 2-year study of the proposal was mandated. (The report of the group studying the issue w[illegible] submitted to Congress on Mar. 25, 1980).

The interest then and now in extending social security coverage to employment not currently under the system has its origin in both programatic and financing concerns.

The programmatic concerns were stated in the Report of the Committee on Ways and Means to the House on the 1977 amendments:

> There are gaps in protection of workers who have worked both under the CSR Civil Service Retirement system and social security; some employees only qualify for benefits under one system so that their benefits are not based on their lifetime earnings and contributions to both systems, while other employees fail to get benefits under either system. The second problem is that many employees who have worked under both systems are able to qualify for social security benefits by working for relatively short periods in jobs covered under social security, and to also qualify for substantial CSR benefits.
>
> These social security benefits generally are based on substantially less than a full lifetime of covered work and are heavily weighted and represent a very high return on the employee's contributions. This situation is unfair to all workers covered under social security and to their employers, who must bear the cost of the windfall benefits payable to Federal employees. NOTE: U.S. Congress. House. Committee on Ways and Means. Report to the House on H.R. 9346, The Social Security Amendments of 1977. 95th Congress, 1st session. Report no. 702, Part 1. Oct. 12, 1977. p. 34-35.

Similar concerns were expressed about employees of State and local governments and nonprofit organizations whose jobs are not covered by social security. In addition, there is the concern that if many of the employees of State and local governments, which are currently under the system, exercise their option to withdraw, a rather large negative impact on social security revenues could result.

As for the financing implications of mandatory coverage, the extensions of coverage could result in significant increases in revenues to the social security system in the short run. Under the bill reported by the Committee on Ways and Means prior to House action on the 1977 amendments, the proposed extensions were estimated to bring in new revenues amounting to $14.7 billion in 1982 and $17.8 billion in 1983 (including HI revenues). Outlays resulting from the new coverage would have been negligible in 1982 and amounted to less than $100 million in 1983.

The action proposed by the committee might be considered as one end of the spectrum, since it would have covered all workers in noncovered employme[illegible] regardless of their age or length of service in their government jobs. T[illegible] other extreme, which is reflected in a number of more recent proposals including that of the recent Advisory Council and the National Commission on Social Security, would cover only new government workers on a mandatory

basis. The added financing from this approach would be much less significant, but still substantial, as reflected by the following estimates added revenues:

TABLE 6. Revenues resulting from coverage of new government employees

(not presently covered by social security, beginning Jan. 1, 1982)

Calendar year:	Billions
1982	.7
1983	2.4
1984	3.9
1985	5.8
1986	7.8

The long range savings estimated to result from this proposal is roughly 0.5% of taxable payroll.

The principal arguments for and against mandatory coverage follow.

The arguments for:

(1) The perception of preferential pension treatment of Federal, State, and local government employees would be eliminated.

(2) The gaps in coverage and "windfall" benefits resulting from movement in and out of employment covered by social security would be eliminated.

(3) Significant new revenues could be brought into the social security system.

The arguments against:

(1) Many government workers view the idea as a means of deliberalizing benefits, and

(2) less drastic approaches could be undertaken to solve the problems of coordinating the various noncovered pension systems with social security.

Other new potential sources of revenue for social security

Other ideas that could generate large amounts of new revenues for the social security system are the diversion to the system of tax revenues resulting from the decontrol of oil prices; the creation of a special excise tax on gasoline earmarked for social security; and the creation of special excise taxes on alcohol and tobacco which might be funneled into the Disability Insurance trust fund.

An idea, proposed by former Representative John Anderson, to obtain alternative revenues for the social security system is to impose a $.50 per gallon excise tax on gasoline and use the revenues to reduce social security

taxes (H.R. 6071 in the 96th Congress). Similarly, Senator Hart introduced a bill in the last Congress establishing a tariff of $10 per barrel on imported oil with the proceeds used to reduce social security taxes (S. 2466).

Still another idea, proposed by Representative Gephardt, would be to increase the excise tax on cigarettes and alcoholic beverages, funnel the proceeds into the Disability Insurance trust fund, and then lower payroll taxes accordingly (H.R. 3374 in the 96th Congress).

D. Potential Reductions in Future Benefit Obligations

Any consideration given to the financial problems of the system or to reducing the payroll tax would be incomplete without a review of possible benefit reductions. Dissatisfaction with the level of the payroll tax reflects, at least for some, the belief that the program has grown too expensive. For others, interest in benefit reductions reflects the belief that certain types of benefits are "excessive" or duplicate benefits provided by other programs.

Probably the two most prominent benefit reduction ideas to reduce future obligations of the system are to raise the retirement age and alter the benefit formula to reduce the proportion of prior earnings that social security replaces. Neither would have a major short-run impact on costs, but their long range impacts could be enormous.

The proposal to raise the retirement age has recently been endorsed by the National Commission on Social Security as well as strongly favored by numerous members of the recent social security advisory council. It also had been part of an alternative Republican bill considered at the time of passage of the 1977 Amendments. Typically, such proposals have called for a gradual raising of the age that full social security benefits can be paid (from 65 to 68) and the age that reduced benefits can be paid (from 62 to 65), beginning around the turn of the century. The social security actuaries estimate that such changes would practically eliminate the long term deficit of the system. The proposal has also received support because of the increases that have and are projected to continue in life expectancy -- the major argument being that the percentage of one's life spent working and on the retirement rolls should be the same for past and future generations of retirees.

Proposals to lower the future replacement rates of the program -- the amount of past earnings the benefits replace -- also could have a major long range saving effect on the system. Even small reductions in future replacement rates, e.g., in the 5% to 10% range, could similarly eliminate the system's long term deficit, as well as have sizable impact in the 1980s. Such changes could be accomplished by changing the way the initial benefit formula is indexed each year (frequently referred to as altering the "bend points"). Limiting the indexing provisions for just a couple of years could quickly bring replacement rates down to more sustainable long range levels.

Other cost-reduction suggestions include limiting the size of the automatic benefit increase provided every June, phasing out or reducing the dependent spouse's benefit, establishing new limits on family benefits, phasing out the student's benefits (recently proposed by the Reagan Administration), and eliminating the lump-sum death payment, the minimum benefit, (also proposed by the Reagan Administration), and retroactive payments.

The arguments for and against benefit reductions depend heavily on the ture of the specific proposals involved. General arguments apply best to proposals calling for across-the-board type reductions. Even then, however, general arguments may not fit the circumstances neatly.

With this note of caution, the following are a few of the more frequently cited pros and cons raised in regard to benefit reductions.

The arguments for:

(1) The costs of the social security program have become uncontrollable, and, including Medicare, they now account for almost 30% of Federal expenditures.

(2) Social security resembles a basic income transfer program, taking income from those who have it and providing it to those who don't, yet much of its expenditures go to persons who don't need it.

(3) Various forms of benefits of the system often duplicate other types of Federal or State and local government expenditures.

The arguments against:

(1) Workers would lose faith in the system if they perceive that their future benefit rights are being eroded by benefit reductions.

(2) Depending on the nature of the benefit reductions, considerable nancial hardship could be created for many persons already believed to be finding it difficult to make ends meet.

MAJOR FINANCING PACKAGES NOW BEFORE CONGRESS

The importance of correcting the financial imbalances confronting the social security system is amply reflected by the swiftness with which the 97th Congress and the President have begun to sort out their preferences among the available options. As the foregoing discussion suggests, the question for the system is not one of whether the system can be restored to sound financial condition, but how it will be done. The policy options are abundant -- but those around which a political concensus can be reached are more limited. The urgency of the situation, however, may diminish ideological differences.

With less than 6 months having transpired in the 97th Congress, two major financing packages have begun the process of testing the political viability of various options. The approaches in the Pickle bill, H.R. 3207, and the Administration's package reflect at least some limited consensus that the long-run financial imbalance of the system occurring during the next century should be addressed by belt-tightening. The major courses of action suggested by the Pickle bill are raising the age at which full retirement benefits would be paid from 65 to 68, and shifting one-half of the Medicare Hospital Insurance (HI) tax to the OASDI system with an equivalent General nd reimbursement to the HI program. Under the bill, early retirement at 62 would still be available, but at lower levels. A 35% reduction would occur if retirement were elected at age 62, rather than the current 20% reduction. This change would be accomplished gradually over the period 1990 to 1999, and

would eliminate most of the projected long term deficit of the system. The HI reallocation to OASDI, coupled with the General Fund infusion, has equally large effect on the system's long term financial condition.

President Reagan's major proposal is to lower future replacement rates a few percentage points for all new beneficiaries, including the disabled and survivors as well as retirees. This would be done by altering the benefit formula (through constraints on the growth of the so-called "bend points"). By gradually lowering replacement rates (the percentage of an individual's earnings which social security benefits replace) over the next 5 or 6 years, the program's long term costs can be brought almost in line with the tax schedule now built into the law. The age-65 retiree with average steady earnings over his career could expect to receive benefits equal to 38% of his earnings in his final year of work, rather than 42%. The replacement for a steady worker retiring at 65 under the Pickle bill would drop to about 34% or 35%, but there would be little or no change in replacement rates for the disabled and survivors.

The amount of long term cost reductions that would arise from raising the age for full benefits or altering the benefit formula is roughly the same, but the other reduction proposals in the Administration's bill more than double the savings that would be achieved by altering the benefit formula, and substantially exceed the aggregate long term benefit reductions arising from the Pickle bill. The first such reduction in the Administration's package, which would be effective immediately for newly eligible retirees in 1982, would increase the benefit reduction factors used when workers and their spouses elect early retirement. The worker's reduction for retirement at age 62 would rise from the current 20% to 45%. The age-62 spouse reduction would rise from the current 25% to 45%. The second proposal wou[ld] phase-in, over 3 years beginning in 1982, a 3-year lengthening of the earnings averaging period used to compute benefits. This is referred to as moving the "age-computation point" from age 62 to age 65. Typically a lengthening of the averaging period means that more years of zero or low earnings would get thrown into the worker's "average earnings" computation, and this creates a lower "average." This in turn would produce lower benefits, and thus add to the reduction in replacement rates caused by the benefit formula change. These two proposals along with the benefit formula change account for more than 80% of the savings from the Administration's package. Most of the rest of the cuts are in the DI program.

The long term "surplus" of the program is about the same under the two bills, however, because in addition to its cost-reduction measures, the Pickle bill would permanently allocate one-half of HI revenues to the OASDI program.

The following table, which shows the effects of these two bills in "percent of taxable payroll" figures, illustrates the long run financial differences between them.

TABLE 4
Average surplus (+) or deficit (-) of social security system over next 75 years
(in percent of taxable payroll)

	Pickle bill (H.R. 3207)	Reagan Package
Raising age for full benefits	+1.35	---
Restraining growth of benefit formula	---	+1.30
Other cost-reduction measures	+ .26	+1.76(1)
Reallocating 1/2 HI revenues to OASDI	+1.37	---
Total financial improvement from proposals	+2.98	+3.06
Current long term deficit	-1.52	1.52
Proposed long term surplus	+1.46	+1.54

----

(1) One such measure within this figure, accounting for .02% of payroll, is a revenue measure -- covering sick pay up to 6 months.

"Percent of payroll" is a short-hand method of stating the size of the system's deficit or surplus, as well as the effects of various proposals. The average cost of the system over the next 75 years is estimated to be 13.74% of payroll. The average income to the system is estimated to be 12.22% of payroll (the difference being 1.52 as reflected above in the table). In today's dollar values, 1% of payroll is equal to $12-13 billion annually.

In summary, the Administration's package would reduced the overall cost of the OASDI program in the long run by 22%. The proposed benefit reductions in the Pickle bill would reduce the long run costs by 12%.

In the short run, the financial differences between the Pickle bill and the Administration's package are more significant. Overall, both bills put the system on approximately the same financial footing over the next 5 years. Trust fund assets, or reserves as they are sometimes called, would grow, but in terms of how much they would represent of one year's expenditures, they would still be "relatively" low. Under the Reagan package and pending economic assumptions, reserves at the beginning of calendar year 1986 would amount to roughly 30% of 1986 expenditures and could be as low as 21% under more adverse economic conditions. (NOTE: This would be the "worst-case" scenario used by the Administration developing its financing proposals.) Under the Pickle bill, reserves at the beginning of FY86 under the pending economic assumptions (calendar year figures are not yet available) would be about 40% of 1986 expenditures. (A comparable "pessimistic" forecast of the Pickle bill has not yet been priced). Reserves would be even lower in the intervening years. In neither bill would near term reserves be considered substantial or even sufficient. Historically, trust fund reserves have amounted to as much as 5 years worth of benefits (for instance, in the early 1950s). In the very early years of the program, a general rule frequently ascribed to was that the level of assets in the trust funds should be sufficient to meet 3 years worth of benefits. In the early 1970s anywhere from 75% to 125% of one year's outgo was considered sufficient. A more recent perspective suggests that reserves should be sufficient to weather a significant recession. A 30% to 40% reserve cushion may not make it.

To build even the limited reserves the Administration is striving for, more than $86 billion in cumulative benefit reductions have to be enacted for the 5 calendar years 1982-1986. This figure includes some $33-$34 billion in budget cuts proposed earlier this year. The Pickle bill, on the other hand, would cut only some $10 billion in benefits during the period, but would require infusions from the General Fund into the HI program amounting cumulatively to something on the order of $90-$100 billion.

The major elements in the $86 billion savings which would arise under the Administration's bill are proposed reductions in early retirement benefits and disability benefits. The reductions in these areas account for about $45 billion of the overall cut. About 70% of the 1.5 million workers who begin receiving benefits each year receive reduced early retirement benefits. Their reduction ranges from five-ninths of 10% for those retiring one month before reaching age 65 to 20% for those retiring at 62. Under the Administration's proposal these reductions will increase to 1.25% (for retirement one month early) to 45% (for an age-62 retirement). This proposal alone accounts for almost $18 billion of the aggregate $86 billion savings. The proposal has such a large effect because it would be immediately effective for all persons who reach age 62 in 1982 or later. Benefits under the proposal could be as much as one-third lower than under current law for

persons electing retirement at 62. Full benefits would still be available at ..e 65; however, eventually these age-65 benefits would be somewhat lower ..an current law as the benefit formula change and the lengthening of the averaging period proposal are phased in over the next few years.

In the disability program, the Administration is proposing nine reduction measures (including those in its earlier budget package) accounting for some $27 billion in benefit cuts over the next 5 years. During this period, these cuts would amount to a 20% cut in the cost of the DI program. In the long run they would reduce the size of the DI program by more than one-third. Most of these savings would result from tightening up eligibility for benefits. The program's "recent work" requirements would be made more stringent. Individuals who had not worked in at least 6 out of the 13 quarters prior to becoming disabled and who also did not work in 7 1/2 out of the 10 years before becoming disabled would be precluded from receiving disability benefits (older disabled workers, however, might be eligible for reduced early retirement benefits if they are between the ages 62 to 64). The current "recent work" test only requires that an individual have worked in 5 out of 10 years prior to becoming disabled. These changes in the "recent work" test account for nearly $14 billion of the $27 billion in aggregate disability cuts. Of the other seven disability cuts, the major one would be to base the determination of whether a disabling condition exists solely on medical factors. The person's age, experience and skills would no longer be considered in determining if, in conjunction with the impairment, he or she can no longer work. This would produce an $8 billion savings over the next 5 years. Historical data suggest that about one in four awards are based on these vocational considerations.

Of the remaining proposals in the Administration's package, three account for most of the other savings during the next 5 years. Eliminating benefits to students, age 18-21, saves about $11 billion; eliminating the minimum benefit saves $7 billion; and moving the effective date of the annual benefit increase from July to October (the beginning of the fiscal year) saves some $6 billion.

In addition to these cost reductions, the Administration's package would gradually eliminate the program's earnings limitation for persons 65 and older over the next 4 years, producing a 5-year cost of about $6.5 billion. And, finally, the Administration's package would reduce the scheduled tax rate for employees and employers by .1% each in the period 1985-1989 and by 1.2% each after 1990 and through the year 2020 (assuming a 50% reserve ratio can be sustained after 1990). The following schedule shows the current and proposed tax rates.

Period	Present law tax rates	Proposed tax rates	Changes
1981	6.65%	6.65%	--
1982-1984	6.70	6.70	--
1985	7.05	6.95	- .10
1986-1989	7.15	7.05	- .10
1990-2019	7.65	6.45	-1.20
2020 and after	7.65	7.55	- .10

With this reduction in the payroll tax, the long-range average surplus of the system of 1.54% of taxable payroll (from Table 4) would be lowered to .49% of taxable payroll.

While the Pickle bill significantly changes the age-adjustment factors raising the age at which full benefits can be paid and lowering early retirement benefits, this proposal would not have any effect in the short-run since it would not begin to be phased in until 1990. It would not be fully effective until 2000. Among the various benefit reduction proposals in the Pickle bill, the only one with any sizable near term savings is the one to eliminate the student benefit, which would cut costs over the next 5 years by $7 to $8 billion.

The bill avoids near term benefit reductions such as those under the Administration's package as well as alternative tax increases, by shifting one-half of the revenues now going to HI to the OASDI program. This one change accounts for about 90% of the reserve buildup in the OASDI program over the next 5 years.

The bill also makes a near term reallocation of HI revenues, on the order of $14 billion, which is not made up by a General Fund infusion. This would be a one-time unreimbursed tax reallocation in 1982. HI reserves at the beginning of FY86 would be on the order of 45% to 50% of 1986 expenditures, even with this $14 billion loss.

Additional details on the specific proposals in the Pickle bill and the Administration's financing package will be included shortly in IB81036 "Social Security: Reagan Budget and Financing Proposals and Congressional Action in the 97th Congress."

LEGISLATION

P.L. 96-403, H.R. 7670
The 96th Congress approved a 2-year DI (Disability Insurance) to OASI reallocation of the tax rates to eliminate the possibility of a financing deficiency through the end of 1981. (The measure reshuffles the tax allocations to the two funds only for 1980 and 1981.) The measure was signed into law (P.L. 96-403) on Oct. 9, 1980. This will give the new Congress time this year to consider various alternatives to solve the financing problem over the long term.

Listed below are some of the bills that have thus far been introduced in the 97th Congress that would alter the financing of social security.

H.R. 150 (Brodhead)

Substitutes general revenue financing of DI and HI for payroll tax financing. Introduced Jan. 5, 1981; referred to Committee on Ways and Means, and Interstate and Foreign Commerce.

H.R. 264 (Guyer)

Allows individual to elect to contribute to private retirement plan rather than participate in social security. Introduced Jan. 5, 1981; referred to Committee on Ways and Means.

H.R. 479 (Roe)

Reduces payroll tax and partially finances OASDI and Medicare programs with general revenues. Introduced Jan. 5, 1981; referred to Committee on

Ways and Means.

H.R. 889 (Levitas)

Provides for coverage of Federal workers. Introduced Jan. 16, 1981; referred to Committee on Ways and Means.

HR. 1018 (Conable)

Provides for partial financing of HI with general revenues; freezes taxable earnings base in 1981/82; lowers tax rate. Introduced Jan. 22, 1981; referred to Committees on Ways and Means, and Interstate and Foreign Commerce.

H.R. 1121 (Lagomarsino)

Reduces social security payroll taxes by providing general revenue financing of HI. Introduced Jan. 22, 1981; referred to Committee on Ways and Means.

H.R. 1568 (Addabbo)

Provides for general revenue financing of OASDI and HI. Introduced Feb. 3, 1981; referred to Committee on Ways and Means.

H.R. 1605 (Seiberling)

Reduces payroll tax and finances Medicare through general revenues. [illegible]troduced Feb. 3, 1981; referred to Committee on Ways and Means.

H.R. 1809 (Gephardt et al.)

Provides for income tax credit for social security taxes paid in 1981/82. Introduced Feb. 6, 1981; referred to Committee on Ways and Means. Other bills with similar provisions include H.R. 1186, H.R. 2350, and H.R. 3190.

H.R. 1848 (Annunzio)

Provides for increases in taxable earnings base; reduces payroll tax rates and provides for general fund financing. Introduced Feb. 17, 1981; referred to Committee on Ways and Means.

H.R. 2184 (Williams of Mont.)

Repeals payroll tax increases in 1981/82 and uses general fund financing. Introduced Feb. 25, 1981; referred to Committee on Ways and Means.

H.R. 2795 (Green)

Raises retirement age from 65 to 68, beginning in year 1999. Introduced Mar. 24, 1981; referred to Committee on Ways and Means.

H.R. 3207 (Pickle)

See narrative above. Introduced Apr. 7, 1981; referred to Committee on Ways and Means.

H.R. 3393 (Pepper)

Provides partial financing of Medicare through general revenues, interfund borrowing, liberalization of earnings test, greater reduction in early retirement benefits, and other provisions. Introduced May 1, 1981; referred to Committee on Ways and Means.

H.R. 3457 (Conable, by request of Administration)

See narrative above; contains Administration's budget proposals. Introduced May 6, 1981; referred to Committee on Ways and Means.

S. 44 (Bradley et al.)

Provides for income tax credit equal to 10% of social security taxes paid in 1981/82. Introduced Jan. 5, 1981; referred to Committee on Finance.

S. 484 (Chiles)

Raises retirement age from 65 to 68, beginning in year 2000. Permits interfund borrowing. Provides for general fund financing over HI. Reduces payroll taxes. Phases out student benefit and minimum. Eliminates payroll tax for persons over age 65. Introduced Feb. 17, 1981; referred to Committee on Finance.

REPORTS AND CONGRESSIONAL DOCUMENTS

U.S. Congress. House. Committee on Ways and Means. Subcommittee on Social Security. Background materials on options for financing the social security programs. Washington, U.S. Govt. Print. Off., 1979. 44 p. (96th Congress, 1st session. WMCP: 96-35)

----- Social security and economic cycles. Washington, U.S. Govt. Print. Off., 1980. 21 p. (96th Congress, 2d session. WMCP 96-75)

U.S. Congress. Senate. Committee on the Budget, Indexation of Federal programs, Part II, Subpart A, The indexing of social security. Washington, U.S. Govt. Print. Off., 1981. 403 p.

U.S. Congress. Senate. Committee on Finance. Subcommittee on social security staff data and materials related to social security financing. Washington, U.S. Govt. Print. Off., 1980. 69 p.
At head of title: 96th Congress, 2d session. Committee print 96-32.

U.S. Congress. Senate. Special Committee on Aging. Summary of recommendations and surveys on social security and pension policies, Washington, U.S. Govt. Print. Off., 1980. 48 p.

CHRONOLOGY OF EVENTS

05/12/81 -- Reagan Administration announced 14-point plan to correct social security short and long term financing problems.

03/27/81--04/07/81 -- Social Security Subcommittee of House Ways and Means Committee conducted "tentative" markup session on social security financing legislation.

02/17/81 -- Social Security Subcommittee began a series of hearings on the system's financial problems.

10/09/80 -- President signed H.R. 7670, creating P.L. 96-403.

09/25/80 -- Senate passed H.R. 7670 and sent bill to President for signing.

09/16/80 -- Senate Finance Committees approved H.R. 7670 and H.R. 5295, with amendments, including tax reallocation measures previously passed by Senate in S. 2885.

08/21/80 -- Senate Finance Committee ordered reported H.R. 5829, providing for $39 billion in income tax reductions for 1981.

07/21/80 -- House passed H.R. 7670.

07/01/80 -- Full House Ways and Means Committee approved H.R. 7670.

06/30/80 -- Full Senate approved S. 2885, the fiscal year 1981 Budget Reconciliation bill, including Finance Committee recommendation to reallocate tax rates to the OASI program.

06/25/80 -- Subcommittee on Social Security of House Ways and Means Committee recommends 1980-1981 partial reallocation of DI rate to OASI program (H.R. 7670).

06/19/80 -- Senate Finance Committee recommends 1980-81 partial reallocation of DI rate to OASI program as proof of budget reconciliation measures.

03/17/80 -- Subcommittee on Social Security of House Committee on Ways and Means began 2 days of hearings on Social Security aspects of President's FY81 Budget.

02/22/80 -- Senate Finance Committee began two days of hearings on social security financing.

12/19/79 -- Senate passed Crude Oil Windfall Profits Tax measure (H.R. 3919) including provision creating a taxpayers trust fund for possible use in providing payroll tax relief.

11/08/79 -- House Ways and Means Committee began 3 days of hearings on VAT.

11/01/79 -- Senate Finance Committee reported out H.R. 3919 with provision creating Taxpayers Trust Fund.

09/28/79 -- Subcommittee on Social Security of House Committee on Ways and Means began 5 days of hearings on social security financing.

08/01/79 -- House Republican leadership proposed $36 billion tax relief measure, including partial rollback of social security tax increases.

01/24/79 -- Democratic Caucus voted resolution calling for rollback of social security taxes in 1981.

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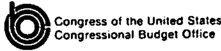
A CBO STUDY

Paying for Social Security: Funding Options for the Near Term

February 1981



PAYING FOR SOCIAL SECURITY:

FUNDING OPTIONS FOR THE NEAR TERM

Congress of the United States
Congressional Budget Office

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.

Alice M. Rivlin
Director

February 1981

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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

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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

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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

Year	Employee and Employer Rates, Each (in Percents)					Taxable Earnings Base (in Dollars)
	OASI	DI	OASDI Combined	HI	OASDHI Combined	
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.

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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.

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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 Balance	(As a Percent of Outlays) 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 Balance	(As a Percent of Outlays) 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 Balances	(As a Percent of Outlays) 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.

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

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.

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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,

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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.

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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

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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.

APPENDIX 2

MATERIAL RELATED TO HEARING

ITEM 1. LETTER FROM SENATOR JOHN HEINZ, CHAIRMAN, SENATE SPECIAL COMMITTEE ON AGING, TO HENRY J. AARON, PH. D., THE BROOKINGS INSTITUTION, WASHINGTON, D.C., DATED JUNE 17, 1981

DEAR DR. AARON: I would like to thank you for your insightful testimony at the hearing concerning the short-term financing problems with social security held by the Special Committee on Aging. I regret that I had to leave before I had an opportunity to explore a number of the issues with you and would appreciate your response to two questions for the record.

There seems to be a general concern today that using general revenues to finance social security, even if only through the use of a borrowing authority, would add to budget deficits in periods of high unemployment and low productivity unless offsetting reductions were made in other areas of the budget. Flexibility for social security would, therefore, be achieved at some cost to other Federal programs. With borrowing there is concern that continuing deficits in the social security trust funds could create a debt too large to pay back out of future surpluses.

Whether these dangers are likely, I realize, depends on what happens to the economy. I would like to know, however, whether you have looked at any existing or possible income sources which might operate in a different cycle from payroll tax revenues and which could be earmarked for use in buffering the social security system. I would also be interested in any thoughts you might have on how limits could be placed on borrowing to avoid the possibility of outrunning social security's ability to pay back the loan.

Second, as you mentioned, the traditional method for buffering the system has been to build up adequate reserve ratios. Certainly, over the long run, this would be one of our concerns. But over the short term, we may have to get by with our depleted reserves until we can afford to build them up again. If we choose to continue payroll tax financing alone for the system and adopt either intermediate or pessimistic assumptions for the economy, what do you think a minimal reserve ratio would have to be to provide the necessary cushion in the near term?

I appreciate your willingness to answer these questions for the record.

Warm regards,

JOHN HEINZ, *Chairman.*

ITEM 2. LETTER FROM HENRY J. AARON, PH. D., THE BROOKINGS INSTITUTION, WASHINGTON, D.C., TO SENATOR JOHN HEINZ, DATED JUNE 29, 1981

DEAR SENATOR HEINZ: Your letter of June 17 contained a number of explicit and implicit questions regarding the financing of social security.

Question 1. With continuing budget deficits a source of deep concern, would not the use of general revenues to assist social security come at the expense of other Government programs?

Answer. Fiscal policy goals should be set in terns of the overall deficit or surplus, adjusted for employment conditions. The deficit or surplus is simply the sum of the deficit or surplus in the social security system and the deficit or surplus in the remainder of the consolidated budget. The important question, therefore, at given Federal spending, is what fraction of revenues will be collected through payroll taxes allocated to social security, and what fraction from other revenue sources.

At present, we are contemplating a reduction in social security benefits, which will tend to reduce the deficit, and a reduction in income taxes, which will tend to increase the deficit. These decisions are being taken at the same time and should not be made without regard for each other. Congress could elect to reduce income taxes by slightly less than it otherwise would do and to use the proceeds to support social security (using general revenues to pay for part of medicare and shifting part

of medicare payroll taxes to OASI is a desirable way to do this). The combination of these changes would leave the deficit unchanged, to a first approximation.

In other words, there is no necessary conflict between the use of general revenues for social security and other Federal programs. There is a conflict, at a given deficit, between such use of general revenues on the one hand, and either Federal spending on other programs or tax cuts, on the other.

Question 2. Are there revenue sources, other than the payroll tax, which might operate on a different cycle from the payroll tax and which could be earmarked for use in buffering the social security system?

Answer. The instability of the social security system in the short run stems from employment conditions and especially from variation in the real wage differential, which in turn has been caused primarily by price shocks. Price shocks have tended to boost inflation and, through induced changes in monetary policy, to suppress economic activity.

I know of no revenue source that could be expected to vary in a pattern that would offset the effects of such price shocks on the social security system.

I believe that effective buffers for social security must deal with the indexing of currently payable benefits or must provide some device for adding to revenues on a formula basis related either to economic conditions or to the conditions of the trust fund.

Question 3. How could limits be placed on borrowing to avoid the possibility of liabilities so large that social security is incapable of paying them?

Answer. Borrowing needs would be generated by short-term events that reduce reserves. Ability to repay depends on a subsequent excess of revenues over expenditures. The present tax schedule is highly likely to generate surpluses of some magnitude starting in 1985. Thus, it is likely that a rule that stipulated that repayment of loans should begin when reserves reach a stipulated level, say 35 percent of 1 year's outlays, would trigger repayment automatically.

To deal with the contingency that projected surpluses do not materialize, I would favor a formula-triggered increase in payroll tax rates to achieve the needed surplus. For example, I would urge that payroll taxes be increased by, say, 0.5 percent each on employer and employee, effective in the first year following a year or two successive quarters in which the rate of unemployment fell below and remained below, say, 6.5 percent. Congress might well decide that it preferred to reduce benefits rather than let such a tax increase go into effect, but that choice should be made at the time.

Question 4. If social security financing continues to consist of payroll taxes alone, what would be an adequate reserve under either the pessimistic or intermediate assumptions?

Answer. The answer to that question depends on the formula used for indexing currently payable benefits. If that formula is changed to use the CPI or a wage index whichever is lower, then a minimally adequate index for the long run, in my opinion, would be about 50 percent. With the current indexing rule, I would aim for 75 percent. Either reserve would be sufficient to enable the social security system to weather a recession as severe as that experienced in 1974.

More important than the longrun target, however, is the speed with which we approach such a target and what we do until such a target is achieved. Such a reserve cannot be achieved in much less than a decade.

Until then, it is vital to adopt the buffers described in my testimony if Congress wishes to avoid either recurrent short-run crises, when economic downturns occur, or the need to enact drastic, and unwarranted, cuts in benefits.

For the very near term I believe an overall reserve below 15 percent should be a cause for immediate action, although much would depend on whether or not a tax increase were expected to raise the reserve promptly.

I hope that you find these responses helpful.

Sincerely yours,

HENRY AARON, *Senior Fellow.*

ITEM 3. LETTER FROM SENATOR JOHN HEINZ, CHAIRMAN, SENATE SPECIAL COMMITTEE ON AGING, TO DR. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, DATED JUNE 19, 1981

DEAR DR. RIVLIN: I would like to thank you for your testimony at the hearing concerning the short-term financing problem with social security held by the Special Committee on Aging. I regret that I had to leave before I had an opportunity to explore the issues with you and would appreciate your response to one question for the record.

You mentioned in your testimony that the absolute minimum reserve ratio is 9 percent of annual payouts, but that this is not a desirable level. You suggested Congress might wish to build reserve ratios up to a more adequate level and selected a ratio of 50 percent of annual payouts for the combined trust funds to be achieved by 1986. This figure seemed to be based on what studies have shown would be a necessary contingency reserve to weather periods of recession. I am concerned, however, that the cost of achieving the 50 percent cushion by 1986 would be quite high. Do you feel that it would be unwise in any way for Congress to choose a lower reserve ratio target for 1986, say 20 to 25 percent? Could you explain your opinion on this?

I appreciate your willingness to answer this question for the record.

Warm regards,

JOHN HEINZ, *Chairman.*

ITEM 4. LETTER FROM DR. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, TO SENATOR JOHN HEINZ, DATED JULY 1, 1981

DEAR MR. CHAIRMAN: Thank you for the opportunity to appear before your committee on the issue of social security's short-term financing problem.

Maintaining the social security trust funds at a 9-percent level of annual outlays, as I stated in my testimony, is the absolute minimum necessary in order to insure the continued flow of benefit payments. Studies have shown that balances of 60 to 100 percent of outlays are needed to make sure that there are sufficient trust fund reserves to withstand a recession slightly more severe than that which occurred during the 1974-75 period. I have enclosed a study evaluating trust fund reserve levels, as well as statements on the question by the 1979 Advisory Council on Social Security and by the National Commission on Social Security.

The estimate in my testimony of $80 to $130 billion in additional funds needed by the social security system to reach a level of 50 percent of outlays by 1986 was an example of the dollar infusion required to approach a more adequate trust fund reserve. A reserve of 25 percent would also be above the absolute minimum needed and would require $11 to $54 billion in added income or reduced benefits over the 1981 to 1986 period. However, as I also emphasized in my testimony, even a slight change in the economy might again necessitate additional congressional action—a course which might be unnecessary if the funds were built to a more substantial reserve level. If the economy does not experience a downturn during the next 5 years, the 20 to 25 percent reserve you mentioned should be adequate for the period.

If I can be of any further assistance, please let me know.

Sincerely yours,

ALICE M. RIVLIN, *Director.*

ITEM 5. LETTER FROM SENATOR JOHN HEINZ, CHAIRMAN, SENATE SPECIAL COMMITTEE ON AGING, TO JAMES R. SWENSON, CHAIRMAN, COMMITTEE ON SOCIAL INSURANCE, AMERICAN ACADEMY OF ACTUARIES, DATED JUNE 17, 1981

DEAR MR. SWENSON: I would like to thank you for your testimony at the hearing concerning the short-term financing problem in social security held by the Special Committee on Aging. I regret that I had to leave before I had an opportunity to explore the issues with you and would appreciate your response to one question for the record.

Why would it be necessary, if Congress enacts your recommendation for the use of wage/price indexing as a "safety valve," for us to additionally use pessimistic assumptions and a target of a 25 percent reserve cushion in determining the amount of savings or revenue needed over the short term? It seems to me, even if the pessimistic assumptions were realized over the next 5 years, that these approaches combined would produce more savings than necessary. Would not either a 25 percent reserve cushion based on pessimistic assumptions or a wage/price indexing by themselves produce a sufficient cushion for the near term?

I appreciate your willingness to answer this question for the record.

Warm regards,

JOHN HEINZ, *Chairman.*

ITEM 6. LETTER FROM JAMES R. SWENSON, CHAIRMAN, COMMITTEE ON SOCIAL INSURANCE, AMERICAN ACADEMY OF ACTUARIES, TO SENATOR JOHN HEINZ, DATED JUNE 30, 1981

DEAR CHAIRMAN HEINZ: On behalf of the American Academy of Actuaries, thank you for the opportunity to discuss short-term financing issues involving social security.

This letter will respond to the question directed to me in your letter of June 17, 1981. Following is the question as described in that correspondence:

"Why would it be necessary, if Congress enacts your recommendation for use of wage/price indexing as a 'safety valve,' for us to additionally use pessimistic assumptions and a target of a 25 percent reserve cushion in determining the amount of savings or revenue needed over the short term? It seems to me, even if the pessimistic assumptions were realized over the next 5 years, that these approaches combined would produce more savings than necessary. Would not either a 25 percent reserve cushion based on pessimistic assumptions or wage/price indexing by themselves produce a sufficient cushion for the near term?"

There are several issues which should be discussed before responding to this question. First, it would be highly desirable to maintain reserve levels much larger than the reserve level of 25 percent of annual outlays that I judged to be the minimally acceptable level for the next 5 years given political and economic realities. This minimally acceptable level is needed to permit time for subsequent legislative action should actual economic conditions prove worse than expected. A more desirable reserve level objective would be in the range of 75 and 125 percent of annual outlays as recommended by two advisory councils and the National Commission on Social Security.

Second, the judgment which lead to the conclusion that 25 percent was a minimally acceptable reserve level was based on the assumption of enactment of a "safety valve" provision limiting benefit increases to wage increases when "real wage" losses occur. Since the margins protecting the program from adverse economic conditions are very thin, this type of provision is essential to protect the program and its recipients. Even if the reserve margins were much larger, this type of provision may be warranted both to preserve intergenerational equity between taxpayers and beneficiaries and to help maintain the reserve margins.

Third, it is impossible to accurately predict future economic conditions. Because of this fact, a range of assumptions should be employed and forecasts should be made based upon this range of assumptions. History has proved that it is not prudent to rely only upon "best estimate" assumptions. Instead, there should be adequate contingency plans and provisions to protect the program from unexpected adverse economic conditions.

Given all of this as background, it is my personal opinion that it is desirable but not essential to combine all three elements to solve the short-term financing problems. That is, it is not essential to employe in combination: (1) A 25 percent reserve level; (2) a "safety valve" provision limiting benefit increases to the lesser of wage or price increases; and (3) pessimistic assumptions. Instead, as minimum steps, the 25 percent reserve level and the "safety valve" provision should be used in conjunction with "best estimate" assumptions.

In my testimony, former President Carter's 1982 budget assumptions were characterized as the "best estimate" assumptions. Under forecasts using those assumptions, maintenance of the 25 percent minimum reserve level would require approximately $65 billion of additional taxes or benefit reductions to be spread throughout the period from 1982 to 1986. These additional taxes or benefit reductions would be in addition to any benefit reductions resulting from the "safety valve" provision. If legislation were enacted producing these additional taxes or savings and further providing the "safety valve" provision, subsequent political action might be required, but there would be sufficient time for such action.

The academy hopes that the testimony and this response is helpful in solving the short-term financing problems of this essential program.

Sincerely,

JAMES R. SWENSON, *Chairman.*

ITEM 7. PROPOSED AMENDMENT TO THE SOCIAL SECURITY ACT, SUBMITTED BY JAMES R. SWENSON, CHAIRMAN, COMMITTEE ON SOCIAL INSURANCE, AMERICAN ACADEMY OF ACTUARIES

Section 201(c) of the Social Security Act is amended by adding at the end thereof the following new sentence:

"Such report shall also include a statement by the Chief Actuary of the Social Security Administration expressing his or her opinion: (1) That the techniques and methodology used in preparing the actuarial status of the trust funds are in accordance with generally accepted actuarial principles; and (2) whether the cost estimates and the assumptions on which they are based are in the aggregate reasonable for the purpose for which they are intended taking into account the experience and expectations of the program, including a statement of the government sources of the assumptions used therefor, where appropriate."

(b) Section 1817(b) of such act is amended by adding at the end thereof the following new sentence:

"Such report shall also include a statement by the chief actuarial officer of the Health Care Financing Administration expressing his or her opinion: (1) That the techniques and methodology used in preparing the actuarial principles; and (2) whether the cost estimates and the assumptions on which they are based are in the aggregate reasonable for the purpose for which they are intended taking into account the experience and the expectations of the program, including a statement of the governmental sources of the assumptions used therefor, where appropriate."

(c) Section 1841(b) of such act is amended by adding at the end thereof the following new sentence:

"Such report shall also include a statement by the chief actuarial officer of the Health Care Financing Administration expressing his or her opinion: (1) That the techniques and methodology used in preparing the acturial status of the trust fund are in accordance with generally accepted actuarial principles; and (2) whether the cost estimates and the assumptions on which they are based are in the aggregate reasonable for the purpose for which they are intended taking into account the experience and the expectations of the program, including a statement of the governmental sources of the assumptions used therefor, where appropriate."

(d) The amendments made by this section shall be effective on January 1, 1982.

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