STATEMENT BY

Alice M. Rivlin
Director
Congressional Budget Office

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Mr. Chairman, I am pleased to appear today to discuss the problems of the Social Security system in the context of overall economic performance. I plan to comment both on the effects that changing economic conditions may have on the financial soundness of the Social Security trust funds, and on the net budgetary implications of several policy options for Social Security.

The Social Security system is a matter of concern today for two reasons. First, the balance in the Old Age and Survivors' Insurance (OASI) trust fund—the largest of Social Security's three trust funds—has declined rapidly in recent years; without further Congressional action, the OASI fund will be unable to pay benefits sometime late in 1982. Balances in the combined trust funds, which include Disability Insurance (DI) and Hospital Insurance (HI) as well as OASI, are considerably greater, but whether these reserves will prove adequate to ensure payment of all benefits for the next five to ten years depends largely on the performance of the economy.

Second, Social Security payments have been growing rapidly, both in relation to the Gross National Product (GNP) and to the federal budget (see Table 1). Social Security outlays have increased from 2.3 percent of GNP in 1960 to a projected level of about 6 percent of GNP this year. Social Security outlays now represent more than one-fourth of the total budget, and the CBO projects that they will account for nearly 30 percent of federal spending by fiscal year 1984.

Achieving a balanced budget by 1984 will require major reductions in spending if no new taxes are to be imposed. Total spending for benefit payments to individuals will come to about $315 billion in 1981, and is expected to grow to almost $400 billion by 1984. Other major outlays in that year are expected to

TABLE 1. TOTAL OLD AGE, SURVIVORS, DISABILITY, AND HOSPITAL INSURANCE (OASDHI) OUTLAYS AS A PERCENT OF THE FEDERAL BUDGET AND OF GROSS NATIONAL PRODUCT (in billions of dollars)

Year	OASDHI Outlays	Percent of Federal Budget	Percent of GNP
		Actual	
1950	.8	1.9	.3
1960	11.7	12.7	2.3
1970	36.8	18.7	3.8
1975	78.4	24.2	5.4
1980	152.1	26.2	5.9
		Projected	
1981	169.0	25.6	6.0
1982	190.6	26.6	6.0
1983	210.0	27.9	6.0
1984	231.0	28.9	5.9

NOTE: Projected figures based on CBO economic assumptions, September 1981.

be $260 billion for defense and $85 billion for net interest costs. Since total revenues in 1984 are projected to be about $750 billion, a balanced budget would leave little room for other federal spending unless benefits to individuals or spending for defense were to be reduced.

SOCIAL SECURITY IN THE RECENT PAST

This is the second time in four years that the Social Security system has faced projections of dangerously low reserves. When the Social Security Amendments of 1977 were passed, most analysts believed that financial soundness was guaranteed for the OASI and DI funds for at least the next several decades. At that time, the Social Security Administration's actuaries recognized that, under their economic assumptions, the margin for error in the trust funds would be quite small for at least the next five years. The economy's performance has in fact been significantly worse than was projected, resulting in Social Security's current funding difficulties.

A comparison of actual experience with the economic assumptions used by the Social Security actuaries to project trust fund balances illustrates these problems (see Appendix Table A). The 1977 Trustees' Report, for example, projected an increase in the Consumer Price Index (CPI) of 5.3 percent in 1979 and 4.7 percent in 1980. The actual increases in those two years, however, were 11.3 percent and 13.5 percent, respectively.

Inflation raises .trust fund outlays because benefit amounts are linked to the CPI, but in the past such increases have been offset by increased revenue increases resulting froa higher wages. In 1979 and 1980, however, prices rose faster than wages, •o that real wages declined by about 2 percent in 1979 and by 5 percent in 1980. The 1977 Trustees' Report, in contrast, had projected real wage increases of 2.5 and 2.4 percent for those two years. In fact, real wage growth has been ouch lower and inflation considerably higher than was anticipated even under the "pessimistic" set of economic assumptions used by the Social Security actuaries to project trust fund balances at the time of the 1977 Amendments.

The trust funds would have even greater financing problems were it not for the large—and to some extent unanticipated— growth in the labor force that has occurred over the last decade, and that has helped to increase tax revenues to the funds. This growth may, however, contribute to the long-run financing problems of the system when the time comes for this exceptionally large cohort of workers to retire.

Despite unprecedented growth in the labor force, the economy's failure to perform as well as projected has resulted in substantially lower trust fund balances than had been expected.

The combined OASI and DI trust funds' reserves at the beginning of calendar year 1981 amounted to 18 percent of annual outlays, compared with the 21 percent anticipated in the 1978 Trustees' Report. Trust fund reserves as low as this are a cause for some concern. A minimum reserve of 9 to 12 percent of annual outlays must be on hand at all times in order to pay benefits without delays and much larger reserves would be needed to provide a cushion against adverse economic conditions.

Given Social Security's sensitivity to economic performance, prudent budgeting may call for much larger trust fund reserves than have been realized in the recent past or than are currently anticipated. Without these reserves, frequent or sudden program changes may be required. In a program that represents a long-term commitment around which people plan their lives, such changes can cause substantial hardship and may undermine overall public confidence in the system. Larger reserves--such as the 75 percent of annual outlays recommended by the 1979 Advisory Council on Social Security--would insulate the Social Security programs from the consequences of unexpectedly poor economic performance.

SENSITIVITY OF THE TRUST FUND BALANCES TO ECONOMIC CONDITIONS

Any set of economic assumptions is highly uncertain, and the uncertainty grows as the period of projection extends further into the future. Despite such reservations, however, the CBO has prepared two sets of ten-year projections of trust fund incomes, outlays, and balances, using two sets of economic assumptions (see Tables 2 and 3).

The first set of assumptions is an extension of the CBO's baseline economic assumptions for the next five years. In this scenario, it is assumed that the trends in employment and growth projected through 1986 will continue through 1990. This set of assumptions is somewhat more optimistic than those used by the Social Security actuaries for the lower of their two intermediate economic paths.

The second set portrays a more pessimistic scenario, which builds on an alternative three-year forecast constructed by Data Resources, Inc. Under this scenario, slow money growth conflicts with the Administration's tax and spending policies to produce continued high levels of interest rates. Because nominal interest rates do not fall in line with the slower rate of inflation, real interest rates rise sharply in the early years. The result is significantly slower real growth than in the CBO baseline projection, and a growth rate in real wages comparable to that which occurred over the last decade. Even this set of assumptions is not extremely pessimistic, however, in that it too assumes steady economic growth and declining rates of inflation. (Both sets of assumptions are shown in Appendix Table B).

TABLE 2. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES, BY FISCAL YEAR (In Billions of dollars): BASED ON CBO ECONOMIC ASSUMPTIONS

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
				OASI						
Outlays	122.5	138.1	151.8	166.2	181.3	196.8	214.2	232.8	253.8	276.5
Income[a]	122.6	128.7	140.4	154.1	172.8	190.0	-205.4	222.7	239.1	271.4
Year-End Balance	24.7	15.2	3.8	-8.3	-16.8	-23.7	-32.5	-42.6	-57.3	-62.5
Start-of-Year Balance (as Percent of Outlays)	20.1	17.9	10.0	2.3	-4.6	-8.6	-11.1	-14.0	-16.8	-20.7
				DI						
Outlays	17.5	19.3	20.0	21.0	22.3	24.2	25.7	27.8	29.7	32.0
Income[a]	13.3	21.8	26.0	29.2	36.1	41.8	46.6	52.0	57.6	70.1
Year-End Balance	3.4	6.0	11.9	20.1	33.9	51.5	72.4	96.6	124.5	162.6
Start-of-Year Balance (as Percent of Outlaya)	43.9	17.8	29.9	56.8	90.0	139.9	200.5	260.6	324.9	389.2
				HI						
Outlays	29.0	33.2	38.2	43.8	50.1	57.0	64.2	73.6	83.6	94.9
Income[a]	33.0	38.4	42.8	47.3	53.1	61.3	67.4	73.0	78.0	82.8
Year-End Balance	18.4	23.7	28.3	31.8	34.9	39.2	41.8	41.2	35.8	23.5
Start-of-Year Balance (aa Percent of Outlays)	49.9	55.6	62.0	64.6	63.6	61.2	60.5	56.8	49.3	37.5
				OASDHI						
Outlaya	169.0	190.6	210.0	231.0	253.7	278.0	304.7	334.2	367.1	403.4
Income[a]	168.8	188.9	209.1	230.6	262.0	293.1	319.4	347.7	374.7	424.3
Year-End Balance	46.5	44.9	44.1	43.7	51.9	67.0	81.7	95.0	102.8	123.6
Start-of-Year Balance (aa Percent of Outlays)	27.7	24.4	21.4	19.1	17.2	18.7	22.0	24.5	25.9	25.5

SOURCE: CBO. Baaed on CBO's preliminary economic assumptions. Includes the effects of the Omnibus Reconciliation Bill of 1981.

NOTE: Minus sign denotes a deficit.

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

TABLE 3. **PROJECTIONS** OF SOCIAL **SECURITY** TRUST FUND OUTLAYS, **INCOMES,** AND **BALANCES,** BY FISCAL YF.AR **(In Billions** of **dollars):** BASED ON **PESSIMISTIC** ECONOMIC ASSUMPTIONS

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
OASI										
Outlays	122.S	138.3	152.4	166.7	181.6	197.6	214.2	232.1	252.2	274.2
Income[a]	121.5	127.1	137.5	147.6	163.9	179.0	192.6	208.7	224.2	254.9
Year-End Balance	23.6	12.5	-2.4	-21.6	-39.3	-57.6	-79.1	-102.5	-130.5	-149.7
Start-of-Year Balance (aa Percent of Outlays)	20.1	17.1	8.2	-1.5	-11.9	-19.9	-26.9	-34.1	-40.6	-47.6
DI										
Outlays	17.5	19.3	20.1	21.1	22.3	24.2	25.6	27.6	29.4	31.6
Income[a]	13.2	21.6	25.4	28.1	34.4	39.7	44.1	29.4	54.8	66.8
Year-End Balance	3.3	5.7	11.1	18.0	30.1	45.7	64.2	85.9	111.3	146.5
Start-of-Year Balance (aa Percent of Outlays)	43.9	17.4	28.3	52.4	80.7	124.4	178.3	232.5	291.9	352.4
HI										
Outlays	29.0	33.2	38.2	43.8	50.1	57.0	64.7	73.5	83.4	94.7
Income[a]	32.7	38.0	42.0	45.5	50.6	58.1	63.6	68.7	73.2	78.2
Year-End Balance	18.1	22.9	26.6	28.3	28.8	30.0	28.8	24.0	13.8	-2.7
Start-of-Year Balance (as Percent of Outlays)	49.9	54.6	59.8	60.7	56.7	50.6	46.3	39.2	28.8	14.6
OASDHI										
Outlaya	169.0	190.8	210.7	231.7	254.1	278.5	304.5	333.1	365.1	400.5
Income[a]	167.3	186.7	204.9	221.2	249.0	276.9	300.3	326.7	352.2	400.0
Year-End Balance	45.1	41.0	35.2	24.8	19.7	18.0	13.8	7.5	-5.4	-5.9
Start-of-Year Balance (aa Percent of Outlaya)	27.7	23.6	19.5	15.2	9.7	7.1	5.9	4.2	2.0	-1.3

SOURCE: CRO. Includes the **effects** of the **Omnibus** Reconclltatton **Bill** of **1981.**

NOTE: **Minus** stgn **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.**

Under the CBO's baseline projection, the three trust funds will continue to have a positive combined balance, although balances in the OASI fund will become negative in 1984 and will remain below zero for the rest of the decade. The combined balances of the three funds will continue to be low relative to total outlays, especially in 1984 through 1986. If borrowing among the three trust funds is authorized, however, the CBO projects at this time that trust fund balances would be just sufficient to allow payment of all benefits through 1990. Negative balances in the OASI fund will be offset by growth in the DI fund, and in the HI fund through 1987. After 1987, however, HI balances will begin to decline due to projected increases in hospital costs. By 1990 the combined balances of the three funds as a percent of outlays will also begin to fall.

Under the pessimistic scenario, the financial condition of the trust funds would be considerably worse. Under these assumptions, balances in the combined funds would fall below the level needed to pay benefits some time in 1985. Combined balances would continue to decline through the rest of the decade, and they would fall below zero in 1989. As under the baseline assumptions, the situation would be most critical in the OASI fund, although the HI fund would also begin to decline rapidly after 1986 and would be depleted by 1990. The balance in the DI fund would continue to increase as a result of the higher tax rates for this fund enacted in 1977. The growth in this fund's balance, however, would not offset the declines in the other two.

In short, although the CBO currently projects that the combined trust funds will maintain an aggregate balance sufficient to allow expected benefits to be paid over the next decade, the margin for error is very small. If economic conditions--especially real wage growth--are even slightly worse than now projected, legislative action beyond the authorization of interfund borrowing would probably be necessary to ensure the viability of the system.

OPTIONS FOR THE FUTURE

Four major types of action could be taken with respect to the Social Security trust funds. First, the Congress could choose to make no changes beyond the adoption of interfund borrowing. Some risks are inherent in this strategy, however, given the sensitivity of trust fund balances to adverse economic conditions and the very small margins for error anticipated over the next decade. Further, since Social Security does represent a long-term commitment that affects people's plans, making decisions about changes in the system as early as possible is desirable to allow potential beneficiaries some time to adjust.

Transfers to the Social Security trust funds from other parts of the budget represent a second possible course of action. One such plan--financing of one-half of HI benefits from general revenues, with the reallocation of about one half of HI taxes to the other two funds--has been proposed by Representative Pickle.

The CBO estimates that this would result in about $21 billion in additional revenues to the OASDI funds in fiscal year 1983, and about $100 billion through 1986. This amount would be enough to raise the combined reserve ratio to more than 40 percent by 1986. A change of this type would be simply a reallocation within the unified budget, however, and would not contribute either to balancing the budget or to reducing the growth of government spending.

A third type of option would generate additional trust fund revenues through tax increases. This could be accomplished by further increasing the Social Security tax rates, by raising the taxable wage base, or by taxing a portion of Social Security benefits and allocating the resulting revenues to the trust funds. Any of these options could be designed to restore financial soundness to the system, and all would move toward a balanced budget. Such tax increases might, however, have negative effects on labor supply and work incentives, and would do nothing to decrease the size of the government sector.

Reductions in benefit payments are the fourth possible course of action and the only one that would both contribute to a balanced budget and help to reduce the growth of government spending. So far, most Social Security benefit reductions have applied only to specific and relatively small groups of beneficiaries. Examples of further cuts of this type might include the cancellation of the earnings test exemption for workers between 70 and 72 years old, the elimination of benefits for otherwise unentitled parents of entitled children over 6 years old, and the extension of the family maximum benefit rates now applied to disability cases to retired worker and survivor families as well. Each of these proposals would save about $2 billion to $3 billion over the next five years, and total savings would be small relative to trust fund outlays. Only relatively fev beneficiaries would be affected, but reductions for many of these people would be very large.

In contrast, broad-scale benefit reductions affecting all beneficiaries in the same way would produce much greater savings and would not disproportionately affect specific recipients. Such benefit reductions could be designed to affect new beneficiaries only, or they could apply to both current and prospective beneficiaries.

Short-run savings would generally be limited for changes that affected only new beneficiaries, since even new beneficiaries would need some warning of major reductions. Longer-run savings, however, could be very large. Examples of this type of proposal would include raising the age of retirement, reducing incentives for early retirement, and changing the formula used to calculate initial Social Security benefits. Proposals to raise the retirement age almost all include lengthy phase-in periods, so there would be no immediate savings. On the other hand, the Administration's plan to reduce incentives for early retirement by lowering benefits for workers retiring at age 62 to 55 percent of the full benefit could save up to $17.6 billion by 1986. This proposal could seriously disrupt the retirement plans of people now nearing 62, however, if it were implemented without a phase-in period. The Administration's proposal to index the "bend points" in the Social Security benefit computation foraula by only 50 percent of the rise in covered wages over the next five years would be less disruptive. It would also produce substantial long-run savings--enough, in fact, to offset almost entirely the projected long-run deficit in the system. Savings through 1986 under this proposal would be about $4 billion.

Much larger short-run savings would result from changes in the way Social Security benefits are indexed--an approach that would affect current as well as prospective beneficiaries. Since benefit increases would be smaller for all recipients, immediate savings would be large. Benefits in relation to contributions would also differ less for workers retiring in different years than they would under proposals affecting new beneficiaries only.

In addition, many observers believe that Social Security benefits have been overindexed in the recent past, because of both the now-corrected technical flaw in the Social Security benefit -formula and the way homeownership costs are treated in the C?I. Further, prices have risen faster than wages over the last three years, which means that incomes of workers have declined relative to those received by Social Security beneficiaries.

On the other hand, large reductions in the cost-of-living adjustment (COLA) could create substantial hardships for those among the elderly with relatively low benefits and little other income. This would be especially likely if the changes applied not only to Social Security but also to means-tested entitlement programs such as Supplemental Security Income (SSI).

Benefit outlays could be reduced through indexing changes in several ways. Cost-of-living Increases could be postponed for a short period, an index other than the CPI could be used to calculate COLAs, or somewhat less than the total increase in the CPI could be used to adjust benefits. A three-month postponement of the COLA, from July to the start of the fiscal year in October, would save an estimated $2.9 billion in 1982. If this change were made permanent, total savings through 1986 would be $14 billion to $15 billion. Using the lower of wage and price increases to index benefits would save nothing in 1982, since wages and prices are expected to increase at similar rates, although this option would help to maintain trust fund balances if real wages fell in the future. Finally, if benefits were simply increased less than the full amount of the CPI, savings in the immediate future would probably also be less than under the proposal to postpone the COLA. Savings could be very large, however, if the cut in the COLA were repeated over several years. If the COLA were restricted to 85 percent of the CPI* in each of the next five years, cumulative savings through 1986 would be about $22 billion.

CONCLUSION

In summary, the performance of the economy is crucial to the financial position of the Social Security trust funds. Tinder the CBO's baseline assumptions, interfund borrowing alone will be just sufficient to allow benefits to be paid in a timely fashion throughout the 1980s. On the other hand, under slightly more pessimistic assumptions, trust fund balances are projected to decline below a viable level by the middle of the decade. Under these circumstances, either additional revenues to the trust funds or reductions in benefits will be necessary. Moreover, if the size of the federal budget is to decrease relative to the GNP, and substantial growth in spending for defense is to occur, reductions in Social Security benefits will almost certainly be needed.

APPENDIX TABLE A. COMPARISON OF SOCIAL SECURITY ADMINISTRATION TRUSTEES' INTERMEDIATE ECONOMIC ASSUMPTIONS WITH ACTUAL EXPERIENCE (in Percents)

Trustees' Report	Average Unemployment Rate	Increase in CPI	Increase in Average Covered Wages	Real Wage Increase
		For 1977		
1977 Report	7.1	6.0	8.4	2.4
1978 Report	7.0	6.5	7.7	1.2
Actual Experience	7.0	6.5	7.3	0.8
		For 1978		
1977 Report	6.3	5.4	8.1	2.7
1978 Report	6.3	6.1	7.2	1.1
1979 Report	6.0	7.6	8.5	0.9
Actual Experience	6.0	7.6	8.0	0.4
		For 1979		
1977 Report	5.7	5.3	7.8	2.5
1978 Report	5.9	6.1	7.9	1.8
1979 Report	6.0	9.4	8.3	-1.1
1980 Report	5.8	11.5	8.4	-3.1
Actual Experience	5.8	11.3	9.3	-2.0
		For 1980		
1977 Report	5.2	4.7	7.1	2.4
1978 Report	5.4	5.7	7.9	2.2
1979 Report	6.2	7.4	8.0	0.6
1980 Report	7.2	14.2	9.6	-4.6
Actual Experience	7.2	13.5	8.5	-5.0

SOURCE: Office of the Actuary, Social Security Administration

NOTE: Minus sign denotes decrease.

APPENDIX TABLE B. ECONOMIC ASSUMPTIONS UNDER TWO SCENARIOS, FISCAL YEAR 1981-1990 (in Percents)

Fiscal Year	Change in Real GNP	Unemploy- ment Rate	Change in CPI	Treasury Bill Rate	Change in Real Wages[a]
1981					
CBO Baseline	1.6	7.4	11.0	14.6	-1.4
Pessimistic	1.4	7.4	10.9	14.6	-1.9
1982					
CBO Baseline	2.7	7.4	7.8	12.7	.3
Pessimistic	1.3	7.6	8.1	14.5	-.7
1983					
CBO Baseline	4.1	7.0	7.0	11.8	1.4
Pessimistic	3.2	7.3	7.2	14.6	-.2
1984					
CBO Baseline	4.0	6.6	6.4	10.4	2.0
Pessimistic	2.2	7.3	6.2	13.6	1.0
1985					
CBO Baseline	3.8	6.3	6.0	9.4	1.3
Pessimistic	3.0	7.2	6.0	12.6	1.0
1986					
CBO Baseline	3.4	6.1	5.9	8.8	1.2
Pessimistic	3.0	7.1	5.7	11.5	2.2
1987					
CBO Baseline	3.1	6.0	5.8	8.1	1.3
Pessimistic	3.0	7.1	5.4	10.6	1.7
1988					
CBO Baseline	2.9	6.0	5.6	8.1	1.2
Pessimistic	2.9	7.0	5.8	9.6	1.7
1989					
CBO Baseline	2.8	6.0	5.6	7.8	1.1
Pessimistic	2.8	7.0	5.6	8.7	1.7
1990					
CBO Baseline	2.7	6.0	5.6	7.6	1.0
Pessimistic	2.7	7.0	5.6	8.1	1.1

SOURCE: Congressional Budget Office

a. Change in real average covered wages calculated on a calendar year basis.