Statement of

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Mr. Chairman and Members of the Committee:

I appreciate this opportunity to discuss with the Joint Economic Committee the financing problems confronting the social security system.

Over the next few years, the reserve funds of this system will be reduced because of the combined effects of inflation and recession. This depletion was to be expected. The crucial questions that need to be addressed are how long the trust funds' reserves will continue to be depleted and whether they will be replenished as the economy recovers. Predictions on the status of the trust funds' reserves in the early 1980s largely depend on the assumed future inflation and unemployment rates.

However, while the stability of the trust funds' reserves over the next five to ten years will depend most heavily on overall economic trends, other major factors affect the financial strength of the system in the future. Under any set of reasonable economic assumptions, it is clear that the current tax and benefit structure will not maintain the trust funds' solvency in the long run. The reasons for this are two fold: (1) the ratio of beneficiaries to workers will rise substantially after about 2012; (2) a flaw in the benefit computation formula will increase retirement benefits relative to earned wages especially after about 1995. These two factors have a significant impact on the future balance of trust fund income and outgo.

To correct these longer-run problems, changes in the benefit and/or tax structure are necessary, but need not be made immediately. However, because any legislation that corrects for the consequences of actual economic trends will affect the trust funds' reserves into the distant future, there is both the need and the opportunity for the Congress to consider the entire set of remedies together.

By addressing both the immediate and the longer-run problems now, Congress will also allay anxieties and uncertainties of the public concerning the financial stability of the social security program. Because workers are likely to make contributions for forty years before benefits begin and because social security is the foundation of their retirement plans, public acceptance and support of the program is important. Furthermore, public support may depend upon a better understanding of the system by the 100 million persons who are paying social security taxes and the 31 million persons who receive social security benefits.

My discussion today will focus upon the severity and causes of the solvency problems, both over the next five to ten years as well as over the next 20 to 75 years and how various possible solutions will affect the benefits to different types of individuals. Finally, I will discuss the advantages of considering the remedies to these financing problems together.

I. The Size and Nature of the Financing Problems

The social security system operates on a pay-as-you-go basis; it does not accumulate large revenues in order to finance future claims. Automatic tax and benefit adjustments were enacted in 1972 to balance receipts and expenditures. This adjustment permits the amount of earnings subject to the payroll tax to rise as average wages rise and the level of benefits to rise as consumer prices increase. These rate and benefit adjustments are expected to keep income and outgo roughly balanced on the average. In years of sustained growth, receipts grow faster than expenditures so as to produce a reserve. This reserve fund is expected to be drawn down in recession years or years when relatively large, rapid price increases occur without commensurate increases in taxable wages.

The tax and benefit adjustments enacted in 1972 would keep the funds in balance, on the average, if two economic assumptions prove correct: (1) that total wages subject to the payroll tax, on the average, increase by 6 percent annually because of increases in employment and current dollar wages, and (2) that prices, on the average, increase at 4 percent annually. Whether or not reserves are depleted depends upon the actual performance of the economy. If total wages increase more slowly, then revenues will be reduced. Also, higher rates of inflation mean higher trust fund outlays.

Between fiscal years 1970 and 1975, the trust funds' reserves increased from $37.7 billion to $48.1 billion. However, because the trust funds' outlays increased from $30.3 billion to $64.7 billion over the same period, the reserves as a ratio to current year's benefits fell from 125 percent to 75 percent. This substantial decrease in the ratio of reserves to annual benefits occurred as a result of both a short-fall in expected revenues (caused by high unemployment) and an unusually large increase in benefits (caused by rapid price increases).

Past inflation rates increased the base level of benefits, and it is largely because of this that absolute decreases in the funds' reserves can be expected over the next few years. But even this absolute reduction in reserves is not necessarily an indication of insolvency. The purpose of a reserve in a pay-as-you-go system is to cushion short-term financial shocks. Hence, the system is in need of adjustment only if:

- the financial condition is getting worse and gives no sign of correcting itself; or
- while capable of correcting itself, it appears to be running out of funds before it can correct itself.

Whether or not either of these conditions will hold over the next few years will be determined by actual performance of the economy. However, there is no question that a depletion of reserves will occur eventually under current policy because of the long-term demographic changes in the population and the legislated increases in benefits.

A separate but very important factor with a strong bearing on the trust funds' deficits over the next five years is the unforeseen and as yet unexplained rise in disability insurance costs. Because disability insurance may require special treatment of both an administrative and structural nature, it is preferable to discuss separately the Old Age and Survivors Insurance fund (OASI) and the Disability Insurance fund (DI).

OASI Fund Over the Next Five Years

The prognosis for OASI over the next five or so years depends upon macroeconomic events.

Table 1 compares the 1976 Trustees' Report projection (intermediate assumptions) and CBO's most recent estimate. The key difference in the assumptions is the higher inflation estimates in the Trustees' Report for fiscal years 1977 through 1979. The effect of this is to provide higher cost-of-living increases to beneficiaries, so that by 1981, the Trustees' estimates of fund disbursements is almost $4 billion higher ($108.0 billion versus $104.3 billion).

As can be seen from Table 1, both sets of projections show a deficit in every fiscal year from 1976 to 1981, although the CBO estimates reserves at the end of fiscal year 1981 of $31.4 billion, which is about $7 billion higher than the Trustees', mainly because of the lower rates of inflation assumed. Under both the Trustees' and CBO projections, the reserves at the end of fiscal year 1981 will be less than one-third of the annual benefits paid out.

Table 1 -- Comparison of Trustees' Projection (Intermediate assumption) and CBO Projection of the Progress of the Old Age Survivors Insurance (OASI) Trust Fund for Fiscal Years 1976-81

	1976	TQ	1977	1978	1979	1980	1981
Trustees' Projection (Intermediate Assumptions)							
Economic assumptions: calendar year							
Annual increase in wages (subject to SS tax)	77	--	8.5	9.4	8.5	7.7	6.7
Annual increase in prices	63	--	6.0	6.0	5.5	5.0	4.5
Rate of unemployment	7.7	--	6.9	6.6	6.2	5.7	5.2
Maximum taxable wage	15300.		16500.	17700.	19200.	21000.	22800.
Total income	62.4	16.6	71.8	79.1	87.2	95.6	103.3
Total outgo	64.2	17.2	73.4	81.5	89.7	98.7	108.0
Net increase	-1.8	-.6	-1.6	-2.4	-2.5	-3.1	-4.7
Reserve, end of year	38.1	37.5	35.9	33.5	31.0	27.9	23.2
CBO Projection							
Economic assumptions: calendar year							
Annual increase in wages (subject to tax)	7.0	--	8.0	8.0	8.3	8.1	8.1
Annual increase in prices	6.3	--	5.5	5.0	5.0	5.0	5.0
Rate of unemployment	7.4	--	6.6	6.6	6.0	5.5	5.0
Maximum taxable wage	15300.		16500.	17700.	19200.	20700.	22500.
Total income	62.5	16.7	71.7	78.7	86.4	95.1	102.9
Total outgo	64.4	16.8	73.8	80.3	87.5	95.4	104.3
Net increase	-1.9	-.1	-2.1	-1.6	-1.1	- .3	-1.4 *
Reserve, end of year	38.0	37.9	35.8	34.2	33.1	32.8	31.4

* The sharp increase in deficit results from a decline in tax rate as 0.1% of taxable payroll is shifted from OASI to DI under current law.

What is more disturbing than the continuous depletion of reserves during this period is the lack of a distinct turn-around in the reserve situation. Indeed, under the Trustees' projections, annual deficits appear to be growing larger. In the CBO projections, the annual deficit falls from $1.1 billion in fiscal year 1979 to $.3 billion in fiscal year 1980, but rises again in fiscal year 1981 to $1.4 billion. This increased deficit in 1981, however, results from the legislated decrease in the OASI tax and not from changed economic assumptions. In 1981, the OASI tax rate drops from 8.7 percent on taxable wages to 8.6 percent. (This tax is shifted to DI.) If this decrease in the OASI tax did not occur, then the projected OASI deficit in fiscal year 1981 would be approximately equal to that of fiscal year 1980.

The continuing strong deficit situation under the Trustees' estimates and the lack of a turnabout under the CBO estimates reflect the economic assumptions used. While the current tax and benefit structure of the social security system is based on a 4 percent increase in inflation and a 6 percent increase in taxable wages, the economic projections used by the Trustees and CBO have utilized higher rates of inflation which, in turn, are inadequately compensated by higher growth rates in taxable wages.

These projections raise questions about whether the automatic adjustments currently built into the social security system are adequate to maintain the solvency of the fund over

the next five to ten years. Indeed, the Trustees have shown under pessimistic economic assumptions for inflation and particularly unemployment that the OASI reserves could be exhausted by 1981. Of course, under more optimistic assumptions--that is, lower inflation rates and lower unemployment rates--a rebuilding of the OASI reserves would be projected.

OASI Beyond the Mid-1980s

If unfavorable economic conditions continue, then revenues could be increased to cover the short-fall in the near future. But small changes in revenues will not solve the deficit problem foreseen for the next 75 years.

The long-range deficit will require much more basic changes. The combined social security payroll tax rate (OASDI) is now 9.9 percent and will rise to 11.9 percent in the year 2011 under current law. In order to keep the funds in balance under current law, tax rates would have to be increased by 75 percent, averaging about 19 percent over the next 75 years. This is principally because of two factors: first, revised demographic projections which show fewer persons of working age compared to the number of social security beneficiaries; and, second, a defect in the automatic adjustments to the benefit formula written into law in 1972, containing an annual adjustment which causes future benefits to grow so rapidly for some groups that they will certainly exceed wages at retirement.

The seriousness of this problem was first brought to public attention in the 1975 Trustee's Report.

The Demographic Shift. Knowledge that those born during the postwar baby boom of 1947 to 1954 would be retiring in about 2012 to 2020 has long been built into the long-range projections. However, the continuation of the decline in the fertility rate following the baby boom and the depth of the decline have only recently been accepted as actuarial assumptions. These changes in fertility rates would bring about the lowest ratio of working age population to retired population that the system has ever experienced. The ratio will shift from 30 beneficiaries per 100 workers in 1975 to 50 beneficiaries per 100 workers in 2030. To fund the additional beneficiaries with the smaller ratio of taxpayers would require an increase of about 20 percent over scheduled tax rates for each worker.

The second factor is the benefit computation formula. It is worthwhile taking a closer look at the formula and its defect because major proposals to revise the formula are about to be presented to the Congress.

The social security benefit computation formula is simply an equation to determine how much of the earnings that were lost by retirement, death, or disability will be replaced by the benefit. The summary equation is:

(Average lifetime wages) x (wage replacement factor) *

= benefit amount

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* The wage replacement factor is the percent of average monthly wage to be replaced by benefits. It is not a single value. It is graduated into different values over dollar-range brackets so that persons with lower wages get a higher percentage of their former earnings replaced.

Under the statutory changes made in 1972, whenever benefits for those already on the rolls are increased to keep pace with the cost of living, the wage replacement factor is also increased by the same percentage. This was established to assure that every future retiree who had the same average lifetime wage as a current retiree could receive the same benefit. This adjustment or indexing overlooked the fact that average lifetime wages of the future retiree are also rising and, therefore, the benefit formula is actually overadjusted. Chart 1 illustrates this problem.

Until about 1995, this overadjustment compensates for a different adverse phenomena: the lengthening of the period over which wages are averaged. In 1950, the Social Security Act was amended so that the averaging period would include only those years since 1950. This means that until 1995, when the period stabilizes at 45 years, the averaging period will increase and therefore the average lifetime wage and the related benefit level would become smaller as a percentage of final wages.

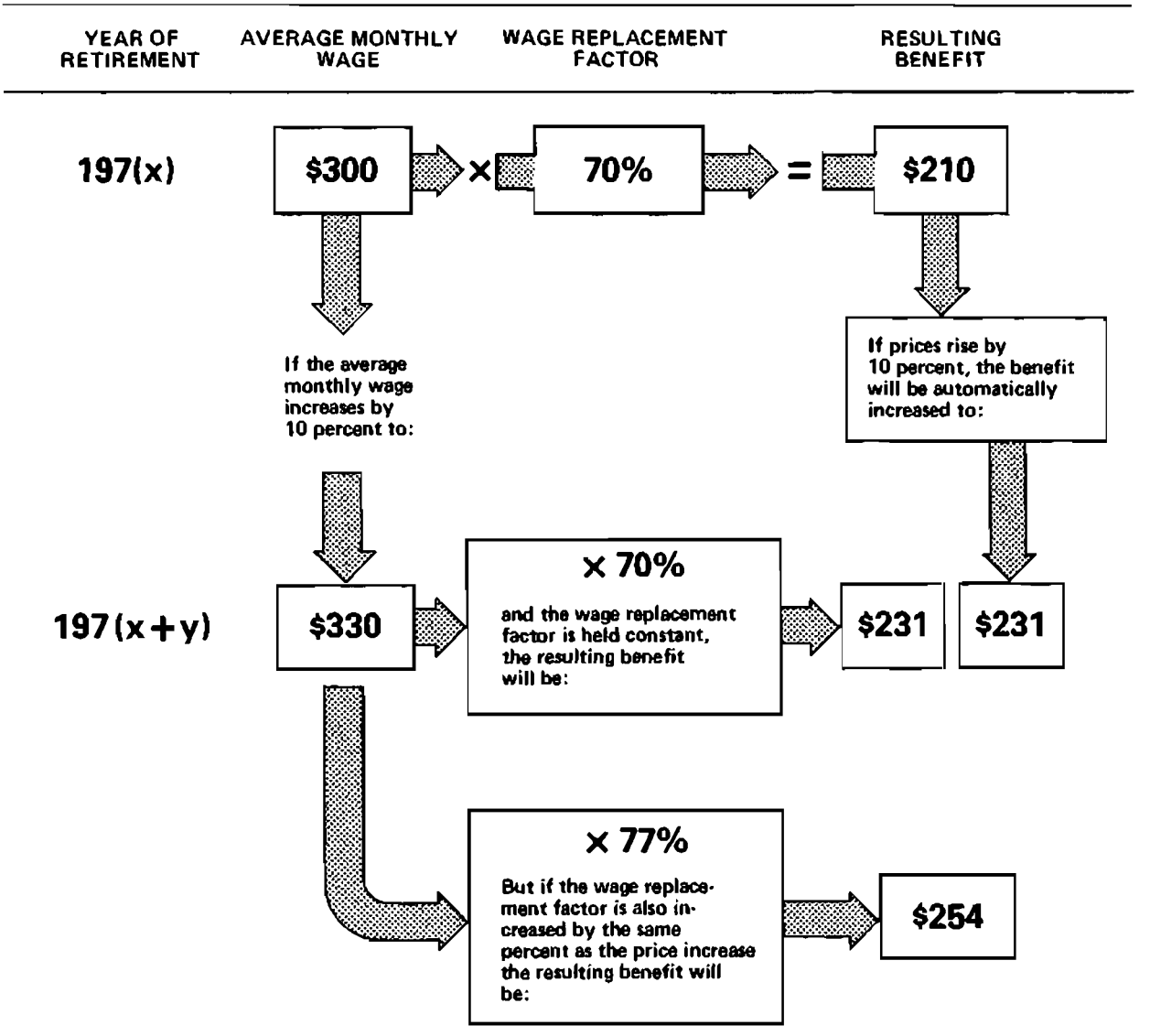
As a result, simply eliminating the indexing of the wage replacement factor (commonly known as "decoupling") would, if no other adjustment is provided, decrease the ratio of retirement benefits to final wages.

Disability Insurance

The Disability Insurance (DI) trust fund is in dire condition for reasons that go beyond those affecting the OASI fund. The DI fund is sensitive to the same economic changes as the OASI fund, and in fact more so to unemployment (because disabled workers are more vulnerable to loss of

Chart 1

HOW THE "COUPLED" BENEFIT FORMULA OVERADJUSTS THE OASDI PROGRAM FOR INFLATION



employment). However, a greater problem for this program is the continued and as yet unexplained increase in the number of beneficiaries. Since 1965, the number of new beneficiaries has risen sharply and the rate at which persons are leaving the benefit rolls has fallen sharply. As a result, the actuaries have revised their estimates of normal costs for this system six times since 1965.

Both the Trustees and CBO projections indicate (as shown in Table 2) that the DI fund reserve would be exhausted by fiscal year 1979. If special authority were to be enacted to allow funds to be shifted from the OASI to the DI trust fund, the combined fund reserves would be decreased by the rapidly increasing DI annual deficits. Without structural changes, the DI program would accumulate total deficits by fiscal year 1981 of $7.2 billion and $15.7 billion under the Trustees' and the CBO estimates respectively.

The difference between the Trustees estimates and the CBO estimates reflects different judgments as to whether the rate of new benefits will begin to stabilize. CBO has no basis to assume that the current rates will level off. They may, in fact, but the estimates can only reflect the current knowledge of probabilities. In any case, it is clear that some strong action will have to be taken before 1981 and that the action may include revision of both administration and structure of the fund.

Table 2 -- Comparison of Trustees' Projection (Intermediate Assumption) and CBO Projection of the Progress of the Disability Insurance (DI) Trust Fund for Fiscal Years 1976-81

	1976	TQ	1977	1978	1979	1980	1981
Trustees' Projection (Intermediate Assumptions)							
Total income	8.4	2.2	9.5	10.7	11.8	12.8	14.6
Total outgo	9.6	2.7	11.3	12.9	14.5	16.4	18.3
Net increase	-1.2	-.5	-1.8	-2.2	-2.7	-3.6	-3.7
Reserve, end of year	7.0	6.5	4.7	2.5	-.2 *	-3.8 *	-7.2*
CBO Projection							
Total income	8.3	2.2	9.4	10.6	11.6	12.7	14.5
Total outgo	9.6	2.7	11.9	13.9	16.4	18.0	20.7
Net increase	-1.3	-.5	-2.5	-3.3	-4.8	-5.3	-6.2
Reserve, end of year	6.9	6.4	3.9	.6	-4.2*	-9.5*	-15.7*

* Fund has no authority to go into a negative balance. These figures are demonstrative of what would happen if the fund were to borrow at prevailing interest rates.

In light of the fundamental differences in the nature of the OASI and DI problems, there would seem to be a very strong argument to treat the DI program separately with regard to remedies.

The House Ways and Means Committee is undertaking an intensive study of the program. There is some concern that the unpredictable increase may be due to:

a. Liberalization of the law;

b. A greater awareness of the program and a consequent larger application rate;

c. The accelerated increase in the administrative burden on the Social Security Administration through the assignment of the Black Lung and SSI programs which may have caused a deterioration in the quality of program operations; and

d. The increase in judgmental factors in the determination of disability.

Combined OASDI Trust Fund Reserves

The OASI fund is likely to have between $23 billion and $31 billion in reserves by 1981, and the combined reserves of OASI and DI trust funds could be between $15 and $16 billion. Even at this level of reserves, it would appear that the combined trust fund revenues will be adequate for the next several years

under all but the most pessimistic assumptions. However, if the annual deficit in DI continues at a rate of $4 to $6 billion, then the combined OASDI trust fund reserves could be depleted within a few years.

While such a prognosis does not necessarily warrant action this year or next, it is likely that steps will have to be taken within the next five years, if for no other reason than to correct for the deficiency in the DI fund. Congress could wait five years or more to determine how the long-term solvency problems should be handled. However, this might unnecessarily heighten public concern, particularly for those who depend on social security for retirement income.

II. Possible Remedies

A. Immediate Proposals

One option before the Congress is the President's proposal contained in the fiscal year 1977 budget. The proposal would increase the OASDI payroll tax by 0.3 percent of earnings subject to tax for both employer and employee and institute certain long-range reductions in benefit eligibility. The new tax rate would raise the current combined rate of 9.9 percent to 10.5 percent and would maintain a large positive balance in the combined OASI and DI funds through 1982. This proposal presumes that:

- -- Before the funds are depleted, Congress will take the next step of revising the benefit structure to correct for the overadjustment in future benefits, and
- -- Afterwards, Congress may, with less pressure, correct the remaining deficit over the long term.

Some may object to this approach, not only because of a disagreement about the need for action in this session, but because of the nature of the immediate action. An increase in the tax rate aggravates the regressive nature of the payroll tax and could increase inflationary pressures in the short run.

As an alternative, tax revenue can be increased, still within the payroll tax structure, by increasing the amount of earnings subject to tax. This would shift the additional burden to higher wage earners. The affected wage earners would not be paying a greater tax rate on their total wages than would persons with lower wages. However, a wage base increase is less efficient than a tax rate increase because it would create entitlement to higher benefits in the future. In fact, under the current program structure, these future benefit costs would actually increase the long-range deficit.

If immediate corrective action is deemed to be necessary, there are at least two other approaches besides revenue increases under the payroll tax structure that could provide temporary relief until permanent remedies are selected.

1. Provide a grant from general revenues. The amount needed, if no other remedies were adopted before 1981, would range from zero under the most optimistic economic assumptions to $13 billion under the Trustees' most pessimistic assumptions.

2. Emergency borrowing authority from the general fund. Congress could provide a limited authorization to cover temporary deficits by borrowing from the U.S. Treasury. Unlike an outright grant, it would permit the system to retain its self-financing structure while at the same time avoiding long-term measures to correct short-term crises. Provisions of this type have

been enacted in the past but have never been used. This alternative assumes annual surpluses in the future large enough to repay the loans.

B. Structural Reforms

Structural changes in the system include higher levels of revenues or lower levels of benefits. The higher levels of revenues may be achieved either by increasing the payroll tax or by some support from general revenues. The lower levels of benefits may be achieved either by a general reduction in benefit levels (lowering the ratio of benefits to final wages) or by selective reductions in eligibility and entitlement (reducing the progressive nature of the benefit, shifting some dependency and survivor benefits to other programs). The magnitude of the structural changes in revenues or benefits depends upon the extent to which revised economic assumptions differ from those now used in the social security system.

1. Higher Levels of Revenues

Increases in payroll tax. If the entire deficit were to be remedied by a one-time increase in the payroll tax rate, it would require an increase of 6 percent of taxable payroll in the OASI fund (63 percent higher than the current rate) and 2 percent of taxable payroll in the DI funds (128 percent higher than the current rate). These increases would have to be put in place at once.

If tax rates were increased annually by only enough to meet current costs, the tax rate for OASI would have to be 23.7 percent of taxable payroll in the year 2050 (119 percent over the rate currently scheduled for that year) and for DI it would have to be 4.87 percent (or 286 percent over the rate currently scheduled for that year). Table 3 summarizes these tax increases on annual and one-time adjustment bases.

Table 3: Current and Necessary Tax Rates as a Percent of Taxable Payroll a/

	Tax Rates in Current Law			Necessary Revisions		
Annual Adjustment	OASI	DI	Total	OASI	DI	Total
1975 (CY)	8.75	1.15	9.90	9.29	1.36	10.65
2050 (CY)	10.2	1.7	11.9	23.72	4.87	28.59
One-time Adjustment	9.43	1.54	10.97	15.42	3.51	18.93

a/ 1976 Trustees Report -- "intermediate" assumptions

Under an immediate or one-time increase, the fund would build up a huge surplus in the early years. With annual increases, the combined tax rate would have to be almost 29 percent of covered wages, a rate which would be intolerable.

Support from general revenues. There has long been controversy about the propriety of adding revenues to the system from general revenues. Those who argue against it defend their position mainly on the need to preserve the integrity of the self-financing system. Those who argue for general revenue

support defend their position mainly on the basis that a very large part of the benefit commitment is not entirely wage-related, but also includes income redistribution from the richer to the poorer participants. Under these circumstances, it is said to be inequitable to support such transfers of income with funds raised by regressive taxes, particularly when higher incomes derived from sources other than wages are not taxed.

2. Lower Levels of Benefits

General Benefit Reductions. Most proposals for correcting the benefit computation formula would eliminate the indexing of the wage replacement factor (the relationship of benefits to average wages) and replace it by indexing the earnings history. "Indexing" earnings history translates each past year's earnings into current year's values by multiplying the past year's earnings by the growth that has taken place in some other economic factor.

The two most popular alternatives for indexing earnings history are to index by (a) wages or (b) prices. The differences between them may become an important issue.

The Social Security Advisory Council of 1975 suggested wage-indexing the earnings history in order to stabilize the current relationship between benefits and final wages. All prior year wages would have the same comparative value as wages earned in the year before retirement. This approach would eliminate half the deficit.

Earnings history could also be indexed by price. Since prices over a long period of time do not grow as rapidly as wages, the relationship of benefits to final wages would decline continuously over time. Therefore, all other things being equal, price-indexing develops more savings. It could be employed to eliminate the entire deficit by itself. One should recognize, however, that this would be tantamount to an across-the-board reduction in benefit commitments for future retirees. This is the exact situation that many fear: Although taxes will remain high, future social security benefits as a percentage of final wages will be reduced.

The advantage of wage indexing is that it preserves the relative level of benefits with regard to current wages for all future beneficiaries. However, it produces less savings than price indexing.

The advantage of price indexing is that it produces more savings for the system. However, it does this by sustaining a high level of payroll taxes while reducing the relative level of benefits.

Those who argue for price-indexing contend that adjustments can be made later by future Congresses whenever they believe that to be necessary. Funds would have to be found at that time to finance any increases. These increases could be offset by other benefit reductions.

Earnings history is not the only element in the formula that can be indexed. In addition to, or instead of, earnings history, the dollar range of the brackets to which the wage replacement factors are applied can be indexed. Alternatively, other types of adjustments are possible, such as changing the length of the period over which earnings are averaged or the number of years that can be dropped out in calculating the average wage.

It is a crucial but not well understood point that while indexes and values of all the elements of the formula can be combined in a number of ways to produce many different results, each change in the valuation of any element in the formula will affect different groups of individuals differently. For example, workers whose earnings rise more slowly or end earlier in life than the average worker will be gainers in a formula that indexes earnings history (because it will increase the value of earnings earlier in life). About 12 percent of the population fall into this group. Wage indexing can increase the effective or countable average lifetime earnings of workers by as much as 50 percent; price indexing by as much as 25 percent. Increasing the number of years excluded from the period over which wages are averaged will benefit workers who move in and out of covered employment or whose earnings are highly variable.

Specific reductions in benefits. Except for those changes in the benefit computation formula which would involve drastic future reductions in benefits as a percentage of final wages, indexing benefits will eliminate only about half of

the long-term deficit. Other options to reduce benefits for more narrowly targeted groups should be considered.

For example, a large part of the costs under this system consists of income transfers from high-wage earners to the low-wage earners, or to the dependents of retired workers. The degree to which these transfers occur and are desirable in this system rather than in other public assistance systems is worth considering because: (1) social security is an inefficient system for delivering assistance to the poor; it uses average lifetime earnings as the criterion for current need, providing costly windfalls to some nonneedy; (2) particularly when the system is in serious deficiency, it may be appropriate to shift the financing of nonwage-related benefits to other programs, paid out of general progressive taxes, rather than to finance these benefits from the regressive payroll tax; and (3) there may never be a better opportunity than now, when there is a visible need to reduce costs, to reexamine the depth of involvement of this system in providing minimum income to all social security beneficiaries.

While it is possible to consider the structural proposals separately, this should not be done. They interact with respect to which individuals would be affected and by how much; with other income transfer programs; and with some of the immediate actions being proposed.

In summary,

1. While it does not seem to be necessary to act immediately to avoid undue risk to the short-term status of the fund, action is likely to be needed within five years.

2. It is desirable to consider measures that could be taken immediately in terms of their interaction with permanent structural changes.

3. Changes in the benefit computation formula, while necessary, are probably not sufficient to solve the long-term deficit.

4. There is time to consider other major permanent changes of a structural nature which, together with changes in the benefit computation formula, would be sufficient to restore long-term financial stability to the program.

5. This may be the most appropriate time for the Congress to think through a complete set of changes which would be adequate to solve the total financial problem while improving the equity of this important program.