STATEMENT OF

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The rise in the Social Security tax rate and the expansion of the taxable wage base scheduled for January 1, 1981, are likely to produce adverse economic effects--namely higher inflation and lower employment. Increases in employers' contributions raise labor costs; these higher costs may in turn be passed on to consumers in the form of higher prices and can also lead to higher unemployment. Increases in employees' contributions to Social Security reduce disposable income and may result in lower levels of aggregate demand.

At the same time, outlays from the Social Security trust fund that pays benefits to retired workers and their dependents and survivors (the Old Age and Survivors Insurance fund--OASI) are expected to exceed revenues during the next few years. For the Social Security system as a whole to remain solvent during the next decade, either the 1981 payroll tax increase must go into effect as scheduled, or another source of revenues to the Social Security trust funds must be found.

To assist the Committee in considering solutions to these problems, my testimony today will deal with four issues:

- o The contribution of payroll taxes to inflation and unemployment;
- o The financial status of the Social Security system if the scheduled 1981 tax increase goes into effect;

- o The financial status of the system if the 1981 tax increase is rescinded; and
- o Means other than the 1981 increase for financing the Social Security system.

PAYROLL TAXES AND STAGFLATION

In 1981, both employees and employers are scheduled to pay significantly more in Social Security payroll taxes. Both will face a rise from the present rate of 6.13 percent to 6.65 percent. At the same time, the taxable wage base will go from $25,900 to $29,700.

This increase in payroll taxes could contribute to "stagflation"--a situation in which inflation and unemployment are simultaneously high--because the rise in employers' contributions could increase total labor compensation by nearly 0.4 percent. The magnitude of these short-term economic effects will depend on the degree to which the tax is eventually shifted from firms to employees, or from firms to consumers, and how rapidly these shifts occur.

Employers can respond to rising Social Security contributions in a number of ways. They may be able to shift the tax "backward" to employees by holding down the growth rate of wages and fringe benefits. Alternatively, they may be able to shift the tax "forward" to consumers by raising product prices. Finally, if they were unable to change wages or prices, firms might be forced to accept diminished profits. A combination of all three responses is most likely to occur in the two- or three-year period following the payroll tax increase, since contracts with both employees and customers restrict firms' freedom to change wages and prices quickly.

A consensus concerning the pattern of these responses--that is, the combined effects of forward shifting, backward shifting, and reduced profits--does not exist at present. The Congressional Budget Office's (CBO's) current assumption is that three-fourths of the tax will be shifted forward through price increases in the first eight quarters following the increase, while the remainder will eventually be shifted backward to employees in the form of wage adjustments. (CBO is undertaking a study now to enhance its ability to forecast the economic effects of future changes in payroll taxes.)

Postponing the scheduled 1981 Social Security tax increase could have several advantages. The inflation and unemployment rates would both be reduced slightly. Under CBO's current shifting assumptions, the CPI would be reduced by 0.2 percent and the unemployment rate would be reduced by 0.2 percent by the fourth quarter of 1983. Thus, elimination of the 1981 increase might succeed somewhat in reducing stagflation. Although the inflation and unemployment effects are relatively small, the advantageous feature of this approach is that both effects would be in the desired direction. (Complete results and assumptions are found in Table 1.)

TABLE 1. CUMULATIVE EFFECTS OF ELIMINATING THE SCHEDULED 1981 INCREASE IN PAYROLL TAX RATES AND MAXIMUM TAXABLE INCOME, RELATIVE TO BASELINE FORECAST, CALENDAR YEARS 1981-1983

	1981	1982	1983
CPI (percent change)			
Current law	9.6	9.4	8.6
Rescind 1981 increase	9.4	9.4	8.6
Unemployment (percent)			
Current law	7.5	7.5	6.8
Rescind 1981 increase	7.4	7.3	6.6
Employment (thousands)			
Current law	98,500	100,500	103,200
Rescind 1981 increase	98,700	100,850	103,550

NOTE: Forecasts are based on the assumption that the January 1981 increase is eliminated but all other changes under current law remain intact. However, the scheduled increase of 0.05 percentage point in January 1982 will increase the rate to 6.18 percent rather than the 6.70 percent under current law.

In addition, canceling the 1981 increase would probably enhance the effectiveness of wage-price guidelines. No rise in the employers' share would cushion cost increases, and none in the employees' share could increase take-home pay. As a result, both business and labor would be more likely to adhere to the guidelines.

THE FINANCIAL STATUS OF THE SOCIAL SECURITY SYSTEM UNDER CURRENT LAW

At present, both CBO and the Administration estimate that the solvency of the Social Security system will improve over the next five years. The combined balance of the three separate trust funds--Old Age and Survivors Insurance (OASI), Disability Insurance (DI), and Health Insurance (HI)--will grow. But the financial situations of the three funds will differ greatly. Outlays from the OASI fund will exceed revenues, and by fiscal year 1983, OASI balances are likely to become negative. At a minimum, the trust funds need a balance of 9 to 12 percent of yearly outlays at the start of the year to guarantee that the system will be able to meet all that year's monthly payments in a timely fashion. The OASI trust fund balance is likely to fall below the level needed to meet monthly payments early in fiscal year 1982. (Table 2 displays these projections.)

TABLE 2. ACTUAL AND PROJECTED SOCIAL SECURITY TRUST FUND BALANCES AT THE START OF THE FISCAL YEAR AS A PERCENT OF EXPECTED YEARLY OUTLAYS, FISCAL YEARS 1980-1985 AND 1990: IN PERCENTS

Individual and Combined Trust Funds	1980	1981	1982	1983	1984	1985	1990
OASI	26.6	19.8	10.2	1.9	a	a	a
DI	36.0	41.9	49.7	59.2	70.3	84.1	197.1
HI	57.7	59.6	70.9	84.0	94.3	101.3	112.0
OASDI	27.8	22.6	15.3	9.3	5.0	2.2	17.9
OASDHI	32.7	28.5	24.2	21.6	20.3	19.8	37.7

SOURCE: Based on CBO's March 1980 economic assumptions.

a. Negative balance.

In contrast to OASI, the balances in the DI and the HI funds are likely to grow steadily during the next five years. As a result, several options have been proposed that would enable all three trust funds to remain solvent for the next decade. These options include fund-to-fund borrowing, reallocation of the payroll tax earmarked for each fund, and merging the three into one general OASDHI fund.

The OASI fund's financial problems, which are attributable largely to stagflation, could bring about policy responses--such as increased payroll taxes--that themselves cause increased stagflation. Social Security revenues and benefit payments (and hence trust fund balances) depend in the short run on inflation, employment, and the growth rate of money wages. To the extent that money wages grow at a slower rate than the CPI (by which benefits are automatically increased), trust fund balances decline. Furthermore, the growth in revenues falls as unemployment rises. Thus, a payroll tax increase becomes necessary precisely when elimination of an increase or lowering of payroll taxes would be recommended to deal with prevailing economic conditions of stagflation.

THE FINANCIAL POSITION OF THE SOCIAL SECURITY SYSTEM WITHOUT THE SCHEDULED 1981 TAX INCREASE

If the 1981 tax increase is not instituted, the effect on the economy as a whole could be beneficial, but the Social Security system would experience severe financial difficulties. Not only would the short-term measures cited earlier be insufficient to solve the financing problem of the OASI trust fund, but also the combined OASDHI fund balance as a percent of expected outlays would fall to 6.9 percent in 1983 and the combined balance would become negative by 1984 (see Table 3).

TABLE 3. ACTUAL AND PROJECTED SOCIAL SECURITY TRUST FUND BALANCES AT THE START OF THE FISCAL YEAR AS A PERCENT OF EXPECTED YEARLY OUTLAYS, IF THE 1981 TAX INCREASE IS RESCINDED, FISCAL YEARS 1981-1985 AND 1990: IN PERCENTS

Individual and Combined Trust Funds	1980	1981	1982	1983	1984	1985	1990
OASI	26.6	19.8	6.8	a	a	a	a
DI	36.0	41.9	42.0	39.9	39.5	41.1	107.6
HI	57.7	59.6	55.1	47.3	38.7	28.0	a
OASDI	27.8	22.6	11.3	a	a	a	a
OASDHI	32.7	28.5	18.4	6.9	a	a	a

SOURCE: Based on CBO's March 1980 economic assumptions.

a. Negative balance.

ALTERNATIVE FINANCING APPROACHES

To realize the beneficial effects of eliminating the scheduled 1981 payroll tax increase while maintaining the solvency of the Social Security system, either alternative sources of revenue must be found or benefits must be cut back.

Other Revenue Sources. Funding of the Social Security trust funds could be achieved by:

- Trust fund borrowing from general revenues;
- Countercyclical transfers to the trust funds from general revenues, with or without repayment;

- o Use of other earmarked taxes to supplement payroll tax receipts; or
- o Use of general revenues to finance the HI trust fund.

These approaches offer several advantages. They would allow cancellation of the scheduled 1981 payroll tax increase without causing the trust funds to become insolvent. Any of these methods could be expanded, if the need arose, to resolve longer-term financing problems. And public concern about inadequate funding of future benefits could be allayed, although this is less likely if borrowing were not repaid.

Regrettably, these approaches also have several disadvantages. Financing from general revenues would weaken or completely break the link that now exists between contributions and benefits. Many observers consider this to be a critical feature in distinguishing between an entitlement program such as Social Security and means-tested income transfer programs. Furthermore, these proposals would require that people who are not covered by Social Security (such as federal employees), and some of those now receiving benefits, help pay for the system. General revenue financing would also require a larger federal deficit, reductions in other programs, or another source of revenue. Suggestions for the latter, such as a tax on gasoline, increased income taxes, or a value added tax would have effects that would partially offset the benefits of reduced payroll taxes.

Both Robert M. Ball, former Commissioner of Social Security, and the Advisory Council on Social Security have recommended that the HI fund be financed by general revenues and the HI portion of the payroll tax be allocated to OASI and DI. One argument for this approach relative to other general revenue options is that a link between contributions and benefits does not exist for HI as it does for OASI and DI. According to former Commissioner Ball, this option would allow the elimination of the 1981 payroll tax increase as well as maintenance of the current 6.13 percent tax rate on both employers and employees for the next 50 years. The Advisory Council has estimated that the payroll tax rate could be lowered to approximately 5.6 percent under moderate economic assumptions. A disadvantage of this approach is that alternative revenue sources must still be found and their offsetting effects considered.

Tax Credits for Social Security Contributions. Indirect general revenue financing could be implemented by a refundable tax credit. The payroll tax could be allowed to rise sufficiently to cover benefit payments and the tax credit used to reduce the impact on employers and employees. H.R. 4990 introduced by Representative Gephardt would provide a 20 percent credit against payroll tax contributions for both employers and employees. The beneficial effects of the credit are likely to be smaller, however, than those of a direct payroll tax reduction, unless it could be implemented through reduced tax withholdings in each pay period. Furthermore, lower-income employees are less likely to file tax returns in order to get the credit than are higher-income employees.

Restructuring Social Security Benefits. The need for increased revenues could be relieved by changing the level of benefits or their tax treatment. For example, in its 1980 budget proposals, the Administration proposed reducing or eliminating several benefits. Alternatively, Social Security benefits could be taxed and the revenues returned to the trust funds. Proposals for such benefit changes, however, tend to be controversial.

OTHER SOCIAL SECURITY POLICY OPTIONS

Other Social Security policy options include a temporary reduction of payroll taxes and exempting youth from coverage by the Social Security system.

A temporary postponement of the scheduled 1981 tax increase could serve as a countercyclical policy. This approach would probably require countercyclical borrowing from the general fund to compensate for the temporary reduction in revenues. Alternatively, with the qualifications stated previously, this policy could be implemented by a refundable tax credit equal to a specific proportion of the payroll taxes paid by employers and employees. The advantage of these options is that the payroll tax rates would be set at levels sufficient to maintain trust fund solvency in the long run, while temporary reductions would be used as a short-term anti-stagflation measure. The primary disadvantage is that alternative funding sources would have to be found on a temporary basis.

Some employees, particularly young people, could be excluded from payroll taxation. This option would reduce overall labor costs. Moreover, it is targeted toward a group with high unemployment rates. This type of targeting would probably stimulate employment without giving further impetus to inflation. Such an approach might, however, require general revenues to replace lost payroll tax receipts.

OTHER OPTIONS TO REDUCE LABOR COSTS

The adverse economic effects associated with rising payroll taxes stem from increased labor costs. There are several ways to reduce other labor costs. These options include:

- Eliminating the federal unemployment insurance (UI) payroll tax;
- Forgoing or postponing future increases in the minimum wage; and
- Subsidizing future costs that might be mandated to employers.

Funding of federal unemployment insurance trust funds could be achieved through general revenues and the federal portion of the UI payroll tax removed. At present, the effective federal UI payroll tax is 0.7 percent of the first $6,000 of wages. Firms in some states may have an additional 0.3 percent of previous years' rates added as a result of borrowing from the federal fund. Eliminating these payroll costs would provide a cushion against the scheduled Social Security tax increase and would probably partially offset its adverse effects on inflation and employment.

The January 1981 minimum wage increase could be postponed or eliminated. The simultaneous imposition of a higher minimum wage and increased payroll taxes is likely to have a significant effect on labor costs, particularly for firms with a high proportion of low-paid employees. Furthermore, the option to shift the Social Security payroll tax increase "backward" to low-paid employees is limited or removed by the legislated minimum wage. Finally, the double increase in labor costs is likely to have a particularly bad effect on the employment status of low-wage, high-unemployment groups such as youths, women, and minorities.

Finally, the Congress is now considering policies that would ultimately increase labor costs, such as provision of catastrophic health insurance. Many such proposals would require employers to offer health insurance plans and to pay a large portion of the premiums. Employers who now do not provide these plans would probably be those most burdened by the scheduled Social Security tax and minimum wage increases. The Congress may want to take into account the effects on stagflation of such proposals.

CONCLUSION

At the moment, combating stagflation and assuring solvency for the Social Security system are of great concern. Eliminating the scheduled 1981 payroll tax increase would probably reduce both inflation and unemployment slightly. But the revenues from the increase, or from some other source, would be needed to ensure that all Social Security benefits would continue to be paid in a timely fashion.