

On the other hand, a reduction that affected all beneficiaries equally--for example, a proportional reduction in the benefit formula--could threaten the adequacy of retirement incomes for some recipients. Increases in the age of retirement could also have that effect, since those who retire early often have both lower lifetime earnings and less access to other sources of retirement income than those who continue working. The impact of changes in the retirement age on benefit adequacy could be particularly large for those who have health problems that are not sufficiently severe to qualify them for disability benefits, or who become unemployed relatively late in life.

A similar trade-off would affect retirees in different generations. Current retirees are receiving relatively high benefits compared with their Social Security contributions, both because benefit levels were increased substantially during the 1970s and because many have not contributed to the system over their entire working lives. For this reason, benefit reductions that would affect only those retiring in the fairly distant future would reduce rates of return for beneficiaries who, even under current law, will have lower benefits relative to their contributions than those who are retired now or who retire in the near future. If such options were combined with tax increases affecting current workers, who will become future beneficiaries, rates of return for this group would fall even more. On the other hand, since incomes are projected to grow over time, reductions affecting future beneficiaries might have less impact on income adequacy than would reductions in the benefits of current recipients.

Similar considerations apply to options designed to stabilize trust fund balances. If the trust funds were supplemented from general revenues during a recession, the costs would in effect be borne by taxpayers--that is, primarily by workers. If, on the other hand, benefit increases were linked to some form of wage index or to the lower of wages and prices, retirees would share the burden of poor economic performance through reductions in the purchasing power of their benefits. During an extended recession, this type of option could significantly increase poverty among the elderly.

### Combinations of Options

Finally, it may be desirable to combine two or more of the options. This could be done in such a way as to add resources to the system as they were needed, thereby avoiding large buildups in trust fund balances. Adjustments could be made if economic conditions turned out to be either better or worse than expected. Combining options could allow the burdens of tax increases and benefit reductions to be spread over a large number of workers and beneficiaries, thus minimizing the impact on any one person.

If options affecting the same groups were combined, however, the total impact on individuals could be very large. For example, if an increase in the age of eligibility for full retirement benefits was combined with one of the changes in the benefit computation formula analyzed in this paper, benefits at age 65 could be reduced by almost one-fourth relative to what they would be under current law.<sup>5</sup> Even for those aged 68, the combined reduction could still be about 13 percent. Similarly, if payroll tax increases were the sole means of eliminating the projected long-run deficit, future Social Security tax burdens would increase by about 15 percent on average over the next 75 years.

Large cumulative effects could be avoided by combining options that did not affect the same groups at the same time. For example, a formula change or an increase in the retirement age for future retirees could be combined with a tax increase affecting primarily workers or with a benefit reduction affecting primarily current beneficiaries. Under such combinations, each person would be affected less, at least at any one time, than under a combination of benefit reductions or a series of payroll tax increases, although some people might be affected at different times in their lives both as workers and as recipients. In addition, by combining options such as a formula change or an increase in the retirement age with a tax increase taking place after 2020, for example, the buildup of much larger reserves than under current law could be avoided.

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5. See Chapter VIII for further details.

**Financing Social Security:  
Issues and Options for the Long Run**



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## CHAPTER I. INTRODUCTION

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The Social Security system faces both a long-term and a short-term financing problem. The long-term problem stems primarily from changes in the age structure of the population that are expected to occur after the year 2000. The short-term problem reflects the current economic situation, which has caused Social Security outlays to rise faster than receipts. Although some action will be necessary within the next year to allow the continued payment of benefits, as the economy recovers payroll tax receipts should provide enough income to cover outlays for retirement, survivors, and disability benefits until the ratio of workers to beneficiaries begins to decline rapidly after 2010.<sup>1</sup>

The long-term problem for Social Security is primarily demographic rather than economic in nature. A decline is expected in the number of workers contributing to Social Security, relative to the number of people receiving Social Security benefits. In 1980, there were about five people of working age for every person age 65 or over. By 2030, when the "baby boom" generation has retired, that ratio is expected to be cut in half, to about two and one-half working-age persons to each person 65 or over. If Social Security benefits were maintained at the same levels as under current law, therefore, and if no other major changes were made in the program, workers would have to contribute a larger proportion of their earnings to Social Security than is now required.

The ratio of workers to beneficiaries at any point in time is important for Social Security, because the system is funded on a pay-as-you-go basis.

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1. The Social Security system consists of three trust funds--the Old Age and Survivors Insurance (OASI) fund, the Disability Insurance (DI) fund, and the Hospital Insurance (HI) fund. Benefits for retirees and their families and for survivors of deceased workers are provided through the OASI fund, the largest of the three funds. Under current law, however, balances in this fund are projected to be so low by the middle of 1983 that action will be needed to pay all benefits on time. Even if authorization for this fund to borrow from the other two trust funds is extended past the current expiration date of December 1982, the problem will be only temporarily postponed. By 1985, reserves in the three funds combined are projected to be too low to allow all benefits to be paid in a timely fashion. For further details on the short-run financing problem, see Appendix C.

In other words, current tax receipts are used to pay current benefits, rather than being held in reserve to pay benefits for today's workers when they retire. The system does build up reserve funds when tax receipts exceed benefit payments, which it draws against in periods when benefit outlays exceed income. In the last 20 years, however, these funds have never held more than the equivalent of two years' total benefit payments.<sup>2</sup>

The projected decline in the ratio of workers to beneficiaries over the next 75 years is such that--under current law--the income received by the Social Security system is expected to average about 13 percent less than the annual outlays needed to pay benefits.<sup>3</sup> This gap, although large, is not as large as might be anticipated, given the increase in the relative size of the beneficiary population. There are two major reasons for this. First, payroll tax rates are already scheduled to rise under current law, in 1985 and 1990. Tax rates for employers and employees and the self-employed will go up about 15 percent between 1982 and 1990. Second, and even more important, these projections assume that real wages--that is, wages adjusted for inflation--will grow by about one and a half percent a year, on average, over the next 75 years. This rate of growth, which is expected to result in a similar growth in payroll tax receipts, is high compared with the experience of the last 5 years, when real wages have declined by an average of 1.7 percent per year. It is quite comparable to the rate of growth in average annual wages over the 15 years before that, however.

Social Security balances are expected to fall in the 21st century even if the economy performs better over the next few decades than it has in the recent past. The magnitude of the problem will depend to some extent on factors such as productivity increases, birth rates, and mortality rates over the next three or four decades. While these variables are difficult to

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2. While this statement is true of the combined reserves of the three Social Security trust funds, individual funds have accumulated larger reserves in relation to their particular benefit outlays. Unless special enabling legislation is passed, reserves in one trust fund cannot be used to pay benefits from another.
  3. This includes taxes and outlays for the OASI and DI programs only. Unless otherwise stated, all long-run projections given in this paper are based on the Alternative II-B economic and demographic assumptions of the 1982 Annual Report of the Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds. The CBO does not develop long-run economic projections. The II-B assumptions are given in Appendix B, which also summarizes long-run actuarial cost and revenue estimation methods.

predict accurately, a long-run deficit for the trust funds is projected under all but the most optimistic economic and demographic assumptions.<sup>4</sup>

Thus, it may be desirable to enact legislation now to strengthen the financial position of the system over the long run. In a program like Social Security, around which people make long-term plans and decisions, sudden changes can prove very disruptive. Further, frequent changes and projections of long-run insolvency undermine public confidence in the system.

Long-run balances can be improved in only two major ways: revenues can be increased, or benefits can be reduced relative to the levels they will reach under current law. This paper focuses on these options, and analyzes several specific proposals of each type. In addition, it examines some recent proposals to stabilize trust fund balances in order to prevent recurring fluctuations resulting from cyclical economic performance.

Two important caveats need to be mentioned before the plan of the paper is presented. First, this paper deals only with the two Social Security trust funds that provide cash benefits--the Old Age and Survivors Insurance (OASI) fund, which provides benefits for retirees and their families and for the survivors of deceased workers, and the Disability Insurance (DI) fund, which provides benefits for disabled workers and their families. The third Social Security trust fund financed through payroll taxes, the Hospital Insurance (HI) trust fund, provides hospitalization benefits under Medicare, and is projected to have much more severe long-run financing problems than the OASI and DI funds.<sup>5</sup> Both the causes and the timing of these problems, however, are different from those facing OASI and DI. Consequently, options for change in HI also differ substantially and therefore are not addressed in this paper.<sup>6</sup>

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4. In this context, the term "optimistic" means favorable to the trust funds. Thus, an optimistic path is one that combines strong economic performance with high mortality and fertility rates. The sensitivity of the long-run estimates to economic and demographic assumptions is discussed in more detail in Chapter II.
  5. Medicare benefits other than hospitalization benefits are provided through the Supplementary Medical Insurance (SMI) fund. Although SMI is technically part of the Social Security system, it is funded through general revenues and premiums paid by beneficiaries rather than through the payroll tax, and is not discussed in this paper.
  6. For more information on problems facing the Medicare program and on options for that program, see the forthcoming CBO paper on the benefit structure of Medicare.

Second, this paper considers only incremental changes in the Social Security system. It assumes, for example, that Social Security benefits will continue to be linked to lifetime earnings through a benefit computation process similar to that now employed. Similarly, it assumes that financing for Social Security will continue, at least primarily, to be provided through specially earmarked tax revenues. Further, only options aimed primarily at ameliorating the financial problems of the system are discussed here. In the recent past, a number of plans for a more complete restructuring of the Social Security system have been proposed, but these are beyond the scope of this paper. Options of this type include, for example, plans to divide benefits into two parts, one means-tested and the other linked to earnings;<sup>7</sup> earnings-sharing between spouses; and the elimination of benefits for spouses and dependents.<sup>8</sup>

Instead, this paper focuses on options to improve the financial position of the trust funds without changing the basic structure of the system, by reducing benefit levels or by increasing revenues. The next chapter discusses the magnitude of the projected long-run financing problem, and briefly describes the major approaches to its solution discussed in the remainder of the paper. Chapter III outlines the basic benefit computation procedure, in order to allow a better understanding of the specific options presented in the next three chapters. Chapters IV and V analyze two major ways in which outlays for benefits could be reduced relative to current law over the long run: lowering the levels of initial retirement and disability benefits through changes in the computation formula, and raising the retirement age. Chapter VI considers changes in benefit indexation procedures aimed at stabilizing trust fund balances over the long run. Chapter VII then examines various alternatives for generating additional trust fund revenues. The final chapter presents the comparative implications of different means of reducing benefits or raising revenues, and also briefly discusses the effects of combining options of two or more types.

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7. See Michael Boskin, ed., The Crisis in Social Security: Problems and Prospects (Institute for Contemporary Studies, 1977).
  8. See U.S. Department of Health, Education, and Welfare, Social Security and the Changing Roles of Men and Women (February 1979); Rita Ricardo Campbell, Supplementary Statement to the Report of the Quadrennial Advisory Council on Social Security (May 1975); and Virginia Reno and Melinda Upp, "Social Security and the Family," American Enterprise Institute Conference on Taxation and the Family, October 1981.

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## CHAPTER II. THE LONG-RUN FINANCING PROBLEM: BASIC APPROACHES

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As discussed in Chapter I, the Social Security program faces a long-run financing problem because of the expected growth in the number of beneficiaries relative to the size of the working population. This chapter considers the dimensions of that problem, provides some background information on the Social Security system, and outlines some options for improving trust fund balances over the long run.

### MAGNITUDE OF THE LONG-RUN FINANCING PROBLEM

Over the next 75 years, the Social Security system is expected to have a deficit equal to about 13 percent of annual outlays, on average. Deficits will vary considerably over time, however, as Table 1 shows. Under current projections, trust fund balances will build up between 1990 and 2015, then decline fairly rapidly, and will be depleted sometime between 2025 and 2030.<sup>1</sup>

The estimates of tax rates, costs, and differences shown in Table 1 are all given as percentages of "taxable payroll," which is the total wage base subject to Social Security taxes--about \$1.36 trillion in 1982.<sup>2</sup> Thus, the long-run average yearly deficit in OASDI of 1.82 percent of taxable payroll would be equivalent in 1982 to an annual deficit of about \$25 billion.

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1. Unless otherwise stated, all long-run projections given in this paper are based on the Alternative II-B economic and demographic assumptions of the 1982 Annual Report of the Board of Trustees, Federal Old Age and Survivors Insurance and Disability Trust Funds. The CBO does not develop long-run economic projections. The II-B assumptions are given in Appendix B, which also summarizes long-run actuarial cost and revenue estimation methods.
  2. The 1982 Trustees' Report defines taxable payroll as follows:

Taxable payroll is defined as that amount which, when multiplied by the combined employee-employer tax rate, yields the total amount of taxes paid by employees, employers, and the self-employed. In practice, the taxable payroll is calculated as a weighted average of

TABLE 1. OASDI TAX RATES, COST RATES, AND RATIOS OF BALANCES TO OUTLAYS, SELECTED YEARS 1985-2060

Year	As a Percentage of Taxable Payroll <sup>a</sup>			Start-of-year Balances as a Percentage of Outlays
	Tax rate <sup>b</sup>	Cost rate <sup>c</sup>	Differenced <sup>d</sup>	
1985	11.40	11.70	-0.30	-4
1990	12.40	11.64	0.76	-19
1995	12.40	11.42	0.98	15
2000	12.40	11.03	1.37	64
2005	12.40	10.95	1.45	128
2010	12.40	11.53	0.87	177
2015	12.40	12.82	-0.42	177
2020	12.40	14.44	-2.04	125
2025	12.40	15.97	-3.57	31
2030	12.40	16.83	-4.43	e
2035	12.40	17.02	-4.62	e
2040	12.40	16.80	-4.40	e
2045	12.40	16.66	-4.26	e
2050	12.40	16.72	-4.32	e
2055	12.40	16.81	-4.41	e
2060	12.40	16.81	-4.41	e
25-year Averages				
1982-2006	12.01	11.37	0.64	33
2007-2031	12.40	14.08	-1.68	e
2032-2056	12.40	16.81	-4.41	e
75-year Averages				
1982-2056	12.27	14.09	-1.82	e

SOURCE: 1982 Annual Report of the Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds; based on Alternative II-B assumptions.

- a. Taxable payroll is the total of all wages on which Social Security taxes are paid, adjusted for differences in tax rates.
- b. Combined employee-employer tax rate for the OASDI funds.
- c. Cost rate is estimated outlays as a percentage of taxable payroll.
- d. Difference between tax rates and cost rates.
- e. Balances become negative during remainder of the projection period.

Estimates of long-run Social Security costs and revenues are generally expressed as a percentage of taxable payroll rather than as dollar amounts because wages and prices are expected to grow at different rates over time, and it is therefore difficult to assess the meaning of estimates given in terms of future dollars. Taxable payroll provides a useful standard of comparison for long-run costs and revenues, since it is the basis on which revenues are calculated. Social Security revenues can be estimated simply by multiplying taxable payroll by the combined payroll tax rate, since payroll tax receipts account for almost all trust fund revenues.<sup>3</sup> If long-run costs (that is, benefit payments) are also expressed as a proportion of taxable payroll, they can be compared directly with tax rates, to get an estimate of the surplus or deficit in any given time period.

In considering these estimates, it may be helpful to remember that, in 1982, 1 percent of taxable payroll equals almost \$14 billion. Thus, for example, a difference between Social Security costs and revenues of 4.43 percent of taxable payroll, as is projected in 2030, would equal about \$60 billion if it occurred in 1982.

Several important factors must be considered in assessing the estimates of the magnitude of the long-run financing problems shown in Table 1. For example, although costs are projected to rise faster than revenues, they are not projected to rise as much relative to the gross national product (GNP). Over the next 20 years, total costs will actually decline relative to GNP, from about 5 percent now to less than 4.4 percent in 2005. They will then start to rise, reaching a peak of just over 6 percent of GNP in 2030 (see Table 2). Even if benefits are maintained at current law levels, therefore, the tax rates necessary to pay for them may not increase in proportion to the increase in the population who will be beneficiaries if the economy grows as projected over this period.

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the earnings on which employees, employers, and self-employed persons are taxed. The weighting takes into account the lower tax rates on self-employment income, on tips, and on multiple-employer "excess wages," as compared with the combined employee-employer rate.

3. In addition to payroll taxes, the OASDI trust funds also receive interest on their reserves, and a very small amount of income from general revenues that is used to pay for special benefits not funded through the payroll tax.

TABLE 2. OASDI TAX REVENUES AND COSTS IN RELATION TO GROSS NATIONAL PRODUCT, SELECTED YEARS 1985-2060

Year	As a Percentage of GNP		
	Tax Revenues	Costs	Difference <sup>a</sup>
1985	4.92	5.05	-0.13
1990	5.27	4.94	0.33
1995	5.17	4.76	0.41
2000	5.03	4.48	0.55
2005	4.95	4.36	0.59
2010	4.85	4.51	0.34
2015	4.76	4.92	-0.16
2020	4.66	5.44	-0.78
2025	4.58	5.90	-1.32
2030	4.49	6.10	-1.61
2035	4.41	6.05	-1.64
2040	4.33	5.86	-1.53
2045	4.24	5.70	-1.46
2050	4.17	5.62	-1.45
2055	4.09	5.54	-1.45
2060	4.01	5.44	-1.43

SOURCE: Congressional Budget Office. Calculations based on Alternative II-B assumptions, 1982 OASDI Trustees' Report.

a. Negative numbers indicate a deficit.

Because payroll tax revenues are not projected to increase as fast as GNP, however, the trust fund deficit will grow faster than outlays as a proportion of GNP, and will peak in 2035 at about 1.64 percent of GNP. In part, this growth in the deficit relative to GNP is attributable to the assumption that untaxed fringe benefits such as employer-provided pensions and health insurance will continue to grow as a proportion of employees' total compensation, so tax receipts will be based on a declining proportion of employees' total compensation. If the proportion of total compensation provided as fringe benefits grows more slowly than projected, however, the trust fund deficit will be smaller.

Both because the projected trust fund deficit is small, on average, relative to GNP, and because its size varies significantly over time, some analysts argue that action in the near future to resolve the long-run problem would be premature. As Table 1 shows, the problem is much larger after 2025 than before. Over the next 25 years, an average yearly surplus of 0.64 percent of payroll is projected for the OASDI trust funds under the Alternative II-B assumptions, and trust fund balances do not actually start to decline until about 2015. Moreover, any set of 75-year projections of economic behavior is subject to a wide range of error, so that the projected problems may never materialize.

On the other hand, projections of the long-run financial status of the trust funds are quite sensitive to the economic and demographic assumptions upon which they are based, and the risks associated with worse-than-expected economic and demographic conditions could be quite large. The 1982 Trustees' Report employs a range of economic and demographic assumptions to prepare estimates of long-run costs and revenues. Only under the most optimistic of these, known as Alternative I, is there no long-run deficit in the OASDI funds. Alternative I assumes, for example, that the rate of growth in real wages rises to 3 percent per year by 1987, and then levels off at 2.5 percent per year by 1992. This implies a faster rate of growth in wages than has been sustained for any period of time over the last 25 years. In contrast, under Alternative III, the most pessimistic of the alternatives, the 75-year deficit in the OASDI trust funds is projected to average 6.47 percent of payroll per year--a percentage that would be equivalent to almost \$90 billion in 1982. Also, under this alternative, an average yearly deficit of 0.72 percent of payroll in OASDI is projected even over the next 25 years. Alternative III assumes that prices continue to grow faster than wages until 1985, and that after 1985 real wages grow at a slowly increasing rate, leveling off at 1 percent per year in 1992 and later.<sup>4</sup>

Thus, while the financing problems of the trust funds may be much less than is now feared if the economy performs well, if the birth rate is high, and if mortality rates do not decline as sharply as expected, they could also be much worse if the opposite occurs. Given the high degree of uncertainty concerning the Social Security system's long-term financial well-being, it may be desirable to consider options to increase long-run balances in the near future, both to guarantee an adequate phase-in period and to restore public confidence in the system. Should the financial position of the trust funds turn out to be much better than anticipated, future benefits could be increased or taxes reduced.

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4. For more information on the details of these alternative sets of assumptions, see the 1982 Trustees' Report.

The appropriate set of options for consideration depends to some extent on one's view of the long-run operation and purposes of the system. Before turning to a brief overview of possible types of options and some criteria for choosing among them, therefore, the next section provides some background information on the operation and development of the system.

### THE SOCIAL SECURITY PROGRAM: BACKGROUND INFORMATION

The Social Security system is a set of social insurance programs designed to protect workers and their families against income losses and medical costs associated with old age, disability, and death. Social Security cash benefits are paid to retired and disabled workers who have worked long enough to gain insured status, and to their spouses, children, and survivors.<sup>5</sup> In addition, through the Hospital Insurance and Supplementary Medical Insurance programs, Medicare benefits are provided to those who are disabled or over the age of 65, and eligible for Social Security cash benefits.<sup>6</sup>

Social Security cash benefits are paid out of two trust funds--the OASI fund and the DI fund--which are both financed through a tax on wages. As discussed earlier, funding is on a pay-as-you-go basis--that is, current benefits are paid for out of current tax receipts. Social Security payroll taxes are paid by both employers and employees, on earnings up to the maximum taxable wage, which increases every year to reflect general wage growth. Self-employed workers pay taxes at a rate between the employee rate and the combined employer-employee rate.<sup>7</sup>

Benefits are determined for eligible workers according to a formula based on a measure of lifetime earnings. (This process is outlined in detail in Chapter III.) Benefits for spouses, dependents, and survivors depend both on the insured worker's lifetime earnings and on the recipient's relationship to the insured worker. In addition, other factors such as the age of

- 
5. See Appendix A for a summary of the rules determining eligibility for and amounts of benefit payments.
  6. Disabled workers become eligible for Medicare only after a two-year waiting period.
  7. In 1982, the maximum taxable wage is \$32,400, and the combined tax rate for the OASI and DI trust funds is 5.4 percent each for employers and employees. The rate for self-employed workers is 8.05 percent.

retirement, earnings after retirement, and benefits received by other family members can also affect benefits received.<sup>8</sup>

Although Social Security benefits are based on lifetime earnings in covered employment, workers' benefits are not simply a fixed proportion of earnings. In addition to the adjustments for early retirement and for spouses, children, and so forth, mentioned above, the benefit computation formula itself has been designed to provide benefits that are a higher proportion of preretirement earnings for those with low lifetime earnings than for those with higher earnings. This reflects a perception that relatively high replacement rates--that is, benefits as a proportion of preretirement earnings--are necessary for those with relatively low earnings, in order to help provide them with adequate retirement incomes.<sup>9</sup>

Since the inception of the Social Security system, this concern for benefit adequacy has been balanced against a belief that benefits received should have some relationship to the contributions--that is, tax payments--made by workers. Thus, additional taxable earnings result in benefit entitlements that are higher in absolute terms, but that are a declining proportion of average lifetime earnings. Up to the present, all retirees have had expected lifetime benefits exceeding their contributions; this will not be the case, however, under current projections for some future retirees with high lifetime earnings.

Both coverage and benefit levels have expanded substantially over the years, largely in response to concerns about the adequacy of retirement incomes. The percentage of persons 65 and over receiving Social Security benefits has risen from about 63 percent in 1959 to 91 percent in 1981, and average benefits in real terms have increased by over 60 percent during the same period.<sup>10</sup> At the same time, the proportion of those over 65 in poverty has fallen from about 35 percent to about 15 percent.

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8. For more details, see Appendix A.

9. Another reason for setting lower replacement rates for high earners is that such workers probably paid relatively high taxes during their working lives, so their benefits would be a higher proportion of their after-tax earnings, and their net, or after-tax, replacement rate would be closer to lower-wage earners' than their before-tax rate. In addition, low-wage earners probably benefit less from the tax-exempt status of Social Security.

10. Calculation based on average retired-worker benefits.

Benefits have also increased relative to preretirement earnings, with the largest increases occurring during the early 1970s. The replacement rate for workers retiring at age 65 who always earned the average wage rose from about 35 percent in 1959 to a peak of about 54 percent in 1981, and is now about 49 percent.<sup>11</sup> Replacement rates are higher for those with lower lifetime earnings, and lower for those with higher lifetime earnings.

Much of the increase in benefits during the 1970s was due to a technical flaw in the indexing method contained in the 1972 Social Security amendments. This flaw caused benefits to rise faster than prices, and although it was corrected in the 1977 amendments, all those who were eligible for benefits in 1972 through 1979 now have higher benefit levels than they would have received in the absence of this flaw. Under the 1977 amendments, replacement rates will continue to fall until 1990, when they will stabilize at about 42 percent for an average wage earner retiring at 65.

As discussed earlier, funding is not projected to be available to pay for benefits at the levels scheduled under current law after about 2025. The next section briefly describes the basic approaches available for improving the long-run financial outlook for the trust funds, and discusses possible criteria for choosing among them.

#### POLICY OPTIONS: AN OVERVIEW

The financial status of the trust funds could be improved in two major ways over the long run: either benefits could be reduced relative to current law, or revenues could be increased. Each of these approaches could be implemented in a number of different ways, however. Nor are these approaches necessarily mutually exclusive--it would certainly be possible to design options that included both benefit reductions and tax increases.

Some important considerations apply to the assessment of either type of approach. These include the magnitude and timing of the impacts of each option, and its effects on different groups of workers and beneficiaries. Options that are similar or complementary in terms of the size and timing of their effects may have quite different impacts on those in different

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11. Because of differences in the treatment of workers born in different years that have resulted from the transitional benefit guarantees enacted in the 1977 Social Security amendments, a 62-year-old worker retiring in 1982 who had always earned the average wage would have a replacement rate (before adjusting for early retirement) of about 43 percent. See Appendix A for further details.

population groups. Some criteria with which options could be assessed include:

- o Effects on the adequacy of beneficiaries' incomes, both now and in the future;
- o Effects on rates of return on contributions--that is, total expected benefits relative to total contributions--for beneficiaries at different earnings levels and in different generations; and
- o Focus of the effects--that is, the extent to which they have large impacts on a few persons or small impacts on many.

The first two of these criteria reflect the system's longstanding goals of maintaining benefit adequacy for low-income retirees, while providing a fair return on taxes paid by those with higher incomes. Most options involve some trade-offs between these goals. Under current law, workers with high earnings receive lower rates of return on their contributions than do those with low earnings.<sup>12</sup> If benefit reductions are focused on those with high earnings, this discrepancy will be increased. Reductions affecting beneficiaries with low lifetime earnings, however, may reduce benefit adequacy and increase poverty rates among the old.

The trade-off between benefit adequacy and the provision of a fair rate of return for all workers also occurs across generations of retirees. Those who are now retired or who will retire in the near future will receive very high rates of return on their Social Security contributions, as compared with those in future generations. On the other hand, real wages, and therefore real benefits, are expected to grow over time, as are benefits from private pension plans, so future generations of retirees may have more resources available to them than do current retirees.

Finally, options could also be judged on the relative magnitude of their impacts for those they do affect. Those that affect a small number of people a great deal may cause greater hardships than those that have a relatively small impact on a large number of people.

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12. In assessing rate-of-return computations, it should be noted that most such computations are based on pretax income and do not include the advantages accruing to high-income beneficiaries from the tax-exempt status of Social Security benefits. In addition, allowance is rarely made for the insurance value of the benefit-indexing provisions.

The remainder of this paper examines specific options for improving trust fund balances, and assesses them against these broad criteria. These specific options include both benefit reductions and revenue increases. A brief overview of the advantages and drawbacks of each of these major approaches is given below.

### Benefit Reductions

Major approaches to reducing benefits over the long run include changing the benefit computation formula and increasing the age of retirement.<sup>13</sup> The primary arguments in favor of such cuts are that real benefit levels and retirement incomes from other sources such as pensions are expected to grow over time, so future benefits could be reduced without reducing most retirees' standard of living, relative to the present. In other words, if retirees' incomes grow, benefit levels could be reduced without threatening their adequacy for most recipients.

On the other hand, sources of retirement income other than benefits are not evenly distributed across beneficiaries, and are not generally indexed, so benefit reductions could increase poverty among the elderly, especially if future periods of high inflation occur. If the cuts were concentrated on those with higher benefits, the threat to benefit adequacy would be reduced, but rates of return on contributions could fall to very low levels for some high earners. If incomes grow, cuts affecting primarily those retiring several decades from now would also pose less of a threat to benefit adequacy than cuts implemented now. Rates of return for future retirees will be low even under current law relative to those now received, however, and such options would reduce them further.

Finally, some options, such as changing the benefit computation formula, would affect all new retirees, while others, such as increasing the penalty for retiring early, would primarily affect certain smaller groups of retirees.

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13. Details of these options are given in Chapters IV and V. Although some do not regard increasing the age of retirement as a benefit cut, such an option would reduce lifetime benefits for all workers, and could be designed to have exactly the same effects on replacement rates at various ages as a formula change with comparable savings. Changes in methods of indexing benefits after retirement have not been considered as a major approach to reducing benefits over the long run, although the implementation of such changes as a way of improving trust fund stability is discussed in Chapter VI.

## Revenue Increases

The financial outlook for the trust funds could also be improved by increasing revenues. This could be done either by increasing payroll taxes or by allocating revenue to the trust funds from some new source, such as income taxes on benefits.<sup>14</sup> Most options to increase revenues would primarily affect workers, who in general have higher incomes than beneficiaries.<sup>15</sup> In addition, since at any time there are more workers than beneficiaries, a payroll tax increase of a given magnitude would affect workers' incomes less than a benefit cut with the same effect on the trust fund would affect beneficiaries' incomes.

On the other hand, a tax increase affecting workers would reduce workers' returns on contributions, and rates of return are already expected to fall over time as the system matures. If implemented in the near future, such a tax increase would further increase the burden on current workers relative to current retirees. In addition, increases on taxes affecting wages might also reduce work incentives, which could cause workers to work fewer hours and to retire earlier. If this occurred, additional revenues resulting from this approach could be significantly reduced.

Another type of option to increase trust fund revenues would be to transfer funds from general tax revenues, or to allow the trust funds to borrow from general funds. With given targets for the unified budget deficit, however, this option would require either reduced spending in other areas of the budget or increases in other taxes, as compared to other measures to improve trust fund balances.

## Stabilization Measures

In addition to the problems associated with the projected long-run deficit, the trust funds could also face some temporary financing problems in future periods of poor economic performance. Even with benefit cuts or increases in revenues as compared with current law, Social Security reserves are likely to be low over the next 15 years, and may be low at other points in the future. Under these circumstances, as recent experience has shown,

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14. Details of these and other options to increase revenues are discussed in Chapter VII.
  15. An exception would be taxing Social Security benefits. This would be comparable in its effects to a benefit cut focused on higher-income beneficiaries.

cyclical downturns in the economy can place severe strains on the funds. Thus, in addition to benefit reductions and tax increases aimed at improving average trust fund balances over the long run, this paper also presents several options that would stabilize trust fund balances by preventing large fluctuations in periods when the economy performed poorly.

There are two major approaches to this problem: either benefits could be linked more closely to wages, so that they would grow more slowly in periods of slow wage growth, or additional revenues could be provided to the trust funds in periods of high unemployment or rapid increases in prices relative to wages.<sup>16</sup> In general, options of the first type would protect the trust funds, but could result in reductions in the purchasing power of benefits during economic downturns. Options of the second type would maintain benefit levels but would require additional taxes or spending reductions in other areas, if targets for the unified budget deficit are to be maintained.

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16. These two approaches are outlined in more detail in Chapters VI and VII, respectively.