PAYING FOR SOCIAL SECURITY:

FUNDING OPTIONS FOR THE NEAR TERM

Congress of the United States
Congressional Budget Office

NOTE

In some tables, details may not add to totals because of rounding.

PREFACE

By the start of next year, the trust fund that finances the Social Security benefits of retired workers, their dependents, and survivors--the Old Age and Survivors Insurance (OASI) fund--will encounter a cash flow problem. The system's two other trust funds, which cover Disability Insurance (DI) and Hospital Insurance (HI) payments, should remain relatively sound, however. A wide variety of options are available to the Congress to remedy the OASI fund's immediate difficulties. Short-term choices range from various ways of altering the accounting mechanisms of the trust funds, to reducing benefit amounts, to increasing revenues into the system. Undertaken at the request of the Senate Budget Committee, this study focuses on short-run financing issues only. Since the paper concentrates primarily on the trust fund situation, it does not give estimates of all possible budgetary effects that could result from implementing any of the various options. Similarly, farther-reaching issues affecting Social Security's prospects 30 or 40 years hence present different analytical problems and must be considered in another forum. In keeping with CBO's mandate to provide objective and nonpartisan analysis, this paper offers no recommendations.

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CONTENTS

TABLES

TABLES (Continued)

73-780 0 - 81 - 2

SUMMARY

According to projections made by the Congressional Budget Office, the Old Age and Survivors Insurance (OASI) trust fund, the largest of the three funds that finance the Social Security system, will encounter financial difficulties during the first part of fiscal year 1982. Similar projections have been made by the Social Security Administration's actuaries. By the end of that year, the OASI fund is projected to have just over $7 billion in reserve (see Summary Table 1). The other two funds, Disability Insurance (DI) and Hospital Insurance (HI), however, are projected to be in a much stronger position for the 1981-1986 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.

THE RANGE OF AVAILABLE OPTIONS

The 97th Congress has a number of approaches it could take to ensure the soundness of the three trust funds that finance the Social Security system. The options examined in this study fall into three categories:

- Changing the trust fund accounting methods. Such approaches would involve borrowing among the three trust funds, merging the funds, or further realigning the portions of payroll tax revenues earmarked for each of the funds. (One such realignment was enacted last year.) They would not alter either the amount or timing of benefits or the tax rates currently legislated. At a minimum, taking such actions would give the Congress time to consider further measures.

- Modifying benefit amounts. This could be accomplished by changing the method used to adjust (that is, index) benefits for inflation or by making certain benefit cuts.

- Finding additions or alternatives to the payroll taxes that finance the system. The use of general revenues to finance part of Social Security is one option in this category. Additional payroll tax increases, as have been enacted in the past, is another.

SUMMARY TABLE 1. CBO PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOME, AND BALANCES, TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

Trust Fund	1981	1982	1983	1984	1985	1986
OASI						
Outlays	122.6	141.4	158.7	178.0	199.3	222.6
Income a/	117.8	129.0	143.0	159.1	181.9	203.7
Balance b/	19.7	7.4	-8.2	-27.1	-44.5	-63.5
DI						
Outlays	17.5	19.6	21.0	22.7	24.8	27.5
Income a/	12.6	21.9	26.4	30.0	37.7	44.4
Balance b/	2.8	5.2	10.6	17.9	30.9	47.7
HI						
Outlays	27.9	34.1	38.7	44.7	51.9	59.9
Income a/	31.9	38.3	43.2	48.4	55.5	65.5
Balance b/	18.5	22.7	27.2	30.8	34.4	40.1

NOTE: Minus sign denotes a deficit.

a/ Includes tax receipts, interest, and certain general fund transfers.

b/ Balances as of end of fiscal year.

The Constraints of Current Law

Under current law, benefits for each of the Social Security programs can be paid only from the specific trust fund of that program. Because of timing differences between the revenue inflows and the benefit payments, trust fund balances at the start of each fiscal year should be at least 9 percent of that year's anticipated outlays. Because the OASI trust fund's reserves in the early months of fiscal year 1982 will probably fall to a critical level, while the reserves of the DI and HI trust funds will not, there will be a cash flow problem only in the OASI fund. The OASI balance, according to CBO, is seen to be 14.0 percent of outlays by the start of fiscal year 1982, falling to 4.7 percent by the start of the next year (see Summary Table 2). The assets of the DI and HI funds, however, continue to grow as a percent of outlays.

SUMMARY TABLE 2. CBO PROJECTIONS OF 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	20.0	14.0	4.7	a/	a/	a/
DI	43.9	14.4	24.6	46.7	72.2	112.1
HI	51.9	54.2	58.6	60.8	59.5	57.5

a/ Negative balance.

THE CAUSES OF THE PROBLEM

The OASI fund's current difficulties are occurring despite increases in the tax rate and the maximum amount of earnings subject to the payroll tax (that is, the tax base) legislated in the Social Security Amendments of 1977. Before the amendments were enacted, both the OASI and DI trust funds were expected to be depleted by the early 1980s. The recurrence of the problem in the OASI trust fund that the 1977 amendments were designed to correct is the result of a combination of economic circumstances and structural features of the system. Together, these forces have acted to reduce revenues into and to increase outlays from the OASI trust fund. The major factors leading to OASI's current problem are:

- o High rates of inflation;
- o Low productivity growth and declines in real wages;
- o Growth in and anticipated continuation of high unemployment rates; and
- o Allocation of what appears in retrospect to have been too large a share of the payroll tax to the DI and HI trust funds in the 1977 amendments.

The difficulties leading to the passage of the 1977 amendments came about because declining real wages and high unemployment rates during the 1974-1975 recession reduced payroll tax receipts into the trust funds below their projected levels, while high inflation rates and large ad hoc benefit increases accelerated payments from them. In addition to the overall tax increase legislated in 1977, the Congress also earmarked a larger share of the overall payroll tax for the DI trust fund at the expense of the OASI fund, since at the time, DI was the fund thought to be most at risk. Subsequent events slowed the growth rate of the DI program, enabling that trust fund to increase its balances substantially. Without new legislation, however, DI reserves cannot be reallocated to assist the OASI trust fund.

In 1979 and 1980, generally high inflation rates attributable in part to large increases in oil prices and record high interest rates combined to depress real income growth. This decline in real incomes again limited the growth in revenues to the trust funds. In addition, high rates of inflation led to large automatic cost-of-living adjustments in benefits, further drawing down or limiting increases in the trust funds' reserves.

The U.S. economy experienced a mild economic downturn concentrated in the first half of 1980, followed by a moderate recovery in the latter part of that year. A weak recovery is expected in the first half of 1981. The higher unemployment resulting from the slowdown will further weaken the trust funds, because fewer workers will contribute payroll taxes, and because more older workers will elect to retire earlier. Even with a mild economic upturn, however, the expected persistence of high inflation rates over the next few years and the slow growth of real income will further stimulate growth in outlays while limiting revenues to all three funds.

SHORT RUN OPTIONS

Various actions are available to the Congress to ensure that the OASI fund has adequate reserves to meet all its obligations. Some of these options, taken alone, would shore up the trust funds only for an additional year or two; others, alone or in combination, would guarantee adequate reserves for longer periods.

Accounting Changes

Neither benefit payments nor scheduled tax rates would be affected by any option confined to changes involving the accounting mechanisms of the three funds. If economic conditions turn out to be better than current forecasts show--with rates of unemployment and inflation lower than are now anticipated--accounting changes alone might be sufficient to ensure OASI's adequacy over the 1981-1986 period. According to CBO's projections, however, if accounting adjustments only are made, other changes will be needed by 1984 to ensure that all three trust funds continue to have sufficient reserves.

Interfund Borrowing. The Carter Administration's budgetary proposal for fiscal year 1981 contained a plan that would allow any Social Security trust fund to borrow from the others as the need arose; the borrowing fund would make repayment when it could. The 1982 proposed budget again contained a similar general plan. Advocates of this approach hold that it would preserve the identity, and hence the Congressional "accountability," of the three separate trust funds. Although considered by the 96th Congress, this plan was not adopted.

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 into 1984, since all three funds combined would have enough reserves to meet all anticipated outlays during this period. By the start of 1985, estimates based on current economic assumptions indicate that other measures would be needed.

According to CBO's projections, the balances of the OASI and DI funds together would exceed 9 percent of both funds' projected outlays through fiscal year 1981 and into fiscal year 1982 (see Summary Table 3). In fiscal year 1982--the first year interfund borrowing would be needed--some $6.9 billion would have to be borrowed by the OASI fund from the DI and HI funds. To maintain adequate OASI balances through 1983, the minimum amount of borrowing needed would be $24 billion. By mid-1984, borrowing would involve other sources.

SUMMARY TABLE 3. 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.

Realignment of Payroll Taxes. Another way the Congress can respond to a short-run deficit while maintaining the separate identities of the three trust funds is to realign the currently scheduled payroll tax rates among the funds and increase the share earmarked for the OASI trust fund. The 96th Congress adopted a measure of this sort as Public Law 96-403, with the aim of giving the next Congress time to examine Social Security issues in greater detail.

Merging the Trust Funds. Merging all three trust funds into one new fund, which would serve as a repository for all payroll tax receipts, is another alternative available to the Congress. This option, however, could lead to some loss of Congressional control in monitoring the status of the three programs, although maintaining a separate accounting system for each program could offset this disadvantage.

Benefits Changes

A wholly different approach to strengthening the trust funds' positions is embodied in choices that would reduce program outlays. Most of these would involve modifying the way annual cost-of-living benefit increases are calculated. A few would effect some benefit cuts.

Modifying the Annual Cost-of-Living Benefit Increase. To keep Social Security benefits abreast of inflation, they are adjusted (indexed) annually to reflect rises in the cost of living. At present, the yearly adjustments in OASI and DI benefits are automatic, and the measure according to which benefits are adjusted is the Consumer Price Index (CPI). Critics of the CPI have argued, however, that this index measures inflation improperly, at times overstating the cost-of-living rises that affect most people and thus leads to excessive Social Security benefit increases.

A way of limiting outlays from the Social Security trust funds therefore could be to select a different index--one that compensates for the CPI's flaws--to compute yearly benefit adjustments. Under this approach, benefits would still be altered to allow for inflation, while appreciable savings to the trust funds could be realized.

One such indexation modification that has been proposed would use the Commerce Department's personal consumption expenditure (PCE) "chain index", which could save the trust funds roughly $11 billion by 1986 if it were adopted in 1981. The Labor Department's "modified rental equivalent," which substitutes costs of rented housing for the homeownership component in the CPI, could yield a projected savings of approximately equal amounts by the end of fiscal year 1986. Savings resulting from these indexes are not certain if they were first implemented in 1982, however.

Another option suggested would limit the Social Security cost-of-living adjustment to the lower of a wage or price index. This option would enable beneficiaries to maintain their position relative to active workers in times of falling real wages, but maintain their real standard of living when real wages are rising. It would, however, result over time in lower real benefits for recipients.

Placing some limit on the yearly benefit increase generated by the CPI is also an option. Such a cap would be similar to the one placed by the President on federal pay raises. Limiting the Social Security cost-of-living increase to 67 percent (two-thirds) of the CPI's increase, for example, would alone generate nearly enough savings to ease the OASI funding short-run problem.

Cuts in Certain Benefits. A number of benefit cuts have been proposed in past budgets. These include eliminating the minimum, lump-sum death and certain parents' benefits and phasing out student benefits. These proposals have never been accepted by the Congress. Enacting them would, however, help the OASI trust fund's short-term financial problem, and if combined with other actions, could go somewhat farther to securing the trust fund's position.

Revenue Modifications

There are a number of revenue changes that the Congress could adopt to assist the trust funds. One possibility would be to allow borrowing by the Social Security system 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.

General Fund Borrowing. One way of ensuring the solvency of the trust funds without resorting to explicit tax changes would be to permit Social Security to borrow funds from the U.S. Treasury. Such an option would avoid tax increases or benefit cuts. It could, however, increase pressures on the federal budget, forcing cuts in other areas or adding to the size of the deficit.

Payroll Tax Changes. The various ways of raising Social Security revenues to assist the OASI fund include a number of tax changes. One would follow past practice by raising the payroll tax rate for employers, employees, and self-employed persons. A permanent increase of 0.5 percent above currently scheduled rates would alone just barely raise the revenues that the OASI fund will need by 1986; a more substantial increase of 1.0 percent would

73-780 0 - 81 - 3

provide the system with a quite ample cushion. A second approach would involve eliminating the ceiling on wages subject to the payroll tax and taxing all earnings instead. This would provide some but not all of the added revenues the OASI fund will need. A third possibility would involve changing the tax liability for self-employed persons, whose earnings are now taxed at roughly three-fourths of the combined employer and employee rate, to the full employer/employee rate.

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. A bill introduced in the 97th Congress (S. 44) would allow employees and employers a refundable 10 percent credit on their payroll tax contributions to offset the increases mandated by the 1977 amendments for 1981 and 1982. Credits to offset further increases could also be refundable and could be proportional to an individual's total payroll tax contribution.

General Revenue Financing. The 1979 Social Security Advisory Council recommended reallocating the HI share of the tax rate among the OASI and DI trust funds, along with reducing the overall payroll tax rate. The plan would call for financing HI from earmarked income tax revenues. Financing only HI program benefits from general revenues 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.

Alternatively, to assist the trust funds, the Congress could decide to forego the income tax reductions it has periodically enacted in the past to offset inflation-induced increases in tax liabilities. Some portion of the revenues maintained by keeping taxes at their present rates could be earmarked for the OASI trust fund.

SEVERAL OPTIONS IN COMBINATION

Taken alone, most 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 reapportioning part of the DI share of payroll tax revenues to the OASI fund.

LONGER RUN ISSUES

Of the longer-run Social Security issues on the Congressional agenda, at least one item--universal coverage--could have ramifications for both the immediate and the more distant future. Expanding the system to require participation by civilian federal workers and some state and local government employees now exempted from the system could augment the payroll tax's revenue base. A quite different approach that would more gradually affect the trust funds' position would be to tax Social Security benefits according to the graduated schedules that now apply to other income. Doing so could increase income tax payments made by beneficiaries whose total retirement incomes are larger, and the resulting revenues could be earmarked for the trust funds.

CHAPTER I. INTRODUCTION

Nearly four years ago, in response to concern over developing problems in the Social Security trust funds, the Congress passed the Social Security Amendments of 1977 (Public Law 95-216). This legislation raised both future tax rates and the maximum amount of a person's total earnings on which these rates must be paid. For the most part, the increased revenues resulting from the amendments were channeled into two of the three trust funds that finance the system: the Disability Insurance (DI) and Hospital Insurance (HI) funds. Both of these funds had been experiencing extremely rapid increases in spending in the preceding years. At the time of the amendments' passage, it was generally felt that the newly legislated tax increases would be sufficient to ensure the fiscal viability of the Social Security system for the ensuing 30 years.

In the interim, however, unexpected economic developments--particularly rapid inflation and low real wage growth--have radically changed the program's prospects. According to projections made by both the Congressional Budget Office and the Social Security Administration's actuaries, the Old Age and Survivors Insurance (OASI) fund--the largest of the system's three trust funds--will experience a cash flow problem during fiscal year 1982. Thus, the Congress will have to address the Social Security system's financing situation once again to ensure that the reserves in the OASI trust fund remain above a critical level. Because the HI and DI trust funds are expected to remain strong, however, a number of short-term solutions to the OASI fund's problem are readily attainable.

SHORT TERM PROJECTIONS

As part of its regular reports to the Senate and House Committees on the Budget, CBO estimates outlays from and income to the Social Security trust funds. The periodic estimates of the financial status of the Social Security system are based on CBO's forecasts about the behavior of the economy as a whole. Despite differences in forecasting methods, economists and actuaries generally concur that, because of the poor performance of the economy in recent years, the near-term prospects of the OASI trust fund's finances are not good. The projected problem is serious only for the OASI trust fund, however; the DI and HI trust funds each should remain reasonably strong.

During the past session of Congress, Public Law 96-403 was enacted to reallocate some revenues from the DI to the OASI trust fund for calendar years 1980 and 1981. The purpose of this legislation was to give the Congress time to devise a plan to resolve the OASI fund's worsening financial status. By 1984, however, the sum of the three trust funds' combined reserves will be insufficient to meet all expected cash payments. Some action other than further realignment of the payroll tax revenues will be necessary in the coming five years.

Cash benefit payments from the Social Security trust funds are assured by the government; a number of alternatives are available that would maintain this assurance. This paper summarizes the short-term financing problem and some of the readily available solutions. If the Congress takes some action before the end of 1981, then, under current projections the system should be able to meet all its obligations in the near term.

CBO's present projections of the status of the trust funds rest on an assumption that there will be a steady though gradual improvement in the economy starting in calendar year 1981. It also assumes that the rates of inflation and unemployment will remain at levels higher than those that characterized previous economic upturns. The combination of rapid inflation, high unemployment, and falling real wages has been a major cause of Social Security financing problems in the past. If such economic circumstances do not coincide again, the system's financial condition should improve over current projections; if not, the opposite will occur.

In addition, these projections rest on the assumption that the payroll tax increases legislated by the 1977 amendments for 1981 and thereafter will be allowed to go into effect as scheduled. There is some interest in rescinding or rolling back the tax increase that went into effect on January 1, 1981. If such a course, but no other, were taken, the outlook for the trust funds could be markedly worse.

HOW THE SYSTEM WORKS

Social Security is financed by a payroll tax 1/ on earnings, with portions of its revenues earmarked for each of the trust funds. All persons who work in employment covered by the program pay a mandatory tax on their earnings up to a maximum dollar amount. Employers pay an equal tax rate for these workers. Under current law, as of 1981, the tax is levied at a rate of 6.65 percent of the first $29,700 of earnings for both the employer

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1/ Familiar to most covered workers by the designation F.I.C.A., Federal Insurance Contributions Act.

and employee. Table 1 summarizes the current payroll tax schedule. Self-employed persons pay at a rate of 9.3 percent, which roughly equals three-fourths of the combined employer and employee rate.

TABLE 1. CURRENT LAW SOCIAL SECURITY PAYROLL TAX RATES FOR EMPLOYERS AND EMPLOYEES AND TAXABLE EARNINGS BASES, BY INDIVIDUAL AND COMBINED TRUST FUNDS, 1979-1986

	Employee and Employer Rates, Each (in Percents)					Taxable Earnings Base
Year	OASI	DI	OASDI Combined	HI	OASDHI Combined	(in Dollars)
1979	4.330	0.750	5.080	1.050	6.130	22,900
1980	4.520	0.560	5.080	1.050	6.130	25,900
1981	4.700	0.650	5.350	1.300	6.650	29,700
1982	4.575	0.825	5.400	1.300	6.700	32,100 a/
1983	4.575	0.825	5.400	1.300	6.700	34,800 a/
1984	4.575	0.825	5.400	1.300	6.700	38,700 a/
1985	4.750	0.950	5.700	1.350	7.050	42,900 a/
1986	4.750	0.950	5.700	1.450	7.150	47,700 a/

SOURCE: Public Law 95-216.

a/ Automatic increase based on statutory formula and CBO's preliminary economic assumptions.

The Trust Funds and Pay-As-You-Go Financing

Social Security is funded on a pay-as-you-go basis, which makes the system particularly sensitive to economic fluctuations. For the most part, the annual flow of tax revenues into the trust funds is used to pay for the current outflow of benefit payments. No provision is made for accumulating the funds' assets at a level equal to anticipated payments. Rather, expected future payments are guaranteed solely by the government's power to tax. The role of the trust funds is to provide a reserve to cushion temporary shortfalls in revenues or unexpectedly large increases in outlays for benefits. Since nearly all workers now pay Social Security taxes, overall collections depend upon the aggregate nationwide level of earnings. A reduction in the