STATEMENT OF

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

- Current projections of the financial status of the Social Security trust funds; and
- Short-run options to remedy the situation.

CURRENT PROJECTIONS OF THE TRUST FUND BALANCES

Based on the set of economic assumptions adopted by the Congress in the First Concurrent Resolution on the Budget for Fiscal Year 1982, the Congressional Budget Office projects that at the start of fiscal year 1983 the balance in the Old Age and Survivors Insurance (OASI) fund--the largest of the three trust funds that finance the Social Security system--will fall to 9.2 percent of the estimated $157 billion in outlays for that year (see Table 1). Approximately $1 billion will remain in the OASI fund by the end of that year; in the absence of legislative action, it will be depleted shortly thereafter. The Disability Insurance (DI) trust fund, however, is projected to improve its position substantially through 1986, with reserves increasing to 132 percent of outlays, while the Hospital Insurance (HI) fund's balance is projected to grow to over 80 percent of annual outlays over the period. Although the problem with the OASI trust fund is serious, there is no question that action by the Congress will guarantee the continued payment of benefits on time to Social Security recipients.

TABLE 1. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES, TO FISCAL YEAR 1986 (In billions of dollars)

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

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

The Nature of the Trust Funds

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

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

Sensitivity to Economic Conditions

The OASI fund's current difficulties result primarily from Social Security's sensitivity to the economy. Trust fund revenues are primarily a function of aggregate earnings. When unemployment rises and earnings grow more slowly than expected, revenues fall below projected levels. For example, a sustained 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 sensitive to price level changes, because benefit amounts are indexed annually to changes in the Consumer Price Index (CPI). When inflation rates are high, benefit payments grow

sharply. The recent combination of high inflation, relatively high unemployment rates, and low rates of growth in real earnings has led to the deterioration in the trust fund balances.

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

The current projections, shown in Table 1, are based on the economic assumptions underlying the First Concurrent Resolution: that the rate of inflation will fall to 6.2 percent by 1983 and 4.2 percent by 1986, and that the unemployment rate will fall to 5.6 percent by the end of 1986 (Table 2). These assumptions are similar to those of the Administration. Like any economic forecast, they are uncertain and grow increasingly so as they go further into the future. For this reason, it is frequently asked what effect a different set of economic assumptions would have on the trust fund projections. CBO has constructed a set of internally consistent alternative assumptions for its analysis of the Administration's 1982 budget request. Under these assumptions (also shown in Table 2), the inflation rate declines, but not by as much as under the economic assumptions of the First Resolution, reaching 8.9 percent in 1983 and 7.1 percent by 1986. The unemployment rate falls to 7.2 percent by 1986.

TABLE 2. ALTERNATIVE ECONOMIC ASSUMPTIONS, BY CALENDAR YEAR

	1981	1982	1983	1984	1985	1986
Real GNP (Percent Change, Year Over Year)						
First Resolution	2.0	4.2	5.0	4.5	4.2	4.2
Alternative	1.3	2.5	2.7	3.0	3.8	3.7
CPI (Percent Change, Year Over Year)						
First Resolution	11.1	8.3	6.2	5.5	4.7	4.2
Alternative	11.3	9.5	8.9	8.2	7.7	7.1
June Social Security Benefit Increase (Percent)						
First Resolution	11.2	9.3	6.6	5.8	4.9	4.4
Alternative	11.2	9.8	9.2	8.4	7.9	7.2
Unemployment Rate (Percent, Annual Average)						
First Resolution	7.5	7.2	6.6	6.4	5.9	5.6
Alternative	7.8	7.9	7.8	7.7	7.5	7.2

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

Both of these sets of economic assumptions forecast real economic growth in each year over the five-year period; no further downturns in the business cycle are forecast. Yet, even with the economy growing at only

slightly different rates, the difference between the economic assumptions results in a difference in the estimated combined OASI, DI, and HI trust funds' balances of $60 billion by the end of 1986. If real growth should continue at the levels that have occurred over the most recent past instead of at the higher levels projected under both sets of economic assumptions, the problem in the trust funds would worsen.

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

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

SHORT-RUN OPTIONS

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

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

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

Accounting Changes

I would first like to discuss three possible accounting changes:

- 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 accounting options. The first two of these three accounting options are implicit in the Administration's plan for Social Security, and are spelled out in detail in the current financing bill before the Social Security Subcommittee of Ways and Means (H.R. 3207).

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

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

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

Realignment of Payroll Taxes or Merging the Trust Funds. Similar results could be achieved by realigning the way the payroll tax is apportioned among the three trust funds or by merging the funds into one new fund. The 96th Congress enacted a realignment measure for fiscal year 1981 (Public Law 96-403) with the aim of giving this Congress time to examine Social Security issues in greater detail. Merging all three trust funds into one new fund could lead to some loss of Congressional control in monitoring the status of the three programs. Maintaining a separate accounting system for each program could offset this disadvantage, however.

Benefit Changes

An alternative way of easing the cash flow problem would alter benefits. Some choices in this category would involve modifying the way annual cost-of-living benefit increases are calculated. Other alternatives, involving selective benefit reductions, have been reported by the Senate Finance and by the House Ways and Means Committees in their

reconciliation packages sent to the Budget Committees. If these packages become law, the trust funds, with interfund borrowing or the realignment of the payroll tax rate, should be able to meet cash benefit payments without further action over the next five years under either set of economic assumptions.

Modifying the Annual Cost-of-Living Benefit Increase. To keep Social Security benefits abreast of inflation, they are automatically indexed annually to reflect rises in the CPI. These adjustments are costly; the increase in benefits resulting from the automatic indexing provision will add $3.5 billion to expenditures in fiscal year 1981, approximately $18 billion in fiscal year 1982, and a total of between $217 billion and $258 billion over the 1981 to 1986 period.

There are a number of rationales for modifying the way benefits are adjusted for inflation. Benefit increases might be capped at some percent of the CPI's growth rate, compensating for past increases in the replacement rate resulting from a technical flaw in the indexing mechanism. Such a limit could also be justified on the grounds that Social Security benefits have been increasing at higher rates than average earnings, improving the Social Security recipients' position relative to workers, or on the basis that housing costs have overstated the increase in the cost of living as measured by the CPI. Limiting the July 1982 Social Security benefit increase to 85 percent of the increase in the CPI, for example, would lower fiscal year 1982 Social Security outlays by about $0.5 billion. It would lower outlays in 1983 by much more since that would be the first full year the option was in effect. Outlays would be $2.5 billion lower under

First Resolution assumptions and $2.9 billion lower under the alternative set in 1983. Alternatively, the Congress may chose to look at another index by which to adjust benefits, such as a rental-equivalent CPI or a wage index. The impacts on federal outlays of these options are very difficult to predict, however.

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

Eliminating Certain Benefit Payments. Several options to reduce or phase out certain specific benefits have been proposed by past Administrations. These options involve the phasing out of students' benefits, and the elimination of the lump-sum death benefit and the minimum benefit. One rationale for these proposals is that such benefits have recently been duplicated by other federal programs more directly targeted toward recipient groups. These options have been included by the Senate Finance Committee in their reconciliation instructions. Along with provisions to tighten eligibility for Disability Insurance and a few other changes, the Senate Finance Committee bill would add over $2.5 billion in 1982 to the trust funds, and more than $25 billion over the five-year 1982-1986 period. Along with interfund borrowing, these options would be sufficient to ensure

benefit payments through 1986, maintaining the combined trust fund balances at over 12 percent of outlays in each year even under the alternative set of economic assumptions.

Revenue Modifications

A number of tax changes could raise the revenues needed by the OASI fund. Among the possible revenue options, one would allow the Social Security system to borrow from the general fund in times of economic stress. Other options would involve further payroll tax increases or the introduction of income tax revenues, either directly or indirectly, to support the three trust funds.

Payroll Tax Changes. Congress could follow past practice by raising the payroll tax rate for employers, employees, and self-employed persons. An increase in currently scheduled rates of between 0.5 percent to 1.0 percent would alone raise the revenues that the OASI fund will need by 1986. Along with one of the accounting options, such an increase would provide the system with an ample trust fund reserve in the short run. To lessen the inflationary and other restrictive economic effects of a payroll tax increase, such an increase could be accompanied by an income tax credit or deduction. These tax credits could be refundable and would be proportional to an individual's total payroll tax contribution.

General Revenue Financing. Both the 1979 Advisory Council on Social Security and the National Commission on Social Security have recommended reallocating the HI share of the payroll tax rate among the OASI and DI trust funds, while also lowering the overall rate. Various plans call for financing either all or one-half of HI from an earmarked portion of income tax revenues. Financing HI program benefits in this manner has been justified on the grounds that such benefits are not related to lifetime

payroll tax contributions and therefore need not be paid for from a separate fund financed by a payroll tax. Such a tax change would help reinforce the OASI fund.

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

Both general revenue financing and general fund borrowing, however, have potential shortcomings. They could increase pressures on the federal budget, forcing cuts in other areas, forestalling reductions in the size of the deficit, or creating an upward pressure on income taxes.

Several Options in Combination

Taken alone, many of the options outlined above offer limited potential to solve the OASI trust fund's financing problem. Accounting changes alone could entirely ease the short-run problem, at a minimum, under optimistic economic assumptions, but would not do so with less optimistic ones. The OASI trust fund will certainly need additional funds within the coming 18 months. Accounting changes, given no further downturn in the business cycle, could allow continued payments 2 or 3 additional years before more changes could be needed. But if several actions were taken simultaneously, the fund's prospects could be markedly improved. Combining any one of the three accounting changes, for example, with one of the possible modifications in the indexing mechanism would put the OASI fund in a secure position through the end of fiscal year 1986 under current projections. Similarly, the adequacy of the OASI fund could be

assured by enacting a 0.5 percent payroll tax increase above currently scheduled rates, while at the same time reapportioning part of the DI share of payroll tax revenues to the OASI fund.

A More Adequate Reserve

Thus far, I have discussed options in terms of their potential to enable the system just barely to maintain benefit payments with some minimum level of trust fund reserves. The Congress, however, may wish to consider building up the funds to a more adequate level. The trust fund balances can be viewed as contingency reserves to enable the system to absorb unexpectedly large differences between revenue and outlay flows that occur during recessionary (and other) periods. Studies have shown that an adequate contingency reserve during these periods would require balances of between 60 and 100 percent of outlays at the start of the year. This level of reserves, it is argued, would be sufficient to maintain the system through a further economic downturn slightly more severe than that of 1974-1975 without having to raise taxes or lower benefits until a recovery was under way.

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

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