

**STATEMENT BY**

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**before the  
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Mr. Chairman and Members of the Commission, I am here today to discuss two separate but related problems: the large federal budget deficits projected for the next few years, and the short-term financing difficulties of the Social Security system.

In recent years, Social Security outlays have grown more rapidly than federal spending as a whole, and they will continue to increase as a proportion of the budget. With the prospect of continuing large budget deficits, further efforts to cut spending will be needed and, within this context, it will be necessary to consider some reductions in Social Security. Moreover, some changes in the Social Security program will be necessary in any case, since reserves are projected to fall to critically low levels in the near future. Therefore, benefit reductions, tax increases, or general revenue transfers will be required to resolve the short-term Social Security financing problem. Of these alternatives, however, only the first two would also address the problem of federal budget deficits.

#### THE OVERALL BUDGET OUTLOOK

The problems of growth in federal spending and large budget deficits are not new, but last year's legislation which cut revenues substantially more than spending, coupled with recession and declining inflation, has exacerbated the situation. Under the April baseline budget projections of the Congressional Budget Office (CBO), which were prepared before the passage of the First Concurrent Resolution on the Budget and which assumed a moderate economic recovery for fiscal years 1983 to 1985, budget deficits were projected to escalate rapidly (see Table 1). By 1985,

TABLE 1. PROJECTED FEDERAL DEFICITS (By fiscal year, in billions of dollars)

	1983	1984	1985
<b>April Baseline Projections<sup>a</sup></b>			
Unified budget deficit	182	216	233
Off-budget spending	21	21	20
Total deficit	203	237	253
<b>First Concurrent Resolution on the Budget for 1983<sup>a</sup></b>			
Unified budget deficit	104	84	60
Off-budget spending	21	21	20
Total deficit	125	105	80
<b>Budget Resolution with Preliminary CBO Reestimates<sup>b</sup></b>			
Unified budget deficit	141-151	145-160	143-158
Off-budget spending	21	21	20
Total deficit	162-172	166-181	163-178

a. Based on CBO's economic assumptions of April 1982.

b. Based on CBO's preliminary economic assumptions of July 1982.

the total deficit was projected to exceed \$250 billion, or 5 percent of gross national product (GNP). Such large and growing deficits in a period of projected economic recovery are a source of considerable concern.

As a consequence, the First Concurrent Resolution on the Budget instructed the committees of both Houses of the Congress to bring forward legislation to lower spending and raise taxes for fiscal years 1983-1985. Projections of the budget under the economic and policy assumptions of the First Concurrent Resolution showed substantially lower deficits, and the elimination of the projected growth in deficits after 1983.

The size of the deficit is sensitive to the economy's performance, however, and the economy almost never behaves exactly as forecasters expect. Like the assumptions used in the First Concurrent Resolution, the CBO's most recent forecast still shows a recovery in the second half of this year. Unfortunately, the failure of interest rates to decline as anticipated in the spring despite falling inflation, and the unexpected depth of the recession, suggest a somewhat less robust recovery than seemed likely earlier this year. These high interest rates have resulted, at least in part, from an unusual combination of tight monetary policy and expansionary fiscal policy, and have created doubts about whether the recovery will prove to be sustainable.

Under the new CBO economic forecast and technical reestimates, the unified budget deficits projected under the policies of the First Resolution will rise from about \$110 billion in fiscal year 1982 to between \$140 and \$160 billion annually for fiscal years 1983-1985. Most of the increase in the projected deficits comes from lower than anticipated revenues, which result both from slower growth in real output and from lower rates of inflation than were previously projected. Federal spending is also projected to increase somewhat over earlier forecasts, mostly because of higher debt service costs resulting from both higher interest rates and higher deficits.

These projections, it must be emphasized, assume enactment for the 1983-1985 period of about \$126 billion in spending reductions and \$98 billion in revenue increases, as well as \$47 billion in management savings and \$108 billion in reduced interest costs, all of which were included in the First

Concurrent Resolution. The new CBO reestimate does not mean that these belt-tightening actions are futile, since the projections still show a substantial improvement over the April baseline numbers. They do indicate, however, that moving closer to budgetary balance by the mid-1980s is likely to be much more difficult than was previously thought.

With projected deficits of approximately \$150 billion (\$170 billion including off-budget spending), balancing the budget in the next few years is neither realistic nor desirable. It is essential, however, that the government set out and stick with a plan for sure and steady progress toward a sounder federal budget. In order to achieve significant reductions in the deficit, further reductions in spending and increases in taxes will be necessary.

#### SOCIAL SECURITY AND THE FEDERAL BUDGET

If substantial reductions in spending are to be achieved, changes in areas of the budget that have thus far been excluded from major spending cuts--defense and pensions--will have to be considered. By 1985, spending for national defense, pensions, Medicare,<sup>1</sup> and net interest will account for three-quarters of federal outlays under the policy assumptions of the First Budget Resolution, as shown in Table 2. The remaining spending categories--nondefense discretionary spending and other entitlements--are those already hardest hit by the reductions of the past two years, and are also those that are projected to grow most slowly. If the 1985 budget were

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1. Although Medicare benefits were reduced in 1981 and more reductions are being voted on now, outlays for Medicare will continue to increase much faster than overall federal spending, largely as a result of rapidly rising hospital costs.

TABLE 2. COMPOSITION OF FEDERAL OUTLAYS (By fiscal year, in billions of dollars)

	Actual 1980	Projection 1985 <sup>a</sup>	Change
National Defense (except retired pay)	124	263	139
Pensions and Medicare <sup>b</sup>	182	313	131
Other Entitlements	87	113	26
Nondefense Discretionary	140	138	-2
Net Interest	52	122	70
Other Spending and Receipts	<u>-8</u>	<u>-38</u>	<u>-30</u>
Total	577	911	334

a. First Concurrent Resolution on the Budget for Fiscal Year 1983 with preliminary CBO reestimates.

b. Old Age and Survivors Insurance, Disability Insurance, Railroad Retirement, Black Lung, Federal Employee Retirement and Disability, Hospital Insurance, and Supplementary Medical Insurance.

to be balanced without reductions in spending for defense, pensions, and Medicare, nondefense discretionary spending and other entitlement programs would have to be cut by an additional 60 percent.

The bulk of federal spending for pensions and all spending for Medicare flow through the Social Security trust funds. By 1985, outlays from the Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds are projected to be almost \$200 billion, and outlays from the Hospital Insurance (HI) and Supplemental Medical Insurance (SMI) trust funds are expected to reach \$70 billion. Under these projections, Social Security cash

benefits will grow by almost 70 percent, and health benefits will more than double, over the 1980-1985 period. As a result, total Social Security benefits will account for almost 30 percent of the budget by 1985, up from 26 percent in 1980.

Although major efforts have been made to reduce total federal spending over the last few years, little has been done to slow the growth in Social Security benefits--particularly the cash benefits. The benefit reductions enacted last year reduced outlays for Social Security cash benefits by less than 2 percent, and generally affected only a small proportion of beneficiaries.<sup>2</sup> In contrast, means-tested entitlement programs--such as Aid to Families with Dependent Children (AFDC), Medicaid, food stamps, and other nutrition programs--have been cut substantially more. Although outlays for means-tested entitlement programs represent about 18 percent of total benefit payments to individuals, cuts in these programs enacted in 1981 accounted for 40 percent of the total reduction in benefit payments. Further spending reductions in the means-tested programs are now being voted on, whereas no further changes in the Social Security cash benefits programs are being considered, although reductions in Hospital Insurance outlays of \$9.7 billion over the 1983-1985 period have been proposed by the House-Senate conference committee.

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2. Examples of cuts in the OASI and DI programs are the elimination of students' benefits and the cap on family benefits for disabled workers. Cuts in Medicare have included reductions in hospital reimbursement rates and increases in the deductible amounts paid by Medicare beneficiaries.

### THE SHORT-TERM OUTLOOK FOR SOCIAL SECURITY FINANCING

In addition to Social Security's importance to the overall budget, the program also faces serious short-term financing problems of its own. Under current law, the OASI fund, the largest of the trust funds, will be unable to pay all of its benefits on time by July 1983. Even assuming that interfund borrowing is extended indefinitely and that those HI changes in the conference committee agreement are enacted, the combined reserves of the three trust funds are projected to be about 13 percent of annual outlays at the beginning of fiscal year 1984 and less than 8 percent by the beginning of 1985 (see Table 3). Reserve levels this low may make timely payment of benefits difficult, because cash benefit payments are made at one time early in each month, while tax payments are received continuously during the month. In addition, such low reserve levels may undermine public confidence in the Social Security system and cause recipients unnecessary anxiety.

Thus, substantial outlay reductions, revenue increases, or both will be required in order to build up trust fund reserves to an adequate level over the next few years.<sup>3</sup> In order to maintain reserves equal to only 12 percent of outlays, for example, the combined funds would need \$11 billion in added revenues or outlay reductions in fiscal year 1984, and \$3 billion more in 1985, in addition to the HI changes already a part of the conference committee agreement.

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3. The term "reductions," as applied to outlays and benefits in this statement, refers to reductions relative to current law. Such reductions do not necessarily imply lower nominal levels, however, although most would entail reductions in both spending and benefits measured in real terms.



TABLE 3. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES BASED ON CONFERENCE COMMITTEE AGREEMENT (By fiscal year, in billions of dollars)

	1981	1982	1983	1984	1985
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	Old-Age and Survivors Insurance				
Outlays	122.3	138.3	152.6	166.2	179.0
Income <sup>a</sup>	121.6	127.4	144.5	144.1	161.8
Year-End Balance	23.8	12.9	4.8	-17.3	-34.5
Start-of-Year Balance (as percent of outlays)	20.1	17.2	8.5	2.9	-9.7
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	Disability Insurance				
Outlays	17.3	18.4	19.2	19.7	19.7
Income <sup>a</sup>	13.0	21.3	18.7	27.3	33.6
Year-End Balance	3.4	6.4	5.9	13.5	27.4
Start-of-Year Balance (as percent of outlays)	44.4	18.5	33.1	29.9	68.7
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	Hospital Insurance				
Outlays	29.3	34.5	37.8	43.0	48.6
Income <sup>a</sup>	32.9	37.6	35.7	46.0	51.5
Year-End Balance	18.1	21.3	19.2	22.2	25.2
Start-of-Year Balance (as percent of outlays)	49.5	52.5	56.3	44.6	45.8
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	Combined OASI, DI, and HI				
Outlays	168.9	191.1	209.5	228.8	247.2
Income <sup>a</sup>	167.4	186.3	198.9	217.4	246.9
Year-End Balance	45.3	40.5	29.8	18.4	18.1
Start-of-Year Balance (as percent of outlays)	27.7	23.7	19.3	13.0	7.5
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SOURCE: Preliminary CBO estimates based on July 1982 economic assumptions and the House-Senate conference committee agreement of August 15, 1982.

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. Income in 1983 reflects interfund transfers as authorized under Public Law 97-123.

Reserves of about 12 percent provide little margin for error, however. In fact, given Social Security's sensitivity to the economy's performance, prudent budgeting calls for trust fund reserves considerably above 12 percent, in order to avoid frequent or sudden program changes in response to unexpectedly adverse economic conditions. Over the past decade, forecasts of trust fund balances have consistently been overly optimistic and reserves have been depleted faster than expected. In a program that represents a long-term commitment around which people plan their lives, frequent program changes can cause substantial hardship and may undermine public confidence in the system. Larger reserves--maybe as much as the 75 percent of annual outlays recommended by the 1979 Advisory Council on Social Security--would help to insulate the Social Security system from economic shocks.

#### OPTIONS

Changes in the Social Security program must be considered in two contexts. First, the budget deficit cannot be reduced significantly without substantial reductions in the growth of spending and further tax increases, and to achieve these while exempting Social Security programs would be extremely difficult. Second, Social Security balances are declining, and could reach critically low levels in fiscal year 1984. Even if interfund borrowing is extended indefinitely, additional program changes will be needed in the near future to maintain the solvency of the system and to build up reserves to a prudent level.

There are three types of options that could improve trust fund balances--benefit reductions, tax increases, and revenue transfers from other sources. The first two of these would also reduce the overall budget deficit; the third would not.

#### Benefit Reductions

Reductions in Social Security benefits enacted so far have been fairly minor in comparison to the size of the program. In general, while comparatively few beneficiaries have had their benefits reduced, the impact on those who have has been relatively large. In contrast, broad-scale benefit reductions affecting all beneficiaries in a similar way could produce much greater savings, and would not disproportionately affect specific recipients. Modifying the indexing of Social Security benefits is an example of this type of benefit change.

Savings from indexing changes over the next three years could range from about \$7 billion for a permanent shift of the cost-of-living adjustment from July to October to \$21 billion for eliminating the cost-of-living increase to be paid in July 1983. Other indexing options that could also produce large savings are displayed in Table 4. Any of these options would reduce federal deficits, although these alterations in annual cost-of-living adjustments alone might not generate sufficient savings quickly enough to avoid the cash flow problems anticipated for the trust funds by fiscal year 1985.

TABLE 4. SOCIAL SECURITY OUTLAY SAVINGS UNDER DIFFERENT COST-OF-LIVING ADJUSTMENTS (COLA) (By fiscal year, in billions of dollars)

	1983	1984	1985	Total 1983-1985
Eliminate 1983 COLA	2.2	9.2	9.5	20.9
Delay COLAs From July to October	2.2	2.1	2.8	7.1
Cap COLAs at 4 Percent	0.6	2.7	4.4	7.7
Set COLAs at Growth in Wages Minus 1.5 Percentage Points <sup>a</sup>	0.2	0.9	0.9	2.0

SOURCE: Congressional Budget Office.

- a. This option would result in small savings in outlays in the short run because of projected low productivity growth. Over the longer run, however, outlays could be either higher or lower than under current law, depending upon the relative behavior of wages and prices.

In addition to generating savings in total federal spending and in the trust funds, several other reasons for reducing benefits have been advanced. Social Security benefits have risen rapidly over the last decade, largely as a result of the automatic price-indexing of benefits that has taken place since 1975. Many analysts believe that benefits have been overindexed, both because of a now-corrected flaw in the original indexing method, and because of problems with the Consumer Price Index (CPI). The CPI, on which benefit increases are based, gives excessive weight to mortgage

interest rates and housing prices, which have risen more rapidly than other prices in the recent past. If cost-of-living adjustments had been computed using an index that included a rental equivalence measure of housing costs, for example, benefits would now be 5 to 6 percent lower.

Even if such an index had been used, however, benefit increases would still have outstripped the growth in wages over the last few years, when high rates of inflation have been accompanied by low rates of growth for the economy as a whole. Since 1979, for example, benefits have increased by about 50 percent, while average annual earnings have risen less than 40 percent. Thus, Social Security beneficiaries have received a degree of protection from the effects of poor economic performance that has not been available to wage earners.

Finally, as discussed earlier, Social Security cuts so far have been relatively small, especially compared to those in means-tested entitlement programs. While some Social Security recipients have very low incomes, most have more resources available to them than do the recipients of benefits from means-tested programs such as AFDC, food stamps, and Medicaid.

On the other hand, reductions in current law cost-of-living adjustments would lower the real value of Social Security benefits over time. This would lead to a higher incidence of poverty among the aged and disabled, particularly among the very old. While programs such as

Supplemental Security Income (SSI) and food stamps do provide some measure of protection for Social Security recipients with low incomes, the asset test under SSI and the unwillingness of many aged and disabled individuals to apply for means-tested benefits prevent many of the poor from participating in these programs.<sup>4</sup> One approach that would cut federal spending while protecting the poorest of the elderly would be to combine reductions in Social Security cost-of-living adjustments with liberalizations of the asset test and benefit levels under SSI.

#### Tax Increases

A second option that would both improve Social Security trust fund balances and reduce the overall budget deficit would be to increase taxes. Social Security cash benefits and medical services paid for by the HI fund are financed primarily through the payroll tax, which now provides about one-third of total federal revenues. Payroll tax rate increases are scheduled under current law for 1985, 1986, and 1990, and about 40 percent of federal revenues are expected to come from this source by the end of the decade.

Additional tax revenues for Social Security could be generated either through further increases in payroll tax collections, or through the imposition of new taxes with revenues dedicated to the trust funds (see

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4. Because of automatic offsetting increases in spending for programs such as SSI, food stamps, and veterans' pensions, the federal budget savings would be about 95 percent of the savings to the Social Security trust funds from an across-the-board benefit cut.

Table 5). Payroll taxes could be increased by moving forward the tax rate increases that are already scheduled. For example, added revenues of \$17 billion over the next three years would result if the 1985 and 1986 tax rate increases were to begin in 1984 instead.

Alternatively, Social Security coverage could be extended to some or all of those workers not now covered--for the most part, federal, state, and local government employees. Covering new government employees, for example, would generate \$5.7 billion in additional trust fund receipts during fiscal years 1983-1985. The impact on the budget as a whole would be substantially less, however, since some of the added trust fund revenues would come from employer taxes paid by federal agencies, and some could come from employee contributions now made to the Civil Service Retirement program.

Another approach would be to subject a portion of Social Security benefits--for example, the half that one might associate with the employer share of the payroll tax--to the personal income tax, and to direct the \$18 billion in new receipts over the next three years to the trust funds. This proposal is, in essence, a benefit cut, but in contrast to indexing changes, it would protect low-income Social Security recipients, since they generally would still pay no taxes. Instead, the tax increases would be focused on higher-income beneficiaries, particularly those with substantial incomes in

TABLE 5. ADDITIONAL TRUST FUND REVENUES UNDER VARIOUS TAX CHANGES (By fiscal year, in billions of dollars)

	1983	1984	1985	Total 1983-1985
<b>Payroll Tax Rate Increase</b>				
a. Move 1985 and 1986 increases to January 1, 1984	--	10.8	6.2	17.0
b. Move 1985, 1986, and 1990 increases to January 1, 1984	--	22.8	23.3	46.1
<b>Extend Social Security Coverage to Federal, State, and Local Government Employees</b>				
a. New employees only	0.5	1.8	3.4	5.7
b. All employees	11.1	16.3	18.2	45.6
<b>Tax 50 Percent of OASI Benefits<sup>a</sup></b>	4.5	6.5	7.0	18.0
<b>Tax 50 Percent of OASI Benefits for Recipients with Income Above \$20,000 (Individual)/\$25,000 (Couples)<sup>a</sup></b>	1.2	1.8	2.2	5.2

SOURCE: Congressional Budget Office.

NOTE: Unless otherwise indicated, the effective date is January 1, 1983.

- a. These estimates assume that the trust funds would receive the added revenues as income tax liabilities accrued, rather than when the income taxes were actually paid. Estimates are preliminary and subject to revision.



addition to their Social Security benefits. To protect low- and moderate-income beneficiaries further, the tax could be imposed only on those with total incomes above a given level ( \$20,000 for an individual and \$25,000 for a couple, for example), although this would generate substantially less revenue.<sup>5</sup>

Other revenue-generating alternatives include increases in excise tax rates on goods such as alcohol and tobacco, which are known to be associated with increased health risks. Revenues from this source could be earmarked for the DI and HI trust funds.<sup>6</sup>

Providing additional funds for Social Security through tax increases could reduce the need for major reductions in benefits that would cause hardships for some recipients. On the other hand, substantial tax increases --especially those that would increase the costs of employment--may be undesirable as long as unemployment remains high. Payroll tax increases would also lower the rate of return on contributions received by current workers, which under present law will already be lower, in general, than that received by current beneficiaries. Finally, although tax increases could reduce the deficit, they would not affect the share of GNP devoted to federal spending.

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5. Unemployment insurance benefits, for example, are now taxed in this manner.
  6. A proposed increase in excise taxes on cigarettes has been included in the Tax Equity and Fiscal Responsibility Act of 1982, but revenues from this tax would not be allocated to the trust funds.

### General Revenue Transfers

The third possible approach to the problem of declining Social Security balances--transfers from other parts of the budget--would improve the financial status of the Social Security trust funds, but would not contribute to reducing federal deficits. Transfers could be funded either directly from general revenues or by loans from the Treasury to the trust funds, to be repaid with interest when the trust funds recover from their short-term financing difficulties.<sup>7</sup>

General revenue borrowing would be an attractive option if there were no overall budget deficit problem, since it would permit gradually phasing in changes that would improve the trust fund balances in the long run. At the present time, however, using general revenue transfers as the sole means of resolving the Social Security financing problem would place the entire burden of deficit reductions on other portions of the budget. This approach could also be viewed as lessening the fiscal discipline imposed by payroll tax financing.

In the short run, however, a combination of benefit reductions and tax increases such as those described above could still leave the trust funds with

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7. Under the "intermediate B" assumptions of the 1982 Social Security Trustees' Report, the combined OASDI trust funds will have positive and increasing balances beginning in 1994. The HI fund, however, is projected to encounter ever-declining balances beginning in 1984, and would be unable to pay back any borrowing from the Treasury.

temporarily inadequate balances, particularly if economic conditions are worse than expected. The enactment of a limited provision for general revenue borrowing when trust fund balances become very low might be considered, in order to provide the trust funds with an automatic margin of safety.

### CONCLUSION

In summary, the persistence of large federal budget deficits and the short-term financing difficulties of the Social Security system are related problems that must both be resolved in the near future. Substantial reductions in the budget deficits will be difficult to achieve without reductions in Social Security, however. Further, Social Security reserves are now low, and some actions will be necessary soon in order to ensure timely payment of benefits. In evaluating various alternatives for Social Security, it is important for the Commission to consider the impact of its recommendations on the federal budget as a whole.