

STATEMENT OF

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Mr. Chairman: I am pleased to appear before this committee to discuss Social Security financing. In my remarks, I will address three major issues:

- o Currently projected problems in the Social Security trust funds;
- o The nature and causes of the problems; and
- o The short-run options to remedy the situation.

CURRENT PROJECTIONS OF TRUST FUND BALANCES

The Congressional Budget Office projects that, by the start of fiscal year 1982, the balance in the OASI fund--the largest of the three trust funds that finance the Social Security system--will fall to 14.0 percent of the estimated \$141.4 billion needed for that year's outlays (see Table 1). 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. By early 1983, the OASI fund will be depleted. At the same time, however, the Disability Insurance (DI) trust fund appears to improve its position substantially through 1986, with reserves increasing to 112 percent of outlays. The Hospital Insurance (HI) fund's balance will remain at roughly 50 to 60 percent of annual outlays over the 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.

TABLE 1. 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	<u>b/</u>	<u>b/</u>	<u>b/</u>

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	5.1	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.

THE NATURE AND CAUSES OF THE PROBLEM

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

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 individual earnings grow more slowly than expected, revenues fall below projected levels. For example, a sustained one percent rise in the unemployment rate over three years can diminish all three trust funds' balances by as much as \$15 billion. At the same time, benefit payments are mainly a function of 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 and unemployment rates, and low growth in real earnings has led to the deterioration in the trust fund balances.

Although CBO's projections, like any economic forecasts, are uncertain and grow increasingly so as they go farther into the future, the immediate OASI problem seems clear. Even with some improvement in the economy during the next two years, the reserve positions of the trust funds are expected to weaken. High levels of unemployment are likely to continue

exerting pressure on the trust funds, as fewer workers contribute payroll taxes, and as a number of older workers retire sooner than they would have if the labor market were stronger. High rates of inflation, meanwhile, will lead to large automatic cost-of-living increases in benefits. CBO projects a benefit increase of roughly 12 percent in July 1981, adding some \$16 billion to outlays in 1982. 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.

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:

- o Changing the trust funds' accounting methods,
- o Modifying benefit amounts, and
- o Increasing or finding alternatives to the payroll tax revenues that finance the system.

Some of these options, taken alone, would maintain the trust funds only for an additional year or two; others, alone or in combination, however, would guarantee adequate reserves for longer periods.

Accounting Changes

I would like first to discuss three possible accounting changes:

- o Interfund borrowing among Social Security's three trust funds,
- o Realigning the payroll tax rates among the funds, and
- o Merging the three funds.

Neither benefit amounts, nor the scheduled payroll tax rates, would be affected by enacting any of these three options. Their potential as short-term solutions to the current OASI fund problem is based on the estimate that, all together, the three funds have adequate amounts on reserve to cover all three funds' anticipated obligations into 1984 (see Table 2). The first two of these three accounting options would respond to Congressional concern about maintaining the separate identities, hence the accountability, of the three funds.

TABLE 2. 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.

Interfund Borrowing. The Carter Administration's budgetary proposals for fiscal years 1981 and 1982 contained plans to allow one trust fund to borrow from the others as the need arose; the borrowing fund would make repayment when it could. 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. But by the start of 1985, according to CBO's estimates of a similar plan, additional measures would be needed.

Realignment of Payroll Taxes. Current law stipulates that the payroll tax revenues that finance Social Security are apportioned among the three trust funds at fixed percentage rates. The present alignment of tax portions has brought about the current imbalance among the funds. Thus, the Congress has the option of realigning the payroll tax portions, increasing the share earmarked for the OASI trust fund. The 96th Congress enacted a measure of this sort for fiscal year 1981 (Public Law 96-403) with the aim of giving this Congress time to examine Social Security issues in greater detail. A further tax realignment could accomplish roughly the same result as interfund borrowing.

Merging the Trust Funds. Merging all three trust funds into one new fund to serve as a repository for all payroll tax receipts is another possible approach. Although this option 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.

Benefits Changes

An alternative approach that would ease but probably not eliminate the cash flow problem would include a number of options to alter benefits. Some choices in this category would involve modifying the way annual cost-of-living benefit increases are calculated. Others would phase out or eliminate certain specific benefits.

Modifying the Annual Cost-of-Living Benefit Increase. To keep Social Security benefits abreast of inflation, they are indexed annually to reflect rises in the cost of living. Under current law, benefits are automatically adjusted each year according to changes in the CPI.

One deficiency in the present system of indexing is that the CPI overstates the actual rise in the cost of shelter and the importance of housing in total living costs. In its 1982 budget, the Carter Administration proposed switching to a variant of the CPI, the CPI-X1, which is based on a rental-equivalence approach to measuring housing costs. If the CPI-X1 were implemented in time to affect the July 1981 adjustment in Social Security benefits, fiscal 1982 outlays would be reduced by about \$2 billion. The impact on federal outlays in future years is very difficult to predict.

Alternatively, the Congress could cap the indexing of benefits. For example, limiting the July 1981 Social Security benefit increase to 85 percent of the increase in the CPI would lower fiscal year 1982 Social Security outlays by about \$2.8 billion. Such a limit could be justified on grounds that Social Security benefits have been increasing at higher rates than earnings,

and they are expected to do so again this year. But if an 85 percent cap were made permanent, substantial declines in real benefit levels would ultimately result. For example, by late 1986, benefits for the average retired worker would be about 8 percent lower than under current policy.

Alternatively, Social Security benefits could be indexed either to a cost-of-living measure or a wage-level measure, whichever was lower. This would mean that, in normal years, when wages rise faster than prices, the purchasing power of benefits would be protected. In periods of recession, however, when wages lag behind price increases, Social Security beneficiaries would not receive larger increases than the average wage earner. If this option were implemented for the 1981 benefit increase, it would reduce Social Security outlays by an estimated \$3.8 billion in 1982 and \$25.2 billion over the 1982-1986 period. Over time, though, it would lower real benefits below the levels anticipated under current law; the extent of the reduction would depend upon the performance of the economy.

Eliminating Certain Benefit Payments. A number of options to reduce or phase out certain specific benefits have been proposed by past Administrations. These options involve the phasing out of students' and certain parents' benefits, and the elimination of the lump sum death benefit and the newly awarded minimum benefits. One rationale for these proposals is that such benefits have recently been duplicated by other federal programs more directly targeted toward recipient groups. The enactment of these options would save more than \$1 billion in 1982 and approximately \$13 billion over the 1982-1986 period.

Revenue Modifications

Among the revenue options, one possibility would be to 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. A number of tax changes could raise the revenues needed by the OASI fund. One would follow past practice by raising the payroll tax rate for employers, employees, and self-employed persons. By itself, a permanent increase of 0.5 percent above currently scheduled rates (from 6.7 percent to 7.2 percent in 1982, for example) would just barely raise the revenues that the OASI fund will need by 1986; a more substantial increase of 1.0 percent would provide the system with a quite ample cushion (see Table 3). Another approach would involve eliminating the ceiling (now set at \$29,700) on wages subject to the payroll tax and taxing all earnings instead. This would meet almost all of OASI's needs through 1986.

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. To offset the increases mandated for 1981 and 1982 by the 1977 Social Security amendments, two bills have been introduced (in the House as H.R. 7046 and in the Senate as S. 44) that would allow employees and employers a refundable 10 percent credit on their payroll tax contributions. Credits to offset further increases could also be refundable and would be proportional to an individual's total payroll tax contribution.

General Fund Borrowing. Permitting Social Security to borrow funds from the Treasury would avoid tax increases or benefit cuts. It could, however, increase pressures on the federal budget, forcing cuts in other areas, increasing the size of the deficit, or creating an upward pressure on income taxes.

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. The plan would call for financing HI entirely from an earmarked portion of income tax revenues. One bill that has been recently introduced, H.R. 1018, proposes to finance only half of HI from general 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. If HI were financed entirely from general revenues and the overall payroll tax rate remained unchanged after 1981, OASI revenues could increase by \$25 billion in 1982 and by nearly \$190 billion through 1986 (see Table 3).

TABLE 3. 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 Rate by 0.5 Percent <u>b/</u>	10.0	15.6	17.5	19.5	21.8
Increasing Payroll Tax Rate by 1.0 Percent <u>b/</u>	20.0	31.1	34.9	39.1	43.6
Eliminating the Ceiling on Taxable Earnings <u>b/</u>	5.4	16.9	18.6	19.6	21.0
Reallocating the HI Portion of Payroll Tax Rate to OASDI <u>c/</u>	24.9	38.5	43.2	39.7	40.7

SOURCE: 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.

b/ As an offset to these payroll tax increases, H.R. 7046 (if extended beyond 1981) would reduce income tax revenues over the period by the following yearly amounts: \$13.2 billion, \$20.6 billion, \$23.1 billion, \$26.8 billion, and \$30.6 billion.

c/ 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.

Several Options in Combination

Taken alone, many 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 reappropriating part of the DI share of payroll tax revenues to the OASI fund.

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