SOCIAL SECURITY FINANCING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

FEBRUARY 22 AND 25, 1980

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
60-596 O WASHINGTON : 1980 HG 96-65

S 361-35

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SOCIAL SECURITY FINANCING

FRIDAY, FEBRUARY 22, 1980

U.S. SENATE,
SUBCOMMITTEE ON SOCIAL SECURITY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:40 a.m. in room 2221, Dirksen Senate Office Building, Hon. Gaylord Nelson (chairman of the subcommittee) presiding.

Present: Senators Nelson, Baucus, and Danforth.

[The press release announcing these hearings follows:]

[Press Release No. H-7]

FINANCE SUBCOMMITTEE ON SOCIAL SECURITY TO HOLD HEARINGS ON SOCIAL SECURITY FINANCING

The Honorable Gaylord Nelson (D., Wis.) Chairman of the Subcommittee on Social Security of the Committee on Finance, announced today that the Subcommittee will hold hearings on the financing of the Social Security program.

The hearings will be held starting at 9:30 a.m. on Friday, February 22, 1980 and at 2:00 p.m. on Monday February 25 in Room 2221 Dirksen Senate Office Building.

Testimony will be received from the Administration, economists and social security experts on the financial status of the social security trust funds, on recommendations regarding short- and long-term financing of the trust funds and on the Administration's proposal for interfund borrowing.

Senator Nelson said, "The social security system directly affects the lives of most Americans. Some 35 million people receive monthly compensation from the social security trust funds and over 100 million persons presently are contributing to the system. Congress has a legal and moral responsibility to the American people to insure that social security benefits are available to them when they expect and deserve protection from earnings losses or from the high costs of being hospitalized.

"These hearings will assess the status of the social security programs and the trust funds which finance them. It is vitally important for Congress and the relevant Congressional committees to continually review the most important social programs in this country and explore ways to improve upon them."

Witnesses for the two days of hearings are:

FRIDAY, FEBRUARY 22 (9:30 A.M.)

The Honorable William J. Driver, Commissioner of Social Security.

Henry Aaron, Senior Fellow, Brookings Institution and Chairman, 1979 Advisory Council on Social Security.

A panel consisting of: William Hsiao, Associate Professor of Economics, Harvard University; Michael Boskin, Professor of Economics, Stanford University and Director of Social Insurance Research, National Bureau of Economics.

MONDAY, FEBRUARY 25 (2:00 P.M.)

The Honorable Alice M. Rivlin, Director, Congressional Budget Office.

The Honorable Milton Gwirtzman, Chairman, National Commission on Social Security.

Robert M. Ball, Senior Scholar, National Academy of Sciences and former Commissioner of Social Security.

A panel consisting of: Cyrus Brickfield, Executive Director, American Association of Retired Persons—National Retired Teachers Association; Jacob Clayman, President, National Council of Senior Citizens.

In view of the widespread interest in this matter, Chairman Nelson indicated that further hearings will be held to receive testimony from other interested individuals and organizations. The schedule for these further hearings will be announced at a later date.

Written statements.—Persons not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. Written testimony for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with 5 copies to Michael Stern, Staff Director, Senate Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than March 7, 1980.

Senator NELSON. The Subcommittee on Social Security begins hearings today to receive testimony on the status of the social security trust funds and on various options to finance social security benefits in the near and long term.

Social security, in my judgment, is the most important and successful social program in our history. It is a retirement program. It is a disability insurance program. Hospitalization benefits are provided to older citizens, spouses, and dependents of eligible beneficiaries of those who receive social security benefits.

Altogether, 35 million Americans receive monthly social security benefits. To pay for these benefits, about 115 million workers and their employers will pay social security payroll taxes in 1980.

In order to economize on time, I will just have the balance of my statement printed in the record so we can move on to hear our witnesses this morning.

[The opening statements of Senators Nelson and Dole follow:]

OPENING STATEMENT OF SENATOR GAYLORD NELSON, SENATE FINANCE SUBCOMMITTEE ON SOCIAL SECURITY

The Subcommittee on Social Security begins hearings today to receive testimony on the status of the social security trust funds, on the administration's proposal to authorize borrowing among the social security trust funds, and on various options to finance social security benefits in the near and long-term.

Social security, in my judgement, is the most important and successful social program in our history. It is a retirement program. It is a disability insurance program. Hospitalization benefits are provided to older citizens. Spouses and dependents of eligible beneficiaries also receive social security benefits. Altogether, thirty-five million Americans receive monthly security benefits. To pay for these benefits, about 115 million workers and their employers will pay social security payroll taxes in 1980.

In the last four and one-half decades, social security has become an integral part of American life. Virtually every American has a stake in social security—either as a contributor, as a beneficiary or a potential beneficiary. The President's 1981 budget underscores the vastness and importance of the various social security programs.

Twenty-seven percent of the federal government's revenue in fiscal 1981 will come from social security payroll taxes. On the expenditure side, 27 cents of every federal dollar—$164 billion in all—will be spent on social security. This is a huge commitment of resources by any measure, but perhaps more importantly, it is one area of the budget for which there is strong public and political support.

Over the years, the American public has demanded secure and financially sound social security trust funds. Congress has responded by approving numerous measures to safeguard the financial stability and integrity of the trust funds.

In the future, there can be no question that social security benefits will remain secure. Those persons who are now retired or who will become eligible for social security benefits in the future can depend on social security—not as a matter of welfare or charity, but as an earned right.

As everyone knows, the social security programs have been affected by the poor performance of our economy. Inflation has increased benefit payments beyond any acturial projections. High unemployment has resulted in income to the trust funds being less than was anticipated a few years ago and also has meant that more persons are collecting benefits because of early retirement or disability, and this is all compounded by very low or negative economic growth and high interest rates.

Congress responded to these economic conditions and enacted legislation in 1977 to revise certain benefit provisions in a manner which resulted in some reduction in obligations, and also provided for additional income by increasing both social security tax rates and the amount of annual earnings subject to social security taxation. More recently, both the Senate and House of Representatives approved legislation making modifications in the nation's disability insurance program. When finally adopted, this legislation will reduce the outgo from the social security trust funds.

The social security tax increases enacted in 1977 were necessary to protect the social security funds from bankruptcy. But nonetheless, there has been a great deal of interest in various proposals to provide relief from the tax increases that went into effect this past January and the social security tax increases that are scheduled next year and beyond. One of the purposes of these hearings is to explore every possible means of reducing individual and business payroll taxes, while providing sufficient revenues to the trust funds.

Coupled with this interest is a growing concern about the financial soundness of the social security programs over the next few years. Recent forecasts of the impact of high inflation and an upcoming recession on the social security trust funds indicate that at least one of them, the Old Age and Survivors Insurance Trust Fund, may not have adequate enough resources to meet its benefit obligations completely beginning possibly as soon as late 1981.

In the consideration of these issues, the Subcommittee will receive testimony today and on Monday from the Commissioner of Social Security, economists and social security experts, the Congressional Budget Office, older Americans groups, and two advisory groups empanelled by Congress to formulate recommendations on the social security programs. Additional hearings will be scheduled to hear from business and labor groups, small business and consumer organizations and the insurance industry.

OPENING STATEMENT OF SENATOR DOLE, SOCIAL SECURITY SUBCOMMITTEE

Mr. Chairman, the social security program could be headed for real trouble in the future. On the one hand, economic pressures and expanded benefits over the years have put a great strain on the financial stability of the trust funds. On the other hand, individual taxpayers and employers are suffering under extremely burdensome taxes to pay for the program. The chairman is to be commended for holding these hearings, and for promising to hold further hearings, on the financing question because we must start thinking about ways to balance the needs of the recipients and the taxpayers while maintaining the integrity of the program.

No one is more concerned about preserving the social security program than the Senator from Kansas. Nevertheless, alleviating the adverse impact of heavy payroll taxes on working Americans is of equal importance. If taxpayers did not consider these taxes to be a real burden, we would not have to consider legislation recently to bar employers from paying their employees' share of the FICA tax without paying a tax on that tax. We would not have had such an outcry against that provision in the disability bill, and we would not have seen such an overwhelming vote to exempt small businesses and other organizations from the provisions. We would also not be seeing so many State and local governments contemplating pulling out of the social security program. Consequently, we must find ways to solve the financial problems of the social security program other than the further increase of the tax rates and the wage base.

There are a variety of possibilities for accomplishing this goal, ranging from benefit reductions to general fund financing. I understand the administration is suggesting an interim measure to head off the near-term bankruptcy of the OASI trust fund by allowing interfund borrowing. A similar approach, which might be more appropriate, is to reallocate the amount of the tax which is assigned to each trust fund. However, neither of these approaches will solve the long-run problems faced by the program as evidenced by the new economic forecasts of Government and private economists alike. Therefore, we should not be lulled into thinking that simply moving funds around will eliminate the need for real reform.

I realize that the projected economic situation precludes a social security tax cut at this time unless benefits to current beneficiaries are cut—a very unattractive

prospect—or other financing is made available. However, I believe we can provide the mechanism for a future tax cut in the event that the economy improves. If we decide to provide for interfund borrowing when the reserves of one of the trust funds go below a certain level, we should add a provision that taxes will be decreased by some amount if reserves exceed a certain level. For example, if the reserves of the trust funds each exceed 40 percent, the tax for the employer and employee. Each, could automatically be cut by one-tenth of 1 percent. By putting such a mechanism in the law, whether the reserves are actually likely to improve sufficiently to trigger the tax cut or not, we at least make clear our desire to hold the line on payroll taxes and reduce them as soon as possible. In the meantime, the Congress should consider a general tax cut to help offset these heavy payroll taxes.

Mr. Chairman, I look forward to examining the testimony of the witnesses today and in the future. I am sure their suggestions will give the members of the Finance Committee the necessary options for deciding how best to balance the needs of taxpayers and recipients without disturbing the goals of the social security program.

Thank you, Mr. Chairman.

Senator NELSON. The committee is pleased to have as our first witness the Honorable John C. Culver, Senator from Iowa.

Senator Culver, the committee is very pleased to have you here today.

STATEMENT OF HON. JOHN C. CULVER, U.S. SENATOR FROM THE STATE OF IOWA

Senator CULVER. Thank you very much, Mr. Chairman. I am pleased to have this opportunity to appear before you today to discuss a matter of vital importance to social security retirees as well as taxpayers.

I wish to commend you, Mr. Chairman, for convening these prompt hearings to address the short-term cash flow problems of the Social Security Old Age and Survivors Trust Fund.

I am testifying today not on behalf of those who make the actuarial projections and economic analyses—who will be well represented by witnesses following me. Rather, I come today on behalf of Iowa's social security retirees and taxpayers, who will be directly affected and are deeply concerned.

I wish to voice my wholehearted endorsement of the concept of social security interfund borrowing authority. This proposal offers our best hope for avoiding asking further economic sacrifices of either social security retirees or taxpayers during the 1980's.

Unless corrective action is taken, the Social Security Old Age and Survivors Trust Fund is projected to encounter serious cash flow problems by 1982. The Carter administration, the Congressional Budget Office, the National Commission on Social Security, and the 1979 Advisory Council on Social Security have each projected an inadequate old age trust fund reserve in the 1980's. Its reserve could drop below one month's benefits as soon as late 1981—creating cash flow problems and preventing timely benefit checks. The reserve could disappear in 1982 or 1983—depleting the fund and preventing full benefit checks. The old age trust fund is projected to remain in this depleted condition throughout the 1980's before recovering in the early 1990's and expanding into the next century.

In contrast, both the disability and hospitalization trust funds' reserves relative to annual outlays are projected to be more than adequate and to expand during the 1980's. In fact, the disability reserve is now estimated to continue to grow over the next 75 years. These two reserves are such that the combined reserves of all three social security trust funds are projected to be adequate

beyond the year 2000, barring serious unforeseen economic conditions.

Therefore, authorizing borrowing between the trust funds, which the Social Security system cannot presently do, likely would completely avert any cash flow or depletion problems for the old age trust fund in this decade. This simply involves a temporary shifting of funds, for instance from the disability to the old age trust fund, to be fully repaid with proper interest as soon as practicable.

This new borrowing flexibility has recently been proposed by President Carter in his state of the Union message and his fiscal year 1981 budget. And it was a major recommendation of a report issued last month by the National Commission on Social Security, chaired by Milton Gwirtzman.

Also, in correspondence to the Budget Committees last summer, the Congressional Budget Office cited interfund borrowing as the alternative to the following more drastic steps: reducing retiree and survivor benefits in real terms; raising payroll taxes beyond the already scheduled increases; or utilizing general revenues on either a temporary or permanent basis.

Mr. Chairman, we must act to insure our 30 million social security retirees and survivors of full, uninterrupted benefits throughout the 1980's. Our retirees are already struggling to make ends meet as inflation erodes the value of their modest pensions and savings, and as the cost of many basic necessities, such as utilities and medical care, outpace the increases in their social security benefits.

And we must not ask our 114 million social security taxpayers, who likely will be asked to shoulder already scheduled payroll tax increases, to contribute any more hard-earned dollars than absolutely necessary to keep the social security system sound. These working people are hard pressed just to keep up with the overall double-digit inflation, to say nothing of the spiraling costs of energy and housing.

Mr. Chairman, I would like to offer one specific suggestion for improving on the present administration formulation of the interfund borrowing proposal. I understand it is recommending that this new grant of borrowing authority expire in 1990. However, I note that the latest Social Security Administration projections reveal that the old age trust fund will remain depleted through the 1980's until it recovers in 1992 or 1993 and expands for a decade or two.

While I am mindful that these projections are tentative and subject to considerable fluctuation, I do believe that we should draft this borrowing authority to completely correct this short-term cash flow problem as calculated under the best contemporary estimates.

Perhaps this borrowing flexibilty should become permanent, but at least it should not expire before 1995 so we can be reasonably confident of having averted the old age trust fund's short-term problem in its entirety.

To conclude in the simplest terms, Mr. Chairman, the overall tax revenues are now projected to be adequate to meet the Social Security system's obligations through the turn of the century. Therefore, we must not penalize retirees by curtailing benefits or taxpayers by levying even higher taxes, simply because one fund

encounters temporary cash flow problems while another fund has more than ample resources.

Further sacrifices from our retirees or taxpayers are unacceptable when a commonsense solution such as interfund borrowing is readily available. This borrowing flexibility would help to insure proper retirement benefits into the next century.

Mr. Chairman, I do not believe this situation is cause for immediate concern over social security income. Rather, it is cause for prompt congressional action. I urge the Finance Committee's favorable consideration.

Thank you.

Senator NELSON. Thank you, Senator Culver.

As you know, some, at least on the House side, are against interfund transfers and borrowing with the required payback. They would favor reallocation.

I think you are correct in saying that borrowing is more flexible than reallocation would be. After all, the percentage assignment of the revenues from the social security tax to DI and HI and OASI were all arbitrary decisions or guesses by the Congress as to how much it would take to support each fund.

Now it turns out that the projections are that the disability insurance and the hospital insurance funds will continue to increase their percentage of annual pay-out and the OASI funds will continue to go down.

As I recall, the OASI starts at 24 percent of 1 year's payout in January of this year, and will decline steadily—unless something is done, either by reallocation of borrowing or borrowing—to 14 percent or whatever it is in 1982, to zero, whereas the other fund balances will continue to increase.

I am inclined, without having heard all the arguments on both sides, to agree with your position that there is more flexibility in using the borrowing concept than the reallocation concept if, in fact. flexibility is the most important aspect.

We all have to keep in mind, in any event, that it really is one fund. We simply allocate certain amounts to certain specific purposes, and we are going to have to address in the future the question of medicare and whether that ought to be funded in some other way.

Medicare is the only major non-wage-related provision in the act. Surely, if we had had a national health program at the time that medicare was adopted, it would have been a part of that, not part of the social security retirement system. I think this is a question that the Congress is going to have to address in the very near future.

I did advocate and offer an amendment in the Finance Committee when we handled the 1977 amendments to begin a transfer of medicare funds to OASI of the so-called earmarked medicare funds and the infusion of general funds. Whether that is the best idea, I am not certain.

But I don't believe there is any sentiment for general fund infusions to meet the retirement obligations. The medicare obligation is quite another matter.

The committee is very appreciative of your taking the time to come here this morning and give us the benefit of your testimony.

Senator CULVER. Thank you, Mr. Chairman.

I might just say a word about the argument of reallocation versus borrowing authority. It seems to me that the disadvantage of reallocations is that they can be inadequate and require continual reallocation and adjustment. The problem we are facing today, as you suggested, is a result of inadequate reallocations 2 years ago.

This is particularly true when we are operating with such sensitively low reserve ratios as we will be in the 1980's. I believe that we in Congress would be better off spending our energy and our time not involving ourselves in periodic readjustments but by really addressing the long-range problems of the system and trying to find some solutions.

I am not opposed to reallocation, but I do think it should be accompanied by borrowing authority to bolster public confidence in the system, to give it the flexibility it really needs, and to respond to sudden economic changes in view of the volatility and unpredictability of our general economic climate in the country now and in the immediate years ahead.

Senator NELSON. I don't think there is any question, at least in my mind, that borrowing gives it more flexibility. There is, I suppose, what you might identify as a psychological problem. There are those who worry that if you borrowed money from DI or HI and OASI, there is an obligation to pay it back, and some of those who are retired have some fear that somehow or another that might jeopardize their retirement fund.

Of course, it would not, as we would not, will not, cannot permit that to happen. In terms of the fund, it really is all one great big fund in which we just have set up three separate trust funds. If you abolish those trust funds as such, you would still have to keep books as though they were trust funds so that the Congress would know how much is going to disability and how much is going to medicare and how much is going for other purposes.

That is the one caution. Some people do worry that if you borrow, you jeopardize. In my judgment, that is not so, but sometimes perceptions are more important than reality, especially in your business and mine. [General laughter.]

Senator CULVER. Thank you, Mr. Chairman.

Senator NELSON. Thank you.

Our next witness is Mr. William J. Driver, Commissioner of Social Security.

Mr. Driver, the committee is very pleased to have you appear before us today. We are all aware of your long and distinguished career both in Government and out of Government. I know that around the Congress, your appointment was widely acclaimed on a bipartisan basis because of your past distinguished record.

The committee is pleased to have you before us. I believe this is your first appearance since your appointment.

Mr. DRIVER. That is correct, Mr. Chairman.

Senator NELSON. Your statement will be printed in full in the record, and you may present it however you desire.

STATEMENT OF WILLIAM J. DRIVER, COMMISSIONER OF SOCIAL SECURITY, ACCOMPANIED BY LAWRENCE THOMPSON, ASSOCIATE COMMISSIONER OF SOCIAL SECURITY FOR POLICY

Mr. DRIVER. Thank you very much, Mr. Chairman.

I have with me this morning Mr. Lawrence Thompson, the Associate Commissioner of Social Security for Policy.

Senator NELSON. I have had pleasurable discussions on social security a number of times with Mr. Thompson. He is welcomed to the committee.

Mr. DRIVER. Thank you, sir.

I would like to review with you briefly the most recent projections of the status of the social security trust funds and consider some of their implications for the future.

I would also like to discuss the President's proposal for interfund borrowing, which will ease some of the short-term problems that will arise over the next few years.

As you indicated earlier, social security is our Nation's foremost social program, representing a major and impressive achievement in social justice. Reassurance that this program is financed soundly and that benefit commitments will be met is a goal that we all share.

We feel that those who receive social security benefits, as well as those who will one day be entitled to receive them, should have no question in their minds that the benefits will be paid and paid on time.

The predicted downturn in the economy and the less than favorable projections for quick recovery in the period ahead have given rise to some unease about the stability of the social security trust funds. We have attached to my statement this morning a table showing the projected operations of the old age and survivors insurance, disability insurance, and hospital insurance trust funds, based upon the economic forecasts embodied in the President's 1981 budget.

This forecast includes a mild recession in 1980, some recovery in late 1980 and continuing through 1981, and a return over the following 4 years to full employment and moderate rates of inflation.

Our trust fund projections, like those included in the department budget, assume that the tax increases and wage base expansions provided in current law will go into effect as scheduled. As the table shows, we project that the old age and survivors insurance fund will have cash flow problems because of insufficient reserves by the end of next year.

Permitting the OASI fund to borrow from the DI fund or reallocating payroll tax rates between the two would avoid cash flow problems in 1981, although the OASI and DI reserves would become insufficient in 1982.

Yet if we look at all three trust funds taken together—OASI, DI, and HI—we project that the social security programs have sufficient revenues in the aggregate to meet all benefit commitments.

While these projections are encouraging, they are less promising than those used in 1977 when the current social security tax schedules were established. Projections at that time, when the current

payroll tax schedule was enacted, indicated that while trust fund reserves would be low until revenues from the major rate increases scheduled for 1981 and later were realized, there would nevertheless be adequate funds to cover benefit payments.

These projections, however, were based upon an economic forecast which did not foresee the high rate of inflation we have experienced over the past 3 years, caused in large part by the continuing escalation in the price of oil.

Senator NELSON. Mr. Driver, I have forgotten and perhaps you have the figure. What was the inflationary assumption of the actuaries at the time we acted on the 1977 amendments?

Mr. DRIVER. Could I come back to that?

Senator NELSON. Fine.

Mr. DRIVER. The very large increases in the price of imported oil affect both benefit outlays and payroll tax revenues. Increased oil prices have contributed to a substantial rise in the CPI, the index to which social security cost-of-living increases are tied.

The July 1979 cost-of-living adjustment in OASDI benefits of 9.9 percent added nearly $10 billion to the system's annual obligations and the upcoming June 1980 adjustment of 13 percent will add another $13 billion annually.

Wages, however, have not kept pace with inflation. The accelerated outflow of our national income caused by the oil price increases is one reason for the slowdown in the growth of workers' earnings and therefore in payroll tax revenue.

In addition, more complex and less well understood forces in the economy have held gains in productivity below the levels expected on the basis of historical experience. This decline in productivity also contributes to a slowdown in the growth of workers' earnings and therefore payroll tax revenues.

In 1977 it was projected that real wages would increase by 2.7 percent in 1978, 2.5 percent in 1979, and 2.4 percent in 1980. Real wages actually increased by only 0.9 percent in 1978, decreased by 2.8 percent in 1979, and are projected to decrease by 2.4 percent in 1980.

A recitation of these facts makes clear that the courageous action of the Congress to raise taxes in enacting the 1977 amendments was absolutely critical. Had changes in the tax rates and the earnings base not been enacted then, the disability insurance trust fund would have encountered cash flow problems in 1979, and the combined OASDI funds would have become unable to meet benefit payments late this year.

In light of this recent economic history and the current projections of continued inflation and the mild economic downturn, it is clear that all of the tax increases and the wage base expansions that are scheduled in the law will be required to maintain the trust funds.

It is also clear in retrospect that the 1977 legislation shifted more funds to the disability insurance and hospital insurance programs than were required to maintain these programs. Experience with respect to both the DI and HI programs turned out to be more favorable than had been expected, as you have indicated.

The disability incidence rate declined at a greater rate than had been forecast, and inflation in hospital costs slowed considerably.

Taken together, however, the three trust funds are expected to have sufficient income and reserves in the aggregate to meet the needs of the total program over the next 5 years.

The current projections show that although outgo for the three funds combined will exceed payroll tax income by $2.3 billion this year, by 1985 income will exceed outgo by some $25 billion. Combined trust fund reserves as a percent of outgo will fall from 29 to 21 percent in 1983 and 1984, and will rise to 23 percent by the beginning of 1985.

We are therefore recommending legislation to permit borrowing among the three trust funds to meet the projected temporary shortfall in the OASI trust fund. We believe that interfund borrowing is the best way to respond to this temporary situation and to assure the continued financial integrity of the program as a whole.

If our projections hold true, interfund borrowing should resolve the near-term financing problems of the OASI fund without causing basic changes in social security financing. At the very least, interfund borrowing is necessary to guarantee benefit payments until economic trends become clearer.

Basically this proposal would enable the managing trustees to shift funds among the trust funds under certain conditions with specified terms for repayment. Specifically, whenever the assets of one fund at the end of a 12-month period are less than 25 percent of estimated outlays during that period, the Board of Trustees could instruct the managing trustee to borrow from the other trust funds in an amount sufficient to bring that fund's assets up to 25 percent.

Borrowed amounts plus interest would be repaid to the lending fund when the reserve of the borrowing fund reaches 30 percent of its annual outgo. The interest rate would be set at such a level that after the loan has been repaid, the lending fund would be in the same financial position as it would have been in if the borrowing had not occurred.

Of course, the proposal assumes that the revenues from the tax and wage base increases scheduled under current law will be realized.

We are proposing that the authority for interfund borrowing expire at the end of 1990. The primary purpose of the interfund borrowing authority is to meet a temporary shortfall during the early and middle years of the 1980's in the OASI trust fund. Current projections show that payroll tax increases now scheduled will begin to rebuild the OASI reserves so that after 1990, borrowing authority will no longer be necessary.

The 1990 expiration date will allow the Congress to review the efficacy of the interfund borrowing provision and to decide whether it should be extended or allowed to expire.

Another proposal which we have considered but are not recommending is a reallocation of the payroll tax rate among the OASI, DI, and HI trust funds. We are, of course, willing to work with the committee if it wishes to provide for a reallocation of tax rates in addition to interfund borrowing, but we feel that reallocation in itself is not sufficient to provide the beneficiaries of the social security program the guarantee that they need and deserve.

Any allocation of tax rates that appears appropriate today may become inappropriate a few years hence, just as the 1977 one has already proved inappropriate. Our interfund borrowing plan, on the other hand, will always prevent cash flow problems from developing in a single fund at a time when overall reserves are adequate.

It is possible, of course, that economic conditions may differ from those on which our projections are based. In the past few months, for example, developments have occurred which have caused many analysts to revise their forecasts. The Federal Reserve Board took action in October and again in February to tighten the supply of money, thereby causing interest rates to rise significantly.

At its December meeting, OPEC raised prices by an average of about 25 percent. Nevertheless, despite these negative factors, the economy has been surprisingly strong and the long-predicted recession has not yet materialized.

With the economy changing so abruptly and in such an unpredictable fashion, social security financing must provide the flexibility for the system to withstand fluctuations. Based on current forecasts, we believe that interfund borrowing provides this flexibility.

We also believe that it would be unwise to make more drastic changes in social security financing at a time when the economic outlook is not clear. We are, of course, constantly monitoring the economy and will advise the committee if further adjustments appear to be necessary.

The administration's interfund borrowing proposal has the advantage of being neutral in its effect on benefits, payroll taxes and the overall Federal budget. It can, however, make a major contribution to public confidence in the social security system and help assure the beneficiaries that their benefits will be paid regardless of temporary economic downturns.

The proposal has been endorsed by the National Commission on Social Security, and we urge that you give it prompt consideration.

That concludes my statement, Mr. Chairman.

Senator NELSON. Thank you.

Mr. DRIVER. I have asked Mr. Thompson to read into the record, if you would, the inflation rates that you asked for.

Senator NELSON. The assumptions on which we based the last social security adjustments and tax rate?

Mr. THOMPSON. Those were the assumptions of the 1977 trustee's report. By way of background, the cost-of-living benefit increase in 1977 was 5.9 percent. The report projected that and then it went on to project that in 1978 the increase would be 5.5 percent. It actually was 6.5 percent.

The report projected in 1979 the benefit increase would be 5.2 percent. The actual increase was 9.9 percent. The projection for 1980 was a benefit increase of 5 percent, and the most recent projection based on the 1981 budget assumptions is that the July increase will be 13 percent.

And finally, for 1981 the 1977 trustee's report projected a 4.2 percent benefit increase, and the budget assumptions now project a 9.9 percent benefit increase.

Senator NELSON. Thank you.

Obviously, that is the heart of the problem, the inflation question. While we are at it, do you happen to have the unemployment projections? I don't need them right now, but if you would submit them for this hearing record so that we could put them in at this particular place in the record, I would like to have in the record the 1977 assumptions.

[The information referred to follows:]

TABLE 25.—VALUES OF SELECTED ECONOMIC AND DEMOGRAPHIC FACTORS UNDER 3 ALTERNATIVE SETS OF ASSUMPTIONS, CALENDAR YEARS 1977-2051

Calendar year	Average annual unemployment rate
Alternative I:	
1977	7.1
1978	6.3
1979	5.6
1980	5.0
1981	4.5
1982	4.5
1983	4.5
1984 and later	4.5
Alternative II:	
1977	7.1
1978	6.3
1979	5.7
1980	5.2
1981	5.0
1982	5.0
1983	5.0
1984 and later	5.0
Alternative III:	
1977	7.1
1978	6.4
1979	6.6
1980	6.6
1981	6.3
1982	6.0
1983	5.6
1984 and later	5.5

Source: 1977 Annual Report of the Board of Trustees of the Federal OASI and DI Trust Funds (p. 45).

Senator NELSON. Would this make any sense? It is all one fund. Each taxpayer, employer, employee pays a specific rate. It isn't divided up into DI, HI, OASI rate. It all goes into one fund, and then we sit here trying to guess how much it is going to cost for disability insurance and how much for medicare and how much for OASI. Why not just abolish those trust funds? You would have to keep the books.

What is gained by having them earmarked in this way, and the earmarking based upon assumptions in which the imponderables far outweigh the ponderables? It doesn't make much sense.

Mr. DRIVER. I suppose the principal gain is that it brings us together periodically to discuss the state of the economy. [General laughter.]

Senator NELSON. Thank you. That is the only reason I have heard. It is good enough. [General laughter.]

Senator NELSON. Thank you very much, Mr. Driver. We appreciate your taking the time to come.

Mr. DRIVER. Thank you.

Senator BAUCUS. Mr. Chairman.

Senator NELSON. Oh, I am sorry. Senator Baucus came in on my right. I never notice anybody coming in on that side. [General laughter.]

Senator BAUCUS. I have a question, Mr. Driver. As Senator Nelson has pointed out, inflation rate projections are part of the problem here. What are the assumptions to 1985 as to rates of inflation?

Mr. DRIVER. 1985?

Senator BAUCUS. Through 1985. You said that you feel with this interborrowing authority, everything would be in good shape at least through 1985. I am just curious what your projections are for inflation and unemployment through 1985.

Mr. DRIVER. Under the heading of benefit increase percentage changes predicted into the future, which would correspond to the figures Mr. Thompson read regarding 1977 amendments, for 1979, 9.9; 1980, 13; 1981, 9.9; 1982, 8.4.

Senator BAUCUS. Excuse me. What I heard for 1980 projection was 5 percent.

Mr. THOMPSON. That was the projection made in 1977. This is our current projection and the projection that our estimates are based on.

Senator BAUCUS. Excuse me. What are your current projections?

Mr. DRIVER. These are the ones I am giving you now, on which were predicated the recommendations.

Senator BAUCUS. And what are they again, please?

Mr. DRIVER. Starting in 1980, 13; 1981, 9.9; 1982, 8.4; 1983, 7.7; 1984, 7.1; 1985, 6.3.

Senator BAUCUS. What is the basis for that decline in projected rates of inflation?

Mr. THOMPSON. It may be that it is wishful thinking. There is a general opinion among economists, the private sector forecasters, the CBO and the administration all having essentially the same pattern, in thinking that there is something unusual about a 13 inflation rate and that it is not going to continue.

We may differ as regards how quickly the inflation rates decline. It may be that future events will prove us wrong. But in the administration's projected gradual decline in the rate of inflation, they are not the only ones who are projecting that.

Senator BAUCUS. I only asked because in 1977, the projection was declining rates for each of the succeeding years, too. In fact that did not turn out to be the case.

Mr. THOMPSON. That is correct. That underscores, I think, the uncertainty of the economic situation right now. All we can do is make the best guess and make a guess which corresponds to the projections the private sector and the CBO and the other people are making.

Senator BAUCUS. How much of an increase do you project in the number of beneficiaries?

Mr. DRIVER. We may have to submit that for the record.

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Senator BAUCUS. If you could, please. Just in your own mind do you know just generally what it is?

Mr. DRIVER. It is something over 300,000 a year increase.

Senator BAUCUS. That is total.

Mr. DRIVER. Yes.

Mr. THOMPSON. There is underlying our projections an assumption of how many total beneficiaries there will be in each year broken down by program. We can give that to you even subdivided by category, like disabled workers, dependents of disabled workers.

Senator BAUCUS. If you could, please.

Mr. THOMPSON. We could submit that for the record. We didn't bring it with us today.

[The information referred to follows:]

ESTIMATED NUMBER OF OASI AND DI BENEFICIARIES IN CURRENT PAY AT THE END OF CALENDAR YEARS 1979–85, CONSISTENT WITH THE BENEFIT PAYMENT ESTIMATES FOR OMB'S MARCH UPDATE ASSUMPTIONS

[In thousands]

Calendar year	OASDI total [1]	OASI [1]				DI		
		Total	Retired workers	Dependents	Survivors	Total	Disabled workers	Dependents
1979	35,013	30,236	18,970	3,648	7,618	4,777	2,870	1,907
1980	35,625	30,897	19,594	3,679	7,624	4,728	2,867	1,861
1981	36,264	31,563	20,230	3,704	7,629	4,701	2,878	1,823
1982	36,902	32,203	20,847	3,715	7,641	4,699	2,904	1,795
1983	37,578	32,868	21,488	3,727	7,653	4,710	2,941	1,769
1984	38,341	33,590	22,168	3,740	7,682	4,751	2,995	1,756
1985	39,118	34,312	22,835	3,757	7,719	4,806	3,060	1,746

[1] Excludes transitionally uninsured workers.

Note.—Totals may not equal the sum of rounded components.

Senator BAUCUS. Thank you very much.

Senator NELSON. Thank you very much.

[The prepared statement of Mr. Driver follows:]

TESTIMONY OF WILLIAM J. DRIVER, COMMISSIONER OF SOCIAL SECURITY

Mr. Chairman and members of this distinguished subcommittee, I appreciate the opportunity to appear before you today to discuss the financial condition of the social security program.

This morning I will review with you the most recent projections of the status of the social security trust funds, and consider some of their implications for the future. I will also discuss the President's proposal for interfund borrowing, which will ease some of the short-term problems that will arise over the next few years.

Social security is our Nation's foremost social program. It represents a major and impressive achievement in social justice. Thirty-five million people receive social security benefits every month to carry them through periods of income loss upon the retirement, death or disability of a family breadwinner. Reassurance that this program is financed soundly and that benefit commitments will be met is a goal that we all share. Those who receive social security benefits, as well as those who will one day be entitled to receive them, should have no question in their minds that their benefits will be paid.

The predicted downturn in the economy and the less-than-favorable projections for quick recovery in the period ahead have given rise to some unease about the stability of the social security trust funds. We must work together to demonstrate quickly to the public that action will always be taken when necessary to guarantee the payment of social security benefits.

CURRENT PROJECTIONS AND STATUS OF TRUST FUNDS

The attached table shows projected operations of the old-age and survivors insurance, disability insurance, and hospital insurance trust funds, based upon the economic forecast embodied in the fiscal year 1981 budget. This forecast includes a mild recession in 1980, some recovery in late 1980 and continuing through 1981, and a return over the following 4 years to full employment and moderate rates of inflation. Our trust fund projections, like those included in the Department's budget and in other data submitted to Congress, assume that the tax increases and wage base expansions provided in current law will go into effect as scheduled.

As the table shows, we project that the old-age and survivors insurance trust fund will have cash flow problems because of insufficient reserves by the end of next year. Permitting the OASI fund to borrow from the DI fund or reallocating payroll tax rates between the two funds would avoid cash flow problems in 1981, although the OASI and DI reserves would become insufficient in 1982. Yet if we look at all three trust funds taken together—OASI, DI and HI—we project that the social security programs have sufficient revenues in the aggregate to meet all benefit commitments.

CHANGES IN ECONOMY SINCE 1977 AMENDMENTS

While these projections are encouraging, they are less promising than those used in 1977, when the current social security tax schedules were established.

Projections made at the time of the 1977 amendments, when the current payroll tax schedule was enacted, indicated that, while trust fund reserves would be low until revenues from the major rate increases scheduled for 1981 and later were realized, there would nevertheless be adequate funds to cover benefit payments. However, these projections were based upon an economic forecast which did not foresee the high rate of inflation we have experienced over the past 3 years, caused in large part by the continuing escalation in the price of oil.

The very large increases in the price of imported oil affect both benefit outlays and payroll tax revenue. Increased oil prices have contributed to a substantial rise in the CPI, the index to which social security cost-of-living increases are tied. The July 1979 cost-of-living adjustment in OASDI benefits of 9.9 percent added nearly $10 billion to the system's annual obligations; and the upcoming June 1980 adjustment of 13 percent will add another $13 billion annually.

Wages however, have not kept pace with inflation. The accelerated outflow of our national income, caused by the oil price increases, is one reason for the slowdown in the growth of workers' earnings and therefore, in payroll tax revenues.

In addition, more complex and less well understood forces in the economy have held gains in productivity below the levels expected on the basis of historical experience. This decline in productivity also contributes to a slowdown in the growth of workers' earnings and, therefore, payroll tax revenues. In 1977, it was projected that real wages would increase by 2.7 percent in 1978, 2.5 percent in 1979, and 2.4 percent in 1980. Real wages actually increased by only 0.9 percent in 1978, decreased by 2.8 percent in 1979, and are projected to decrease by 2.4 percent in 1980.

Recitation of these facts makes clear that the courageous action of the Congress to raise social security taxes in enacting the 1977 amendments was absolutely critical. Had changes in the tax rates and the earnings base not been enacted in 1977, the disability insurance trust fund would have encountered cash flow problems in 1979, and the combined OASI and DI funds would have become unable to meet benefit payments late this year.

In light of this recent economic history and the current projections of continued inflation and a mild economic downturn, it is clear that all of the projected tax increases and wage base expansion that are scheduled in law will be required to maintain the trust funds.

It is also clear in retrospect that the 1977 legislation shifted more funds to the disability insurance and hospital insurance programs than were required to maintain those programs. Experience with respect to both the disability and hospital insurance programs turned out to be more favorable than had been expected. The disability incidence rate declined at a greater rate than had been forecast and inflation in hospital costs slowed considerably. This more favorable experience is predicted to continue in the future. As the table illustrates, DI and HI trust fund reserves are projected to increase in each year through 1985. The HI trust fund reserve ratio will more than double, growing from about 54 percent of 1 year's outgo at the beginning of this year to 113 percent at the beginning of 1985. The DI trust fund reserve will more than triple over the same period.

As I mentioned earlier, however, the three trust funds are expected to have sufficient income and reserves in the aggregate to meet the needs of the total program over the next 5 years. The current projections show that, although outgo for the three funds combined will exceed payroll tax income by $2.3 billion this year, by 1985 income will exceed outgo by some $25 billion. Combined trust fund reserves, as a percent of outgo, will fall from 29 percent to 21 percent in 1983 and 1984, and will rise to 23 percent by the beginning of 1985.

We are therefore recommending legislation to permit borrowing among the three trust funds to meet the projected temporary shortfall in the OASI trust fund. We believe that interfund borrowing is the best way to respond to this temporary situation and to assure the continued financial integrity of the program as a whole. If our projections hold true, interfund borrowing should resolve the near-term financing problems of the OASI fund without causing basic changes in social security financing. At the very least, interfund borrowing is necessary to guarantee benefit payments until economic trends become clearer.

Basically, our proposal would enable the Managing Trustee to shift funds among the trust funds under certain conditions, with specified terms for repayment. Specifically, whenever the assets of one fund at the end of a 12-month period are less than 25 percent of estimated outlays during that period, the Boards of Trustees could instruct the Managing Trustee to borrow from the other trust funds an amount sufficient to bring that fund's assets up to 25 percent.

Borrowed amounts plus interest would be repaid to the lending trust fund when the reserve of the borrowing fund reaches 30 percent of its annual outgo. The interest rate would be set at such a level that after the loan has been repaid the lending trust fund would be in the same financial position as it would have been in if the borrowing had not occurred. Of course, the proposal assumes that the revenues from the tax and wage base increases scheduled under current law will be realized.

We are proposing that the authority for interfund borrowing expire at the end of 1990. The primary purpose of the interfund borrowing authority is to meet a temporary shortfall in the OASI trust fund during the early and middle years of the 1980's. Current projections show that payroll tax increases scheduled in the law for 1985 and 1990 will begin to rebuild the OASI reserves so that after 1990 borrowing authority will no longer be necessary. Also, the 1990 expiration date will allow the Congress to review the efficacy of the interfund borrowing provision and to decide whether it should be extended or allowed to expire.

Another proposal which we have considered but are not recommending at this time is a reallocation of the payroll tax rate between the OASI, DI, and HI programs. We are, of course, willing to work with the Committee if it wishes to provide for a reallocation of tax rates in addition to interfund borrowing. But a reallocation is not sufficient by itself to provide social security beneficiaries the guarantee that they need and deserve. Any allocation of tax rates that appears appropriate today may become inappropriate a few years hence, just as the 1977 allocation has already proved inappropriate. Our interfund borrowing plan, on the other hand, will always prevent cash flow problems from developing in a single trust fund at a time when overall reserves are adequate.

It is possible, of course, that economic conditions may differ from those on which our projections are based. In the past few months, for example, important developments have occurred which have caused many analysts to revise their forecasts. The Federal Reserve Board took action in October and again in February to tighten the supply of money and thereby caused interest rates to rise significantly. At the December OPEC meetings, oil prices were increased by an average of about 25 percent. Nevertheless, despite these negative factors, the economy has been surprisingly strong, and the long predicted recession has not yet materialized.

With economic events changing so abruptly and in such an unpredictable fashion, social security financing must provide the flexibility for the system to withstand fluctuations in the economy. Based on current forecasts, we believe that interfund borrowing provides such flexibility. We also believe that it would be unwise to make more drastic changes in social security financing at a time when the economic outlook is not clear. We are, however, constantly monitoring the state of the economy and will advise the committee if further adjustments appear to be needed.

The Administration's interfund borrowing proposal has the advantage of being neutral in its effect on benefits, payroll taxes, and the overall Federal budget. It can make a major contribution to public confidence in the social security system and help assure social security beneficiaries that their benefits will be paid regardless of temporary economic downturns. The proposal has been endorsed by the National Commission on Social Security, and we urge that you give it prompt consideration.

I thank you for the opportunity to provide the Administration's views to your subcommittee.

Financial Status of the OASI, DI, and HI Trust Funds under Present Law Based on the Economic Assumptions Contained in the President's 1981 Budget 1/ 2/

Calendar Years 1979-1985
(amounts in billions)

Calendar Year	Income					Outgo					Net change				
	OASI	DI	OASDI	HI	OASDHI	OASI	DI	OASDI	HI	OASDHI	OASI	DI	OASDI	HI	OASDHI
1979	$90.1	$15.6	$105.8	$22.7	$128.5	$93.2	$14.3	$107.4	$21.3	$128.7	-$3.1	$1.4	-$1.7	$1.4	-$ .3
1980	101.8	17.9	119.8	26.2	145.9	108.3	15.9	124.2	24.0	148.2	-6.5	2.0	-4.5	2.2	-2.3
1981	115.4	21.6	137.0	34.8	171.8	125.2	17.8	143.0	27.3	170.3	-9.8	3.8	-6.0	7.5	1.5
1982	130.7	24.8	155.4	40.0	195.5	141.5	19.8	161.3	31.2	192.5	-10.9	5.0	-5.8	8.8	3.0
1983	146.6	28.3	174.9	45.6	220.5	157.5	21.8	179.3	35.6	214.8	-10.9	6.5	-4.4	10.0	5.6
1984	163.9	32.0	195.9	51.4	247.3	173.9	24.0	197.9	40.6	238.5	-10.0	8.0	-2.0	10.9	8.9
1985	188.2	40.7	228.9	59.2	288.2	190.4	26.4	216.8	46.2	262.9	-2.1	14.3	12.2	13.1	25.2

Calendar Year	End of year balance					Funds at beginning of year as a percentage of outgo during year				
	OASI	DI	OASDI	HI	OASDHI	OASI	DI	OASDI	HI	OASDHI
1979	$24.5	$ 5.6	$30.1	$12.9	$42.9	30%	30%	30%	54%	34%
1980	18.0	7.7	25.6	15.0	40.7	23	35	24	54	29
1981	8.1	11.4	19.6	22.5	42.1	14 3/	43	18	55	24
1982	-2.7	16.5	13.7	31.3	45.1	6	58	12 4/	72	22
1983	-13.6	23.0	9.4	41.3	50.7	0	76	8	88	21
1984	-23.6	31.0	7.4	52.2	59.6	0	96	5	102	21
1985	-25.7	45.3	19.6	65.3	84.8	0	117	3	113	23

1/ Also assumes present regulations.

2/ Totals do not necessarily equal the sum of rounded components.

3/ Without interfund borrowing authority, the OASI fund will have cash flow problems and become unable to pay benefits in 1981.

4/ With interfund borrowing between OASI and DI (but not HI), the combined OASI and DI funds will have cash flow problems and become unable to pay benefits in 1982.

Senator NELSON. Our next witness is Mr. Henry Aaron, senior fellow, Brookings Institution, and Chairman, 1979, Advisory Council on Social Security.

Mr. Aaron, the committee is very pleased to have you take the time to come and appear this morning in your capacity as chairman of the Advisory Council on Social Security.

Your statement will be printed in full in the record and you may present it however you desire.

STATEMENT OF HENRY AARON, CHAIRMAN, ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. AARON. Thank you very much, Mr. Chairman and Senator Baucus.

I would like to excerpt certain portions of my testimony, beginning with my thanks for the opportunity to present the recommendations of the Advisory Council.

Before getting into the body of the testimony, I should point out that the change in economic assumptions that has occurred in recent months and the attendant changes in projections of the social security trust funds have caused me to change some of the numbers that we used in the Advisory Council report.

The Advisory Council throughout its deliberations was aware of and deeply concerned by the growing sense of concern about the financial security of social security benefits. The Council's view one expressed here this morning: that benefit obligations to all who are now retired or soon will be retired or disabled, will be and should be met in full.

Council members differed about how and when the benefit structure should be modified for those who will retire many years hence, but no member of the Council could see any value to allowing the disabled and those past or near retirement age to worry needlessly about the security of their benefits.

Congress is committed that those benefits will be paid, and this fact should be made obvious to those who now are or soon will be beneficiaries.

With that principle in mind, the Advisory Council structured its recommendations for reforming the financing of social security to accomplish the following objectives. If adopted, the Council's recommendations would provide financing for hospital insurance from general revenues, permit payroll taxes to be cut from 6.65 percent now scheduled in law for 1981 to approximately 6 percent, and held at that level for the next 25 years.

The recommendations, if adopted, would prevent problems of inadequate revenues during the course of a recession and the attendant and needless concern that such shortfalls cause to beneficiaries. They would put the social security system on a sound actuarial basis for the next 75 years by placing in law a schedule of taxes sufficient to support presently legislated retirement, survivors and disability benefits for that entire period.

Senator NELSON. Let me ask a question. The issue, it seems to me, of public confidence is important in terms of the social security system, and one of the assertions that one sees frequently in the paper is that with a shrinking work force and an expanding percentage of people in the country that are retired, the capacity of

those working will be inadequate or the tax will be too overwhelming for them to support those who retire.

You have seen the stories as have I, I am sure. What is your comment on that?

Mr. AARON. Sometime over the next 25 years, the Congress and the American people are going to have to make a judgment about how increased costs of social security are going to be met. If we sustain all present benefits as provided under current law, then beginning early in the 21st century, about 25 years from now, it is true that higher tax rates than are now legislated will be necessary to pay for those benefits.

It seems to me we face three courses of action. We can raise payroll tax rates. The increase over that 25-year period would be significant but it would not be rapid by historical standards.

Senator NELSON. You said the increase over that 25-year period. Do you mean the 25-year period after the 21st century?

Mr. AARON. Yes.

Senator NELSON. The second 25-year period from now.

Mr. AARON. That is correct.

Senator NELSON. The last half of this next 50 years.

Mr. AARON. Yes; alternatively, we could resort to some other source of revenues, general revenues, to support some part of the system.

The third course of action, of course, would be to reduce benefits. Congress is going to have to decide which combination of those three courses of action seem to be most desirable.

The Advisory Council's position was that we ought to begin using revenue sources other than payroll taxes: in particular, that we should move to finance the medicare system with earmarked general revenues, thereby freeing the payroll tax to pay for the cash benefits programs, retirement, survivors, and disability insurance.

On the benefits side, we recommended a number of changes.

Senator NELSON. Could I interrupt for just one moment for a question on that point? If at that time, 25 years from now when you predict that there will have to be some changes in the financing, under the projections upon which you base your assumption that there will have to be increases in the base or taxes or other kinds of funding, would a transfer of the costs of medicare meet the problem? Or rather, by just pulling the medicare expenses out of social security, would the infusion that would result be adequate to meet the problem that you predict will occur around 25 years from now?

Mr. AARON. I think the answer is yes. The payroll tax schedule under our plan would actually provide for lower payroll tax rates cumulatively over the entire 75-year period than are now provided under current law.

There would be a short-term reduction, as I indicate, from 6.65 percent in 1981 to 6 percent. The 6-percent rate would then remain steady through the year 2005, a period during which under current law payroll taxes are scheduled to rise to over 7 percent.

Then in the year 2005 under the Council's recommendation, an increase in payroll taxes to about 7.25 percent would be necessary, but that rate also is lower than the rate now scheduled in current

law. And that rate is not adequate to provide actuarial balance through the 75-year period.

The Council's recommendations, based on the calculations we had done, were sufficient to pay for the benefits as modified by the Council's recommendations, which were very similar to those under current law. It is a long way of answering your question with a yes.

Senator NELSON. Thank you. Go ahead.

Mr. AARON. I will divide my comments into two parts, one dealing with the financing of social security with revenues other than payroll taxes. Then I would like to turn to the shortrun issues, where I believe the administration's recommendations for interfund borrowing are most relevant.

The Council unanimously—and that included business, labor, and public members—agreed that the time had come to finance some part of social security benefits with revenues other than the payroll tax. Members were not unanimous about the particular place where general revenues should be put, but a majority are motivated by the recognition that payroll taxes fall disproportionately on households with relatively low incomes, that payroll taxes contribute to inflation by adding to labor costs, and that the payroll tax is less suited to pay for medicare benefits than it is to pay for earnings-related cash benefits.

Motivated by those considerations, the Council supported the replacement of a part of the payroll tax by general revenues in the belief that it would improve the equity of the tax system and modestly contribute to the fight against inflation.

Senator NELSON. Part of the payroll tax to specifically earmark to any one of the three trust funds?

Mr. AARON. Yes.

Senator NELSON. Is medicare one?

Mr. AARON. Yes; part of the payroll tax that is now imposed, that part which is now imposed to pay for medicare, the Council recommends should be repealed, and a piece of the medicare payroll tax should be shifted over to the survivors, retirement, and disability insurance programs.

Medicare in turn, then, would be supported by an earmarked portion of the personal income tax and a Treasury payment designated as coming from the corporation income tax.

Senator NELSON. Wait a minute. Repeat those last two sentences again.

Mr. AARON. The medicare payroll tax would be repealed. It is projected to be 1.3 percent in 1981.

Senator NELSON. That is 1.3 percent of the whole tax.

Mr. AARON. Imposed on both employers and employees, yes.

Senator NELSON. You are not saying 2.6 total.

Mr. AARON. Yes, it is 2.6 total going into medicare, 1.3 percent of the payroll collected both from employees and from employers. Let me talk in terms of the split rate. Of that 1.3 percent, 0.65, roughly half of it, would be shifted over to retirement, survivors, and disability insurance. The other 0.65 percent we suggest should be repealed, and the funding of medicare should be achieved out of an earmarked component of the personal income tax and a payment

from the Treasury designated as coming from the corporation income tax.

Senator NELSON. What is the rationale for an earmarked component in the income tax? Is that a progressivity question you are attempting to address, or regressivity, whichever way you want to look at it?

Mr. AARON. I deal with that on the bottom of page 7 and page 8 of my testimony. We were motivated to support earmarking by a sensitivity to some objections that have been raised against the use of general revenues in social security since they were first recommended over 40 years ago.

Congress has objected to using general revenues, and for specific reasons. One objection is the sense that if you use general revenues for social security, you are going to lose the discipline that an earmarked tax imposes on the American people and elected representatives through driving home the awareness that any increase in benefits has to be paid for now by an increase in taxes.

Senator NELSON. Let me interrupt to say that is a real concern in the Congress.

Mr. AARON. I believe it is.

Senator NELSON. We have had instances in the past of benefits adopted through amendments on the floor and sometimes in committee that were not adequately funded. I didn't want to interrupt your train of thought but I did anyway. This brings me to a question I want to ask so that I don't forget it.

The large question is: Shouldn't we really have in the Congress a retirement committee with responsibility all in one committee instead of the Armed Services Committee being the committee handling military, and the old Post Office Committee handling Federal employees, and then this committee handling social security, and none of them knowing what the others are doing, with variable kinds of benefits, and so forth and so on?

But more important, there is the question of assuring that the Congress address itself to the cost of benefits at the time they vote for them. In my State, Wisconsin, the retirement fund for State employees has remained very secure, as many around the country are not, for a very simple reason. You may not amend the Wisconsin Retirement Act by a legislative amendment on the floor or even by a proposal from the committee without it first going to the Advisory Committee on Retirement, which then does a computation of what is the cost and what is the additional tax necessary.

So you do not get a circumstance where by some whim of the legislature or political pressures, an amendment is adopted and all of a sudden the cost is there and now a way of paying for it has to be found.

It seems to me to make sense, and I would just wonder about your idea, that you require by rule that any proposed increase in benefits must first go to the appropriate committee. I would hope it would be a retirement committee, but until there is one, it would be this committee and the Ways and Means Committee, so that a report can be made back to the Congress as to what tax is required to meet the benefit.

Mr. AARON. I think that principle is a very important one. It is one which in the case of social security, Congress in effect has

heeded, at least in most cases, by requiring that the system be in actuarial balance. Until recent years balance has been maintained, so that any increase in benefits had to be matched by an increase in taxes.

I think the desire to retain that discipline is widespread. It was strong within the Advisory Council, leading to the recommendation that any use of general revenues be earmarked and flagged in such a way that taxpayers could readily see it and would be forced to see it each year.

So our suggestion is that not only should a portion of the income tax be earmarked for medicare if general revenues are used, but in addition, it should be flagged annually on the taxpayer's tax return. There should be a visible entry showing how much goes to pay for medicare so that benefits must be paid for is sustained.

Senator NELSON. On that point, if it were earmarked from income taxes, then, of course, you would be making a change in the impact of the tax, a progressivity question, because those who are employed and now paying the full cost of medicare, even though they do not have an income high enough to pay an income tax, would be eliminated from contributing to the cost of the medicare program. Is that it?

Mr. AARON. There would be some redistribution. The precise nature of that is really at the discretion of Congress and hinges on the way in which I think this recommendation should be introduced. One of the other criticisms that I have heard of the Council's recommendation is that it would cut taxes now, and increase the deficit thereby contributing to inflation.

I want to stress that this particular issue was one we spent a good deal of time on because we were very sensitive to it. No member of the Advisory Council felt competent to judge how much the United States should collect in revenues overall, but we did feel confident that sometime during the next year or two or three, Congress once again will take steps to make sure that inflation and real economic growth do not push people into progressively higher personal income tax brackets.

It was the Council's sense that at such time, whenever a conclusion is reached that taxes should be reduced to prevent this creeping increase in tax rates from occurring it would be desirable to provide part of that reduction through the a reduction in payroll tax rates. If larger tax cuts were considered desirable, then additional reductions in personal income taxes should be considered.

So the precise distributional effect would depend on exactly how Congress decided to combine a cut in payroll taxes with a change in personal income tax rates.

Senator NELSON. I don't want to get too far diverted, but very frequently criticism is made of the social security system that it is regressive. There are people who argue otherwise, that social security is wage related, that your benefits are based upon your wages, and that it is fair.

There is, in fact, a very substantial transfer in the system in which you will have people—well, I don't have the figures in front of me—getting as high as a 60-percent replacement rate. That is to say, their retirement will amount to 60 percent of what their income was.

And when you get to $75,000, if my memory is correct, you will be at a replacement rate of 33 percent. In other words, those who start paying in 1990 or whatever on a base of $75,000 will retire on a replacement rate of 33 percent, while you have those others in the lower income range getting a replacement rate of 60 percent, which may be all right.

The question I am asking is has the Advisory Council addressed itself to the question of at what point does a covered employee discover that he or she would be better off not covered by social security than being covered? That probably will be arrived at very soon for the self-employed who pay 1½ times the cost instead of 1. They don't have any employer contributing.

I think it is important to be very careful that we address this problem because at some stage you may simply erode the support for the social security system. And that would be understandable. If somebody can find out that they are better off, or even when it gets close, and then their judgment is that they would rather invest their moneys on their own behalf, not worrying, as the system does, about benefits for widows and dependent children on the assumption they aren't going to worry about that for their own, then you get into a very serious political problem.

That has concerned me for some time. Has the Advisory Council addressed that kind of question?

Mr. AARON. Yes, we did. It concerned a number of the members on the commmittee as well. The approach that we chose to take was to recommend——

Senator NELSON. I have just proved I haven't read the report.

Mr. AARON. One of our flaws, I think, was being a bit longwinded. The report is quite lengthy. The specific approach that we took was to recommend a modification of the benefit formula that would improve the return that social security provides for high wage workers.

Senator NELSON. Improve the return?

Mr. AARON. It would improve the return. It would increase the replacement rate that a high wage worker can expect as his earnings go up. In other words, the marginal, the incremental benefit that a high wage worker would receive under the Council's recommended benefit formula would be substantially higher than that under current law.

Senator NELSON. How do you fund that?

Mr. AARON. I will be glad to get into the benefit recommendations, but they will take us quite far afield from the financing question.

Senator NELSON. I will just raise one point about that. Someone out in my State, a housewife who obviously was quite perceptive, raised a question that had never before occurred to me. She was criticizing what is going to happen as the base rates get up to $75,000. She was quite aware that that replacement rate would be 33 percent. She happened to be at a much lower level.

Her question was how do you justify giving a spouse who did not contribute 50 percent of that much higher rate, so that she as a housewife might be getting—she didn't name her figure—might be getting $200 a month as amounting to 50 percent of her husband's benefit, whereas those in the higher bracket might be getting,

conceivably, I don't know what that would be, $500, $800, $1,000 a month.

Did you look at that question?

Mr. AARON. We did go into the treatment of spouses and recommended some modest changes in the way in which nonworking spouses are treated under the social security system. But I will assert that the most devilishly complex and continuously confusing aspect of the Advisory Council's work concerned the treatment of the family under social security.

There was no issue that caused us so much difficulty as that one. It might be worth saying why. There were a number of suggestions that came before us that on the surface seemed to make sense, which by themselves were clearly desirable. Indeed, a number of them we felt were highly promising for the modifications in the social security system.

But in almost every case, the longer we looked, the more certain one could become that we would come up against some unforeseen implication, some twist, some consequence of what seemed to be a desirable principle that we really didn't want to accept, that didn't seem to be desirable.

In the end, we proposed two changes in the treatment of the family. We suggested that on divorce after 10 or more years of marriage the earnings records acquired during marriage should be divided between the spouses for purposes of retirement benefits only.

We recommended that when one spouse dies, the other spouse should be entitled to inherit the earnings record of the decedent and that benefits would then be computed on the basis of the combined record so generated.

Senator NELSON. I don't follow that. The spouse now who has no earnings record gets half of whatever the spouse who has an earnings record gets. If the spouse with the earnings record dies, doesn't the surviving spouse without the earnings record get the full 100 percent of what the deceased spouse would get as a single person?

Mr. AARON. That is correct.

Senator NELSON. What are you saying?

Mr. AARON. In the event the surviving spouse had not worked at all during his or her, usually her, lifetime, the benefit would be unchanged. In the event, however, that the surviving spouse had earnings credits——

Senator NELSON. Oh, you would add those on top.

Mr. AARON. That is right. The purpose would be to make sure that widows derive something extra after retirement from having worked.

Senator NELSON. I am sure you see the kind of trap involved there, however. At the time social security was adopted, a very small percentage of married women worked. So the system decided to make a 50-percent contribution to a spouse who didn't work.

So you make a 50-percent contribution to the spouse who doesn't work, but the system also provided that the spouse who did work could take the 50 percent or the benefits that spouse earned, whichever one was greater. So you start doubling up on the cost of the system if you do that.

Mr. AARON. The point you are raising about cost is also one that we worried about a good deal. We were careful in our recommendations to make sure that we presented a plan that did not increase the overall cost of social security. So although I have described a couple of the benefit liberalizations the Council recommended, the overall package did not increase program costs at all.

Senator NELSON. Thank you. Go ahead.

Mr. AARON. I think there are a couple of other points on the longer term modifications in financing that might be worth mentioning. One is to reemphasize the point that the modifications in the use of payroll taxes in the financing of medicare and in the financing of cash benefits programs would result in both short- and long-term actuarial balance for the cash benefits programs, something which present law does not at present provide.

An additional recommendation of the Council was that it would be desirable not to have the ad hoc base increases scheduled to take place and go into effect. It would not be possible to modify those ad hoc base increases at all, of course, unless additional financing was provided because, as Mr. Driver pointed out, under current financing arrangements, every dollar now flowing into the system is required for the foreseeable future.

But if the Council's recommendation for moving a portion of the medicare tax over to the cash benefits programs was adopted, then it would be possible to also begin to move the wage base back to the same relationship to covered earnings as obtained in 1979.

Senator NELSON. The same base?

Mr. AARON. The same relationship to earnings. The base goes up each year by the same rate as earnings.

Senator NELSON. You mean the so-called ad hoc base increase you could drop. Is that what you are saying?

Mr. AARON. But you would retain the automatic increase in each year.

Senator NELSON. All right.

Mr. AARON. The base would rise with wages.

I think it is worth stressing that what I have described so far are principles that the Council recommends, and they are far more important than the specific numbers or details of the proposal that I have set forth.

For example, the Congress might feel it was possible to finance some part of medicare with general revenues and thereby to reduce somewhat the aggregate payroll tax from 6.65 percent scheduled in 1981. But it might not want to go as far as the Advisory Council did.

The Council considered partway steps, for example, and endorsed one which would have resulted in a smaller infusion of general revenues into the medicare system.

Finally on the longer run issues, the Council explicitly considered and unanimously rejected the value-added tax as one of the sources of revenue for social security. The members felt, again unanimously, that introducing such a tax during the present inflation would make no sense, and that at any time, the VAT would be less equitable than the income tax because it provides no exemptions and deductions and it lacks the close relationshp to earnings

which makes the payroll tax attractive as a support for the earnings-related cash social security benefits.

I would like to turn to the state of the trust funds, the shorter run issues and the ones dealt with by interfund borrowing.

Since 1940, the social security trust funds have served as contingency reserves to prevent the need for raising taxes in the event of recession. The Council considered and rejected arguments that this longstanding policy be scrapped in favor of an effort to build up a large social security trust fund in order to increase national savings.

The social security trust funds have served admirably as contingency reserves during all of the recessions following World War II through what I call the great recession of the mid-1970's. That recession seriously depleted the social security trust funds, necessitating the substantial increase in tax that was enacted in 1977.

Furthermore, it is now apparent that the American and world economies are destined to experience more serious and possibly more protracted instabilities for the foreseeable future than were experienced before 1974.

It is important that the financial health of social security not be held hostage to such economic events as a doubling of petroleum prices which can trigger recession in the United States and the rest of the world.

To deal with this heightened instability, the Council put forward a number of important recommendations. Together with the plan to shift some of the medicare payroll tax to OASDI, which would assure an adequate flow of revenues during the period with economic fluctuations no greater than those experienced before 1974, these other recommendations would protect the social security system against even more severe fluctuations.

First, the Council unanimously recommended merging the old age and survivors insurance trust fund and the disability insurance trust fund, although separate cost analyses of those programs should be continued and published.

When you spoke to Mr. Driver about that possibility, it was clear that you had reached a similar conclusion to the one that the Advisory Council proposed. Such a merger would obviate the need for borrowing between these two funds, which would otherwise be necessary and desirable, during periods such as the present when one fund is insufficient and the others are more than adequate.

Second, the majority of the Council recommended general revenue payments to the social security trust fund to compensate the trust funds for revenues lost during periods of excessively high unemployment. This recommendation is similar to the one advanced in 1977 by the Carter administration.

Third, a majority of the Council also recommended that the trust funds be authorized to borrow from Treasury if reserves fall below about 3 months' payments of benefits. But in the event of such borrowing, the repayment of the loan should begin automatically when reserves reach about 5 months payments, and there are some other conditions that I describe in the testimony.

I believe that the bad economic news of the past several months increases the attractiveness of these proposals. The administration now projects that the OASDI trust funds will lose revenues

through 1984 based on economic assumptions underlying the budget. These assumptions were not chosen for their realism or even their plausibility, but rather to express progress toward the goals of the Humphrey-Hawkins Act.

Other economic forecasts of what is most likely to happen paint an even bleaker picture, with higher unemployment, suggesting larger resulting trust fund deficits. In a footnote I describe some of the alternative forecasts floating around. Just for evidence on the fragility of those proposals, the DRI projection, which you cite in your blue book, which called for 7.8 percent unemployment in 1981 and 7.3 percent in 1982, that projection being made in January, was revised in February to project 7.5 percent in 1981 and 6.9 percent in 1982.

That is good news. I hope that the revision doesn't come in March that carries bad news. But based on the fluctuations of economic events well beyond the control of economic forecasters, I am afraid we can't rule that out.

Senator NELSON. It is always easy to project good news. It is when reality catches up with one that the projection doesn't look so good.

Mr. AARON. I must confess the forecasters have been much more honest in recent years. They do publish post mortems on the relationship between their forecasts and what has happened. And my purpose is not to downgrade the abilities of economic forecasters, which I think are getting better and better, but rather to underscore the increasing importance of events beyond their control, external to the United States, that affect economic conditions.

I think that the interfund borrowing authority is desirable as a short-term measure and may even be sufficient to keep everything balanced through the immediate future if the administration's assumptions are not unduly optimistic. But as frequent revisions of forecasts and a depressing past record of inaccuracy by most forecasters make clear, we can't be sure.

For that reason, I think structural reform along the lines proposed by the Advisory Council is in order.

Let me conclude by saying that I don't believe that any of these recommendations for reforming social security financing should shield the entire system from a thorough, ongoing reexamination. We may well conclude that some benefits are overly generous and should be scaled back, just as we may conclude that some benefits remain inadequate and must be increased.

The Advisory Council undertook such an examination and made some recommendations of both kinds within an overall self-imposed constraint that its recommendations in combination should not increase program costs.

Debate about the desirability and timing of such modifications in social security should and will continue, but while that debate proceeds, I think no good purpose is served by causing needless worry for the millions of aged and disabled for whom social security is the most important and, in some cases, the only financial support.

I also put it another way, which is I don't think that social security should experience the perils of Pauline whenever economic

instability or cartel collusion boosts petroleum prices and plunges the United States and the world into recession.

That is the conclusion of my formal remarks.

Senator NELSON. Thank you very much for your very thoughtful testimony. We appreciate your taking the time to come over and present it today. I will at my leisure examine closely the recommendations of the Advisory Council, which I have not yet had the opportunity to do.

Thank you very much.

Mr. AARON. Thank you.

[The prepared statement of Mr. Aaron follows:]

STATEMENT OF HENRY AARON*

Mr. Chairman, thank you for the opportunity to present to the Subcommittee on Social Security of the Committee on Finance a summary of the recommendations of the Advisory Council on Social Security concerning the financing of social security. The Council consisted of thirteen members representing business, labor and the public. It met over a period of 18 months, held public hearings, and submitted its report in December 1979. That report dealt comprehensively with the social security system. Unless the Committee has specific questions for me on other matters, however, I shall confine my testimony to issues relating to the financing of social security benefits.

Before turning to those recommendations, I should point out that the current forecasts of social security revenues and expenditures differ in important respects from those available to the Advisory Council. In my opinion, the revisions of these forecasts make a number of the Council's recommendations even more attractive—and urgent—than they were before. Because of these revisions, the specific form of the steps necessary that I set forth in this testimony to implement some of the principles that the Council recommended differ somewhat from illustrative examples contained in our report.

My testimony is divided into two main parts. The first presents the Council's recommendation for paying for hospital insurance with earmarked general revenues, thereby ending exclusive reliance on the payroll tax to pay for social security. The second describes a number of recommendations that would make the social security system less vulnerable to economic fluctuations than it is at present.

Throughout its deliberations the Advisory Council was aware of, and deeply concerned by, the growing popular concern about the financial security of social security benefits. It was the Council's unanimous view that benefit obligations to all who are now retired or soon will retire will be and should be met in full. Council members differed about how and when the benefit structure should be modified for those who will retire many years hence. But, we can see no value to causing the disabled or those past or near retirement age needless worry about the safety of their benefits. These benefits will be paid, and it should be made obvious to those who now are or soon will be beneficiaries, that benefits will be paid.

Confidence in the safety of social security benefits is fragile and cannot withstand announcements every couple of years that the trust funds will run dry unless some new action is not immediately taken to deal with some new and unforeseen contingency. It is imperative for the peace of mind of beneficiaries now and in the future that the financing of social security be restructured so that it can withstand the kinds of economic fluctuations that to everyone's regret the nation now faces. With that principle in mind, the Advisory Council structured its recommendations for reforming the financing of social security to accomplish the following objectives. It adopted, the Council's recommendations would:

Provide financing for hospital insurance from general revenues,

Permit payroll taxes to be cut from 6.65 percent in 1981 to 6.0 percent and held at that level for the next twenty-five years,

Prevent the problems of inadequate revenues during the course of a recession and the attendant and needless concern that such shortfalls cause to beneficiaries,

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The views expressed in this statement do not necessarily reflect those of Brookings staff members or the officers and trustees of the Brookings Institution.

Put the social security system on a sound actuarial basis for the next seventy-five years by placing in law a tax schedule sufficient to support presently legislated retirement, survivors, and disability benefits for that entire period.

REDUCING RELIANCE ON THE PAYROLL TAX

The Council agreed unanimously that the time has come to finance some part of social security benefits with revenues from sources other than the payroll tax.

In making this recommendation, this Advisory Council followed in the steps of five prior advisory councils that urged the application of some general revenues to social security benefits. We were motivated by the recognition that payroll taxes fall disproportionately on households with relatively low incomes, that payroll taxes contribute to inflation by adding to labor costs, and that payroll tax is less suited to pay for medicare benefits that are unrelated to earnings than they are for wage-related retirement, survivors, and disability benefits. The replacement of part of the payroll tax by general revenues would improve the equity of the tax system and modestly contribute to the fight against inflation.

Specifically, the Council recommends that the part of the payroll tax imposed to pay for medicare be repealed and that part of this component be shifted to retirement, survivors, and disability insurance. Medicare would be supported by an earmarked portion of the personal income tax and a Treasury payment designated as coming from the corporation income tax.

In 1981 the total payroll tax under current law will be 6.65 percent on both employers and employees, of which 5.35 percent will be for retirement, survivors and disability insurance and 1.3 percent for medicare. If the 1.3 percent payroll tax for medicare were repealed in 1981 and the tax rate for retirement, survivors, and disability insurance were increased from the presently scheduled rate of 5.35 percent on employers and employees to 6.0 percent.

Payroll taxes would be cut from the 6.65 percent scheduled for 1981 under current law to 6.0 percent.

The 6.0 percent rate would be sufficient to pay for retirement, survivors, and disability insurance through the year 2004.

Together with a payroll tax increase in 2005 to 7.25 percent, these changes would place retirement, survivor, and disability insurance in actuarial balance for the next seventy-five years.

I would like to address a number of objections to this proposal that I have heard, because I believe that these objections rest on a misunderstanding of its effect. First, it is objected that the proposal would be inflationary because it would reduce taxes and increase the deficit.

This objection rests on a misconception. The proposal advanced by the Advisory Council would not affect total federal revenues or the size of the federal deficit; rather, it concerns how to raise whatever level of revenues is determined on other grounds to be correct. To explain why this statement is true, let me indicate how I think the Council's recommendation should be put into effect. In recent decades, Congress has periodically cut personal income tax rates to prevent inflation and economic growth from pushing people into even higher tax brackets. As a result of these cuts, income taxes as a fraction of personal income have remained between 10 and 12 percent in all fiscal years from 1960 through 1980. Were it not for the buildup in military expenditures that now seem to be necessary, it is likely that a tax cut would have been enacted to take effect in 1981 or perhaps even 1980. Even with a buildup in defense expenditures, it is likely that Congress will cut personal income tax rates applicable during 1981 or 1982 to prevent the effective rate of personal income taxation from continuing to increase.

My purpose, however, is not to forecast precisely when such a reduction will be enacted. The progressive rate structure guarantees that sooner or later a cut will be necessary. Rather, it is to point out that, whenever a decision is reached that rates should be cut, the Advisory Council urges that some of that tax reduction occur through a reduction of payroll taxes, rather than exclusively through cuts in personal and corporation income tax rates, and that at that time the financing of medicare should be restructured.

I have described how the Council's recommendations could be put into effect if it appears desirable to cut income taxes in 1981. I note that the Administration has not requested a tax cut in the 1981 budget, but it is possible that changes in economic conditions might cause the Administration or Congress to reach other conclusions later this year. If a decision is made not to cut taxes until later, the Council's recommendations could be put into effect then.

The key point is that the Advisory Council is not urging that total federal tax collection be reduced in order to implement its proposals, and I would not suggest

that personal income taxes be increased in order to accomodate a payroll tax cut. We are urging that whenever the Administration and Congress decide taxes should be cut for other reasons, some of the tax reduction should take the form of a decrease in payroll tax rates. Such a change would unambiguously reduce inflation because it would represent a shift from payroll taxes, which contribute to inflation by directly adding to production costs, to other taxes that do not have such inflationary effects. It would not add to the federal deficit and, hence, could have no effect on the price level through that channel.

The second objection to the Advisory Council's recommendations rests on the fear that use of general revenues to pay for any part of social security would remove an important fiscal discipline on Congress and the public. According to this view, the link between payroll taxes and benefits has prevented the American citizenry and its elected officials from thinking that they could vote for increases in benefits without also supporting increases in visible payroll taxes. From another standpoint, it is alleged that the use of general revenues to pay for medicare would deprive American workers of the sense that medicare benefits are an "earned right" to which they are now entitled without a means test or other stigmatizing condition of eligibility. Arguments such as these have persuaded Congress for four decades not to accept the repeated urgings of advisory groups that some general revenues should be used to pay for part of social security.

The Advisory Council considered these arguments and supported the use of earmarked revenues other than the payroll tax to pay for social security only after a majority of its members were convinced that its plan was immune to these criticisms. By earmarking personal income taxes and putting this designation on every tax form, Congress would assure that every taxpayer would be reminded annually that specific taxes must be levied to pay for social security, that increases in medicare benefits must be paid for by increases in those taxes, and that each worker is earning rights to medicare benefits by paying taxes.[1] Each year, some Americans have incomes too low to pay taxes, but it is also true that each year some Americans do not pay payroll taxes. Nearly all Americans pay payroll taxes during some part of their lives, and nearly all pay income taxes. I know of few who would deny financial protection for the costs of health care during old age or disability to those few who have been too poor to pay income taxes throughout their lives.

In short, the Advisory Council's recommendations would preserve the financial discipline that Congress quite rightly for decades has considered so important, and it would preserve the principle that social security benefits are an earned right. I would not have supported the Advisory Council's positions if I felt that either of these important goals was put in jeopardy.

As part of its recommendation that reliance on payroll taxes be reduced, the Advisory Council also urged that the base for the payroll tax continue to cover the same fraction of earnings as were covered in 1979. Raising the earnings base above this level, in the judgment of the Council, would cause social security to intrude undesirably into areas better left to private savings and pensions where forced savings are unnecessary. As a practical matter, this goal could be achieved by suspending the ad hoc base increase in 1981 and by slowing the automatic increase in the base until the relationship prevailing in 1979 was restored.

The Advisory Council explicitly considered and unanimously rejected the value-added tax as one of the sources of revenue for social security. Introducing such a tax during the present inflation would make no sense. At any time, the VAT would be less equitable than the income tax because it provides no exemptions and deductions and it lacks the close relation to earnings which makes the payroll tax attractive as support for earnings-related cash social security benefits.

Let me stress that all of the Council's recommendations described so far embody basic principles that are far more important than the specifics of each proposal. If Congress should find those principles appealing, but feels that they cannot be implemented in full, then steps that moved in the direction of those principles would certainly be desirable—for example, a move to pay for part of medicare with revenues from taxes other than the payroll tax or to reduce the 1981 payroll tax, but not all the way to 6 percent. Indeed, if its full proposal is not accepted, the

[1] The earmarking could be achieved in alternative ways. For example, the amount of revenue needed to pay for medicare in 1981 could be raised by a tax of 1.23 percent of taxable personal income up to $27,000 for single individuals and $54,000 for married couples (compared with the tax in present law for 1981 of 1.30 percent of the first $29,700 of covered earnings for single people, and up to $59,400 for married couples). Alternatively, the revenue could be raised through a personal income tax surcharge of 6.7 percent with a maximum payment of $400 for single individuals and $800 for married couples. The Advisory Council did not take a position on which of these methods would be preferable.

Advisory Council proposed that the payroll tax increase for medicare scheduled for 1981 (0.25 percent of payroll on both employers and employees) be replaced with general revenues. Similarly, moving the wage base some part of the way back to its 1979 relationship to wages would be desirable if full restoration is rejected.

PROTECTING SOCIAL SECURITY AGAINST ECONOMIC FLUCTUATIONS

Since 1940, the social security trust funds have served as contingency reserves to prevent the need for raising taxes in the event of recession. No attempts has been made to accumulate large reserves to fund future liabilities. Rather, the social security system has operated on a pay-as-you-go basis. The Council considered and rejected arguments that this long-standing policy be scrapped in favor of an effort to build up a large social security trust fund in order to increase national savings. If increases in national savings are considered desirable, other means are at hand and would be preferable. As a first step, balancing the federal budget in periods of economic expansion would be appropriate.

The social security trust funds served admirably as contingency reserves during all of the recessions after World War II through the "Great Recession" of the mid-1970's. That recession seriously depleted the social security trust funds, necessitating the substantial increase in taxes enacted in 1977. Furthermore, it is now apparent that the American and world economies are destined to experience more serious and possibly more protracted instabilities for the foreseeable future than were experienced before 1974. It is important that the financial health of social security not be held hostage to such economic events as a doubling of petroleum prices which can trigger recession in the United States and the rest of the world.

To deal with the problem of heightened economic instability, the Advisory Council put forward a number of important recommendations. Together with the plan to shift some of the medicare payroll tax to OASDI (which would assure an adequate flow of revenues during periods with economic fluctuations no greater than those experienced before 1974), these recommendations would protect the social security system against even more severe fluctuations.

First, the Council unanimously recommended merging the Old Age and Survivors Insurance Trust Fund with the Disability Insurance Trust Fund, although separate cost analyses of those programs should be continued and published. Such a merger would obviate the need for interfund borrowing which otherwise is necessary and desirable during periods such as the present when one fund is insufficient and the others are more than adequate.

Second, a majority of the Council recommended general revenue payments to the social security trust funds to compensate the trust funds for revenues lost during periods of excessive high unemployment. Such payments would be made if unemployment exceeded some rate such as 6 percent and if the trust fund balances are less than about 60 percent of annual outlays. The reason for this change is that the social security system should not be penalized for policies—deliberate or inadvertent—that result in excessive reductions in employment and earnings.

Third, a majority of the Council also recommends that the trust funds be authorized to borrow from the Treasury if reserves fall below about three months' payments of benefits. In the event of such borrowing, repayment of the loan should begin automatically when reserves reach about five months' payments. To assure repayment, payroll taxes should be increased automatically if the loan is not otherwise repaid within two years, and provided that unemployment is not greater than 6.5 percent. The Council concluded that provision for automatic repayment is essential to assure the continued discipline of the traditional methods of financing benefits.

I believe that the bad economic news of the past several months increases the attractiveness of these proposals. The Administration now projects that the OASDI trust funds will lose revenues through 1984 based on economic assumptions underlying the budget. These assumptions were not chosen for their realism or even their plausibility, but rather to express progress toward the goals of the Humphrey-Hawkins Act. Other economic forecasts of what is most likely to happen paint an even bleaker picture, with higher unemployment, suggesting larger resulting trust fund deficits.[3] The relative growth of prices and wages which has an even greater impact on the trust funds is also highly sensitive to economic conditions and is hard

[3] For example, the Administration projects and the short-run trust fund estimates presume that unemployment will be 7.4 percent in 1981 and 6.8 percent in 1982. CBO forecasts an unemployment rate of 8 percent in 1981. Wharton forecasts that the unemployment rate will be 7.7 percent in 1981 and 7.9 percent in 1982. Data Resources in January forecast unemployment of 7.8 percent in 1981 and 7.3 percent in 1982; but one month later revised them to 7.5 percent and 6.9 percent respectively.

to forecast accurately. Inter-fund borrowing authority is a desirable short-term measure and may even be sufficient to keep everything balanced through the immediate future if the Administration's assumptions are not unduly optimistic. But, as frequent revisions of forecasts and a depressing past record of inaccuracy by most forecasters make clear, we cannot be sure. Structural reform along with the lines proposed by the Advisory Council is in order.

CONCLUSION

I believe that there can be no question, and there should be no doubt in any person's mind, that present retirees and those soon to retire will receive every penny of benefits to which they are entitled. If that is true, Congress should take steps to assure that this reality is clearly evident to all Americans. No good purpose can be served by exposing the aged and the disabled to periodic unease because the trust funds appear to be running down and Congress must step in at the last minute to keep a promise that was never really in doubt. The recommendations of the Advisory Council would achieve this purpose. Social Security should not experience the Perils of Pauline whenever economic instability or cartel collusion boosts petroleum prices and plunges the United States and the world into recession.

Let me stress that I do not believe that any of these recommendations for reforming social security financing should shield the social security system from a thorough-going reexamination. We may well conclude that some benefits are overly generous and should be scaled back, just as we may conclude that some benefits remain inadequate and must be increased. The Advisory Council undertook such an examination and made some recommendations of both kinds within an overall, self-imposed constraint that its recommendations in combination should not increase program costs. Debate about the desirability and timing of such modifications in the social security system will and should proceed. But while that debate proceeds, no good purpose is served by causing needless worry for the millions of aged and disabled for whom social security is the most important, and in some cases the only, source of financial support.

Senator NELSON. Our final witness today is Dr. William Hsiao, associate professor of economics, Harvard University.

Dr. Hsiao, our committee appreciates your taking the time to come down from Harvard to testify again as you did during consideration of the 1977 social security funding proposals.

I notice that Dr. Aaron just said that one of the options in the future might be to project a more modest benefit schedule. I do recall that you argued before this committee for a more modest replacement rate somewhere between the most conservative one and the one that was ultimately adopted.

I have never looked to see, and you probably have, what that projection would have done respecting the funding of the social security fund, but I do recall that you made that argument at the time we had amendments to the act before us in 1977.

Your statement will be printed in full in the record and you may present it however you desire.

STATEMENT OF WILLIAM HSIAO, ASSOCIATE PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. HSIAO. Senator, I am pleased to have this opportunity to appear before you and I am astonished at your good memory. So I better watch what I say.

Senator NELSON. I had to support one of those options I can remember three things for 3 years but not much more. But there were three options.

Mr. HSIAO. Senator Nelson, let me begin with a confession. My faculty for the art of your business is not very well developed, so please forgive me if I concentrate more on the facts rather than the images this morning.

Senator NELSON. We appreciate testimony based upon the hardest and best facts available, and we appreciate the fact that distinguished witnesses such as you leave the politics of the matter to us. We may not know much about what you are talking about, but we do know something about the latter.

Mr. HSIAO. I am happy to leave the political decisions to you.

I have been a student of social security longer than I care to remember, one of my involvements was being the chairman of an advisory panel appointed by Congress in 1975-76 to study the social security system.

I have some good news and some bad news, so let me start with the bad news first and then hopefully end up with the good news. Social security was the most successful socioeconomic program the United States ever enacted, but right now social security is at a crossroads and confronted with grave problems.

Even the National Retired Teachers Association calls for its fundamental reform. The association argued that a combination of economic and demographic trends call out for fundamental reform, and I agree with that statement.

The choices confronting you are not easy. Neither I nor anybody else can offer a panacea. I can only say that I have a viable and desirable alternative that is worthy of your serious consideration. Let me first begin with a review of what are the major deficiencies and ills of the present program.

First, the social security program lacks resiliency and controllability. Any successful social insurance program must preserve some flexibility in its benefits structure and have some financial margin to cushion against adverse economic, social demographic trends.

The present program is seriously deficient in those regards. The genesis of these deficiencies began in 1972 when Congress passed the 1972 amendment based on a set of incomplete and faulty technical analyses. When that error was corrected in 1977, Congress adopted an indexing method that produced, in my opinion, excessive levels of benefits for some beneficiaries.

When I testified before the Senate Finance Committee in 1977, I predicted that if that wage indexing method is adopted, Congress will be again confronted with these serious financial problems in 2 or 3 years. Unfortunately, my dire prediction came true.

Present benefit structure is a combination of automatic adjustment mechanism with a generous benefit formula which drastically reduced the resiliency of the system and the ability for Congress to control the system. We have legislated ourselves into a straitjacket, and the straitjacket will get ever tighter due to the ever increasing benefits that will go into effect automatically.

I would like to turn to the second problem of the system, which has been explained by other speakers before me. That is the short-term deficit. Just for 1980, it is estimated the deficit for the OASDI program would be around $6 billion. That is according to the official projection.

I believe that is underestimated. The reasons for it are already pointed out by Dr. Aaron. I think the official forecast is based on a set of optimistic assumptions on both inflation rates and unemployment rates. Using a set of realistic assumptions, I believe the

deficit this year will be closer to $10 billion, and this deficit is expected to continue through 1984.

A third major problem confronting social security is the long-term deficit. Social security is a long-range program and very different from other ordinary Government programs. In order to assure the future retirees will receive their retirement income protection, we must make sure the system is in actuarial balance.

Under the present law, the cost of the benefits promised to future retirees in the early part of the 21st century will rise and will cost about 17 percent of the taxable payroll.

Senator NELSON. You are counting both the employer and employee contributions?

Mr. HSIAO. That is correct. I am talking about a combined employer and employee rate.

Senator NELSON. It is now a little over 12.

Mr. HSIAO. In the long run the Congress has only legislated a tax rate of 12.4 percent, leaving a large annual deficit. If we are looking at this deficit in today's dollar terms, that deficit will be equal to $45 billion per year.

Legislation passed in 1977 left the long-term deficit unresolved. While the benefits have been increased by the legislation, financing has not been provided.

The fourth deficiency of the existing program is its adverse effects on savings. People save for various reasons, and one of the important reasons they save is to have adequate income when they retire. If the social security program provides an adequate or overly adequate retirement income to people, then there is no need nor incentive for individuals to supplement the social security benefits by private pensions or personal savings.

I have presented a table in my testimony showing the replacement rate of social security benefits based on the preretirement disposable income. That is the income after income taxes, after social security tax, and the work related expenses.

The social security benefits replace the preretirement disposable income for workers in the lower earning bracket up to 98 percent. For average earners with spouse, social security benefits replace 81 percent. And for people who are earning at the maximum earnings level, which this year is $25,900, the replacement ratio is 60 percent.

I think these facts speak for themselves. For low- and average-income workers with spouse, there would be little need or incentive for them to supplement their social security retirement benefits with private pension or personal savings. Such generous social security benefits will reduce capital accumulation in America, will raise the interest rate and will reduce the amount of funds available for investments.

This morning I appear before you to argue one principal point. I urge you to consider fundamental reform of the social security system. As pointed out by you earlier, Senator, the pay-as-you-go financing basis for the social security program is akin to a chain letter. The scheme works because the current retirees make a claim on the wages of the present workers. If the wages of the current workers are raising rapidly and if the working population are increasing rapidly, this system works.

However, we are confronted with a new set of economic and demographic facts. The working population are not rising proportionately to the retired population. As a matter of fact, it is declining.

Senator NELSON. You mean the numbers of workers, not the wage.

Mr. HSIAO. I am talking about the ratio. The ratio of the number of retired people to the number of working people in America is declining. In other words, there are fewer workers supporting the retirement benefits of a larger group of retirees.

The labor productivity has remained relatively stable rather than rising rapidly as during the 1930's, 1940's, 1950's, and 1960's. Therefore, the system calls out for a basic reevaluation and for reform.

Before I turn to my own recommendations, let me comment on an immediate issue facing your committee. That is interfund borrowing. Balance in the OASI trust fund will be depleted by the end of 1981. The administration proposes to borrow between different trust funds. But the question is whether there is a sufficient reserve in the other trust funds for the OASI program to borrow from.

The 1971 Advisory Council on Social Security thoroughly considered what is the appropriate balance of the trust fund as a contingency reserve. They concluded that the minimum ratio of the fund balance should be 75 percent. Subsequently, other technical experts, including the technical panel advising the current advisory council, have examined the same question and reached the same conclusion.

Senator NELSON. I do recall that, and maybe I am wrong and it was just an assumption of this committee, but I had thought that the minimum annual available payout at the beginning of a fiscal year should be 75 percent and, as a matter of policy, not exceed 150 percent. Is that correct?

Mr. HSIAO. No. Actually, right now the ratio, as I point out in my testimony, is only 33 percent.

Senator NELSON. I understand, but the recommendation that the minimum not go below 75 percent of 1 year's payout, and maybe it was a policy of the Congress that it should not exceed 150 percent.

Mr. HSIAO. I am sorry. I misunderstood your question. The recommendation to Congress was the fund balance should not exceed 125 percent for maximum.

Senator NELSON. All right.

Mr. HSIAO. Now the total balance of all the trust funds is only equal to 33 percent of the annual outlay, far below the minimum standard recommended by technical experts. No individual fund right now has a balance that exceeds the required minimum level.

Consequently, it is my conclusion there is no excess in other trust funds for the OASI to borrow from. Moreover, social security has a long-term as well as a short-term financial deficit. There are no funds available for the OASI program in the long run to repay this borrowing.

Therefore, I oppose the administration's recommendations. I realize I am the lone voice here this morning. I believe the borrowing between the trust funds only postpones the necessity for Congress

to address the issue of reforming the system. At the same time, I think the borrowing will further undermine the public's confidence in social security. Any time you borrow from somebody to pay for current outlay of social security benefits the public would interpret that the system is in serious trouble.

Now let me turn to my recommendations.

Senator NELSON. On this question of borrowing, do you have a suggestion to meet that problem, which appears from the current administration projections to be with us right now? Do you favor action to transfer funds from DI, and HI, to OASI? Do you address that question later here, how you would meet the question of the fact, as you state and others state, that the fund will reach zero annual payout January 1, 1981? Do you address that question?

Mr. HSIAO. Yes, I do. Senator, The financial plight of social security, I think, is undisputed. However, I agree with Dr. Aaron's earlier testimony that we should separate out the short-term problems from the long-term problems.

In the short term I don't think we should alter the benefits that present retirees or people who are retiring in the near future expect to receive from the system. It will be unfair to them because they made retirement plans based on these set of benefits promised to them. So we need additional financing to pay for the benefits.

The question is, then, which tax revenue will have the least negative effect on our present economy. I recommend a tax on gasoline. I realize that is not a popular tax and many people even attribute the defeat of Mr. Clark in Canada to this issue, but let me state there is a difference between the United States and Canada.

Canada, I believe, is a almost self sufficient in supplying its won need of oil. She does not have the need as the Americans to reduce the consumption of oil, and particularly the Western Provinces in Canada which produce oil for export.

Let me turn to my recommendation. I recommend a temporary 30 cent tax on every gallon of gasoline sold in the United States, a temporary tax for the next 5 or 10 years. I suggest that one-third of this tax could be allocated to finance the deficit in the social security system until a permanent reform can be enacted by Congress. Two-thirds of this tax revenue from gasoline tax could be used to reduce the payroll tax.

The reason for my suggestion is that I recognize a tax on gasoline will exacerbate inflation, but this can be mitigated in part by a reduction in the payroll tax.

A tax on gasoline would reduce our dependency on import oil and ease our balance-of-payments problem, and this in turn would strengthen the value of our dollar abroad, as well as put a check on the runaway inflation we are experiencing right now.

In dealing with the structure deficiencies of the present benefit formula, I recommend that we can remedy the problem effectively by altering the method of indexing. Instead of indexing the worker's lifetime earnings by rate of increase in wages, we should do it by a superior method, indexing by prices.

This was our recommendation to this dintinguished committee 2 years ago. Price indexing will protect social security benefits against inflation for those who are retired as well as for those who retire in the future. It will provide a partial automatic adjustment

system which could guarantee a reasonable benefit and preserve a degree of control for Congress over the system.

Senator NELSON. I guess I am not clear what that means. You would index the benefits for retirees by prices.

Mr. HSIAO. Yes, as well as the wage histories of those who have not retired yet. When a worker reaches retirement age, his retirement benefit would be calculated based on his own wage history that is indexed by prices. The effect is that the retirement benefit for workers retiring in the future will be protected against inflation also.

Senator NELSON. That is the recommendation you made a few years ago, isn't it?

Mr. HSIAO. Yes. And I believe through this price indexing method Congress will be able to regulate the benefits in the future in light of the needs of the retired people and our ability to pay for them.

The cost of benefits based on price indexing is manageable. Under the present law, the payroll tax rate will have to rise sharply by 60 percent after year 2020. Benefits under the price indexing requires no significant increase in taxes. Also, the tax rates can remain fairly level for the next 75 years.

The grave problems confronted by social security have solutions, but I do think the program requires serious reexamination and the political will to do something. The solution does not lie in finding new avenues of financing but in restructuring the benefit formula. Regardless of where we find the revenue for a flawed system, the tax burden still falls on the American people.

I would like to turn briefly to the question of general revenue financing, regardless, this is done by shifting funds from the medicare program or creating a new earmarked tax. I would like to point out the simple fact that the U.S. budget has been in a deficit position for a number of years. Even during a period of economic boom, we simply do not have the general revenue money.

If we shift the payroll tax allocation from medicare to cash benefits, you, the Congress, would have to find $26 billion of general revenue funds to finance medicare in 1980. Perhaps somebody can offer you a magic formula to find that fund. But I do not have one.

Second, I like to argue there are other programs which may have more urgent claims on general revenues. Among those programs are the long-term care for our elderly people, welfare reform, housing, urban renewal, and pollution control. I don't think we should exhaust our general revenue on a flawed benefits structure in the social security system.

Senator NELSON. What happens to the burden on the fund under the proposal you make to tie prices in a circumstance which I think exists now, where prices are going up faster than wages? Then your system becomes more expensive than the present one, doesn't it?

Mr. HSIAO. Yes, Senator. That could be one of the deficiencies in our proposal. But I think the past history is on our side. In the short run, the United States has had periods when the rate of inflation exceeds the rate of wage increases. Usually they may last a year or so.

If the United States goes into a prolonged period where the rate of inflation exceeds the wage increases, then we are truly in a serious economic difficulty as a nation. What it means then is the standard of living for Americans is deteriorating continuously, and I think that will tear apart our social fabric and shake our economic stability. Drastic measures would have to be taken to correct the problem, and social security will not be an exception.

Let me conclude my remarks quickly. I come back again to the central theme, urging your committee to give serious consideration to the price indexing method. While this new benefit needs to be phased in gradually and also time is needed for the Congress to enact such a law, funds could be generated by a temporary tax on gasoline. That will not be the most popular tax, but it is a desirable and efficient approach for raising new revenue.

Thank you.

Senator NELSON. I don't understand how the transition would work, but if you did that, you would have to address the question of those employees who are now about to retire this year or next year or 3 years down the way. Suddenly these people would receive, if in fact wages did rise faster than prices, some reduced benefit. Isn't that right?

You would meet that question? You wouldn't reduce their benefits?

Mr. HSIAO. No. I am not suggesting that.

Senator NELSON. When would you tie the pricing system into the benefit system?

Mr. HSIAO. I will recommend some kind of tie-in by 1987, or even 1990.

Senator NELSON. When you say some kind of tie-in, are you——

Mr. HSIAO. I mean a transition between the present benefit structure to the price indexing benefit structure.

Senator NELSON. But are you talking about a tie-in between the new worker who is hired in 1987 and has 40 years to work, or are you talking about the beneficiary who is going to retire in 1987 and 1988? What end of the scale are we talking about?

Mr. HSIAO. I am talking about the beneficiaries who expect to retire between 1987 and 1990.

Senator NELSON. So you are saying that there would be a transition so that people retiring in that period would then receive, presumably, if wages are back in their traditional posture of going up faster than prices, that those people who retire then would be retiring at a lower benefit than they anticipate.

Mr. HSIAO. That is correct, but I like to clarify that, Senator. During the initial period, for the first 10 or 15 years, the difference between wage and price indexing would not be that significant. The difference will accumulate like a geometric progression. The impact will be much greater 30 or 40 years from now, and that is when our demographic problem becomes very acute.

Senator NELSON. Thank you very much for your very thoughtful statement. I certainly appreciate your contribution to the continuing dialog on the financing of social security and appreciate your taking the time to come and testify.

Senator Danforth.

Senator DANFORTH. Mr. Chairman, I am sorry I wasn't here earlier. I intended to be here for the entire hearing. I made the mistake of going over to the windfall conference. I can report to you that absolutely no progress was made this morning.

Senator NELSON. That is why I didn't go. I expected that.

Senator DANFORTH. I know I am going over old ground, but I am very interested in this. First of all, we have the short-term problem.

Mr. HSIAO. Yes.

Senator DANFORTH. And in order to fund our liabilities over the next 5 years, we need how much money?

Mr. HSIAO. We would need somewhere close to about $65 billion.

Senator DANFORTH. We would need $65 billion just to take care of our liability.

Mr. HSIAO. That is right.

Senator DANFORTH. Is that $65 billion over and above what would be brought in in social security taxes?

Mr. HSIAO. Yes. I should explain that the $65 billion represents the difference between the income and outlay.

Senator DANFORTH. Now then, this $65 billion could not be furnished by any structural change in benefits, even if we wanted to do it, immediately, because it could not work. Any change in benefits, whether it is altering the indexing system or gradually increasing the age of retirement or whatever, those are all very long-term measures, isn't that right?

Mr. HSIAO. That is correct, Senator.

Senator DANFORTH. They may be worth considering but they are not going to solve this immediate problem.

Mr. HSIAO. You are right. That is why I suggest that we separate out the short-term problem from the long-term problem.

Senator DANFORTH. And the $65 billion basically could only be made available in two ways. One is by borrowing, and the other is by finding a new source of revenue.

Mr. HSIAO. That is right. I commented before that other trust funds do not have adequate balances for OASI to borrow from. All the technical specialists who have examined what is the minimum appropriate level of the balance in the trust fund all recommend 75 percent. Right now, the combined ratio we have is only 33 percent, one-half of what is considered adequate.

Senator DANFORTH. To raise this $65 billion in 5 years, you are suggesting the only thing we can do is find another source of funds to do it with.

Mr. HSIAO. Right.

Senator DANFORTH. In other words we can impose another type of taxation, gasoline tax or whatever, or we can increase the deficits or we can hope that the windfall tax is going to produce additional revenue or something.

Mr. HSIAO. That is right.

Senator DANFORTH. Now, once that is done, that then removes the linkage between the benefits and the tax. Is there any way that could be solved? Is it possible to deal with the problem by financing the HI trust funds out of general revenue and diverting that portion of social security tax into OASI?

Mr. HSIAO. If you believe to preserve the earnings-related principle in the cash benefit is paramount, that would be one approach. However, I think if Congress made clear to the American public that the gasoline tax is a temporary tax and it will be phased out or it will be allocated for some other use after 5 years, it will not jeopardize this principle of relating the benefits to the payroll tax people pay, because the $65 billion figure I cited for you is less than 8 percent of the total outlay during that period.

Senator DANFORTH. How much of the $65 billion could be borrowed from other funds.

Mr. HSIAO. Perhaps half.

Senator DANFORTH. Half of it?

Mr. HSIAO. Yes. The absolute minimum balance the trust funds must maintain in a short-run is to assure there is adequate funds to pay the benefits. If we use this standard to assess how much can be borrowed between the trust funds, then perhaps one-half can be borrowed.

Senator DANFORTH. Do you think we could borrow half?

Mr. HSIAO. If you combine HI and OASDI together, you can borrow that much for the first 2 or 3 years.

Senator DANFORTH. If you borrow from other funds now and then you also put all of the HI portion of social security tax into OASI?

Mr. HSIAO. I am sorry. I was treating that question differently. I am saying if you want to borrow between trust funds, the OASI program also has to borrow from HI trust funds because the DI trust fund does not have adequate balance.

Senator DANFORTH. If you borrowed from both funds, then you could borrow about half.

Mr. HSIAO. That is probably true.

Senator DANFORTH. Mr. Driver testified, as I understand it, that by 1935 the combined balance of all the trust funds would be $84 billion?

Mr. HSIAO. I have not read his testimony, therefore I do not know what figures he had presented in it.

Senator DANFORTH. What he has is a deficit in OASI by 1985 of $25.7 billion and a surplus in DI of $45.3 billion, and in HI of $65.3 billion, or a combined surplus of $84.8 million.

Mr. HSIAO. Senator, I think it was brought out earlier by other witnesses too, the administration's projection is based on a set of very optimistic assumptions. The projections assume we will meet the goals of the Humphrey-Hawkins bill by 1985. Most economists do believe that is somewhat unrealistic.

If we use a set of realistic projections, that fund actually will be depleted faster. The balance of the fund will be less than what Mr. Driver cited to the committee.

Senator NELSON. Would you mind, after the hearing, looking at the charts that were submitted by Mr. Driver. I believe you are correct, as I understand Mr. Driver, that they were based upon assumptions that the administration has made. Would it be too burdensome an exercise for you to submit for the record what these funds would look like based upon other assumptions that economists may agree upon?

I realize, as you have said, that you may have a vast spectrum of differences here, but there must be some kind of consensus guess.

It would be helpful for us and the record if you could look at the charts submitted by Mr. Driver, particularly the one that shows the end of year balance on the chart in the last page of his testimony, and give us some projections of what your guess or a less optimistic guess might be based upon some expertise among your own or other economists.

Mr. HSIAO. Mr. Chairman, I would be happy to submit that for the record.

Senator NELSON. How long a time would it take you? We do go to printing. We have another hearing on Monday, and then maybe in 10 days we go to printing. Could you get it in?

Mr. HSIAO. By early next week?

Senator NELSON. No, week after next.

Mr. HSIAO. I think that is possible.

Senator NELSON. I don't want to ask too much of you. I have no notion of what time is involved. If you can do it and it isn't too burdensome, we would appreciate it. If it is, maybe we ought to present the question to the Budget Committee or something. I don't want to ask you for a lot of extra work.

Mr. HSIAO. Mr. Chairman, I would be happy to produce such documents for you and I think it can be done if you want it in 10 days or so.

Senator NELSON. I am reminded by staff that the CBO will be presenting figures of theirs on Monday. They may answer the question that I have asked. So I would ask Mr. Ginzburg to send to you, if you will leave your address, the CBO projections. If if turns out they are somewhere around where you think you would come out, fine. I don't want to ask you to do some extra work that may already have been done.

We will send the CBO projections to you.

Mr. HSIAO. Thank you.

Senator DANFORTH. As I understand Mr. Driver's figures, if they are correct then the whole problem could be solved by borrowing. But you don't believe it could be solved by borrowing.

Mr. HSIAO. Senator, I believe the crux of the matter is what is the adequate level of contingency reserve we should keep for the social security system. And my point is that all the technical advisers who have looked at this question on your behalf have concluded you need a minimum of 75 percent. Even Mr. Driver's table shows that we have less than 75 percent now, and when we have interfund borrowing, that ratio will decline even further.

I think the reason we need a contingency reserve is to cushion the system against any unexpected economic shock, and also to preserve the public's confidence in the system. If you look at it purely from a financial perspective, say the cash flow, do we have enough money to pay the benefits for the coming year through interfund borrowing, then I would have to agree that yes, most likely you will have enough cash there to pay for the benefits.

However, if there is another unexpected economic shock, like if OPEC decides to raise oil prices again, then the system will be in dire straits.

Senator DANFORTH. Let me just ask you one more question. In 1977 when we passed that social security financing bill then, it was a very unpopular bill. It increased the tax rate, it increased the tax

base. People who were complaining about it and are now complaining about it. Yet we passed it and it was with the understanding that this would take care of the problem.

We bit the bullet. We committed ourselves to the solvency of the social security system. Now it is 3 years later and we are told that OASI is going broke and that there are not enough funds in the rest of social security to borrow from to make it up. Therefore, we are faced with having to do something about it.

I can tell you there is nothing that can be done here that isn't extremely controversial. A gasoline tax is extremely controversial. So my question is: What went wrong? What happened? How could we have been so wrong in 1977?

Mr. HSIAO. I can offer a couple explanations. One is that, as I pointed out in my testimony, the basic problem is both the economic and demographic conditions in the United States have changed but we continue to operate this program as business-as-usual.

We enacted a very generous benefit formula based on a set of forecasts that used reasonably optimistic assumptions. And when there is an economic disruption for whatever the reason, we do not have the financial reserve in the social security program to deal with it, even for a short period of time.

So the problem is really, one, the benefit formula itself, and second, how much credibility you put into some of these projections. Do you want to allow enough contingency reserve to get built up for unexpected downturns, in out economic conditions?

Senator NELSON. I might say to Senator Danforth we raised this question before Dr. Hsiao testified, with Dr. Henry Aaron, who is chairman of the Advisory Council on Social Security. We were perfectly correct and perfectly safe in our legislating in 1977, assuming that the inflation rate projected at the time was correct. When you look at it, it is very dramatic. The projection was about a 6-percent inflation rate, and since we adjust benefits for the cost of living and the inflation rate has been twice that, the whole financing system was blown apart.

Mr. HSIAO. Yes, and I would like to echo that, Mr. Chairman. For example, the administration's official estimate is based on an inflation rate for 1980 of 11.8 percent, and declining to 6.1 percent by 1985. The unemployment rate would decline to 4.3 percent by 1985.

Well, I hope these romantic visions can be realized. But for sound planning, I do urge that we look at the system in a more realistic manner rather than looking at it in terms of how we hope the economy will do.

Senator DANFORTH. If we take care of the short-term problem, say with the gasoline tax, which we won't do, but supposing hypothetically that we would do that and take care of the short-term problem and re-fund it and put it on a sound footing, then would altering the indexing as you propose take care of the problem long term, or are there more structural changes that are needed?

Mr. HSIAO. Senator, I think there are other structural changes that will come down the road, such as the issue of treating two spouse worker families. But basically, by changing the indexing method for the benefits, you will create some room, some flexibility for you to deal with these other issues as they come down the pike.

Senator DANFORTH. We wouldn't have to do more things like gradually increase the retirement age or have some method of moving toward universal coverage.

Mr. HSIAO. No. Senator, I am confident that if you adopt a price indexing method, that you will not be confronted with the long-range problem which is before you right now.

Senator DANFORTH. So all we have to do is do that plus find $65 billion.

Mr. HSIAO. Well, I thought maybe everybody in this room can open their checkbooks and help you out.

Senator DANFORTH. Thank you very much.

Senator NELSON. Thank you, Dr. Hsiao. We appreciate your taking the time to come and give us the benefit of your thoughtful comments on this.

Mr. HSIAO. Thank you.

[The prepared statement of Mr. Hsiao follows:]

SUMMARY OF MAJOR POINTS IN THE STATEMENT BY WILLIAM C. HSIAO, ASSOCIATE PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

MAJOR DEFICIENCIES AND ILLS OF THE PRESENT SOCIAL SECURITY PROGRAM

1. Lack of resiliency and controllability of present program due to the inappropriate design of the benefit formula.
2. Short term financial deficit that will deplete the trust funds.
3. Long term financial deficit that will require an enormous amount of additional financing if the benefit formula is not revised.
4. Adverse effects on savings and capital investments by the benefit levels provided.

RECOMMENDATIONS

1. A temporary thirty cents tax on each gallon of gasoline. The revenue would be used to finance the short term deficits and to reduce the payroll tax until a fundamental reform of Social Security can be enacted.
2. A restructuring of the benefit formula based on price-indexing. This approach would solve the long range financing problems and stabilize Social Security.

REFORM SOCIAL SECURITY—WILLIAM C. HSIAO, ASSOCIATE PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

I am pleased to have the opportunity to appear before you this morning as you consider the best way to reform the Social Security program.[1] I have been a student of Social Security longer than I like to remember. Some of my involvement with Social Security includes the chairmanship of an advisory panel appointed by the U.S. Congress to study the system in 1975–76 and the position of the Deputy Chief Actuary of the Social Security Administration in 1969–71.

Social Security is the most successful socio-economic program in the history of the United States, but now it is confronted with grave problems. Even the National Retired Teachers' Association calls for its fundamental reform. The Association argues that "A combination of economic and demographic trends call out for fundamental reform" of Social Security. The choices faced by Congress are not easy. No one can offer painless solutions to the problems. Some people propose "bandaid" solutions to short-run problems, such as interfund borrowing. They would only postpone the day of reckoning until the next session of the Congress. The delay in turn would make these problems more pronounced and solutions more difficult and painful. There is no panacea, but what I can offer is a rational and sensible alternative that I believe is worthy of your serious consideration.

First let me briefly review the major deficiencies and ills of our current program:

1. Lack of resiliency and controllability of present program.—Any successful social insurance program must preserve some flexibility in its benefit structure and must have a financial margin of safety in order to adapt to economic, social and demographic changes. The present program is seriously deficient in these regards. The U.S. Congress, with honorable and humane intentions, made benefit levels fully

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[1] The term Social Security is used here to describe the Old-Age, and Survivor and Disability Insurance (OADSI) program, excluding Medicare.

automatic in 1972. This legislation passed in 1972 was based on a set of incomplete and faulty technical analysis. When the error was corrected by the 1977 Amendment, Congress decided to adopt a wage indexing method that produced excessive levels of benefits for some beneficiaries. The combination of an automatic adjustment mechanism with a generous benefit formula drastically reduced the resiliency of the system and the ability for Congress to control the system. We legislated ourselves into a strait-jacket, and the strait-jacket will get ever tighter due to the ever increasing benefit levels. The benefit levels will automatically increase and they will require higher tax revenues. There is little financial margin in the Social Security program to cushion against adverse economic and demographic conditions or to adapt the system to changing environments.

2. *Short term financial deficit.*—Social Security has serious financial deficits in the short-run. Simply put, the system is paying out more money than it takes in. According to the actuarial projections reported in the 1981 budget, the OASDI program will have a total income of $137 billion in 1981 but will pay out $143 billion, a deficit of $6 billion. I believe the deficit is underestimated because the projected revenue is based on an optimistic assumption for unemployment rates which overstates the projected revenue; while the outlay is based on an optimistic assumption for inflation rates which understates the projected outlay. Using a set of realistic assumptions, I estimate the deficit will be closer to $10 billion, 3 to 4 billion dollars more than the official projection.

The deficit is projected to continue through 1984. The balance in the combined OASDI trust funds will decline from a level that equals 24 percent of the annual outlay in the beginning of 1980 to 5 percent in 1984, less than one month's benefit payments. If we examine the balance of the trust fund for Old Age and Survivor Insurance (OASI) separately from the trust fund for Disability Insurance (DI), the OASI fund will be exhausted by the end of 1981, according to my estimates.

3. *Long term financial deficit.*—Social Security is a long range program. Roughly one-half of those born this year will be alive and receiving retirement benefits 75 years from now. In a system with such long term commitments, we are obligated to take a long term look to assure the system is actuarially sound in order for people retiring in the future will be assured to have their retirement income protection. Under the present law, the cost of the benefits promised to future retirees in the early part of the next century will rise to close to 17 percent of the taxable payroll. Financing provided for is only 12.4 percent, leaving a large annual deficit that, in present day terms, equals approximately $45 billion per year. Legislation passed in 1977 left the long term deficit unresolved. While the benefits have been legislated, adequate financing has not been provided. Some observers believe that Congress finds it extremely difficult, if not impossible, to legislate such high tax rates for the next generation of workers to pay for the generous benefits.

4. *Adverse effects on savings.*—People save for various reasons. One important reason for savings is to have adequate income when earnings are reduced because of retirement. If a worker makes rational choices on his lifetime consumption patterns, he would save and plan for his retirement an amount of income that is consistent with his pre-retirement disposable income. When the benefits provided by Social Security replace a large portion of his pre-retirement disposable income, there would be less need and less incentive to supplement the benefits by private pensions and personal savings.

An examination of replacement rates provided by the benefits under current law is shown in Table 1. For workers with spouses, Social Security provides benefits to those who had low earnings that equal their standard of living before they retire. It also replaces 81 percent and 60 percent of the disposable income for those who had average earnings and earnings at the maximum taxable base, respectively.

TABLE 1—REPLACEMENT RATES BASED ON 1979 DISPOSABLE INCOME FOR VARIOUS HYPOTHETICAL WORKERS WITH DIFFERENT EARNING HISTORIES

[In percent]

	Low earnings ($5,400)	Average earnings ($12,200)	Maximum earnings ($22,900)
Single worker	67	55	40
Worker with spouse	98	81	60

Low and average income workers with spouse will have little need to supplement their Social Security retirement benefits with private pension or personal savings because Social Security provides benefits that replace all or a large part of their pre-retirement disposable income. It is reasonable then to expect that such generous Social Security benefits will reduce capital accumulation.

FUNDAMENTAL REFORMS

The pay-as-you-go method of financing Social Security is akin to a chain letter. Current retirees make a claim on the rising wage of an ever increasing working population. During the past three decades, the retirement benefits increased steadily without pushing the payroll tax rates to an exorbitant level because the working population who pay the current cost of the benefits expanded faster than the retired population. Also the productivity of the workers rose rapidly. Now these basic factors which make a chain letter scheme work have disappeared. The ratio of working population to retired population is decreasing instead of increasing. Also labor productivity gains have diminished significantly in recent years. These result from the fundamental changes in our demographic and economic conditions. We cannot continue the present program with business-as-usual attitude. Basic reforms are necessary. Bandaids will not do. Both the benefit structure and the financing may require major overhead.

I would like to comment in interfund borrowing and general revenue financing, then offer my recommended solutions for both the short-run and long-run problems—a temporary gasoline tax and price-indexing the benefits.

1. Interfund borrowing.—Balance in the OASI trust fund will be depleted by the end of 1981. The Administration proposes to allow borrowing between the OASI, DI and Medicare trust funds. The question then is whether there is sufficient reserve in other trust funds for the programs to borrow from each other.

The 1971 Advisory Council on Social Security thoroughly considered the appropriate level of the trust fund as a contingency reserve. They concluded that the minimum ratio of fund balance and annual outlay should be 75 percent. Subsequently, other technical experts who examined the same question also confirm this finding.

Now the total balance of all trust funds is equal to about 33 percent of the annual outlay, far below the minimum standard recommended by experts. No individual fund has a balance that exceeds this minimum level either. Consequently there is no excess in other funds to lend to the OASI program. Moreover, Social Security has a long term as well as a short term financial deficit. There is no fund available from OASDI to repay the loans in the long run. For these reasons, I oppose the Administration's proposal on interfund borrowing. I believe borrowing from any fund only postpones the necessity for Congress to address the issue of reforming the system. At the same time the action will further undermine the public's confidence in Social Security.

2. Financing social security by general revenue.—Many people and groups have long advocated the use of general revenue to finance Social Security. But the simple fact is that the U.S. budget has been in a deficit position for a number of years, even during periods of economic boom. Unless Congress is willing to legislate tax increases, the general revenue needed to finance Social Security will have to come from borrowing against future generations. Under the current economic condition, both tax increase and government borrowing have serious adverse impact on inflation, employment and capital accumulation.

Moreover, I believe the elderly Americans and American workers will be ill-served by general revenue financing of Social Security because it would weaken the earnings related nature of the program. That could jeopardize the long range stability of the entire Social Security system. Also general revenue financing does not address the flaw in the present benefit structure.

When we acknowledge that general revenue funds are limited, it is then necessary to assess what programs may have more urgent claims on general revenues than Social Security. There are many social and economic problems requiring funds. Just to name a few, long-term care, tax reform, welfare reform and national health insurance would all be competing with Social Security.

3. Temporary financing by a special tax on gasoline.—The financial blight of Social Security is undisputed. However, I believe the short-term problems should be separated from the long-term problems. The causes for them are different. The options open to Congress are different.

In the short run, we cannot and should not alter the Social Security benefits for people who retired or expect to retire in the next several years. Many older workers have made plans for their retirement based on what benefits they would receive

under the current law. It is unfair to thwart their expectations. Therefore, additional funds must be provided to finance the projected expenditures in the short run. The question is which tax revenue would have the least negative effect on our present economy. I recommend a tax on gasoline.

A temporary thirty cent tax on every gallon of gasoline sold would produce a revenue of about $33 billion per year. One-third of this tax would finance the deficit of Social Security until permanent reforms can be enacted by Congress. Two-thirds of this tax revenue can be used to reduce the payroll tax. A tax on gasoline would reduce our consumption of gasoline by more than 10 percent. This would reduce our dependency on import oil and ease our balance of payment problems. It would in turn strengthen the value of our dollar abroad. However, this special tax would exacerbate inflation, but the reduction in payroll tax could mitigate it.

4. *Long term reform.*—Deficiencies in the present benefit structure are many. The benefits determined by wage indexing under the present law (shown in Table 1) are so generous that they place the system under great strain to meet these commitments. Congress' failure to provide adequate financing for the benefits in the long-run is an indication of this financial stress. More importantly, the resiliency of the system is seriously impaired when future increases in taxes are already committed to finance the automatic benefit increases. At the same time, the ability for Congress to control the program is diminished because of the fully automatic adjustments of benefits. Moreover, these generous Social Security benefits reduce private savings affecting capital funds for investment.

The problems created by the present benefit formula can be remedied effectively by altering the method of indexing. Instead of indexing the worker's lifetime earnings by rates of increase in wages, we should index the earnings by a superior method—price indexing.

In 1977, the Consultant Panel on Social Security, appointed by Congress, recommended unanimously the price-indexing method. Price-indexing will protect Social Security benefits against inflation for those who are retired as well as those who retire in the future. It provides a partial automatic adjustment system which could guarantee a reasonable benefit and preserve a degree of control for Congress. It could regulate the benefits in the future in light of the needs of retired people and our ability to pay for them.

Benefits specified under current law requires the payroll tax rates to rise sharply by 60 percent in the long term to finance them. Benefits under price-indexing requires no significant increase in taxes. Also the tax rates can remain fairly level in the long term.

The grave problems confronted by Social Security have solutions. The present benefit structure contains the basic flaw. Thus the solution does not lie in finding new avenues of financing but in restructuring the benefit formula. Regardless of where we find the revenue for a flawed system the tax burden falls on the American people.

I recommend that Congress reform the system by adopting the price-indexing method for Social Security benefits. The new benefit structure needs to be phased-in gradually in an orderly manner. During the transitional period, the additional funds required to finance Social Security can be generated through a temporary tax on gasoline. While a new gasoline tax would not be the most popular tax, nevertheless, it is a desirable and efficient approach to raise new revenues.

Senator NELSON. The hearing will resume in this room Monday at 2 p.m.

[Whereupon, at 11:45 a.m., the hearing was recessed, to reconvene at 2 p.m. on Monday, February 25, 1980.]

SOCIAL SECURITY FINANCING

MONDAY, FEBRUARY 25, 1980

U.S. SENATE,
SUBCOMMITTEE ON SOCIAL SECURITY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:20 p.m., in room 2221, Dirksen Senate Office Building, Hon. Gaylord Nelson (chairman of the subcommittee) presiding.

Present: Senators Nelson and Danforth.

Senator NELSON. The Senate Subcommittee on social security will hold its second hearing today on issues concerning the financing of social security. Friday the subcommittee heard testimony from the Commissioner of Social Security, the Chairman of the Advisory Council on Social Security and Dr. William Hsiao, an economist and expert on social security.

Today, the committee will receive testimony from Hon. Alice Rivlin, Director of the Congressional Budget Office; the National Council of Senior Citizens; the American Association of Retired Persons; Mr. Robert Ball, former Commissioner of Social Security; and Milton Gwitzman, Chairman of the National Commission on Social Security.

Our first witness is the Director of the Congressional Budget Office, Hon. Alice Rivlin.

Your statement will be printed in full in the record and you can present it however you desire. The committee is pleased to have you here today.

STATEMENT OF ALICE RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Ms. RIVLIN. Thank you, Mr. Chairman.

I do not think I deserve the title "the Honorable." I think that is reserved for elected officials and Presidential appointees, and I am neither. But I am very happy to be here.

Senator NELSON. Just let me say that not all elected officials are honorable and lots of people who are not elected officials are honorable.

Ms. RIVLIN. In the next few years, the Old Age and Survivors' Insurance—OASI—trust fund, the largest of the three funds that finance social security, is likely to experience some financial problems. The main causes of OASI's anticipated difficulties are continuing high inflation, rising unemployment, and slow economic growth.

The problems we are seeing now are similar to those the Congressional Budget Office—CBO—foresaw last summer. At that time, CBO's estimates indicated a potential problem in the OASI trust fund in 1983 or 1984. Unfortunately, that assessment was based on a somewhat brighter economic outlook than we now see. Present estimates indicate that the OASI fund may experience financing problems by the beginning of fiscal year 1982—that is, by the end of calendar year 1981.

In order to assist the committee in dealing with these problems, my testimony today will concentrate on four areas:

Our current estimates of the financing positions of the three Social Security trust funds OASI, Disability Insurance—DI, and Hospital Insurance—HI;

The impact of recent developments in the economy and the economic outlook on the trust funds;

An analysis of the Administration's proposal to permit interfund borrowing; and

Some alternative responses to the fund's financing problems.

CURRENT ESTIMATES OF THE FINANCIAL POSITIONS OF THE SOCIAL SECURITY TRUST FUNDS

At present, both CBO and the Administration estimate that the overall solvency of the social security system will improve over the next 5 years. Over that period fiscal—years 1981-85, the social security program, including HI, which finances medicare, is expected to receive about $23 billion more in tax revenues and interest than will be spent. Although the combined trust fund balance will grow, the balance as a percent of outlays is expected to fall.

The financial situations of the three separate trust funds, however, will differ substantially. Outlays from the OASI fund will exceed revenues. At the beginning of fiscal year 1980, the OASI trust fund balance reached a level that equaled almost 27 percent of anticipated outlays for the year. This balance could fall to about 9 percent by the start of fiscal year 1982 and to less than 2 percent by the next year. Shortly thereafter, balances are likely to become negative. Table 1 displays these projections. [Attached as p. 4A]

[The table follows:]

TABLE 1.—ACTUAL AND PROJECTED SOCIAL SECURITY TRUST FUND BALANCES AT THE START OF THE FISCAL YEAR AS A PERCENT OF EXPECTED OUTLAYS FOR THE YEAR

Individual and combined trust funds	1980	1981	1982	1983	1984	1985	1990
OASI	26.7	18.9	9.2	1.4	(1)	(1)	(1)
DI	36.1	41.4	49.3	59.1	70.1	85.9	203.7
HI	57.6	58.4	68.5	80.5	89.5	94.5	101.6
OASDI	27.9	21.8	14.3	8.8	5.1	3.0	23.6
OASDHI	32.7	27.6	23.2	20.9	19.8	19.6	40.2

[1] Negative balance.

Source: Based on CBO's January 1980 economic assumptions.

Ms. RIVLIN. At a minimum, the trust funds need a balance of about 9 to 12 percent of yearly outlays at the start of the year to guarantee that the system will be able to meet all of that year's

monthly payments in a timely fashion. The OASI trust fund balance is likely to fall below that level early in fiscal year 1982.

In contrast, the balance in the DI fund is likely to grow steadily during the next 5 years. The balance in that fund at the beginning of fiscal year 1980 was 36 percent of estimated outlays. Primarily as a result of the large increases in taxes earmarked for this fund by the Social Security Amendments of 1977 (Public Law 95-216), and also because of recent declines in the growth rate of disability benefit payments, the DI trust funds is projected to increase to almost 86 percent of outlays by the beginning of fiscal year 1985. Disability benefit payments, however, have been difficult to predict in recent years, and any unexpected increase in disability payments over the next 5 years could reduce the DI fund's balance.

Similarly, the balance in the HI trust fund is also likely to grow, largely because of increases in the covered earnings base legislated in the 1977 Amendments, continuing increases in the HI tax rate, and somewhat slower growth in hospital expenditures than was previously anticipated. At the beginning of fiscal year 1980, the balance of this fund was almost 58 percent of anticipated outlays, and it was expected to rise by almost 95 percent by the start of fiscal year 1985.

In short, the DI and HI trust funds are not currently expected to experience difficulties. It is the OASI fund that is expected to be in trouble.

THE ECONOMIC OUTCOME AND TRUST FUND SOLVENCY

Social Security revenues and benefit payments, and hence trust fund balances, depend, in the short run, both on inflation and employment. The connection between trust fund forecasts and the general economic outlook is particularly evident in the comparison between the January 1979 and 1980 projections issued by both the Administration and CBO. A year ago, the Administration projections, in response to the mandated goals of the Humphrey-Hawkins Act, showed that inflation would decline quickly, reaching 3 percent by 1983, and that the unemployment rate would decline to 4 percent by 1984, as shown in table 2. Had those expectations been realized, the OASI fund would not have experienced financial difficulties.

[The table follows:]

TABLE 2.—COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS AS OF JANUARY 1979 AND JANUARY 1980

[In percent]

	1979	1980	1981	1982	1983	1984	1985
January 1979 assumptions:							
Inflation [1]:							
CBO	-8.2	7.6	6.9	6.6	6.3	5.8	([2])
Administration	7.5	6.4	5.2	4.1	3.0	2.7	([2])
Unemployment [3]:							
CBO	6.2	6.8	6.6	6.2	5.9	5.5	([2])
Administration	6.0	6.2	5.7	4.9	4.2	4.0	([2])
January 1980 assumptions:							
Inflation:							
CBO [1]	[4]12.6	9.6	9.3	8.8	8.2	7.9	7.6

TABLE 2.—COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS AS OF JANUARY 1979 AND JANUARY 1980—Continued

[In percent]

	1979	1980	1981	1982	1983	1984	1985
Administration [5]	[4] 13.2	10.4	8.6	7.8	7.2	6.4	5.7
Unemployment [3]:							
CBO	[4] 5.9	7.0	8.0	7.8	7.1	6.4	6.0
Administration	5.9	7.0	7.4	6.8	5.9	5.1	4.3

[1] Percent change in the Consumer Price Index from preceding 4th quarter to 4th quarter.
[2] Not forecast.
[3] Average for the calendar year.
[4] Actual. Note that the 12.6-percent inflation rate is the increase between the 4th quarters of 1978 and 1979 whereas the 13.2-percent inflation rate is the increase between December 1978 and December 1979.
[5] Percent change in the Consumer Price Index from preceding December to December.

Ms. RIVLIN. At that time, CBO was projecting a rate of inflation that was significantly higher; we expected it to remain above 6 percent in 1983. But that rate looks low by present standards.

Unemployment was projected to rise in 1980 and then to decline slowly, remaining above 9 percent through 1984. Even though these economic assumptions were less optimistic than the Administration's, CBO also expected that the OASI trust fund would not encounter financial difficulties.

In January 1980, both the Administration and CBO projected that the OASI fund would experience an inadequate balance in 1982 and a negative balance in 1983. Current projections differ from those of a year earlier because the underlying economic forecasts are more pessimistic. CBO's and the Administration's are also more similar.

Even though there is widespread agreement that in 1980 inflation will be high and that the unemployment rate will rise, the outlook is by no means certain. As we have seen during the last few years, even when there is considerable agreement, forecasters' predictions may not be realized. One reason is that many events lie outside the range of economic forecasting, such as the world events that cause energy and food prices to rise.

In addition, the behavior of consumers and businesses has proved unpredictable in times of high inflation. The current CBO forecast assumes that savings rates will rise gradually but will remain at low levels over the next 2 years. Should savings increase sharply, long-run economic growth prospects would improve, but growth in the short run would probably be lower.

These economic uncertainties affect projections of trust fund outlays and revenues. The rate of inflation affects trust fund outlays because social security benefits are indexed to the Consumer Price Index (CPI). For example, both the Administration and CBO expect the annual benefit increase that will occur in June 1980 to be about 13 percent, increasing outlays by about $14 billion in the following fiscal year. At the same time, trust fund revenues, which are also affected by inflation, are expected to increase only slightly less than outlays.

Trust fund revenues also depend on the level of economic growth. For example, growth in money wages is likely to slow when economic growth is low, even when unemployment does not

rise, as has been the situation in recent years. And when unemployment does go up, payroll tax receipts are reduced still further.

RESPONSES TO THE SHORT-RUN FINANCING PROBLEM

Policies to deal with the OASI short-run financing problem by altering trust fund revenues fall into two general categories—reallocation of payroll tax receipts among the three trust funds, and additon of funds from general revenues.

Alternatively, of course, benefits could be reduced.

REALLOCATION OF PAYROLL TAX RECEIPTS

One way to reallocate tax receipts among funds is to allow fund-to-fund borrowing. The Administration has proposed that the trust funds be permitted to borrow from one another when the balance in any one fund falls below a critical level. The critical level proposed is 25 percent of outlays in the preceding 12 months. The Administration's proposal restricts the amount of allowable borrowing to whatever amount will raise the borrowing fund's balance to 25 percent of outlays in the preceding 12 months. Repayment with interest would be required when the balance of the borrowing fund exceeded 30 percent of its outlays in the preceding 12 months. Interest would be set at the rate the lending trust fund would have earned by investing in Federal obligations.

One example of how the Administration's proposal could be implemented is for the OASI trust fund to borrow enough to maintain a balance at the beginning of the fiscal year equal to 25 percent of the previous year's outlays—that is, essentially, to borrow the maximum allowed. In this case, CBO estimates roughly $60 billion would have to be borrowed over the period fiscal years 1981 through 1985. An additional $30 billion would probably have to be borrowed by the end of fiscal year 1990. These projections are shown on table 3.

[The table follows:]

TABLE 3.—PROJECTIONS OF OASI BORROWING ON OCTOBER 1 FROM DI, AND SUBSEQUENTLY HI, TRUST FUNDS TO MAINTAIN BALANCE AT BEGINNING OF YEAR OF 25 PERCENT OF PREVIOUS YEAR'S OUTLAYS

[In billions of dollars]

Year	Borrowing by OASI fund for the year	Amount borrowed from DI fund [1]	Amount borrowed from HI fund	Amount repaid to HI fund from DI fund
1981	3.1	3.1		
1982	14.6	2.3	12.3	
1983	14.6	3.0	11.6	
1984	14.0	3.6	10.4	
1985	13.5	5.1	8.4	
1986	7.8	7.8		[2] 3.0
1987	4.1	4.1		10.8
1988	5.4	5.4		10.7
1989	4.7	4.7		13.1
1990	7.9	7.9		[3] 5.1

[1] Assumes that the DI fund maintains a balance at least as large as 25 percent of its outlays in the previous year.

[2] This assumes that the amount by which the DI trust fund balance exceeds 25 percent of the preceding year's outlays is used to repay the HI fund.

[3] Interest could also be paid to the HI trust fund. In fiscal year 1990, after lending the necessary amount to the OASI trust fund, repaying the remaining amount owed to the HI trust fund, and setting aside 25 percent of the previous year's outlays, the DI trust fund would have available additional funds from which interest to the HI trust fund could be paid.

Note.—Details may not add to totals because of rounding.

Source: Based on CBO's January 1980 economic assumptions.

Ms. RIVLIN. The DI trust fund alone is not expected to have sufficient balances to meet these borrowing needs, however. The OASI trust fund would probably also have to borrow from the HI fund in fiscal years 1982 through 1985, and during fiscal years 1983 and 1984 the HI's balance at the beginning of the year would probably fall slightly below 25 percent of its previous year's outlays. Although it appears that the HI loans could be repaid with interest from the DI trust fund by fiscal year 1990, it is less clear that the OASI fund could repay the DI fund.

Senator NELSON. May I ask, does it make any difference?

Ms. RIVLIN. It does not make any real difference. The funds would not be at a dangerously low level in either case.

Senator NELSON. I know that some people express concern that you would be borrowing from the disability fund, or from HI, but is it not just a clear and simple fact that if the fund is adequately funded for the purposes for which it is designed, it would not make any difference and it might make more sense if all the money were in one pool anyway. You may want to keep separate books.

But the reason that HI and DI would be on the increase, in the way they are, is that Congress just made a bad guess, that is all. If they had guessed perfectly, we would not be involved in any transfers.

So I am curious to know whether there is any reason to argue that it makes any difference whether it was paid back or not.

That is our arbitrary decision, Congress arbitrary decision, as to what percent of the tax shall be earmarked to go into the trust fund for medicare or disability insurance.

Ms. RIVLIN. That is right.

As long as the three funds altogether are in good shape, it seems to me not to make very much difference whether you merge the funds and keep separate books, whether you borrow and keep books on that—or indeed whether you change the payroll tax rates themselves again, which would be another possibility.

Senator NELSON. Well, if the funds turned out to be inadequate for any one or all of these programs, of course, the option the Congress would have would be the same whether you have them earmarked or not. If the funds are inadequate, you have either got to raise the taxes, raise the base, cut the benefits, whatever. You have got to make the fund whole.

So it seems to me it would not make much difference. I am just wondering why the admnistration believes that this is a better approach than reallocation or what have you.

Ms. RIVLIN. I cannot speak for the Administration. I think probably it seems, under the circumstances, to be the least change that would take care of the problem.

The administration's plan would also permit the OASI fund to borrow less than the maximum amount. If the trust fund did that, and borrowed only enough to raise its balance at the beginning of the fiscal year to 12 percent of the expected outlays during the

year, total borrowing over fiscal years 1982 through 1985 would be less: it would be about $40 billion. Additional borrowing during fiscal year 1986 to 1990 would be about $17 billion.

As in the first example, the DI fund probably could not lend all these amounts to the OASI fund. Borrowing from the HI trust fund would be needed in fiscal years 1983, 1984, and 1985. Loans from the HI fund could probably be repaid from the DI trust fund, with interest, by 1988, although repayment from OASI to DI appears more problematic; see table 4.

[The table follows:]

TABLE 4.—PROJECTIONS OF OASI BORROWING ON OCTOBER 1 FROM DI, AND SUBSEQUENTLY HI, TRUST FUNDS TO MAINTAIN BALANCE AT BEGINNING OF YEAR OF 12 PERCENT OF EXPECTED OUTLAYS FOR THE YEAR

[In billions of dollars]

Year	Borrowing by OASI fund for the year	Amount borrowed from DI fund[1]	Amount borrowed from HI fund	Amount repaid to HI fund from DI fund
1981				
1982	3.8	3.8		
1983	12.6	7.0	5.6	
1984	11.9	4.0	7.9	
1985	11.5	5.4	6.1	
1986	5.5	5.5		5.5
1987	1.8	1.8		13.3
1988	2.8	2.8		[2]0.8
1989	2.0	2.0		
1990	4.7	4.7		

[1] Assumes that the DI fund maintains a balance at the beginning of each year at least as large as 12 percent of the expected outlays.

[2] Interest could also be paid to the HI trust fund. At the beginning of fiscal year 1988, after lending the necessary amount to the OASI fund, repaying the HI loan, and setting aside 12 percent of expected outlays, the DI fund is expected to have available additional funds from which interest to the HI fund could be paid.

Note.—Details may not add to totals because of rounding.

Source: Based on CBO's January 1980 economic assumptions.

Ms. RIVLIN. The Administration's proposal would solve the short-run financing problems. An additional advantage is flexibility; the plan would resolve any further difficulties that might arise, should economic conditions be somewhat worse than anticipated. Furthermore, the proposal does not limit the Congress future options to restructure the social security system in more fundamental ways to respond to long-term issues. Finally, allowing fund-to-fund borrowing would not affect the outlook for employment and inflation, because the total payroll tax paid by employees and employers would not change. On the other hand, public concern about whether the OASI fund could repay the DI fund might develop.

The second means of reallocating revenues is to realine the payroll tax rates earmarked to the individual trust funds. Simple realinement could overcome the currently predicted short-run financing problem and would not raise the question of whether one fund could repay another, but it would be less flexible in adapting to changing economic conditions. Tax-rate realinement would increase the likelihood that additional legislative changes would be needed in the near future.

A third alternative would be to merge the trust funds but retain separate analyses of expenditures for different types of benefits.

This option shares the advantages of the Administration's proposal, but it is likely to be more controversial. Some people believe that it would make congressional control of the three separate programs more difficult. It would certainly require joint consideration for funding for programs that are now assigned to different functional areas of the budget.

PARTIAL FUNDING FROM GENERAL REVENUES

A greater departure than altering the three trust funds would involve social security's use of general Federal revenues. This could be done, for example, either:

Through trust fund borrowing from the general fund;

Through countercyclical financing from general revenues, with or without repayment; or

Through use of other earmarked taxes to supplement OASDHI payment of payroll tax receipts.

These approaches would solve the short-run financing problem without losing the distinctions among the three trust funds and the system would be able to deal more easily with future fluctuations in economic conditions. Furthermore, any of these approaches could be expanded, if needed, to resolve longer term financing problems. Public concern that there will not be adequate funding to pay for future benefits would probably be allayed, although this is less likely if borrowing were not repaid. Finally, should a decrease in payroll taxes be desired as an anti-inflationary or stimulative policy, it could be combined easily with general revenue funding.

There are several disadvantages to these approaches, however. Some people are concerned that partial reliance on general revenues would eventually lead to complete reliance—that is, elimination of the payroll tax as a source of funding—which in turn might lead to means-tested rather than entitlement benefits. In addition, these proposals would require people not covered by social security, or some of those already receiving benefits, to help pay for the system. Finally, if general revenue financing were used, either another source of revenues would have to be found, or the deficit would have to increase, or other programs would have to be reduced.

General revenue financing could also be incorporated indirectly. For example, the Congress could increase the payroll tax sufficiently to cover benefit payments for the near future and provide an income tax credit to reduce the impact of the increase on employers and employees. Alternatively, components of the social security system, such as medicare, could be removed from the social security system and funded through general revenues. The portion of the payroll tax now allocated to these payroll components could be used to increase funding for the OASI fund and to lower the total payroll tax rate.

REDUCING BENEFITS

There are many ways either to lower benefits in the short run or to limit their future growth. Some have been suggested in the past—for example, in the Administration's 1980 budget proposals.

Such changes could avoid the need for increased funding from payroll taxes, or other sources, as would taxing benefits and returning the revenue to the trust funds. But proposals to constrain benefits tend to be controversial, and many of them have not been given serious attention by the Congress in the recent past.

CONCLUDING OBSERVATIONS

At the moment, responding to the short-term financial problem of the OASI trust fund is a primary concern. In the future, however, both changing demographics and a worsened economic outlook are expected to lead to more severe financial problems. These problems will require extensive consideration by the Congress. The revenue options are basically the same as those that would be adopted in the short run. With more time in which to phase in changes in benefits, however, the Congress may want to consider a major restructuring of the system.

Thank you, Mr. Chairman.

Senator NELSON. Thank you very much for taking the time to come over and give us the benefit of your views on this. We appreciate your thoughtful comments on the social security fund. You submitted an appendix, did you not?

Ms. RIVLIN. There are appendix tables.

Senator NELSON. Are they to be printed immediately following your statement?

Ms. RIVLIN. Yes. There are only four of them.

Senator NELSON. They will be printed in the record immediately following your statement.

[The material referred to follows:]

APPENDIX TABLE 1.—CBO PROJECTIONS OF SOCIAL SECURITY TRUST FUND BALANCES AT THE START OF THE FISCAL YEAR AS A PERCENT OF EXPECTED OUTLAYS FOR THE YEAR

Individual and combined trust funds	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
OASI	26.7	18.9	9.2	1.4	(1)	(1)	(1)	(1)	(1)	(1)	(1)
DI	36.1	41.4	49.3	59.1	70.8	85.9	116.8	149.5	176.6	194.3	203.7
HI	57.6	58.4	68.5	80.5	89.5	94.5	99.1	105.8	109.3	108.1	101.6
OASDI	27.9	21.8	14.3	8.8	5.1	3.0	6.1	11.7	16.3	20.8	23.6
OASDHI	32.7	27.6	23.2	20.9	19.8	19.6	23.6	30.9	35.0	38.9	40.2

[1] Negative balance.

Source: Based on CBO's January 1980 economic assumptions.

APPENDIX TABLE 2.—CBO PROJECTIONS OF SOCIAL SECURITY TRUST FUND BALANCES AT THE START OF THE FISCAL YEAR

[In billions of dollars]

Individual and combined trust funds	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
OASI	22.9	12.7	2.1	−7.8	−17.0	−20.2	−19.4	−19.3	−17.9	−18.8	−5.0
DI	7.4	9.9	13.5	17.8	23.8	34.8	50.3	67.3	86.2	105.3	131.6
HI	15.6	21.2	28.8	37.1	45.3	54.8	67.6	80.6	92.4	100.9	104.8
OASDI	30.3	22.6	15.6	10.0	6.5	14.6	30.9	48.0	68.3	86.8	126.7
OASDHI	45.9	43.8	44.4	47.1	51.8	69.4	98.5	128.6	160.7	187.4	231.5

Note.—Details may not add to totals because of rounding.

Source: Based on CBO's January 1980 economic assumptions.

APPENDIX TABLE 3.—COMPARISON OF CBO AND ADMINISTRATION PROJECTIONS OF SOCIAL SECURITY TRUST FUND BALANCES AT BEGINNING OF FISCAL YEAR AS A PERCENT OF EXPECTED OUTLAYS FOR THE YEAR

Individual and combined trust fund	1980	1981	1982	1983	1984	1985
OASI:						
CBO [1]	26.7	18.9	9.2	1.4	([2])	([2])
Administration [3]	26.6	19.1	9.6	1.9	([2])	([2])
DI:						
CBO [1]	36.1	41.4	49.3	59.1	70.8	85.9
Administration [3]	36.4	44.3	56.0	73.1	92.3	113.1
HI:						
CBO [1]	57.6	58.4	68.5	80.5	89.5	94.5
Administration [3]	57.8	59.2	71.0	87.0	101.0	112.3
OASDI:						
CBO [1]	27.9	21.8	14.3	8.8	5.1	3.0
Administration [3]	27.9	22.3	15.3	10.6	7.6	5.9
OASDHI:						
CBO [1]	32.7	27.6	23.2	20.9	19.8	19.6
Administration [3]	32.8	28.2	25.8	23.2	23.4	24.4

[1] Based on CBO's January 1980 economic assumptions.
[2] Negative balance.
[3] Approximate.

APPENDIX TABLE 4.—PROJECTED SOCIAL SECURITY TRUST FUND OUTLAYS, BUDGET AUTHORITY, AND BALANCES

[In billions of dollars]

Breakdown by individual and combined trust fund	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
OASI:											
Outlays	104.1	121.4	137.6	154.1	171.2	189.6	209.1	231.2	255.4	283.3	314.8
Budget authority	99.3	111.2	127.1	144.1	162.1	186.4	209.9	231.2	256.6	282.6	328.6
Trust fund balance at end of year	22.9	12.7	2.1	−7.8	−17.0	−20.2	−19.4	−19.3	−17.9	−18.8	−5.0
Trust fund balance at beginning of year, as a percent of outlays	26.7	18.9	9.2	1.4	([1])	([1])	([1])	([1])	([1])	([1])	([1])
DI:											
Outlays	15.6	17.9	20.2	22.9	25.2	27.4	29.8	33.6	38.1	44.4	51.7
Budget authority	17.4	20.4	23.8	27.2	30.9	38.6	45.3	50.7	57.0	63.5	78.0
Trust fund balance at end of year	7.4	9.9	13.5	17.8	23.5	34.8	50.3	67.3	86.2	105.3	131.6
Trust fund balance at beginning of year, as a percent of outlays	36.1	41.4	49.3	59.1	70.8	85.9	116.8	149.5	176.6	194.3	203.7
HI:											
Outlays	23.2	26.7	30.9	35.7	41.4	47.9	55.4	63.9	73.8	85.5	99.4
Budget authority	25.4	32.3	38.5	44.0	49.6	57.5	68.1	76.9	85.5	94.0	103.2
Trust fund balance at end of year	15.6	21.2	28.8	37.1	45.3	54.8	67.6	80.6	92.4	100.9	104.8
Trust fund balance at beginning of year, as a percent of outlays	57.6	58.4	68.5	80.5	89.5	94.5	99.1	105.8	109.3	108.1	101.6
OASDI:											
Outlays	119.7	139.3	157.8	177.0	196.4	216.9	238.9	264.8	293.5	327.8	366.5
Budget authority	116.6	131.6	150.8	171.3	192.9	225.0	255.2	281.9	313.8	346.0	406.7
Trust fund balance at end of year	30.3	22.6	15.6	10.0	6.5	14.6	30.9	48.0	68.3	86.5	126.7
Trust fund balance at beginning of year, as a percent of outlays	27.9	21.8	14.3	8.8	5.1	3.0	6.1	11.7	16.3	20.8	23.6
OASDHI:											
Outlays	142.9	165.9	188.7	212.7	237.9	264.8	294.3	328.7	367.3	413.3	465.8
Budget authority	142.0	163.8	189.3	215.4	242.6	282.5	323.3	358.8	399.3	440.1	509.9
Trust fund balance at end of year	45.9	43.8	44.4	47.1	51.8	69.4	98.5	128.6	160.7	187.4	231.5
Trust fund balance at beginning of year, as a percent of outlays	32.7	27.6	23.2	20.9	19.8	19.6	23.6	30.0	35.0	38.9	40.2

[1] Negative balances.

Note.—Details may not add to totals because of rounding.

Source: Based on CBO's January 1980 economic assumptions.

Senator NELSON. Thank you very much for taking the time to come over here and testify today. The committee appreciates it.

We had a day of hearings already and we are going through the record. If there—and there probably will be—are some questions that we would like to submit that occur to us after looking at the record, I assume you would be prepared to respond to them for the record in writing for us?

Ms. RIVLIN. Absolutely, Mr. Chairman.

[The prepared statement of Ms. Rivlin follows. Oral testimony continues on p. 76.]

STATEMENT OF

Alice M. Rivlin
Director
Congressional Budget Office

before the
Subcommittee on Social Security
of the
Committee on Finance
United States Senate
February 25, 1980

In the next few years, the Old Age and Survivors Insurance (OASI) trust fund--the largest of the three funds that finance Social Security--is likely to experience some financial problems. The main causes of OASI's anticipated difficulties are continuing high inflation, rising unemployment, and slow economic growth. The problems foreseen now are similar to those that the Congressional Budget Office (CBO) projected in July 1979. At that time, CBO's estimates indicated a potential problem in the OASI trust fund in 1983 or 1984. Unfortunately, that assessment was based on a somewhat brighter economic outlook than CBO now forecasts.

Present estimates indicate that the OASI fund may experience financing problems by the beginning of fiscal year 1982 (that is, at the end of calendar year 1981). In order to assist the Committee in dealing with these problems, my testimony today will concentrate on four areas:

- CBO's current estimates of the financial positions of the three Social Security trust funds--OASI, Hospital Insurance (HI), and Disability Insurance (DI);
- The impact of recent developments in the economy and the economic outlook on the trust funds;
- An analysis of the Administration's proposal to permit fund-to-fund borrowing; and
- Alternative responses to the OASI fund's financing problems.

CURRENT ESTIMATES OF THE FINANCIAL POSITIONS OF THE SOCIAL SECURITY TRUST FUNDS

At present, both CBO and the Administration estimate that the overall solvency of the Social Security system will improve over the next five years. Over the five-year period from fiscal year 1981 through 1985, the Social Security program (including Medicare) is expected to receive about $23 billion more in tax revenues and interest than will be spent. Although the combined trust fund balance will grow, the balance as a percent of outlays is expected to fall.

The financial situations of the three separate Social Security trust funds wil differ substantially, however. Outlays from the OASI fund will exceed revenues. At the beginning of fiscal year 1980, the OASI trust fund balance reached a level that equaled almost 27 percent of anticipated outlays; this balance could fall to about 9 percent by the start of fiscal year 1982 and to less than 2 percent by the start of fiscal year 1983. Shortly thereafter, OASI balances are likely to become negative. (Table 1 displays these projections.) 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 1. ACTUAL AND PROJECTED SOCIAL SECURITY TRUST FUND BALANCES AT THE START OF THE FISCAL YEAR AS A PERCENT OF EXPECTED OUTLAYS: TO FISCAL YEARS 1985 AND 1990, IN PERCENTS

Individual and Combined Trust Funds	1980	1981	1982	1983	1984	1985	1990
OASI	26.7	18.9	9.2	1.4	a	a	a
DI	36.1	41.4	49.3	59.1	70.8	85.9	203.7
HI	57.6	58.4	68.5	80.5	89.5	94.5	101.6
OASDI	27.9	21.8	14.3	8.8	5.1	3.0	23.6
OASDHI	32.7	27.6	23.2	20.9	19.8	19.6	40.2

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

a. Negative balance.

In contrast to OASI, the balance in the DI fund is likely to grow steadily during the next five years. The balance in the DI trust fund at the beginning of fiscal year 1980 was 36 percent of estimated outlays. Primarily as a result of the large increases in taxes earmarked for this fund by the Social Security Amendments of 1977 (Public Law 95-216) and also because of recent declines in the growth rate of disability benefit payments, the DI trust fund balance is projected to increase to almost 86 percent of outlays by the beginning of fiscal year

1985. Disability benefit payments, however, have been difficult to predict in recent years, and any unexpected increase in disability payments over the next five years could reduce the DI fund's balances.

Similarly, the balance in the HI trust fund is also likely to grow, largely because of increases in the covered earnings base legislated in the 1977 Amendments, continuing increases in the HI tax rate, and somewhat slower growth in hospital expenditures than was previously anticipated. At the beginning of fiscal year 1980 the balance in this fund was almost 58 percent of anticipated outlays and it is expected to rise to almost 95 percent of outlays by the start of fiscal year 1985.

In short, while the DI and HI trust funds are not currently expected to experience difficulties, the OASI fund could fall far below acceptable levels in the near future.

THE ECONOMIC OUTLOOK AND TRUST FUND SOLVENCY

Social Security revenues and benefit payments, and hence trust fund balances, depend in the short run both on inflation and employment. The connection between trust fund forecasts and the general economic outlook is particularly evident by comparing January 1979 and January 1980 projections issued by both the Administration and CBO. In January 1979, the Administration

projections, in response to the mandated goa's of the Humphrey-Hawkins Act, showed that inflation would decline quickly, reaching 3 percent by 1983 and the unemployment rate would decline to 4 percent by 1984 (see Table 2). Had those expectations been realized, the OASI trust fund would not have experienced financial difficulties.

In January 1979, CBO projected that the rate of inflation would be significantly higher and would remain over 6 percent in 1983. Unemployment was projected to rise in 1980 and then to decline slowly, remaining above 5 percent through 1984. Even though these economic assumptions were less optimistic than the Administration's, CBO also expected that the OASI trust fund would not encounter financial difficulties.

In January 1980, both CBO and the Administration projected that the OASI trust fund would experience an inadequate balance in 1982 and a negative balance in 1983. These projections differ from those of a year earlier because the underlying economic forecasts are more pessimistic.

Even though there is widespread agreement that in 1980 inflation will be high and that the unemployment rate will rise, the outlook is by no means certain. As we have seen during the last few years, even when there is considerable agreement, forecasters' predictions may not be realized. One reason is that

TABLE 2. COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS AS OF JANUARY 1979 AND JANUARY 1980: TO CALENDAR YEAR 1985, IN PERCENTS

	1979	1980	1981	1982	1983	1984	1985
January 1979 Assumptions							
Inflation[a]							
CBO	8.2	7.6	6.9	6.6	6.3	5.8	[e]
Administration	7.5	6.4	5.2	4.1	3.0	2.7	[e]
Unemployment[b]							
CBO	6.2	6.8	6.6	6.2	5.9	5.5	[e]
Administration	6.0	6.2	5.7	4.9	4.2	4.0	[e]
January 1980 Assumptions							
Inflation							
CBO[a]	12.6[d]	9.6	9.3	8.8	8.2	7.9	7.6
Administration[c]	13.2[d]	10.4	8.6	7.8	7.2	6.4	5.7
Unemployment[b]							
CBO	5.9[d]	7.0	8.0	7.8	7.1	6.4	6.0
Administration	5.9[d]	7.0	7.4	6.8	5.9	5.1	4.3

a. Percent change in the Consumer Price Index from preceding fourth quarter to fourth quarter.

b. Average for the calendar year.

Percent change in the Consumer Price Index from preceding December to December.

d. Actual. Note that the 12.6 percent inflation rate is the increase between the fourth quarters of 1978 and 1979 whereas the 13.2 percent inflation rate is the increase between December 1978 and December 1979.

e. Not forecast.

many events lie outside the range of economic forecasting. Assumptions about energy and food prices, for example, depend on world politics and weather conditions.

In addition, the behavior of consumers and businesses has proved unpredictable in times of high inflation. The current CBO forecast assumes that saving rates will rise gradually but will remain at low levels over the next two years. Should savings increase sharply, long-run economic growth prospects would improve but growth in the short-run would probably be lower.

These economic uncertainties affect projections of trust fund outlays and revenues. The rate of inflation affects trust fund outlays because Social Security benefits are indexed according to the Consumer Price Index (CPI). For example, both the Administration and CBO expect the annual benefit increase that will occur in June 1980 to be about 13 percent, increasing outlays by about $14 billion in the following fiscal year. At the same time, trust fund revenues are expected to increase only slightly less than outlays.

Trust fund revenues also depend on the level of economic growth. For example, growth in money wages is likely to slow when economic growth is low, even if unemployment does not rise, as has been the situation in recent years. And when unemployment does go up, payroll tax receipts are reduced further.

RESPONSES TO THE SHORT-RUN FINANCING PROBLEM

Policies to deal with OASI's short-run financing problem by affecting trust fund revenues fall into two general categories:

- o Reallocation of payroll tax receipts among the three funds and
- o Addition of funds from general revenues.

Alternatively, benefits could be reduced.

Reallocation of Payroll Tax Receipts

One way to reallocate tax receipts among funds is to allow fund-to-fund borrowing. The Administration has proposed that the trust funds be permitted to borrow from one another when the balance of any one fund falls below a critical level. The "critical level" proposed is 25 percent of outlays in the preceding 12 months. The Administration's proposal restricts the amount of allowable borrowing to whatever amount will raise the borrowing fund's balance to 25 percent of outlays in the preceding 12 months. Repayment, with interest, would be required when the balance of the borrowing fund exceeded 30 percent of its outlays in the preceding 12 months. Interest would be set at the rate the lending trust fund would have earned by investing in federal obligations.

One example of how the Administration's proposal could be implemented is for the OASI trust fund to borrow enough to maintain a balance at the beginning of the fiscal year equal to 25 percent of the previous year's outlays. In this case, CBO estimates roughly $60 billion would have to be borrowed over the period fiscal years 1981 through 1985. An additional $30 billion would probably have to be borrowed by the end of fiscal year 1990. (CBO's projections are presented in Table 3.)

The DI trust fund alone is not expected to have sufficient balances to meet these borrowing needs, however. The OASI trust fund would probably also have to borrow from the HI fund in fiscal years 1982 through 1985 and during fiscal years 1983 and 1984 the HI fund's balance at the beginning of the year would probably fall slightly below 25 percent of its previous year's outlays. Although it appears that the HI loans could be repaid--with interest--from the DI trust fund by fiscal year 1990, it is less clear that the OASI fund would be able to repay the DI fund.

The Administration's plan would permit the OASI fund to borrow less than the maximum amount. If the OASI trust fund borrowed only enough to raise its balance at the beginning of the fiscal year to 12 percent of its expected outlays during the year, total borrowing over fiscal years 1982 through 1985 would be about $40 billion, and additional borrowing during fiscal years 1986 through 1990 would be about $17 billion.

TABLE 3. PROJECTIONS OF OASI BORROWING ON OCTOBER 1 FROM DI, AND SUBSEQUENTLY HI, TRUST FUNDS TO MAINTAIN BALANCE AT BEGINNING OF YEAR OF 25 PERCENT OF PREVIOUS YEAR'S OUTLAYS: TO FISCAL YEAR 1990, IN BILLIONS OF DOLLARS

Year	Borrowing by OASI Fund for the Year	Amount Borrowed from DI Fund[a]	Amount Borrowed from HI Fund	Amount Repaid to HI Fund from DI Fund
1981	3.1	3.1	--	--
1982	14.6	2.3	12.3	--
1983	14.6	3.0	11.6	--
1984	14.0	3.6	10.4	--
1985	13.5	5.1	8.4	--
1986	7.8	7.8	--	3.0[b]
1987	4.1	4.1	--	10.8
1988	5.4	5.4	--	10.7
1989	4.7	4.7	--	13.1
1990	7.9	7.9	--	5.1[c]

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

NOTE: Details may not add to totals because of rounding.

a. Assumes that the DI fund maintains a balance at least as large as 25 percent of its outlays in the previous year.

b. This assumes that the amount by which the DI trust fund balance exceeds 25 percent of the preceding year's outlays is used to repay the HI fund.

c. Interest could also be paid to the HI trust fund. In fiscal year 1990, after lending the necessary amount to the OASI trust fund, repaying the remaining amount owed to the HI trust fund, and setting aside 25 percent of the previous year's outlays, the DI trust fund would have available additional funds from which interest to the HI trust fund could be paid.

As in the first example, the DI fund probably could not lend all these amounts to the OASI fund. Borrowing from the HI trust fund would be needed in fiscal years 1983, 1984, and 1985. Loans from the HI fund could probably be repaid from the DI trust fund, with interest, by 1988, although repayment from OASI to DI appears more problematic (see Table 4).

The Administration's proposal would solve the short-run financing problems. An additional advantage is its flexibility; the plan would resolve additional difficulties that might arise should economic conditions be somewhat worse than anticipated. Furthermore, the proposal does not limit the Congress' future options to restructure the Social Security system in more fundamental ways to respond to long-term issues. Finally, allowing fund-to-fund borrowing would not affect the outlook for employment and inflation because the total payroll tax paid by emloyees and employers would not change. On the other hand, public concern about whether the OASI fund could repay the DI fund might develop.

A second means of reallocating revenues is to realign the payroll tax rates earmarked for the individual trust funds. A simple realignment could overcome the currently predicted short-run financing problem and would not raise the question of whether one fund could repay another, but it would be less

TABLE 4. PROJECTIONS OF OASI BORROWING ON OCTOBER 1 FROM DI, AND SUBSEQUENTLY HI, TRUST FUNDS TO MAINTAIN BALANCE AT BEGINNING OF YEAR OF 12 PERCENT OF EXPECTED OUTLAYS: TO FISCAL YEAR 1990, IN BILLIONS OF DOLLARS

Year	Borrowing by OASI Fund for the Year	Amount Borrowed from DI Fund[a]	Amount Borrowed from HI Fund	Amount Repaid to HI Fund from DI Fund
1981	--	--	--	--
1982	3.8	3.8	--	--
1983	12.6	7.0	5.6	--
1984	11.9	4.0	7.9	--
1985	11.5	5.4	6.1	--
1986	5.5	5.5	--	5.5
1987	1.8	1.8	--	13.3
1988	2.8	2.8	--	0.8[b]
1989	2.0	2.0	--	--
1990	4.7	4.7	--	--

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

NOTE: Details may not add to totals because of rounding.

a. Assumes that the DI fund maintains a balance at the beginning of each year at least as large as 12 percent of the expected outlays.

b. Interest could also be paid to the HI trust fund. At the beginning of fiscal year 1988, after lending the necessary amount to the OASI fund, repaying the HI loan, and setting aside 12 percent of expected outlays, the DI fund is expected to have available additional funds from which interest to the HI fund could be paid.

flexible for adapting to changing economic conditions. Tax-rate realignment would increase the likelihood that additional legislative changes would be needed in the near future.

A third alternative would be to merge the funds but retain separate analyses of expenditures for different types of benefits. This option shares the advantages of the Administration's proposal, but it is likely to be more controversial. Some people believe that it would make Congressional control of the three separate programs more difficult. It would certainly require joint consideration of funding for programs that are now assigned to different functional areas in the budget.

<u>Partial Funding from General Revenues</u>

A greater departure than altering the three trust funds would involve Social Security's use of general federal revenues, for example, through:

- o Trust fund borrowing from the general fund;
- o Countercyclical financing from general revenues, with or without repayment; or
- o Use of other earmarked taxes to supplement OASDHI payroll tax receipts.

These approaches would solve the short-run financing problem without losing the distinctions among the three trust funds and the system would be able to deal more easily with future fluctuations in economic conditions. Furthermore, any of these approaches could be expanded, if needed, to resolve longer-term

financing problems. Public concern that there will not be adequate funding to pay for future benefits would probably be allayed, although this is less likely if borrowing were not repaid. Finally, should a decrease in payroll taxes be desired as an anti-inflationary and stimulative policy, it could be combined easily with general revenue funding.

There are several disadvantages to these approaches, however. Some people are concerned that partial reliance on general revenues would eventually lead to complete reliance (that is, elimination of the payroll tax as a source of funding) which in turn would lead to means-tested rather than entitlement benefits. In addition, these proposals would require people not covered by Social Security, or those already receiving benefits, to help pay for the system. Finally, if general revenue financing were used, either another source of revenues would have to be found, or the deficit would have to increase, or other programs would have to be reduced.

General revenue financing could also be incorporated indirectly. For example, the Congress could increase the payroll tax sufficiently to cover benefit payments for the near future and provide an income tax credit to reduce the impact of the increase on employers and employees. Alternatively, components of the Social Security system--such as Medicare--could be removed from the Social Security system and funded from

general revenues. The portion of the payroll tax now allocated to these program components could be used to increase funding for the OASI fund and to lower the total payroll tax rate.

Reducing Benefits

There are many ways either to lower benefits in the short run or to limit their future growth. Some have been suggested in the past, for example, in the Administration's 1980 budget proposals. Such changes could avoid the need for increased funding from payroll taxes or other sources, as would taxing benefits and returning the revenue to the trust funds. But proposals to constrain benefits tend to be controversial and they have not been given serious attention by the Congress in the recent past.

CONCLUDING OBSERVATIONS

At the moment, responding to the short-term financial problem of the OASI trust fund is of primary concern. In the future, however, both changing demographics and a worsened economic outlook are expected to lead to more severe financing problems. These problems will require extensive consideration by the Congress. The revenue options are basically the same as those that could be adopted in the short run. With more time in which to phase in changes in benefits, however, the Congress may want to consider major restructuring of the system.

Senator NELSON. Thank you very much.

Next we have a panel consisting of James Hacking, assistant legislative counsel, American Association of Retired Persons and National Retired Teachers Association; and Jacob Clayman, president, National Council of Senior Citizens.

If, for the reporter, each of you would identify yourselves, starting at my far left, and give your name and association for the hearing record.

Mr. HACKING. Thank you, Mr. Chairman.

I am Jim Hacking, the assistant legislative counsel for the National Retired Teachers Association and the American Association of Retired Persons. These affiliated organizations have a combined membership nationwide of approximately 12,600,000 elderly persons.

On my immediate left is Ms. Lorie Fiori. She is a member of our legislative staff.

Mr. CLAYMAN. I am Jake Clayman, president of the National Council of Senior Citizens, and Betty Dustin, on my left, who is the research director of the organization.

We do not match the size of our sister organization sitting on my right, but we have 3.5 million, and that is a mighty army, too.

Senator NELSON. Especially led by you.

Mr. CLAYMAN. Thank you, sir.

Senator NELSON. You have statements here. They will be printed in the record. You may present your testimony however you desire.

Do you have some order in which you wish to start?

Mr. CLAYMAN. We do not have plans.

Senator NELSON. That is too big a decision for me to make. You go ahead and decide that for yourself.

Mr. HACKING. Mr. Chairman, I am submitting my full statement for the record of the hearing. I apologize for its length—it is about 60 pages—but given all of the social security issues on which we were asked to comment, we felt that kind of length was necessary.

Senator NELSON. Well, thank you. We are pleased to have your commentary in detail and having glanced through it, I think it will be an informative addition to the record.

Go ahead.

Mr. HACKING. I have also provided the subcommittee with a summary of that statement and I have, in the interests of time, edited that summary down to what I hope is a manageable length.

Senator NELSON. All right.

In presenting your testimony, feel free to summarize as you see fit.

Mr. HACKING. Thank you.

STATEMENT OF JAMES HACKING, ASSISTANT LEGISLATIVE COUNSEL, AMERICAN ASSOCIATION OF RETIRED PERSONS—NATIONAL RETIRED TEACHERS ASSOCIATION

Mr. HACKING. Social security today faces two financing problems: one short term that the Congress attempted, but failed to resolve, via the 1977 amendments; and one long term that is not all that far away anymore.

Economic patterns changed dramatically during the 1970's. Unfortunately, social security was not changed to accommodate them.

Clearly, today, the payroll tax mechanism is incapable by itself of doing the job for which it was intended in an economic environment of high and rising inflation rates, low or no productivity and real wage gains, and almost flat real economic growth.

Even using the administration's 1981 budget economic assumptions, OASI's fund faces a serious cash flow problem. Even combing DI with OASI reserves only delays that problem.

Given that the rate of inflation is now up to 18 percent on an annualized basis, we predict that the OASI cash flow problem will come sooner and be much larger than offically predicted.

All this has come about only 2 years after the enactment of legislation that was supposed to make social security financially sound through the end of the century. What has happened, of course, is that, because of economic developments, program outgo has turned out to be higher and program income has turned out to be lower than was expected.

The economic assumptions relied upon in fashioning the 1977 amendments have turned out to be optimistic in the extreme. Inflation has consistently exceeded projections by a wide margin. The effect on social security of this has been compounded by the effects of lower than expected growth in real wages and real GNP and higher than expected rates of unemployment.

Consequently, the 1977 amendment's financing package has turned out to be inadequate.

We always said it is inappropriate; now it has turned out to be inadequate, too.

It is time that policymakers recognize the extremely damaging financial consequences that economic trends that developed in the 1970's had for social security and proceed to develop a solution that isolates out and responds to those trends, protects the system, and eliminates what is becoming a repeating pattern of short-term financing crises.

High rates of inflation, low or no productivity gains and anemic real rates of growth in GNP are likely to persist for years. Even unemployment is likely to be a serious problem periodically.

Given the horrendous 1.4 percent January increase in the CPI that was just announced and the impact that exploding fuel prices will continue to have during the first quarter of this year, next June's social security increase is almost certain to be higher than the 13 percent that the administration estimates.

The underlying hard-core rate of inflation is continuing to build up. It is not declining.

Short-term social security financial crises of varying magnitudes are one of the byproducts of economic assumptions that turn out to be wildly optimistic.

Until present economic problems have been dealt with successfully we suggest that Congress construct two supplementing and reenforcing financing mechanisms to social security that will protect it over the period required to get our economic house in order—the same period over which social security should be restructured so that it begins to make good, economic sense by helping, rather than hindering, the effort to solve our economic problems.

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The two supplementing, reenforcing or backup mechanisms we have in mind would be designed to offset the financial impact that unexpectedly high rates of inflation and unemployment and unexpectedly low rates of real wage and real GNP growth would have on the program.

One of the two would operate on the expenditure side of social security to defray, with unearmarked Federal Government revenue, the net benefit cost of automatic benefit increases to the extent that they exceed a certain percentage in a given year—perhaps 6 percent would be a realistic trigger figure.

As the inflation rate decreases and the real wage differential increases, the infusion of these supplemental revenues should phase out automatically.

The second mechanism would operate on the revenue side of social security substituting unearmarked Government revenue for the payroll tax revenue the system loses when unemployment exceeds a certain percentage. Again, 6 percent seems to be a realistic trigger figure.

Here, too, as the unemployment rate subsides, any supplementing revenue coming in through this particular mechanism would also phase out automatically.

I wish to comment on the choice of source of the unearmarked revenue that could, under our proposal, end up being used for social security purposes.

To the extent that any such revenue is needed in any given year—and it is devices we propose that would measure precisely how much, if any, is needed in any given year—the choice of source for those funds must be made as part of the congressional budget process in accordance with our economic objectives of reducing inflation to tolerable levels and promoting productivity and real GNP growth.

Given these economic criteria governing the choice of source, we would reject, except during periods of intense recession, deficit spending as a means of raising any of the unearmarked revenue that may be needed.

I shall omit going over the rationale for our proposal. I think it is adequatley outlined on page 6 of the summary and is treated more extensively in the statement I have submitted for the record.

Given the factors that are causing social security's short-term financial difficulties and our recommendations for dealing with them, our reaction to the Advisory Council's short-tern financing recommendations is strongly negative.

First, we find the Council's "general-revenue-for-HI" proposal wholly inappropriate and inadequate. If this proposal is considered at all, it should be considered in the context of reforming and restructuring health care programs or in the context of the development of a national health insurance program.

Tampering with HI financing to bail out the cash benefit programs in the short term is, to us, a rather bad idea. Aside from the fact that this proposal raises the spectre of means-testing medicare, merely shifting over the HI portion of the payroll tax to cash benefits and turning to earmarked Federal income tax revenue to fund HI, still leaves the cash benefit programs with no automatic

assurance that program revenue will be sufficient to cover program expenditures in the short term.

This proposal simply does not provide the kind of financial protection that the cash benefit programs need.

The other short-term financing recommendations made by the Council, while not inappropriate, are still inadequate. The Council proposes nothing that automatically protects the system against the financial consequences of high rates of inflation and low rates of real wage and economic growth.

Although the Council's recommendation for borrowing authority could shield the system from the financial consequences of these other factors, such authority does not compensate the system for revenue losses it sustains because of those factors unless repayment of the loan is forgiven.

It is wholly unrealistic to assume, as this borrowing authority proposal does, that social security will regain sufficienty sound financial footing to be able to repay any loans.

As far as the administration's——

Senator NELSON. May I ask you the same question I asked Dr. Rivlin? What difference does it make? As long as the fund has adequate moneys to support the purposes for which it is designed, what difference does it make whether you borrow it, whether you have them all in one fund, whether you repay it if you do borrow it?

After all, that was decided by Congress and Congress decided to earmark a certain amount for HI on the guess that that was the amount that HI would require and a certain amount for DI on the grounds that that was the amount that it would require.

Nobody would quarrel if, at the time, we had said, well, now, we have computed that and find out that there is too much going to go into HI and too much going into DI. You would have been here, as would everybody else, saying well, if your figures are correct, sure. You had better transfer that to the OASI.

So are we not just arguing foolishly about numbers here?

Mr. HACKING. Well, Mr. Chairman, we have no problem with reallocating, or allowing the trust funds to borrow, or considering all the trust funds together as one unit. All we are simply saying here is that these proposals are not adequate to get the system through the financial crisis that is developing.

Senator NELSON. So you are not quarreling about the question of transferring from one to the other?

Mr. HACKING. No. We are simply saying that that proposal is inadequate to deal with the problem at hand.

Senator NELSON. You mean inadequate to deal with the short-term problem, up to the new automatic increase in 1985?

Mr. HACKING. Yes.

We think that what is scheduled under current law, in terms of payroll taxes, is going to prove to be inadequate.

Senator NELSON. I get you. I guess I misunderstood.

So the question of interfund transfers, borrowing or reallocations, does not concern you?

Mr. HACKING. No. We are perfectly willing to go along with those ideas. They are just not adequate.

Senator NELSON. Yes.

Mr. HACKING. As far as the administration's and the National Commission on Social Security's interfund borrowing and reallocation proposals are concerned, these, too, as I just said, are inadequate to avoid the cash flow problem that is developing.

Economic projections on which the adequacy of these proposals is based are likely to turn out again to be wildly optimistic. That has been the track record all along.

Before commenting on long-term financing issues, I wish to reiterate that, unless the short-term problem in social security is dealt with promptly, appropriately, and permanently, social security will never regain its financial strength. It will simply end up staggering from one short-term financial crisis to another.

Meanwhile, other major long term problems will continue to fester and fail to receive the attention and advance planning they require.

Over the long term, several major trends will cause serious problems for social security. First, there are the economic trends that I have already cited. Second, there is the demographic trend. Third, there is the declining elderly labor force participation trend that is causing a dangerously high degree of dependence among the elderly on Government programs for income support.

To accommodate and help reverse these trends, fundamental change must be made in social security and other related government programs. Social security should be changed such that it becomes much less the social insurance program it is today and it becomes much more a national pension program that encourages and rewards work effort on the part of the elderly, the nonelderly, men and women.

That requires the elimination of the earnings tests, the provisions of actuarially increased benefits for persons who elect to delay filing for benefits until after age 65 and the substitution of a proportional benefit formula for the presently heavily weighted one, a formula that would relate benefits awards closely to earnings, payroll tax contributions and replace not less than that percentage of the individual workers preeligibility wage income that would be necessary to enable that worker and his family to maintain a standard of living in their later years comparable to that achieved prior to eligibility.

Simultaneously——

Senator NELSON. I am not quite sure I understand what you are saying.

As you are aware, there is a substantial transfer involved here, that is to say, there are many cases of people who, on the lower scale, in which a married couple, would receive as high, or higher, than 90 percent—as high as 98, I think you can get—of their retirement income and others under current projections as low as 33 percent, even though they were fully covered all their lives, up in the higher brackets.

Are you suggesting that the income transfer which results in a much, much higher benefit for the lower income level be modified so that it would not be as high in the future?

Mr. HACKING. Yes; we are, in terms of the Social Security program in isolation, but that brings me to the next point I was about to make.

What we are recommending is that while these changes are being made in Social Security, other programs, like SSI, for example, and new programs that could be created, should be put into place to pick up the welfare and social adequacy functions presently being carried by social security in order that we do not have people at the lower end of the income scale suffering from an inadequate income and standard of living.

This is what we call "sorting out the functions" and we think that process is wholly appropriate today, in view of the fact that we now have income support programs, instruments, that exist, like SSI for example, that can be utilized to perform these welfare and social adequacy functions in a more effective and cost-efficient manner than social security.

Again, I repeat, that to accommodate the economic, demographic, and labor force participation trends, fundamental changes are needed in social security that will benefit the elderly, the nonelderly and the Nation's economy in the process. If these trends are ignored and fundamental change is not made, we expect the financial viability of the system to deteriorate and expected benefits will end up being cut in an irrational and unsystematic manner.

We expect that public support for the programs will gradually decline and we expect that the economic situation of the future elderly population will retrogress to the point where the situation of the elderly in the early to mid-1960's, when nearly a third of them were below the defined level of poverty, will like the good old days.

In the long-term financing context, the Advisory Council made only one recommendation, as best we could determine, and that was a scheduling of an increase in payroll taxes in the year 2005. The Council also urged serious consideration of another rather shopworn proposal—raising the age for full benefits from 65 to 68 by the year 2018.

We find these proposals reflective of a head-in-the-sand attitude on the part of the Council that is extraordinarily dangerous. The Council utterly failed to appreciate the dynamics of the interaction among the Nation's economy, social security and the people social security serves as workers and beneficiaries.

The Council elected to perpetuate social security's current structure even though that structure penalizes work effort and hinders what should be a national effort to harness this country's productive capacity in a proper manner.

The Council completely ignored how social security could be changed to provide incentives for continued labor force participation by the elderly with all the attendant and very desirable economic and revenue effects that that would entail.

It is noteworthy that the Council wholly avoided proposing changes such as the elimination of the earnings test or providing actuarially increased benefits, and instead, opted for a blatant benefit cut; namely, raising the age for full benefits to age 68.

Apparently the Council has not yet learned that programs should be designed and changed to serve the needs of people, not vice versa.

In conclusion, then, we urge the subcommittee to deal decisively and permanently with the short-term financing issue. The system

needs additional revenue. We urge you not to adopt a wait and see attitude in the hope that our economic picture will somehow miraculously brighten and that an interfund reallocation and borrowing scheme might work. Trust fund levels are simply too low to play that kind of Russian roulette.

What is ultimately at stake in the resolution of the short-term financing issue is the confidence of the public in social security's continued viability. The system needs some protection from economic conditions while we undertake the major effort that is necessary to get our economic house in order.

Ultimately, the long-term strength of our social programs, including social security depends upon the strength and resilience of our economic locomotive. Whatever is done to deal with social security's financing problems must make sense in the context of our objective to overhaul the economy and bring about price stability in both the short and long terms.

Mr. Chairman, that concludes my statement. I thank the subcommittee for having provided us with an opportunity to comment on it and once Mr. Claymans has finished, my colleague and I would be happy to answer any questions you might have.

Senator NELSON. Thank you very much, Mr. Hacking, for your very thoughtful comments.

Mr. Clayman.

STATEMENT OF JACOB CLAYMAN, PRESIDENT, NATIONAL COUNCIL OF SENIOR CITIZENS

Mr. CLAYMAN. Mr. Chairman, we appreciate the opportunity to appear before this committee. It happens to be my first appearance on this subject before this committee and I look forward to the opportunity in the future to come here more often.

The well-being and peace of mind of past and current generations of workers of all ages has been enhanced by the existence of the social security program. That is a truism, obviously, but from time to time, there are many who are inclined to doubt it.

There is no doubt that the program will continue to function as a vital institution in this society well beyond our own lifetime and that of our children and grandchildren. I am as certain of the basic soundness of social security as I am of the basic soundness of the U.S. Government.

That point of view, all of us in our organization, lend our emotions, our idealism, our strength to its perpetuation.

Therefore, I urge this committee, as well as the entire Senate and the Congress as a whole, to address the financing issues before you without permitting any who are outside of the Halls of Congress to misinterpret the cause or effect of any financial difficulties, to misread the intent of Congress in regards to its support for the social security system or to exaggerate the severity, or impact, of any financing problems.

Certainly it is important not only that problem be resolved, but also that problems be presented for public view in a balanced and accurate fashion. We must not permit, as has happened in the past, unfortunately, exploitation by doomsday prophets who cause unnecessary unrest and add nothing to the public good.

In short, I urge you to protect the faith of the American people in the social security system and thereby their faith in Government and so many of them count on the social security system as their sole, their entire, their complete method of financing their future.

I have happened to see many of them in the last 4 months and I say this with emphasis.

In regard to the short-term cash flow problems, I would like to underscore that the problems are just that—cash flow problems. Not problems that are endemic to the system itself.

In fact, it is only the Old Age and Survivors' Trust Fund which is likely to experience some difficulty in the near future.

The Disability Trust Fund is expected to accumulate a surplus at an increasing rate each year into the foreseeable future. The problem of OASI trust funds dipping to low levels which could endanger timely benefit payments is primarily a result of the poor state of the health of the economy. That is, unexpected higher rates of both inflation and unemployment and the enormous sensitivity of the social security system to these factors.

Certainly needed financing corrections were effected in 1977 and the current problem is not an indication that the 1977 changes were basically seriously in error. It is an indication, however, that perfection in forecasting the level and timing of inflation and unemployment eludes us and that we must be prepared to make minor corrections as the future becomes less distant and greater accuracy in predicting events become possible.

Under some assumptions, the cash flow imbalance was expected during 1982. Under more recent and more pessimistic assumptions, the imbalance could occur as early as next year.

Under all scenarios, the income generated by the 1977 amendments is likely to create a surplus by the mid-eighties.

Therefore, the problem is temporary, over a short period of time, but it does require quick action by Congress.

In offering our suggestions, we feel it is important to take into account several other considerations.

One, concern—on several counts—over the anticipated payroll tax rate increase in 1981 from 6.13 percent on employee and employer each to 6.65 percent; and two, our outstanding active support of the use of general revenues as a significant part of the system.

We are concerned about the 1981 tax rate increase, not only because it has some inflationary bias, but also because it may diminish popular support by current contributors, despite their own current and future stake in the program.

Our preferred remedies to the cash flow problem are as follows:

One, reallocate part of the tax rate now earmarked for the disability insurance trust fund and the hospital insurance trust fund to OASI. This will moderate current problems while, at the same time, minimize the need for congressional intervention for the purpose of resolving cash flow problems in the future.

Two, authorize borrowing between trust funds to permit the maximum flexibility within the program, to maintain safe reserve levels for benefit payments.

Three, finance the hospital insurance trust fund, part A of medicare by one-half general revenues. This is roughly the same as substituting general revenues for the payroll tax increases scheduled to go into effect in 1981 and therefore, the increase need not go into effect, for if revenues are insufficient, as some believe the case may be, permit borrowing from general revenues for the near term to make up any shortfall.

If, however, Congress is unwilling to seriously consider infusing general revenues into the hospital insurance trust fund while still entertaining the notion of preventing the 1981 tax rate increase, then the only option remaining would be to slash benefits, and this, Mr. Chairman and members of the committee, would be totally unacceptable. In such a case, there would be no alternative but to institute the 1981 tax increase as scheduled.

In any event, we urge that Congress act promptly to avert nonpayment of benefits due to the temporary cash flow problem.

We urge that this goal be handled in consonance with the objective of deferring the 1981 tax increase. We urge that general revenues be made available on a permanent basis for up to one-half of the hospital insurance trust fund and we urge that additional general revenues be made available as needed.

Now, then, in regard to the long term financing of social security and the projected adverse consequences of the demographic changes in the next century, I see no compelling reason why Congress must make any major decisions at this early date. Just as it would be inappropriate for the Congress to ignore a problem that could be easily resolved legislatively, it is also inappropriate for the Congress to attempt to resolve a problem that is neither accurately defined or even well-understood.

I suggest that there has been a tendency to exaggerate the problem of the lower ratio of workers to beneficiaries, and even more egregious error committed in suggesting that, whatever the problem, the social security system must solve it.

I believe that as we face the future the primary labor market problem of labor shortage is one that, I suspect, very quickly we face that problem of labor shortages because there are enough people available and there are enough people who want to enter the market on a fresh basis to solve that problem.

Therefore, the only long term change that I recommend is one that is independent of demographic situations. Tripartite financing of social security with general revenue financing, one-half of medicare part A as a first step. The national council has, in the past, indicated its support of tripartite financing. The longer range goal of the National Council of Senior Citizens is a strong social security system covering both cash benefits and health insurance, financed partly through contributions of workers and their employers, thus preserving the important contributory principle of benefits as an earned right and partly by contributions from Government in recognition of society's stake in a well-functioning social insurance system.

I hope, Mr. Chairman, that you will not be disturbed if I take the liberty of making one more brief comment. One of the most visible, and least well-received recommendations of the Advisory Council

on Social Security was that one-half of social security benefits be subject to taxation.

The National Council of Senior Citizens has been deluged with mail opposing this recommendation. I think we have received more mail on this issue than we have on most any other in at least my tour of duty and I am told by those who have been longer, than even on their tours of duty.

In which the context in which the proposal was made, it is nothing more than a benefit reduction and as such, we oppose it. However, if Congress were willing to consider significant tax reforms which would not give preferential treatment to anyone, regardless of source of income, then we would reconsider our position.

The elderly are not opposed to equity, only to inequity. I suppose that I am relatively safe in making the observation at the end that I did because I do not anticipate nor do we in our organization anticipate—and I trust wrongly—that the Congress is ready to make the kind of sweeping tax reforms that are absolutely essential in our society as we do readily believe.

Thank you very much for this opportunity to appear before the committee.

Senator NELSON. Well, I think the Advisory Council's recommendations to subject one-half of social security benefits to the Federal income tax might very well have been defendable if it had been introduced at the time the system was established, but people are now retired and have designed whatever savings they had, and interest in their home and so forth over a long period of years under the assumption that they would have a certain amount of income knowing that their social security income would not be subject to taxation and it was not subject—they did not anticipate that the law would be changed and I think it would be inequitable to do so.

I did introduce a resolution of disapproval in the Senate because I received so much mail from people who were enormously disturbed simply because they were going to be paying $350 or $400 in taxes and they are on the margin right now.

As a matter of fact, in looking at the proposal, of the 24,200,000 beneficiaries of OASI benefits, 10,600,000 would pay tax under that proposal.

It would do nothing to improve the security of the fund because the $3,700,000 in taxes that would be paid would go to the general fund.

Now, I think things need to be done about the Social Security system. I had thought we had taken a position and made changes in 1977 that would be adequate for years to come. Nobody—I do not blame anybody—nobody in the Congress or out of the Congress, none of the actuaries or tax experts anticipated an inflation rate at the level which has been achieved. But based upon the assumptions we had before us we met the problems of social security through the year 2025 or thereabouts, or longer.

But I do not think it makes sense to levy a tax on those benefits and as far as I am concerned, as chairman of this subcommittee, I certainly do not intend to take the matter up, unless somebody on the committee demands that it be taken up.

But in any event, I would be opposed to sending out any proposal that would do that.

Mr. CLAYMAN. Our membership will be deeply appreciative about your observation, Senator.

Senator NELSON. Senator Danforth, do you have any questions?

Senator DANFORTH. Well, if social security is going to be solvent, either more money has got to go into OASI or benefits have got to be cut. It is my understanding that it is your view that there is absolutely no place that you would like to see benefits cut. You would not like to see the age of retirement increased. You would not like to see any change in the indexing formula. Just let somebody else make it up.

Mr. CLAYMAN. You exactly state my position, Senator.

Senator DANFORTH. Gore somebody else's ox?

Mr. HACKING. Senator, that is not an accurate reflection of AARP's position. Our position is that we cannot support deliberalizing changes in social security as a means of dealing with short term financial problems. However, our proposal for a long term restructuring of the program inevitably entails phasing out of welfare and social adequacy functions from social security and having those functions picked up by other programs. We are thus in favor of changes that can be characterized as deliberalizing.

It is just that those changes must be made over lengthy transition periods so that you do not end up defeating the reasonable benefit expectations of workers who are approaching retirement.

Senator DANFORTH. What do you favor changing?

Mr. HACKING. Well, the basic construct we have in mind is to make social security over the long term into a program that is more in the nature of a pension. In other words, one that relates benefit awards strictly contribution earnings records. Social Security would thus place its emphasis on individual equity and earnings replacement.

Now, that in our view, entails phasing out of social security the weighted benefit formula and having the floor protection function which the weighted formula helps perform picked up by SSI. We would also phase out benefits that are derivative and are social adequacy in nature—like, for example, the spouse benefit.

We think that by putting all of the reward in terms of benefits directly on work effort of the primary worker, or if there are two workers in the family on both of them combined, that family income and family standards of living can best be maintained. But if additional supplementation is needed in order to keep people above the poverty level, then other programs with other income and revenue sources ought to be called upon to perform those other functions and do it in a less wasteful and less inefficient manner than the present social security program does.

Senator NELSON. Thank you very much, both of you, for your very thoughtful contribution to the hearing.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 108.]

SUMMARY OF THE STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. Chairman, I am James M. Hacking, the Assistant Legislative Counsel for the National Retired Teachers Association and the American Association of Retired Persons. These affiliated organizations have a combined membership in excess of 12.6 million.

Social security today faces two financing problems—one short term that the Congress attempted but failed to resolve via the 1977 amendments and one long term that isn't all that far away anymore.

Economic patterns changed dramatically during the decade of the 1970's. Social security, however, was not changed structurally to accommodate them. Clearly, today the payroll tax mechanism is incapable, by itself, of doing the job for which it was intended in an economic environment of high and rising inflation rates, low or no productivity and real wage gains and almost flat real economic growth.

Even using the Administration's 1981 budget economic assumptions, OASI's fund faces a serious cash flow problem next year and exhaustion by 1982. Even combining DI with OASI reserves only delays the problem for a year.

Given that the rate of inflation is now up to 18 percent on an annualized basis, we predict that the OASI cash flow problem will come sooner and be much larger than officially predicted. Unless the congress develops the kind of supplemental and reinforcing mechanisms that isolate out, respond to, and insulate social security from the economic causes of the short term problem, we're going to witness a major financial crisis that will precipitate unfortunate consequences. Our message is: action is needed now; public concern is growing.

The 1977 Amendments were supposed to put social security on a sound financial basis through the end of the century. Yet now, only two years later, the system faces real problems. What happened of course is that, because of economic development, program outgo has turned out to be higher and program income has turned out to be lower than was expected. The economic assumptions relied upon in fashioning the 1977 Amendments have turned out to be optimistic in the extreme. The economy has not even come close to moving in line with those assumptions. Inflation has consistently exceeded projections by a wide margin. The effects on social security of this has been compounded by the effects of lower than expected rates of growth in real wages and real GNP and higher than expected rates of unemployment. Consequently, the 1977 Amendment's financing package has turned out to be inadequate. We always said it was inappropriate; now it has turned out to be inadequate also.

It is time that policymakers recognize the inevitable persistence of the adverse economic trends that developed in the 1970s and the extremely damaging financial consequences those trends have for social security, and proceed to develop a solution that isolates and responds to those trends, protects the system, and eliminates what is becoming a repeating pattern of short term financing crises. High rates of inflation, low or no productivity gains and anemic real rates of growth in GNP will persist for years. While unemployment can be addressed more easily because it is more responsive to direct government intervention, nevertheless, because it is inextricably interwined with these other economic problems, unemployment is also likely to be a serious problem periodically.

Given the horrendous 1.4-percent January increase in the CPI and the impact that exploding fuel prices will continue to have during the first quarter of this year, next June's social security increase is almost certain to be higher than the 13 percent which the Administration estimates. The underlying hardcore rate of inflation is continuing to build up. Shortterm social security financial crises of varying magnitudes are one of the byproducts of economic assumptions that turn out to be wildly optimistic.

Until present economic problems have been dealt with successfully (and we have no reason to be optimistic that that will happen in the near future), we suggest that Congress construct two supplementing and reinforcing financing mechanisms for social security that will protect it over the period required to get our economic house in order—the same period over which social security should be restructured so that it begins to make good economic sense by helping rather than hindering the effort to solve our economic problems.

The two supplementing, reinforcing or "back up" revenue mechanisms we have in mind would be designed to offset the financial impact that unexpectedly high rates of inflation and unemployment and unexpectedly low rates of real wage and real GNP growth have on the programs. One of the two would operate on the expenditure side of social security to "defray" with unearmarked federal government revenue the net benefit cost of automatic benefit increases to the extent that they

exceed a certain percentage in a given year—perhaps 6 percent would be a realistic trigger figure. As the inflation rate decreases and the real wage differential increases, the infusion of these supplementing revenues would phase out automatically.

The second mechanism would operate on the revenue side of social security substituting unearmarked government revenue for the payroll tax revenue the system loses when unemployment exceeds a certain percentage. Perhaps 6 percent is again a realistic trigger figure. Again, as the unemployment rate subsides, any supplementing revenue coming in through this mechanism would also phase out automatically.

Now I wish to comment on the choice of source(s) of the unearmarked revenue that could, under our proposal, end up being used for social security purposes. To the extent that any such revenue is needed in any given year—and it is the devices that we propose that would measure precisely how much, if any, is needed in any given year—the choice of source(s) for those funds must be made through the Congressional budget process in accordance with our economic objectives of reducing inflation to tolerable levels and promoting productivity and real GNP growth. Given these economic criteria governing the choice of source, we would reject, except during periods of intense recession, deficit spending as the means of raising any of the unearmarked revenue that may be needed.

The rationale for our proposal is as follows. First, the devices we advocate will circumscribe those areas of economic uncertainty that are so financially damaging to social security—namely high rates of inflation and unemployment and low rates of real wage and real GNP growth. Second, these mechanisms would compensate for economic forecasting errors and assist sound financial planning for future payroll tax needs by assuring that the unanticipated costs associated with unexpectedly high automatic benefit increases would be covered automatically and by assuring a minimum amount of income to the system each year. Third, by constructing these kinds of "economic safety nets", not only would the system be protected, but beneficiaries and workers would be assured of its ongoing viability. Fourth, through these mechanisms, we can avoid having to keep returning to the "payroll tax well" to deal with short term problems and thereby avoid some of the inflationary pressures that payroll tax increases inevitably entail. Finally, some of the revenue potential of the payroll tax mechanism would be "freed up" for the purpose of funding the costs incidental to the social security long term restructuring that must be carried out to deal with the longer term problems the systems faces and turn it into something that makes good economic sense!

Given the factors that are causing social security's short term financing difficulties and our recommendation for dealing with them, our reaction to the Advisory Council's short term financing recommendations is negative. First, we find the Council's "general revenue for HI" proposal wholly inappropriate and inadequate. If this proposal has anything to recommend it, it is in the context of reforming and restructuring health care programs; tampering with HI financing to bail out the cash benefit programs is a rather bad idea. HI payroll tax payments are supposed to be analogous to insurance premium payments to establish benefit eligibility; if this is eliminated then something else—a means test perhaps—may end up being used for eligibility determination purposes. More importantly, however, shifting over the HI portion of the payroll tax to cash benefits and turning to general revenues to fund HI still leaves the cash benefits programs with no automatic assurance that program revenue will be sufficient to cover program expenditures in the short term. This proposal simply does not provide the kind of financial protection that the cash benefit programs need.

The other short term financing recommendations made by the Council, while not inappropriate, are still inadequate. Like us, the Council has called for a supplementing revenue device to replace payroll tax revenue social security loses when unemployment is high. That's fine. However, the Council proposed nothing that would automatically protect the system against the financial consequences of high-rate inflation and low rates of real wage and economic growth. Although one might argue that the Council's recommendation for a borrowing authority could shield the system from the financial consequences of these other economic factors, such authority does not compensate the system for revenue losses it sustains because of those factors unless repayment of the loan is forgiven. It is wholly unrealistic to assume, as this borrowing authority proposal does that social security will regain sufficiently sound financial footing to be able to repay the loan, and that is so even if the HI payroll tax shift is taken into account.

The Administration and the National Commission on Social Security have recommended interfund borrowing and reallocation to help deal with the short term

financing problem. These proposals are inadequate and insufficient to avoid a cash flow problem. The economic projections on which the "adequacy" of their proposals is based are going to turn out to be widely optimistic.

The interfund reallocation and borrowing proposals are being advanced partly because the HI and DI fund appear healthy enough to provide some help to OASI in the short term. Appearances are deceiving. We expect the health of those funds to deteriorate rather rapidly—again because of economic developments.

Before commenting on long term social security financing issues, I wish to reiterate that, unless the short-term financing problem is dealt with promptly, appropriately and permanently, social security will never regain its financial strength. We'll simply stagger from one short-term financial crisis to another. Meanwhile, other major long term problems will continue to fester and will not receive the attention and advance planning they require.

Over the long term, several major trends will cause serious problems for social security. First, there are the economic trends we have already cited. Second, there is the demographic trend; the elderly population will explode in size and proportion. Third, there is the declining elderly labor force participation trend which is causing a dangerously high degree of dependence on government programs for income support. To accommodate and help reverse these trends fundamental change must be made in social security and other related government programs. The magnitude of these changes, will necessitate adequate lead time and transition periods so that they may be gradually phased in.

To begin with social security must be changed such that it becomes much less the "social insurance" program it is today and becomes much more a national pension program that encourages and rewards work effort on the part of the elderly, the non-elderly, men and women. That requires the elimination of the earnings test, the provision of actuarially increased benefits for persons who delay filing for benefits until after age 65, and the substitution of a proportional benefit formula for the present heavily weighted one—a formula that would relate benefit awards closely to earnings/payroll tax contributions and replace not less than that percentage (perhaps 50–60 percent) of the individual worker's pre-eligibility wage income that would be necessary to enable that worker (and his family) to maintain a standard of living comparable to that achieved prior to eligibility. Simultaneously, social security's welfare and social adequacy elements should be phased our and picked up by other new or existing programs that can discharge the welfare/social adequacy function in a more efficient, less costly manner.

Again, I repeat that to accommodate the economic, demographic and labor force participation trends, fundamental changes are needed in social security that will benefit the elderly, the non-elderly and the nation's economy. If these trends are ignored and fundamental change in social security is not made, the financial viability of the system will deteriorate, benefits will end up being cut in an irrational and unsystematic manner, public support for the programs will decline, and the economic situation of the future elderly will retrogress to the point where the elderly's situation in the early to mid 1960's (when nearly one-third were below the poverty threshold) will look like the "good old days."

In the long term financing context, the Advisory Council made only one recommendation—scheduling an increase in payroll taxes (in the year 2005). The Council also urged serious consideration of another shopworn proposal: raising the age for full benefits from 65 to 68 by the year 2018. We find these proposals reflective of a "head in the sand" attitude on the part of the Council that is extraordinarily dangerous. The Council utterly failed to appreciate the dynamincs of the interaction among the nation's economy, social security, and the people social security serves as workers and beneficiaries. With respect to the economy, the Council failed to grasp how changing social security to encourage and reward work effort could have very beneficial impacts on tax revenues (both earmarked and unearmarked) and on economic and productivity growth in general. The Council elected to perpetuate the current basic structure even though that structure penalize work effort and hinders what should be a national effort to harness this country's productive capacity in a proper manner.

For social security, the Council's long term recommendation virtually assures a perpetuation of social security's present struggle to make ends meet. While we can agree with the Council that the economic and demographic trends can be quite volatile, we must point out that sufficient evidence exists to indicate that our future economy and the future demographic makeup of the population are wholly unlikely to provide a very favorable financial setting for the system. Given what is obvious and is a matter of record, it is wise to change the system fundamentally and use its dynamic qualities to improve or ameliorate adverse economic conditions and accom-

modate the demographics. The Council's suggestion that the age for full benfits be raised completely ignores how social security can be changed to provide incentives for continued labor force participation by the elderly with all the attendant, desirable economic and revenue effects that would entail. It is noteworthy that the Council wholly avoided proposing changes such as eliminating the earnings test or providing actuarially increased benefits and instead opted for a blatant benefit cut—raising the age for full benefits.

As far as the people who are served by the system are concerned, the Council's narrow, tunnel vision attitude increases the danger that the system will become financially unable to honor its future benefit commitments because of the absence of changes that would accommodate the system to long term trends. By nature, the system is a long range program that derives its public support from its ability to make long term benefit commitments to current workers. Not being able to honor these commitments because of poor advance planning will seriously damage public confidence. If deliberalizing changes are needed—and we think they are needed in the context of a planned restructuring of the programs—we must begin to make those changes now so that workers' reasonable long term benefit expectations are not defeated in the process. Deliberalizing changes that are made without rational advanced planning and without adequate lead time would undermine the public's willingness to provide the necessary financial backing and support for social security.

CONCLUSION

In conclusion, we urge the Subcommittee to deal decisively and permanently with the short term financing issue. The system needs additional revenue. We urge you not to adopt a "wait and see" attitude in the hope that our economic picture will miraculously brighten and that an interfund reallocation and borrowing scheme might work. Trust fund levels are simply too low to play that kind of Russian roulette.

In general, we think some limited and temporary infusion of unearmarked federal government revenue is the right solution to the short term financing situation. The two revenue mechanisms we recommend—one triggered by unexpected high rates of inflation, the other by unexpectedly high rates of unemployment—will protect the programs from the financial effects of adverse economic developments and at the same time allow policymakers the flexibility to determine the source(s) of any unearmarked funds that may be needed in a given year in accordance with economic policy goals—especially the goal of bringing inflation under control.

What is ultimately at stake in the resolution of the short term financing issue is the confidence of the public in the continued viability of social security. The system needs some protection from economic conditions while we undertake the major effort that is necessary to get our economic house in order and bring an end to the searing inflation, low real economic growth, and cyclical and intense recessions. Ultimately, the long term strength of our social programs depends upon the strength and resiliance of our economic locomotive. Whatever is done to deal with social security's financing problems must make sense in the context of our objective to overhaul the economy and bring about price stability in both the short and long terms.

Statement of the National Retired Teachers Association and the American Association of Retired Persons

ABSTRACT

Short-term financing

Strong evidence exists to indicate that the social security payroll tax mechanism cannot function in our current economic climate of high inflation, low productivity growth and low or negative real wage gains. Because these conditions are very likely to persist during the next few years, we believe a cash-flow problem and even possible exhaustion of the OASI Fund is inevitable unless some form of general revenues is provided to the system.

We suggest two countercylical general revenue devices be used to protect the system from both high inflation and high unemployment. Use of these devices will permanently insulate the system from adverse economic conditions and prevent the cyclical recurrence of short-term deficits which have plagued social security in the 1970's.

Our Associations do not believe that any interfund borrowing or reallocation scheme will provide sufficient funds to keep OASI afloat through 1985. The Administration's projections for the trust funds for the period 1982 through 1985 are based

on overly optimistic economic assumptions which assume progress toward the economic goals set by the Full Employment and Balanced Growth Act of 1978.

Long-term financing

If we fail to deal properly with the social security short-term financing problem and if adverse economic conditions continue for even a short period of time, then there will be no opportunity for the system to regain its financial strength before the onslaught of the more serious long-term deficit.

The major trends which the system must accommodate in the future include: adverse economic trends (inflation, unemployment, low economic growth, low productivity gains) which impact on the system's financing mechanism and the combination of demographic and declining labor force participation trends which will mean that a larger elderly population could become heavily dependent upon a smaller work force.

In response to these trends, the Associations recommend that first, the sytem be changed to encourage work effort on the part of the elderly through elimination of the earnings limitation and the provision of actuarially increased benefits for persons who delay filing for benefits. Over the longer term, we believe the system's benefit structure must be revamped so that benefits are paid largely to workers. Benefits should be more strictly related to prior contributions and replace not less than 50 to 60% of pre-eligibility income. The system's welfare and social adequacy benefit elements would be phased-out and placed on new or existing government programs which would be financed out of general revenues, not payroll taxes.

Instead of becoming a victim of the emerging economic and demographic trends, we believe the system can become a major public policy tool to be used not only for accommodating them, but also for influencing and, in the case of the labor force participation trend, reversing these trends. If these trends are ignored, the financial viability of the system will deteriorate. This could lead to irrational and unsystematic benefit deliberalizations which would seriously undermine crucial public support for the system.

I. INTRODUCTION

The social security system today is plagued with two kinds of financing problems: a short-term deficit which Congress attempted, but failed, to resolve with passage of the 1977 Social Security Financing Amendments and a long-term deficit, a part of which was reduced by the 1977 decoupling legislation, but a substantial part of which still looms in the not-too-distant future.

The social security system was designed to be self-supporting, funded by a payroll tax mechanism which should generate sufficient revenue both to finance benefits on a current cost basis and to permit the build up of adequate contingency reserves that will protect the system from economic downturns. We are now faced with strong evidence that the payroll tax mechanism cannot function properly in our current economic conditions of high inflation, low productivity growth, negative real wage gains, and high unemployment. And, even with all our econometric models, we simply cannot accurately predict when or whether these economic adversities will abate. If some of them persist through the next decade (and there is a significant body of economic opinion to support that theory), then the system may not be able to get itself back on its feet again before the onslaught of the longer-term financing problem.

Over the long term, we fear the convergence on the system of several major trends: (1) the economic trend of lower economic growth and a built-in, high, hard-core inflation rate; (2) the demographic trend which portends a much larger older population relative to the younger, working population; and (3) a declining elderly labor force participation trend which is causing a dangerously high degree of dependence by older persons on government programs for income support. To accommodate and, in some cases, reverse these trends we must be prepared to make fundamental changes in the social security system and related government programs. These changes, because of their magnitude, will necessitate adequate lead time and transition periods so that they may be gradually phased-in.

It is obvious that we must deal decisively and permanently with the short-term financing issue and prevent what has been our recent experience—that is, the cyclical recurrence of a short-term deficit caused wholly by adverse economic conditions. The other major long-term issues will continue to fester and will not receive the attention and advanced planning they require if we must continually confront short-term imbalances.

Our Associations recommend that, in order to maintain public and beneficiary confidence in the system, Congress must take decisive action to solve this short-term financial imbalance problem in a manner that will insure that it will never recur.

This requires that Congress recognize the reasons for the reappearance of the short-term deficit and, based on that recognition, adopt a financing solution that specifically addresses the causes of the problem.

Several financing proposals have been advanced recently by distinguished public bodies. These proposals include: the Administration's recommendation for an interfund borrowing mechanism; the National Social Security Commission's proposal for a reallocation of funds among the three trust funds, interfund borrowing and authority to borrow from general revenues; and the Social Security Advisory Council's recommendation to fund Medicare out of general revenues with the interim backing of a small countercyclical general revenue device and a general revenue borrowing authority. In our opinion, these proposals do not match the magnitude of the financing problem nor do they directly isolate and address its causes.

Using the most recent economic assumptions outlined in the President's 1981 Budget, the Social Security Administration is projecting that the OASI Fund will face a cash-flow problem next year and exhaustion in 1982. Even with combining OASI with the DI reserves, the occurrence of the cash flow problem is delayed only one year to 1982. If one examines closely the economic assumptions underlying these projections, one must conclude that the financing problem is even more imminent and more severe than reflected in these projections. The projections assume that we will be able to hold the annual inflation rate to 11.8 percent in 1980 and to 9.2 percent in 1981. These are clearly optimistic economic goals which are unlikely to be achieved.

These ominous forecasts—which, based on track records of previous forecasts, may very well understate the problem—clearly dictate prompt Congressional action. Unlike any previous experience, the trust fund levels are about to drain so low that they will cease to perform their primary function, that is to provide the system with a cushion of financial protection from the effects of unforeseen adverse economic conditions. Fund levels that reach the bottom of the barrel will provide absolutely no margin for error in forecasting economic conditions and could allow the system to slip precipitously into a situation where benefits cannot be paid as they come due. In a program with outlays as massive as those of social security, a small misestimate of the unemployment and inflation rates (which cannot be forecasted with reasonable accuracy more than 6 months in advance) can mean a major fall-off in expected revenue or a major increase in expenditures. Due to its size and extreme vulnerability to economic conditions, the social security system cannot be realistically financed with a pay-as-you-go mechanism that provides practically no contingency reserves.

Our Associations do not question the willingness of Congress to take action should the prospect of an interruption of benefit payments arise. However, because we are not able to predict economic conditions in a timely or accurate manner and because the system's extremely low reserve levels are making it unusually vulnerable to these conditions, Congress cannot responsibly delay in hope that the economic picture will brighten. Permitting the situation to deteriorate to an acute crisis level would prompt a great deal of anxiety among both beneficiaries, who rely so heavily on the social security system for basic income support, and among workers, who support the system with the expectation that it will be financially sound through their retirement years. If Congress delays in increasing funding for the system, it will almost assure a cash flow problem and it will thus be perpetuating the "scare" stories which undermine the already-fragile public support for social security.

II. SHORT-TERM FINANCING ISSUES

In 1977, confronted with a rapid deterioration of the financial condition of the social security trust funds, Congress conducted a major debate on the design of legislation that was to deal with projected short and long-term funding deficits of the system. At the time, it was projected that the DI Fund would be depleted by 1979 and the OASI Fund would be exhausted by the early 1980's. Congress thought that the product of that extensive debate—the Social Security Amendments of 1977—would place the system on a sound financial basis for at least the next 25 years. Only two years later, there is strong evidence that, despite the large payroll tax increases scheduled in the early 1980s by the 1977 legislation, the system will again be in financial jeopardy in the near future.

A. Causes of Short-term Financial Problem: Adverse Economic Conditions and Uncertain Forecasting

Over the past two years the social security financing mechanism has suffered from the combined effect of two situations: first, unanticipated economic develop-

ments have increased program expenditures at a much faster rate than program revenue; and second, overly optimistic economic assumptions adopted by the Social Security Board of Trustees caused Congress to assume, erroneously, that they had adequately provided for social security's revenue needs (at least through the end of the century) with enactment of the 1977 Amendments.

This Subcommittee should recognize the importance of this second factor and the dangers involved with relying solely on actuarial projections and economic assumptions of the Board of Trustees. At all times, private economic forecasters, as well as the Congressional Budget Office, should be invited to scrutinize the assumptions of the Board of Trustees and the Administration and to point out when they are overly optimistic. It is already a bad situation for the system to suffer from economic conditions which we cannot always accurately predict, but it is worse for it to suffer from overly optimistic economic projections which mislead Congress.

1. Social security's vulnerability to the economy

Over the past eight years, the financial security of the system has proven to be extremely vulnerable to the effects of high inflation, high unemployment, low real economic growth rates, declines in the rate of productivity growth and declining real wage growth. Due to these adverse economic conditions, combined reserves of OASDI plummeted from 73 percent in 1974 to 24 percent at the beginning of this year.

Persistently high rates of inflation cause increased expenditures by the system, since benefits track increases in the Consumer Price Index (CPI). Under the 1972 indexing design, these increased expenditures were to be covered by increased income for the system generated through the automatic expansion of the taxable wage base caused by an inflation-induced growth in wages plus real wage growth above the level reflective of gains in productivity and general growth in the economy. (This marginal growth in total wages above that level of inflation is called the real wage differential.)

Unfortunately, our economy has recently not moved in line with expectations. Inflation has consistently been much higher than expected. We have experienced periods of practically negligible growth in the real wage differential or actual decline in the differential occurring when prices have risen faster than wages. Because of declining real wages and lags in the adjustment process, automatic increases in the taxable wage base have not provided enough income to the system to cover the cost of inflation-induced increases in social security expenditures.

High rates of unemployment for extended periods have also had adverse effects on the financial structure of the system. On the income side, periods of recession, with the high unemployment that accompanies them, severely reduce tax revenue to the system. Since there are fewer jobs available than would otherwise be the case, the aggregate "pool" of wages is smaller and tends to grow at slower rates. On the expenditure side, high unemployment causes increased costs for the system because it causes workers—particularly older, unemployed workers—to be attracted into retirement or disability status. (Since there are no employment options available to them, this status may provide crucial income support for these older workers.)

The sum total effect of these economic trends is that they are severely straining the system's financial viability. Combined social security outgo has tended to grow at rates faster than expected while combined income has tended to grow at rates lower than expected. This process has been rapidly draining the system's trust fund levels and propelling it closer and closer to total depletion of its funds.

It is these trends that are largely responsible for the unraveling of the 1977 financing package in spite of the large payroll tax increases scheduled by that legislation. It has become increasingly obvious that we can no longer rely on the current payroll tax mechanism to meet fully and consistently the short-term financial needs of social security. In addition, we have come to realize that over-reliance on the payroll tax structure to fund the massive social security system has, in and of itself, become a contributing factor to our economic problems, especially inflation since large increases in payroll taxes cause prices to rise because of business' higher labor costs.

Our Associations believe we must not view the social security program in a vacuum, but rather recognize the inevitable persistence of these adverse economic trends and the extremely damaging financial consequences they have for social security. Virtually nothing is being done (except perhaps the Federal Reserve Board's attempt to control the money supply) that would lead a reasonable person to conclude that these adverse economic trends will dramatically change, especially in the near term. Prices went up on average by more than 1 percent a month in 1979 and most forecasters expect this rate to be even higher in early 1980 with the possibility of a mild recession later in the year. We believe that those economic

problems which are most difficult for government to address—that is, high inflation and lack of productivity and economic growth—will persist for a number of years. Problems of unemployment are likely to be solved more easily since they are more responsive to direct government intervention.

Our economic woes were not created overnight; they have been built up over at least the last fifteen years. We believe there is much evidence to question the rapidity with which present economic problems can be righted. When assessing the cause of our present persistent inflation, economists generally look approximately fifteen years back to funding of the Vietnam war by inflation as the beginning of the problem. Since then, the inflation rate has been lifted by over-expansion of the money supply, a seemingly intractable wage/price spiral, soaring energy prices, government deficit spending, the emergence of unfavorable trade balances, excessive government regulation (both adding to costs and discouraging competition), government and private price-push actions and government cost-push and tax-push actions of all kinds. As a consequence there has developed a public psychology of living in an inflation environment. The inflationary expectations of people contribute greatly to the problem. Inflationary forces are building—not declining. It will take many years to unwind them once a start has been made.

Until we are able to deal successfully with our present economic problems—and we are not optimistic that this will occur in the near future—our Associations suggest that Congress endeavor to construct a social security financing structure which is based on realistic assumptions and is reliable and relevant to the economic context within which it must function. Later in this statement we will recommend use of a financing structure that will specifically accommodate these economic trends. It is our contention that only in this manner can Congress avoid the cyclical recurrence of unexpected short-term deficits.

2. Economic forecasting unreliability

There are no precedents in our statistical economic data banks for the simultaneous occurrence of high inflation and little or no economic growth (i.e., stagflation) such as we have been experiencing in this decade. As a consequence, during the late 1970's, economic forecasts have become extremely unreliable.

As demonstrated by Table I, the real wage differential—a crucial determinant of the system's financial status—has been consistently overestimated in the economic assumptions used by the Social Security Board of Trustees. This error is caused by underestimating the level of inflation and overestimating gains in productivity and real economic growth. The sharp contrast between the Board's estimates and the Administration's most recent estimates are also illustrated by Table I.

TABLE I.—PROJECTIONS OF REAL WAGE DIFFERENTIAL OF SOCIAL SECURITY BOARD OF TRUSTEES UNDER INTERMEDIATE ASSUMPTIONS COMPARED TO PRESIDENT'S 1981 BUDGET PROJECTIONS

[Calendar years 1977–81]

Calendar year	1977 trustees report	1978 trustees report	Trustees report	Administration's 1981 budget projects
1977	2.4	[1] 0.4	[1] 0.4	
1978	2.7	1.1	[1] 0.9	
1979	2.5	1.8	−1.1	[1] −3.1
1980	2.4	2.2	.6	−2.7
1981	2.3	2.2	2.5	−0.3

[1] Actual.

Comparing the 1979 Board of Trustees' forecasts of the rate of inflation to actual experience and more recent forecasts is particularly startling. The 1979 Trustees Report predicted a 9.4-percent increase in the CPI for 1979; actual experience was 13.4 percent. The same report predicted a 7.4-percent CPI increase in 1980; recent Administration forecasts estimate 11.8 percent (and this is probably optimistic). For each 1 percent increase in the CPI, the system must expend over $1 billion for the additional benefit increase. For 1980, based on their CPI assumptions, the 1979 Trustees' Report forecast a 7.8-percent benefit increase. We now know it will be at least 13 percent. This represents a misestimate of over $5 billion in necessary expenditures.

Our Associations believe there is already reason to call into question the Administration's assumption that the benefit increase effective in June, 1980 will be 13 percent. As this Sub-Committee knows, this increase is calculated by comparing the average CPI of the first quarter of last year to the first quarter of this year. The Producers' Price Index (formerly called the Wholesale Price Index) registered a huge 1.6-percent increase for the month of January alone. With the sharp rises in energy prices expected early in the year, we believe the CPI for the first quarter of 1980 will be higher than anticipated and could easily trigger a benefit increase in excess of 13 percent.

Accurately forecasting productivity growth is particularly difficult since the cause of the present declining productivity trend is much debated by government and private economists. Economists are uncertain about how much weight to give declining rates of capital investment, research and development and other factors relevant to predicting the productivity trend. Government forecasts (by the Administration and the House Budget Committee) assume far more rapid productivity growth than some private forecasters. These forecasts assume (and we think without adequate grounds) a quick reversal of the recent low (and currently negative) trends in productivity gains. This issue is a particularly troubling one for the social security system since productivity gains have a major impact on the system's revenue, yet most economists are baffled by the recent sharp declines in productivity and, therefore, cannot predict in which direction or to what level the productivity trend will move.

The very rapid rise in energy prices since 1973 (relative to the general price level), as well as the prospect of further increases in the future, has, according to at least one interpretation, caused businessmen to curtail or cease investment in labor-saving machinery and equipment because this would require additional energy use. Instead they opt to substitute relatively cheaper human labor for more energy-intensive machinery. This development, if it is in fact the case, could simultaneously explain slow or negative growth in productivity and the surprising ability of the economy to provide employment opportunities, particularly for women and young people just entering the labor force. If this explanation is accurate, unemployment may be less of a problem for the social security system in the future than the problems of high inflation and lack of real economic and productivity growth.

Complicating the impression of projecting economic conditions is the steady occurrence of unpredictable economic shocks, such as high OPEC price increases, worldwide commodity shortages, and farm price increases caused by adverse weather conditions. These shocks can easily force inflation to climb far higher than expected and eventually dampen the real wage differential.

In addition to these potential shocks, forecasters must face the fact that the hard-core rate of inflation is building up to higher levels. Five to six percent was generally considered the hard-core base for inflation two years ago; that base has easily risen to eight and nine percent under current economic conditions. The hard core rate of inflation is that part of the inflation spiral which will take the longest sustained effort to reduce. In making predictions, we should not be so unrealistically optimistic as to expect a reduction in inflation to less than this hard-core level by 1981—in one year's time. Yet this is precisely the assumption used in the Administration's 1981 Budget and the assumption upon which Congress could base their future actions.

It should be clear that the circumstances outlined above make projections of economic conditions inherently unreliable. Use of economic assumptions which turn out to be unrealistically optimistic can lead Congress to grossly underestimate the revenue needs of the social security system. Short-term financial crises of varying magnitude are the inevitable byproduct of these underestimates.

As stated earlier, in developing financing legislation for the future, our Associations recommend that Congress consult with various private forecasting firms in order to obtain a more balanced and perhaps less politically biased view of economic expectations than that provided by government forecasters. For the sake of the system we hope policymakers will rely less heavily on government projections than they have in the past.

B. Associations' Recommendation: Limited, Temporary and Countercyclical Use of General Revenues

It is clear that many of the critical economic factors described above are impossible to predict with any degree of accuracy. With respect to inflation, even six month forecasts are often wrong. Violently fluctuating economic conditions produce a great deal of uncertainty and therefore make sound financial planning for social security extremely difficult, if not impossible. For this reason, our Associations recommend

use of two countercyclical general revenue devices specifically designed to offset some of the financial impact that high rates of inflation, low rates of productivity and economic growth, and high unemployment have on the program. For over five years we have espoused these types of economic safety nets for the system and we are convinced that only through use of such devices can we ever expect to rid the system permanently of short-term imbalances caused by adverse economic conditions.

Because inflation and these other economic adversities are certain in the near term, if unpredictable in amount, our Associations propose that federal general revenues be used to defray the net cost of automatic benefit increases when these increases exceed a certain percent per year—perhaps 6 percent could be selected as a realistic trigger figure.

The size of the annual general revenue contribution could be determined as follows. First, the cost of the "above-six-percent-part" of automatic benefit increases effected in that year would be determined. Second, there would be set off against that amount, the revenue yield for that year from the automatic wage base increase after deducting the cost of the "six-percent" or below part of the automatic benefit increase.[1]

The rationale for the mechanics of this general revenue financing device comes partly from the design of social security legislation enacted in 1972. As originally intended by that legislation, revenue generated from automatic wage base increases should be sufficient to cover the costs of automatic benefit increases. However, this has not been the system's experience, particularly during recessions or periods of high inflation. Therefore, to the extent the wage base expansion does not cover the increased benefit cost, our suggested financing device would infuse general revenues into the cash benefit programs.

We expect that as the real wage differential begins to increase by the gradual revival of adequate growth in productivity and real economic growth, the revenue generated through the automatic increases in the taxable wage base would eventually balance out the aggregate cost of the automatic benefit increases in effect, thus automatically phasing out the annual general revenue contribution.

In 1976, the Carter Administration proposed a countercyclical use of federal general revenues to replace payroll taxes lost to the system as a result of unemployment rates in excess of 6 percent. The 1979 Social Security Advisory Council also recommended this proposal. Our Associations endorse this type of countercyclical general revenue financing. It would act as another automatic stabilizer—this time on the revenue-income side of social security—and would assist Congress in predicting future payroll tax needs of the system by curtailing another area of uncertainty. However, this device cannot stand alone as the only countercyclical device. It is not likely to produce sufficient revenue to avert the short-term imbalance the system faces because, as we explained earlier in this statement, high rates of inflation combined with low productivity and real economic growth are more likely to be the conditions which will challenge the system's financial structure in the near term. Wide fluctuations in unemployment, because of other factors (including our energy situation), is likely to be less of a problem.

While we recognize that there are many areas of uncertainty (such as mortality, migration, and fertility rates) these factors are much more predictable and much more readily accommodated in terms of financial planning. Since we are not sanguine about quick improvements in our economic condition, our objective for the system's short-term financing is to circumscribe those economic areas of uncertainty that are hard to predict, erratic in nature and extraordinarily damaging to the financial viability of programs on which 33 million people depend. Even if these countercyclical devices require a permanent infusion of general revenues, the system must be insulated, to the extent possible, from these adverse economic conditions. Only in this manner can we establish a predictable basis for planning the needed revenue to be derived from payroll taxes so that the resources can be maintained at reasonably stable levels. We cannot keep going back to the drawing board to deal with short-term financing crises; this is beginning to shake the confidence of the people. We also cannot keep returning to the "payroll tax well"; that "solution" is becoming an increasingly significant contributor to the inflation problem.

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[1] To calculate the yield, this device would have to be altered slightly to take into account the large ad-hoc wage base increases scheduled by the 1977 social security legislation. These base increases which occur in 1979, 1980 and 1981 are larger than what would have occurred automatically. The alteration we suggest would be to disregard the ad-hoc increases and use instead the wage base growth levels that would have occurred automatically under the 1977 legislation.

We do not wish to leave this topic without some comment on the source of the general revenues which we propose to use for social security purposes. In our view, these general revenues can come from: (1) increased and non-earmarked revenue derived from existing or new taxes (2) deficit financing during periods of recession; (3) the shifting of expenditure priorities within the context of the federal budget process; and (4) the fiscal dividend that real economic growth will yield when it resumes.

To the extent that the general revenues are needed in any year, the choice of source(s) for those funds should be made through the Congressional budget process in the light of the needs of the economy at that time. We hasten to add that since our Associations want the federal budget brought into balance and that balance maintained over the business cycle, in coming years, no single source for the general revenues needed should be relied upon year after year.

Our Associations believe that in 1977, by choosing to rely almost exclusively on payroll tax increases to deal with the short-term financial imbalance of the social security system, the Congress made a mistake. At that time we felt compelled to acquiesce in what the legislative process produced because we wanted to avoid the interruption of benefit payments.

Nevertheless, it is now overwhelmingly clear that as a matter of first priority new legislation is needed to introduce some general revenues into social security to avert a potential short-term problem. We also believe it would be economically wise to replace at least some of the payroll tax increases scheduled under current law. The payroll tax increases scheduled for 1981, because of their magnitude, are likely to contribute to our economic problems of inflation, unemployment and low real economic growth. Rather than permitting these scheduled increases to go into effect, it seems to us to make better sense to introduce some general revenues, on a limited and temporary basis and for specific purposes, into the cash benefit programs to deal with the system's short-term imbalance. By dealing with this short-term problem in a resolute manner, the Congress will be free to consider how social security ought to be restructured in the future to accommodate long-term economic and demographic trends.

Allow me to summarize the reasons for our supporting use of countercyclical general revenue devices for the cash benefit programs. First, those two devices will serve to protect the system from the two-fold threat posed by the high rates of inflation, unemployment and low real growth. Second, they would compensate for forecasting errors and assist sound financial planning for future payroll tax needs by assuring a minimum amount of income to the system each year and by assuring that high unanticipated costs of automatic benefit increases would be covered by general revenues. Third, by desensitizing the social security system to adverse economic developments, not only would the system be better protected, but beneficiaries and workers would have better assurance of its ongoing viability. Fourth, by introducing general revenues into the cash benefit programs, some of the inflation pressures that payroll tax increases produce could be avoided. Finally, some of the revenue potential of the payroll tax mechanism would be freed up for the purpose of funding the costs incidental to the social security long-term restructuring that we would like to see carried out over time. We would add that, until a new financing source such as we have advocated is introduced into social security, fundamental change in the social security programs is going to be very difficult, if not impossible, to achieve and fundamental change is increasingly called for.

C. Alternative Proposals To Deal With Short-Term Deficit

Allow me to briefly comment on alternative proposals for dealing with the short-term imbalance situation.

1. 1979 Social Security Advisory Council report

In response to short-term financial concerns, the 1979 Advisory Council made the following recommendations:

Shift financing of HI to earmarked general revenues (half coming from individual income taxes and half from corporate income taxes);

Increase the 1980 OASDI rate by shifting part (0.52 percent) of the HI tax revenue to OASDI and repealing the balance (0.53 percent) of the rate (this would raise the total OASDI to 5.6 percent in 1980 from 5.08 percent); and

To deal with unforeseen economic developments,

(a) institute a countercyclical general revenue device triggered when unemployment exceeds 6 percent and when the combined OASDI trust fund level falls below 60 percent of annual outgo and

(b) authorize the fund to borrow from general revenues when it falls below 25 percent of annual outgo, with repayment of the loan beginnning when the trust fund level comes back to approximately 42 percent (if it does not do that within two years, a payroll tax increase would be triggered provided unemployment exceeded 6.5 percent).

Our associations reaction to the Council's short-term financing recommendations are generally negative. First, we do not believe funding HI out of general revenues is appropriate. This is a proposal which should be considered separately from the short-term financing debate. It is major in scope and in the nature of the change it would make in the social security system. This proposal should be considered on its own merits, not for the amount of payroll tax revenue it would generate for the system. Funding HI out of general revenues would be a major matter necessitating careful deliberation and future planning, perhaps in the context of a NHI plan.

We hope Congress will not seize upon the proposal solely to avert a short-term crisis in the cash benefit programs or to rollback part of the 1981 payroll tax increase.

Second, we believe that shifting payroll taxes from HI to OASDI would not really provide the kind of protection for the cash benefit programs that we want; it just provides more payroll taxes in the short-term. At the same time such a shift reduces, and may ultimately eliminate, payroll tax financing of HI and thereby the stage for a possible introduction of a means test into Medicare.

We acknowledge the argument of those who say that it will be easier to get more general revenue into social security programs by funding part or all of HI out of general funds and shifting the HI portion of the payroll tax over to cash benefits. They argue that HI benefits are unrelated to contributions and life expectancy; but in cash benefits, there are such relationships. The cash benefits programs are thus said to be "actuarial" and therefore suited for payroll tax financing.

There are problems with this line of argument. HI payroll tax payments are supposed to be analogous to insurance premium payments to establish eligibility for benefits; eliminate this and something else—a means test perhaps—may end up being used for determining eligibility. Furthermore, the size of OASDI benefits is not strictly and solely related to earnings records and life expectancy; the number of dependents a worker has is an important determinant. Finally, as far as the ability to predict future costs in the cash benefit area as opposed to the health benefits area is concerned, we are here at this hearing because of the mounting evidence that indicates the lack of ability to predict with any accuracy the future costs of the cash benefits programs.

Our Associations want some general revenues introduced into social security. If the HI payroll tax shift turns out to be the only viable way of achieving that goal, we would go along with it. But it is clearly not the most appropriate way and it might well end up doing more harm than good.

Third, we consider the devices recommended by the Council (outside the HI shift) to be inadequate. The countercyclical device triggered by the 6-percent unemployment rate is not likely to yield much additional revenue to the system because we don't expect the rate to widely exceed that level in the future. However, a device which protects the system from the more likely occurance of high rates of inflation and low rates of real economic and productivity growth would be far more useful to the system in the near future. A countercyclical device geared to unemployment ignores the devastating impact of these other adverse economic conditions which are more likely to persist. One could argue that the Council's recommendation for a general revenue borrowing authority would shield the system from these economic conditions. However, it does not compensate the system for the revenue loss unless repayment of the loan is forgiven. We believe it is wholly appropriate to provide compensation to the system for these economic effects and, in addition, it is unrealistic to assume the system will be able to regain sufficiently sound financial footing to be able to repay the loan. Even with the HI tax shift, the reserve level is likely to dip below 25 percent and remain there (with the borrowing authority) for quite some time.

2. National Commission on Social Security: Interim report recommendations and other proposals involving an interfund reallocation /borrowing scheme

The National Commission highlighted the short-term deficit situation in their recent interim report and made the following recommendations for action:

Permanently reallocate part of the DI rate to OASI;

Provide an interfund borrowing authority among the OASI, DI and HI funds until March, 1985;

Provide a general revenue borrowing authority when the trust fund levels fall below the cash-flow point (generally considered 8 to 9 percent) with repayment of any loan by the end of 1988.

The Administration has recommended an interfund borrowing/reallocation device similar to the Commission's first two suggestions.

In our Association's opinion, these proposals are inadequate for reasons similar to those we cited in comments on the Advisory Council's proposals. We strongly believe the reallocation and interfund borrowing authority will not be sufficient to avert a cash flow problem, In general, we support providing legislative authority for interfund borrowing; however, we do not view this as a sound solution to meet the possibility that the combined level of trust funds will fall to unacceptable levels or be completely exhausted. In our opinion, the amount of revenue generated for the OASI Fund from these devices will not ultimately be sufficient to protect the system from even minor economic downturns or avert a cash-flow problem. Under current assumptions, raising the OASI Fund from the 6-percent reserve level forecast in the budget to the 9-percent level necessary to avoid cash-flow problems in 1982 would require, by our calculation, at least $4.2 billion in a revenue transfer from HI and DI to OASI. That is a large sum, considering total 1982 assets of DI will probably be approximately $16.5 billion and total HI assets $31.7 billion.

Interfund reallocation and borrowing proposals are being advanced partly because the HI and DI Trust Fund levels are currently in a healthy position and could provide some additional funds to OASI in the short term. We suggest that reliance on the DI Fund is ill-advised since a recessionary period could prompt another surge in the number of persons on the DI rolls and hence begin to deplete the DI Fund in a manner similar to what occurred in the mid-1970's. The HI Fund is not reliable either; it is expected to be depleted by the early 1990's, if not sooner. Hospital cost increases continue to soar along at higher than general inflation levels in the absence of effective cost control legislation.

With respect to the general revenue borrowing authority espoused by the National Commission, we believe that under the Commission's total plan, the borrowing authority is very likely to be triggered and, again, we do not believe the system will be financially able to repay the loan within the time frame suggested. We believe compensation via a countercyclical general revenue financing mechanism is required.

3. Payroll tax increase

Our Associations would vehemently oppose any such approach to the short-term financing problem. We favor substituting general revenues for at least part of the 1981 payroll tax increase already scheduled, as described earlier. We are already relying on the payroll tax mechanism to such a degree that it is hindering new business formation and contributing to inflation.

Increasing payroll taxes will do absolutely nothing to insulate the system from fluctuating economic conditions and could even exacerbate the situation. We believe it is now evident that Congress made a mistake in relying exclusively on payroll tax financing in 1977; we hope that the same mistake will not be repeated.

FICA payments are becoming larger and more visible on the pay stubs of current workers and our Associations fear a serious anti-payroll tax revolt that could create a favorable atmosphere for benefit cuts. Those who stand firmly committed to payroll taxes as the sole means of financing social security (on the specious grounds that it introduces discipline and restrains benefit increases) are helping to set the stage for the anti-payroll tax reaction that our Associations want to avoid.

4. Benefit cuts

A Ways and Means Social Security Subcommittee Print published for that Subcommittee's recent hearings suggests some areas of possible benefit deliberalizations, or even taxation of benefits, for the purpose of freeing up necessary revenue in the short term. Our Associations flatly oppose any consideration of benefit deliberalizations or taxation of benefits in the short term. To produce savings, any benefit cut would have to be imposed immediately with no transitional period—a method of deliberalization we vehemently oppose because it would defeat persons' reasonable benefit expectations and allow them no time to adjust their retirement plans accordingly.

We would add that a few of the benefit changes suggested in the Subcommittee print have some merit—particularly that related to phasing-out the weighted benefit formula. However, this is a major issue that should be considered only in the context of long-term restructuring of the system, not with a view toward improving the short-run financial picture.

5. Taxing a portion of social security benefits

The Advisory Council on Social Security has recommended subjecting one-half of social security benefits to income taxation. Our Associations flatly oppose any such proposal. Inflation is rapidly eroding the purchasing power of the income of the elderly—including social security income; we cannot sit idly by and see even more taken away from them through an added tax burden.

Proponents of this proposal point out that by taxing only half of social security benefits, persons whose sole income is from social security would pay no additional taxes, while higher-income retirees, who have income from other sources such as private pensions or savings, would be required to bear the extra tax burden. Although this scheme appears equitable from the standpoint of progressive income taxation, it ignores the other side of the coin—that is, the nature of the current social security benefit and payroll tax structures. Our Associations would argue that since the current social security weighted benefit structure causes higher income persons (who have paid in maximum payroll taxes over their working years) to receive lower social security benefits in relation to their contributions, it would be inequitable to impose additional tax burdens on this group of retirees.

Similarly, for proponents to argue that private pensions and annuities are subject to federal income taxation and therefore, social security ought to be, is inappropriate because it ignores the fact that social security is not a true pension; the program includes many welfare and social adequacy elements.

6. Establishing a value added tax

A tax which originated in Europe, the Value Added Tax (VAT), has been discussed in Congress as an alternative means of raising additional funding for the social security system in order to permit a decrease in payroll taxes and in the incidence of other objectionable features of our tax structure. At the outset, we would state that VAT should be viewed as a tax issue—not a social security issue. From a tax perspective, our Associations submit that introducing a totally new type of tax in the United States, where there already exists a largely progressive tax structure, is unnecessary and ill-advised. Such a tax would not only further complicate tax administration and add fresh uncertainties to the business world, but its initial imposition would be highly inflationary. With annual price increases running well into the double digit rates, now is certainly not the time to consider such a tax.

We recognize that VAT could partially replace other inflationary aspects of our tax structure (like payroll taxes), but we question whether this trade-off is worth it. We would remind proponents that VAT's attempts to offset the impact of other taxes and to discourage consumption will take years to have its desired impact, if it ever does at all. Therefore, without question, VAT will be initially inflationary, and its long-term deflationary prospects are uncertain. It appears to us that VAT would be a dangerous gamble at best.

Perhaps the most serious drawback of VAT is its highly regressive nature. Since it is akin to a sales tax, it will tax goods purchased by the rich and poor alike. Lower-income persons—a disproportionate share of whom are elderly persons—will inevitably pay a higher percentage of their income to meet the VAT tax. Unfortunately it is these persons who are already experiencing great difficulty paying rapidly increasing prices for necessities—such as food, housing, clothing and medical care. It is absurd to suggest VAT should be imposed to discourage consumption among persons whose budgets already cannot be stretched to meet basic necessities.

There has been discussion that VAT's regressivity can be offset for low-income persons through tax credits and other mechanisms, such as the welfare structure. Our Associations believe this will not be possible since most low-income persons do not pay taxes (or file tax returns) and many, particularly the elderly, do not participate in welfare programs.

With respect to social security, our Associations believe we should not look to VAT as an answer to financing problems. From an economic and tax equity standpoint, using VAT to replace part of the payroll tax will simply mean replacing parts of a regressive, inflationary tax with an even more regressive and inflationary tax. From a social security financing perspective, VAT would represent another earmarked tax (like the payroll tax) which will bring in relatively fixed amounts of revenue with no regard to the unpredictable financing needs of the system. VAT, unlike countercyclical use of general revenues, cannot insulate the system from the adverse effects of economic conditions. It is precisely this type of insulation that Congress should seek when it turns to a source other than payroll taxes to meet the system's short-term financing needs.

Our Associations believe we have ample flexibility under our present system of taxation to meet our revenue needs. Turning to VAT would encourage reliance on a

hidden tax that would infiltrate all levels of the price structure and dampen political accountability for overall taxation levels.

III. LONG-TERM FINANCING ISSUES

In the context of this discussion of long-term financing issues, our Associations would like to emphasize the importance of dealing with the short-term financing issue in a resolute and adequate manner. If this is not done and if it takes several years to put our economic house in order, then there will be very little financial respite between the short-term and long-term deficit situations. Current actuarial projections anticipate that the decline in the trust fund levels in the short-term will abate by the mid-1980s and begin to build back up through the rest of the century so that by 2010 (when the long-term deficit situation begins to surface), the fund will temporarily be in an adequate financial position. If this does not occur, due to cyclical recurrences of short-term deficits, then we will have to take action to deal with the much more serious long-term problem sooner than expected.

A. Trends and Factors Affecting Long-Term Social Security Financing

Allow me to briefly outline some of the important trends which are substantially altering the world in which the social security system must function. First, the "income needs" context in which social security operates today has changed dramatically since the program was conceived forty years ago. While we have managed to reduce substantially poverty among the aged, a pernicious trend—the inflation trend—has managed to offset that progress by severely constricting the real income received from sources other than federal government programs—like private pensions, savings and other assets. Because these components are largely unprotected from the effects of inflation, many elderly persons' total real incomes have been declining. While the growth and expansion of federal government programs like social security has brought the elderly up from the bottom of the income scale, the inflation trend is rapidly pushing them down from the top. The result is that the elderly are increasingly concentrated in lower reaches of the income distribution.

More ominous than this, however, is the impact that continuing high-level inflation will have, not just on those fixed-income components like private pension, but even for those components for which some protection is available, like social security. Even though social security benefits are adjusted for inflation, the adjustment comes long after inflation impacts on the person's budget, and the standard used to make the adjustment—the CPI—can underestimate the true impact of inflation on the market basket of goods and services that the elderly consume.

Running parallel to this adverse inflation trend and its effects on the various components of retirement income has been a significant decline in labor force participation by the elderly and a concomitant decline in the significance of wage income as a component (and a relatively inflation-proof one at that) of their total income.

The combination of inflation and labor force participation trends has made it increasingly difficult for the elderly to keep up—that is, maintain an adequate standard of living comparable to that achieved prior to retirement, especially as they get older. Even worse, these trends have fostered an increasing degree of dependence on the part of the elderly for income from government programs, like social security, which do provide some measure of inflation protection. Perpetuation of this degree of dependence will become dangerous as we move into the next century when a much smaller labor force will be responsible for supporting a larger retired population.

In view of future demographic trends, it has become increasingly apparent that policies which create incentives for early labor force withdrawal are imposing serious and unnecessary costs on our economic system and are making it more and more difficult for older persons to maintain adequate standards of living in their later years. An appreciation of the long-term consequences of these trends should prompt a response. Our Associations feel that the best response would be to revise government policies which encourage idle retirement and at the same time to develop a strategy for providing increased job opportunities for older persons.

If we are to devise and implement a national, coordinated older worker strategy, we must, in the process, divest ourselves of some of the tenets about jobs and job markets that have been proven fallacious by the march of events. For example, it is widely held that the number of jobs in the economy is fixed, and older people must retire to provide jobs for younger workers. Continued adherence to this belief virtually requires one to ignore the enormous expansion of job opportunities that the economy has historically been able to generate—for instance, job opportunities

for extraordinary numbers of married women have become available over the past decade. The future population will contain more older persons. The economy must accommodate them.

There is one other thought to keep in mind. A significant portion of the persistent hard core inflation rate which has become part of the economic scene is, in part, the result of the fact that by our laws, prejudices, and customs we have kept too many of the old, and the young, out of the labor force. When we successfully induce more of them back into the productive mainstream of the country we will be easing many of our severe economic problems. More hands will help.

B. NRTA/AARP Recommendations for Long-Term Social Security Reform

Social security—more precisely Old Age and Survivors Insurance (OASI)—is currently the cornerstone of the income of the elderly generation and is likely to remain so for future generations as well. But that does not mean that it should never be changed. On the contrary, it is clear that economic, demographic, labor force participation trends described earlier will dictate that it be changed in fundamental ways.

Our Associations believe that the existing social security system must be restructured incrementally, over a long period of time, until it becomes much less the social insurance program it is today and much more of a "national pension program" which rewards work effort. The first incremental step toward that restructure is elimination of the social security earnings limit.

1. Need for elimination of earnings limit

One of the key elements in changing social security so that it can accommodate future trends, is the elimination of work disincentives which exist in the program. Chief among these, in our Associations' view, is the social security earnings limitation. Our Associations want it abolished, not because we are insensitive to social security's financing problems, not because we are iconoclastic about the "social insurance" nature of the system, and not because we favor elderly "fat cats", but because we firmly believe that, as an economic matter, the earnings test is costly society more than it is worth and will cost even more in light of future economic and demographic trends. In addition, the elderly detest it.

Given this country's historical predisposition to the work ethic and the fact that the only income-related means test imposed by the social security system is on earned income, it ought to be clear why the test is so unpopular among the elderly and why it is so frequently the target of Congressional proposals. Opposition to removal of the test also rests on a number of arguments.

Cost argument

First, it is argued that abolition of the test would be costly to social security, which is already under severe financial strain. Some estimates have put a price tag on complete elimination of the earnings test at as high as $7 billion dollars in increased social security outlays. More recent Social Security Administration estimates indicate $2.1 billion in additional outlays if the test is repealed for persons age 65+ in 1982. This cost argument ignores now much the test now "costs" the overall economy in terms of lost production. Unfortunately we have no official estimates of this figure.

However, we have calculated that if only one million older persons re-enter the labor market on a part-time basis, even earning at the minimum wage, the increase in gross national product that would occur would exceed the $2.1 billion that the Social Security Administration recently estimated would be the annual "cost" of repealing the test for persons age 65 and over. In addition, this argument ignores the "cost" of lost income and payroll tax revenue to federal, state and local governments. Table I on the next page outlines estimates made by Senator Barry Goldwater and economist, Marshall Colberg, regarding the increases in payroll and income tax revenue which would result from elimination of the earnings limit. These estimates indicate that increased tax collections could partially offset the increased cost of eliminating the limit.

Recently, an important article on this subject was published in the September 1979 Social Security Bulletin. This article is entitled "Tax Impact From Elimination of the Retirement Test," and is authored by Josephone G. Gordon and Robert N. Schoeplein of the Office of Research and Statistics, SSA. This study concludes that elimination of the retirement test for workers age 65 to 69 would generate an additional $678.6 million in payroll taxes and an extra $977.8 million in federal individual income taxes. This additional revenue, when combined ($1.656 billion), would offset 79 percent of the $2.1 billion SSA has estimated it would cost to repeal

the test. We believe these findings are significant and lend weight to our Associations' assertion that the test is costing society more in terms of lost tax revenue and contributions to the GNP than it would cost to repeal it.

TABLE II.—ESTIMATED INCREASE IN TAX REVENUE FROM ELIMINATION OF EARNINGS LIMITATION

[In millions of dollars]

	Payroll tax	Income tax	Total
Goldwater estimates: [1]			
High estimate:			
Men	812.7	192.0	1,004.7
Women	279.5	29.7	309.2
Total	1,092.2	221.7	1,313.9
Low estimate:			
Men	632.8	144.0	776.8
Women	209.6	22.0	231.6
Total	842.4	166.0	1,008.4
Colberg estimate: [2]			
Men	141.7	188.6	280.3
Women	97.7	75.7	173.4
Total	239.4	214.3	453.7

[1] Source: Statement by Senator Barry Goldwater, Congressional Record, Nov. 4, 1977, p. S 18756.
[2] Source: Marshall Colberg, "The Social Security Retirement Test: Right or Wrong" (American Enterprise Institute, 1878). pp. 54-56.

Change nature of system

The second major argument advanced in opposition to eliminating the test is that such a change would, in turn, change the nature of the system from social insurance to an annuity payable at a specific age. Those who want the present nature of the social security program perpetuated view social security dollars as intended only for the "retired" and look upon the earnings limitation as the essential mechanism to determine who is retired and who is not. This attitude is short-sighted. Our Associations would argue that fundamental change in the nature of the system is precisely what is needed if we are going to avoid having it become overwhelmed by obvious demographic, economic and labor force participation trends. We believe social security must respond to these trends and be transformed into a system that is work-oriented—one whose benefit and financing structures encourage and reward work effort.

Benefit distribution

The third major argument advanced in opposition to elimination of the test is the "fat cat" or benefit distribution argument. Removal of the test would appear to benefit disproportionately those elderly persons in relatively high income brackets—a not too surprising result in view of the fact that social security is an earnings-related system. Other things being equal, persons with a higher earnings capability are more likely to encounter a test based on earnings levels and are also more likely to have accumulated a higher level of wealth, including social security wealth, over their lifetime.

More importantly, however, there is a large group of hidden beneficiaries who are of relatively low income that the supporters of the earnings limit choose to ignore. The studies that have been done clearly document the fact that large numbers of low income working elderly deliberately hold their earnings down and drop out of the labor force rather than bear the high tax rate that the test and taxes impose on excess earnings. Since these people do not actually have their social security benefits reduced, they are not counted as potential beneficiaries of eliminating the test. Hence, although the distribution of additional social security dollars would still go to the relatively well off, the distribution of the total economic benefit from earnings test abolition would certainly be less skewed in favor of the well-to-do than is presently thought.

Those who would retain the test would rather channel the billions in additional outlays (that the elimination of the test would entail) to low income, non-working older persons. We would argue that this "alternative" of allocating the additional

measure of social security resources to the "right" people has no potential economic gains associated with it and is in a sense more costly and highly unlikely to be undertaken because of the additional cost to the system entailed. This line of argument seems more appropriate to an income-tested welfare program rather than one based on "earned right" and earnings related benefit levels. Our Associations restate again that only income test in social security is the earnings test—a test aimed only at earned income.

Fixed number of jobs

Finally, although the argument is rarely made explicitly, the earnings test is defended as a means of improving the employment prospects of younger workers. This reason for support of the earnings test reveals a dedication to supply control and the belief that making reduced employment a condition of the receipt of social security benefits opens up positions for younger workers and keeps the retired from re-entering the labor market to compete for jobs, perhaps offering their services at lower than market rates. As pointed out earlier in this statement, the economy has been able to accomodate an increased number of workers in the past, and it should be able to do so in the future when our population will contain proportionately more older persons.

Summary

In summary, the National Retired Teachers Association and the American Association of Retired Persons advocate repeal of the earnings limitation because it would in fact benefit large numbers of low income elderly people and because the limitation now imposes a substantial cost on taxpayers through the loss of gross national product and tax revenues—costs we can no longer ignore and shall not be able to afford in the future.

Given the national commitment to the maintenance of reasonable levels of income among the elderly, any share of that income that can be generated through the work effort of willing older persons represents a share that need not be borne by younger taxpayers. Clearly, additional work opportunities benefit older individuals as well, raising their standard of living, providing them with a greater feeling of independence and self-determination and improving their prospects for maintaining their living standard in the face of serious inflation. Just as clearly, the nation as a whole would benefit from the gains in national income and tax collections that would result from our getting the most from our previous investment in the training, education and experience embodied in older persons.

2. Revamping the social security benefit structure and its financial implications for the system

The benefit structure of the national pension program that we contemplate would have the following basic characteristics. First, the benefit formula would be much more proportional and less weighted than the existing one in order to relate benefit awards more closely to contributions. Second, the system would on average, replace not less than 50 to 60 percent of pre-retirement income, in order to give the future elderly a good chance of maintaining in their later years a standard of living comparable to that achieved earlier. Third, welfare and social adequacy benefit elements (including the weighted benefit formula and dependent benefits) would be phased out, placed elsewhere (and financed largely from general revenues) while primary benefits would be increased in order to achieve the earnings replacement goal to 50 to 60 percent. Simply stated, the national pension program would tend to reward work effort because benefits would be awarded primarily to workers and benefits amounts would be related to earnings.

Age 65 would remain the age for receipt of full benefits; however, strong incentives for older persons to continue working would be an essential feature of the national pension program. For example, acturially increased benefits would be provided for those who elect to defer past age 65 application for cash benefits. And, most important, existing work disincentives, such as the earnings limitation, would be abolished.

Statistics clearly indicate that social security is shouldering the major part of the income support burden for the low-income aged and disabled population. It is our belief that this burden, which is currently financed by a payroll tax on workers and their employers, should be gradually shifted to a substantially improved SSI Program which would continue to be financed out of general revenues.

Since we now have two separate instruments, namely social security and SSI, the sorting out of these two functions between these two instruments would permit a more rational and economically effective allocation of limited resources. The nation's resources (Gross National Product) are not increasing in "real" terms as

rapidly as they did in the past because of the combined effects of the accelerating rate of "hard-core" inflation, the declining rate of productivity growth and other related economic trends. In the future we are likely to find ourselves allocating a fixed share of a more slowly growing resource pie among an elderly population that will have vastly expanded.

This situation dictates that we undertake a major revamping of our income maintenance structure. Social security must be changed into a program which rewards and encourages work effort on the part of both young and old. We believe this could be achieved by emphasizing individual equity when awarding benefits (i.e., awarding benefits which are strictly related to prior contributions) by removing existing work disincentives (like the earnings limitation), and by introducing strong work incentives (like actuarially increased benefits). Allocating the income guarantee responsibility to the SSI Program would help to free up the financial (or payroll tax) resources necessary to gradually convert the social security program into one which would encourage work effort and thus represent good economic policy. It is only through increased employment among the general population—especially among the elderly—and the additional tax revenue and GNP growth which such increased employment would generate that the nation can expect to provide adequate levels of income to the expanded aged population which is in our future.

Financing for the pension program would involve use of the two countercyclical general revenue devices described earlier. The program would continue to be financed from payroll taxes on a pay-as-you-go basis (with contingency reserve funds) backed up by these general revenue devices. The addition of these economic safety nets would provide social security (as it evolves into a new pension program) with protection against high inflation and unemployment and with an expanded tax base which would be needed to fund the costs incurred during the early period of the transition to the new program. Financing of the transition would thus be done in a manner less inflationary than that which the addition of still more payroll taxes would entail.

C. 1979 Social Security Advisory Council Recommendations on Long-Term Financing

The Advisory Council made only one recommendation that would increase long-term social security financing—that is, scheduling a payroll tax rate of 7.25% in the year 2005 and thereafter. The Council also urged that serious consideration be given to gradually raising the normal retirement age from 65 to 68 by the year 2018.

Our Association consider these proposals to be rather short-sighted and evidence of a lack of appreciation for the dynamics of the interaction among the economy, the system and the system's participants. These proposals virtually ignore the emerging trends described earlier in this statement.

The Advisory Council quite clearly states its attitude about these trends and their possible impact on the system. The Council believes the economic and demongraphic trends are highly volatile, subject to a great deal of unpredictablilty, and therefore should not be used now as a basis for altering the benefit and financing structures in the future. We believe there are dangers involved in adopting this attitude—dangers for the economy, the system and the people which the system serves.

For the economy, this attitude fails to grasp how changing the social security system so that it strongly encourages work effort can have very beneficial effects on employment, tax revenues, and our economic and productivity growth in general. Failure to change the system so that it is better able to encourage and harness the nation's productive capacity will lead us to waste that capacity and utilize existing tax revenue in an ineffective and inefficient manner. In addition, the short-sighted attitude of the Council fosters an increasing reliance on payroll, rather than non-payroll, taxes to fund the system's current welfare and social adequacy functions. More and more payroll taxes have their obvious bad economic side effects.

For the social security system, the Council's longer-term recommendations will almost insure a continued financial struggle wherein the system will be plagued with trying to make ends meet. We agree with the Council that the trends cited can be volatile. However sufficient evidence exists to indicate that our future economy and the future demographic makeup of our population are not likely to provide a very favorable financial setting for the system. We believe it would be wise to change the system and use its dynamic qualities to improve the adverse economic setting and at least accommodate the demographics. For instance, the Council's suggestion to raise the retirement age ignores how the social security benefit structure can be changed to provide incentives for continued labor force participation by the elderly. The Council wholly avoided changes such as eliminating the retirement

test or providing actuarially increased benefits and, instead, opted for a blatant benefit cut—raising the retirement age.

For the people who are served by the system, the Council's relatively narrow attitude increases the danger that the system will become financially unable to honor its full benefit commitments because no plans are made to accommodate the long-term trends. The system is, by nature, a long-range program which gets its public support from its ability to make long-term benefit commitments to current workers. Not being able to honor those commitments because of poor advanced planning seriously damages public confidence in the system. If benefit changes and, in some cases, reductions are needed in the future, we must begin now so that workers' reasonable long-term benefit expectations are not defeated. Changes or reductions in benefits made without rational planning and without adequate lead time will undermine the public's willingness to provide the necessary financial backing for social security.

IV. CONCLUSION

As an immediate step, our Associations urge this Subcommittee to develop legislation that will permanently deal with the short-term deficit problem. The system obviously needs additional revenue. Congress cannot adopt a "wait and see" attitude in the hope that our economic picture might brighten and that an interfund reallocation or borrowing scheme might work. The trust funds are simply too low to play that type of Russian roulette.

In order to bring the trust fund levels back up to a reasonable level of 50 to 75 percent and to prevent a cyclical recurrence of a short-term deficit, we urge you to provide the additional revenue needed through two countercyclical general revenue devices—one triggered by high unemployment and one triggered by a low or negative real wage differential. These devices will reduce the system's vulnerability to adverse economic developments and at the same time allow policymakers the flexibility to determine the sources of any general revenue funds needed in a given year in accordance with the needs of the economy at the time.

What is ultimately at stake in the resolution of the short-term financing issue is the confidence of the public—both workers and beneficiaries—in the continuing viability of social security. The system needs some protection from economic conditions while we undertake the major effort that is necessary to get our economic house in order and bring to an end the roaring inflation and low real economic growth. Ultimately the strength of our social programs depends upon the strength and resilience of our economic locomotive. Whatever is done to deal with social security's financial problems must make sense in the contest of our objective to improve the economy over both the long and short term periods.

Over the longer term our Associations are advocating fundamental changes in the social security benefit and financing structure to deal with emerging demographic, economic and employment trends. Instead of becoming a victim of these trends, we believe the system can become a major public policy tool to be used not only for accommodating them by responding to people's changing needs, but also for influencing and, in the case of the labor force participation trend, reversing these trends.

Our recommended national pension program is designed with this goal in mind and therefore focuses on rewarding and encouraging work effort on the part of young and old. In this manner we can maintain the vitality of the system and make it more acceptable to both workers and beneficiaries. Workers would be more likely to support the system because it would be more financially stable and it would adhere to the principle of individual equity in awarding benefits. At the same time, older persons would have their income needs more adequately met since the system would encourage them to work and increase the relatively inflation-proof wage component of their income.

In developing recommendations, if Congress ignores these important trends and views the social security system in a vacuum, then the resulting recommendations will contribute nothing to maintaining the ongoing success and viability of the system. In fact, such narrow-minded recommendations will enhance the risk of causing an erosion of much of the progress achieved by the system over the past 40 years. Superficial recommendations which ignore the aggregate impact of evident trends will foster a future deterioration of the system because they will inevitably lead to irrational and unsystematic benefit deliberalizations. These actions, in addition to the irratic process uses to implement changes, will undermine crucial public support for the system.

Just as many trends do not arise overnight, many of the changes dictated by these trends can take on a slow evolutionary process. Our Associations, working on behalf of older Americans, are dedicated to the system's vitality. We envision a program

that has the foresight to anticipate future trends and to accommodate fully the needs of the future generations of people who will be relying on it.

STATEMENT BY JACOB CLAYMAN, PRESIDENT, NATIONAL COUNCIL OF SENIOR CITIZENS

Mr. Chairman, Members of the Committee, my name is Jacob Clayman. I am the President of the National Council of Senior Citizens.

The National Council of Senior Citizens is a non-profit, nonpartisan organization representing more than 3,800 affiliated clubs and State and Area Councils across the nation with a total membership of more than three and one-half million elderly.

I deeply appreciate the opportunity to comment on the current status of the social security trust funds and the outlook for the future.

The well-being and peace of mind of past and current generations of workers of all ages has been enhanced by the existence of the Social Security program; there is no doubt that the program will continue to function as a vital institution in this society well beyond our own lifetime and that of our children and grandchildren. I am as certain of the basic soundness of Social Security as I am of the basic soundness of the U.S. Government. Therefore, I urge this Committee, as well as the entire Senate and the Congress, as a whole, to address the financing issues before you without permitting any who are outside of the halls of Congress to misinterpret the cause or effect of any financing difficulties; to misread the intent of Congress in regard to its support for the Social Security system, or to exaggerate the severity or impact of any financing problems.

Clearly, it is important not only that problems be resolved, but also that problems be presented for public view in a balanced and accurate fashion. We must not permit, as has happened in the past, exploitation by doomsday prophets who cause unnecessary unrest and add nothing to the public good. In short, I urge you to protect the faith of the American people in the Social Security system and, thereby, their faith in the Government.

In regard to the short-term, cash-flow problems, I would like to underscore that the problems are just that—cash flow problems, not problems that are endemic to the system itself. In fact, it is only the Old Age and Survivors Trust Fund which is likely to experience some difficulty in the near future; the Disability Trust Fund is expected to accumulate a surplus at an increasing rate each year into the foreseeable future. The problem of OASI Trust Funds dipping to low levels which could endanger timely benefit payments is primarily a result of the poor state of health of the economy, that is, unexpectedly high rates of both inflation and unemployment, and the enormous sensitivity of the Social Security system to these factors.

Certainly needed financing corrections were effected in 1977 and the current problem is not an indication that the 1977 changes were seriously in error. It is an indication, however, that perfection in forecasting the level and timing of inflation and unemployment eludes us and that we must be prepared to make minor corrections as the future becomes less distant and greater accuracy in predicting events becomes possible.

Under some assumptions, the cash-flow imbalance was expected during 1982; under more recent and more pessimistic assumptions, the imbalance could occur as early as next year. Under all scenarios, the income generated by the 1977 amendments is likely to create a surplus by the mid-1980's. Therefore, the problem is temporary, over a short period of time, but it does require quick action by Congress.

In offering our suggestions, we feel it is important to take into account several other considerations:

(1) Concern—on several counts—over the anticipated payroll tax rate increase in 1981 from 6.13 percent on employee and employer each to 6.65 percent, and

(2) our long-standing active support of the use of general revenues as a significant part of the system.

We are concerned about the 1981 tax rate increase not only because it has some inflationary bias, but also because it may diminish popular support by current contributors in spite of their own current and future stake in the program.

Our preferred remedies to the cash-flow problem are as follows:

1. Reallocate part of the tax rate now earmarked for the Disability Insurance Trust Fund and the Hospital Insurance Trust Fund to OASI. This will moderate current problems while at the same time minimizing the need for repeated congressional intervention for the purpose of resolving cash flow problems in the future;

2. Authorize borrowing between Trust Funds to permit maximum flexibility within the program to maintain safe reserve levels for benefit payments;

3. Finance the Hospital Insurance Trust Fund (Part A of Medicare) by one-half general revenues. This is roughly the same as substituting general revenues for the

payroll tax increase scheduled to go into effect in 1981—therefore, the increase need not go into effect.

4. If revenues are insufficient, (as some believe the case may be) permit borrowing from general revenues for the near term to make up any shortfall.

If, however, Congress is unwilling to seriously consider infusing general revenues into the Hospital Insurance Trust Fund, while still entertaining the notion of preventing the 1981 tax rate increase, then the only option remaining would be to slash benefits. This would be totally unacceptable! In such a case, there would be no alternative but to institute the 1981 tax rate increase as scheduled.

In any event, we urge that Congress act promptly to avert non-payment of benefits due to the temporary cash flow problems; we urge that this goal be handled in consonance with the objective of deferring the 1981 tax increase; we urge that general revenues to made available on a permanent basis for up to one-half of the Hospital Insurance Trust Fund, and we urge that additional general revenues be made available as needed.

In regard to the long-term financing of Social Security, and the projected adverse consequences of the demographic changes in the next century, I see no compelling reason why Congress must make any major decisions at this early date. Just as it would be inappropriate for Congress to ignore a problem that could be easily resolved legislatively, it is also inappropriate for Congress to attempt to resolve a problem that is neither accurately defined nor well understood. I suggest that there has been a tendency to exaggerate the problem of the lowered ratio of workers to beneficiaries and an even more egregious error commited in suggesting that—whatever the problem—the Social Security System must solve it!

I believe that what we face in the future is primarily a labor market problem of labor shortage, one that lends itself to solutions much more easily than our experience with unemployment. After all, we are not newcomers to this problem: we have experienced it in every major war on a scale that dwarfs the problems of the anticipated demographic changes. And we have made the needed accommodations and solved the problems under the crisis of war.

Are we to believe that we cannot find a way to accommodate less drastic needs, under peace-time conditions, and with ample notice? Are we to believe that the private business sector will not find the means to attract more labor when it is in their interest to do so? Are we to assume that given the impact of the demographic change on so many aspects of American life, nothing will change but the costs of the Social Security System? Nonsense!

Therefore, the only long-term change that I recommend at this time is one that is independent of demographic considerations: tri-partite financing of Social Security with general revenues financing one-half of Medicare Part A as a first step.

The National Council has in the past indicated its support of tri-partite financing. The long-range goal of the National Council of Senior Citizens is a strong social security system, covering both cash benefits and health insurance, financed partly through contributions of workers and their employers—thus preserving the important contributory principle of benefits as an earned right—and partly by contributions from the government in recognition of society's stake in a well-functioning social insurance program.

I hope I may have the liberty of one more brief comment. One of the most visible and least well received recommendations of the Advisory Council on Social Security was that one-half of social security benefits be subject to taxation. The National Council of Senior Citizens has been deluged with mail opposing this recommendation. In the context in which the proposal was made, it is nothing more than a benefit reduction. As such, we oppose it!

However, if Congress were willing to consider significant tax reforms which would not give preferential treatment to anyone, regardless of source of income, then we would reconsider our position. The elderly are not opposed to equity—only to inequity!

Thank you for this opportunity.

Senator NELSON. Our next witness is the Honorable Milton Gwirtzman, Chairman, the National Commission on Social Security.

Mr. GWIRTZMAN. Thank you, Mr. Chairman.

I am accompanied by Frank Crowley, the executive director of the commission.

Senator NELSON. Your statement will be printed in full in the record. You may present it however you may desire.

Mr. GWIRTZMAN. Thank you.

STATEMENT OF MILTON GWIRTZMAN, CHAIRMAN, NATIONAL COMMISSION ON SOCIAL SECURITY

Mr. GWIRTZMAN. The proposals relating to short-term financial problems were made as part of our interim report that was submitted to the Congress and to the President early last month. As you may remember, our Commission is bipartisan and independent of both the Social Security Administration and the Department of HEW. We were created by the Congress as part of the 1977 Social Security Amendments for the purpose of making a study of all aspects of social security including financing and submitting a final report in January of next year.

Because of the enormous interest in the short-term financing proposals and because of the numerous bills advocating a postponement or repeal of the tax increases scheduled for next year, we decided to give you an interim report on these two issues before you acted.

In brief, we favor a permanent reallocation of part of the disability tax to OASI. We also favor interfund borrowing on condition that such borrowing would not endanger the fund which makes the loan.

If any of the first funds is in such poor shape that there might be danger the benefits could not be paid on time, we propose that you authorize appropriations to the trust fund that is in difficulty from the general fund of the Treasury of such amounts as may be needed to pay benefits in any specific month, but that this authority terminate on March 31, 1985. And finally, we favor requiring the managing trustee of the fund, who is the Secretary of the Treasury, to repay any amounts borrowed or exchanged between the funds with appropriate interest by the end of 1988.

We feel that these measures would provide sufficent flexibility to avoid the cashflow problems that loom now and for the next 5 or so years. We feel it is important to provide this flexibility, including the borrowing authority from the Treasury, because of the very unusual economic times through which we are passing.

Social security trust funds are extremely sensitive to unexpected changes in economic conditions. The most important element is probably the relationship of the annual increases in covered earnings to the annual increases in the Consumer Price Index. The current tax schedule is based on the assumption that earnings would rise faster than prices and, if this had been the case, the current short-term financing problems might not have developed.

But the reverse occurred and the financial status of the OASI trust fund deteriorated seriously. Moreover, this deterioration seems likely to continue at least through 1981 and perhaps even longer.

It is really impossible to predict the course of prices and wages even for the short term these days. You only have to contrast the estimates you received when you were considering the 1977 amendments with those that were provided you for these hearings.

You were told in 1977 that the CPI increase for 1979 would be 5.3 percent while the rise in covered earnings was expected to be 7.8 percent. The actual increases turned out to be 11.4 percent for the

CPI and 8.3 percent for covered earnings causing a net drain on the combined OASI/DI funds of $1.3 billion.

The 1977 CPI increase projected for 1980 was 4.7 percent. Inflation this year, so far, is proceeding at the rate of 18 percent.

Covered earnings are now estimated to increase 2 percentage points more than was estimated in 1977, but because of the large increase in benefits projected under the cost-of-living provisions, there is now forecast a net drain on the trust fund of $6.5 billion for this year.

We have prepared a table, table 1 of my written testimony, showing the differences between the assumptions used for the 1977 amendments and those used for the estimates prepared for the committee this year. It covers 1979-89.

The current forecast of a positive real wage differential starting in 1982 could be very optimistic. Again, because of the difficulties in forecasting far into the future, current estimates limit price increases after 1984 to 6 percent or less.

Let me just say, as an aside, that although I personally favor the basic idea behind the Humphrey-Hawkins law, it seems strange to me that this law requires that the cost estimates be made on the assumption of full employment when the people making the estimates do not believe there will be full employment. Realistic estimates are essential if you are to make good policy. I do not see how you can use the estimates that CBO and others make for you, if the law forces them to give you unrealistic estimates.

But let me say that I am not criticizing the forecast because even the best economic projections can only extrapolate from the experience of the past, and the most careful forecaster could not have foreseen in 1977 such things as the rate at which OPEC would increase the price of oil and the Federal Reserve would increase the price of money.

So while you hoped—and I think sincerely—to avert any threat to the solvency of the social security system by what you did in 1977—a threat that would precipitate a decline in public confidence—the recent reports of the cash-flow problem in the OASI trust fund beginning as early as next year are again threatening public confidence.

The financing mechanism that was supposed to have been repaired seems out of repair again. The public opinion polls that we have conducted, and that other groups have conducted, have found that public confidence has been adversely affected by these pessimistic reports.

The polls suggest that about half the public has little or no confidence that social security will have the funds to provide them benefits upon retirement. Never before in the history of the program has the public been so pessimistic about the program's future. This pessimism should not be allowed to continue, because too many people depend upon social security, not only for their current or future daily needs, but for their current peace of mind about their future income.

And unless people who are working today are absolutely certain, as they have been in the past, that their benefits will be there when they retire, they could develop a real reluctance to pay the additional taxes, whether through payroll taxes or general reve-

nue, that would be needed to guarantee the benefits that are now the law.

For these reasons, the Commission believes that it would be best to develop financing mechanisms, both short and long term, that are flexible enough so that every time the economy acts in an aberrant manner, the country does not have to go through a crisis of confidence about social security.

The current cash flow problem is limited to the OASI trust fund. Benefits are paid out each month and if one assumes an even distribution of monthly payments, 8.3 percent—one-twelfth of annual expenditures—is the bare minimum needed to assure that benefits can be paid on time.

Those we have consulted indicate that when the estimates show start-of-the-year balances in the trust fund less than 15 percent of expenditures, there can really be no assurance that benefits in those years will be paid on time. I realize that Ms. Rivlin said 9.12 percent, but the point is that you need some margin of error.

The current economic assumptions prepared for your staff, show the OASI fund dropping below the 15 percent danger point this year and becoming totally exhausted in 1982.

The balance in the disability fund seems well beyond cash flow needs, as you have been told.

The estimates we used last fall when we prepared the recommendation in our interim report now seem to have been somewhat optimistic regarding the OASI program and pessimistic regarding DI. As a result the precise reallocation needs to be reevaluated.

The Social Security Administration actuary prepared a new schedule of allocations to the DI program for us which is designed to leave each fund, OASI and DI, with a balance of about the same percentage of outgo at the start of each year. Table 2 in my written testimony shows that reallocation, and Table 3 shows the changes that would result in the DI tax rate. Tables 4, 5, and 6 show the progress of the OASI and DI trust funds for the 1980's.

In summary, our first recommendation is for a reallocation. If that is insufficient to maintain an OASI balance of 15 percent, and the estimates indicate that for the period beginning in late 1980 and continuing through 1987, it would be—we propose that the managing trustee be given by law the flexibility of interfund borrowing, as long as such loans do not endanger the fund from which the loan is taken.

If current projections prove accurate, such a loan might be made from the health insurance fund to OASI and DI beginning in 1983 and possibly earlier, but I repeat, that will be possible only if current projections prove accurate. I would also remind you again of the difficulty of forecasting and that there is no guarantee the DI fund will be as large as estimated.

There is always the possibility that even interfund transfers cannot be made without depleting the other funds beyond the margin of safety. And, if the downward trend in the number of disability claims suddenly reverses itself, or if medicare costs increase even more rapidly than anticipated, then the relatively healthy balances in these funds now predicted, which could allow you to tap them under this borrowing plan, may fall below the margin of safety.

In that case, the Commission feels that, as a last resort, interest-bearing loans from the Treasury are the best way of assuring that benefits will be paid on time.

Last fall when we prepared our recommendation, we thought the loan authority should expire on March 31, 1985 and that all of the loans should be repaid by the end of 1988. The current estimates suggest that the loan authority may be needed for a slightly longer period, and it may be 1989 before the loans can be repaid. We suggest that a thorough, month-by-month analysis of the estimated cash flow is needed to determine the most realistic repayment schedule.

Our final recommendation relates to the many proposals that have been made to postpone the effective date of the payroll tax increase now scheduled for January of next year, or to roll taxes back to 1980 levels as an anti-inflation measure.

We are currently studying the question of how inflationary payroll taxes are compared with other financing devices. We can offer no opinion on that at this time, but we do feel that at the time when the income and outgo of the programs are so delicately balanced, the system should not be deprived of revenue on which it depends for its solvency.

The tax increase scheduled for next January is a relatively large one and every bit of it is going to be needed to pay the benefits anticipated in future years. For example, if the tax rate were held constant at the 1980 levels and if there were no change in the tax base schedule under present law, income to the social security program would decline by $12.4 billion in 1981 and $16.5 billion in 1982. The funds would be depleted extremely quickly.

So no matter what arguments may be made for a repeal or rollback or a postponement on economic grounds, it is evident that reductions of this magnitude cannot be made without either a new revenue source for social security or a major cut in benefits.

Thus, we urge that the increases in the tax rates and the tax base should go into effect in 1981 as scheduled unless appropriate substitute methods generating the necessary additional income needed to maintain the financial soundness of the system can be enacted this year.

In conclusion, I would remind you that our recommendations deal only with the short-term financing problem. In our final report next January, we will make recommendations on long-range financing after the year 2000 when the demographic trends, such as the declining ratio of workers to beneficiaries may join with the economic uncertainties to create an even more difficult situation than we now face .

If Congress will face up to the long-term as well as the short-term challenge, the public confidence that is so vital to this program will be restored to the level of the past and social security will be able to continue indefinitely to play its important part in assuring the well-being of the American people.

Thank you very much, Mr. Chairman.

Senator NELSON. Thank you very much, Mr. Gwirtzman.

Do you have any questions, Senator?

Thank you very much.

[The prepared statement of Mr. Gwirtzman follows. Oral testimony continues on p. 125.]

STATEMENT BY MILTON GWIRTZMAN, CHAIRMAN OF THE NATIONAL COMMISSION ON SOCIAL SECURITY

I am Milton Gwirtzman, Chairman of the National Commission on Social Security.

I am happy to have the opportunity to present to the Subcommittee the recommendations of the Commission relating to the short-term financial problems of social security. These proposals were part of our Interim Report submitted to the President and Congress early last month.

As you know, our Commission is bipartisan and independent of both the Social Security Administration and the Department of Health, Education, and Welfare. We were created by the Congress as part of the Social Security Amendments of 1977 for the sole purpose of making a study of all aspects of social security, including financing. Our final report will be made in January of next year and ordinarily we would not have made any recommendations on financing this early in the game. But the possibility of short-term, cash-flow problems, beginning as early as next year, combined with the large number of bills before the Congress to postpone or repeal the tax increases scheduled for next year, convinced us that it would be better for us to make our recommendations on this aspect of the financing issue before Congress acted, rather than after.

The National Commission proposes that amendments to the Social Security Act be enacted this year to:

1. reallocate a part of the disability insurance tax to the Old-Age and Survivors Insurance fund on a permanent basis;
2. authorize an exchange of money, as interest bearing loans, between the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, and the Hospital Insurance Trust Fund when needed to pay benefits in any specific month, on condition that such transfer will not endanger the fund which makes the loan;
3. if this exchange cannot be made, or would not provide sufficient funds (as interest bearing loans) to pay benefits in any specific month, authorize appropriations to the trust funds from the general fund of the Treasury, of such amounts as may be needed to pay benefits in any specific month—this authority to terminate on March 31, 1985; and
4. require the Managing Trustee of the funds to repay any amounts borrowed or exchanged, with appropriate interest, by the end of 1988.

These measures should provide sufficient flexibility to avoid cash-flow problems, no matter what economic developments take place, for the next five or so years. It is important to provide this additional degree of flexibility to the financing of social security, for we seem to be passing through a time of unusual economic volatility, in which it is impossible to predict the course of prices or wages even for the short term. You have only to contrast the estimates provided Congress when you were considering the 1977 amendments with those provided for these hearings. For 1979 the CPI increase was estimated at 5.3 percent while the rise in covered earnings was expected to be 7.8 percent. The actual increases turned out to be 11.4 percent for the CPI and 8.3 percent for earnings. As a result, the change in real earnings, from a plus 2.5 percent to a minus 3.1 percent, was 5.6 percentage points less than anticipated.

The differences between the assumptions used for the 1977 amendments and those used for the estimates prepared for the Committee this year are shown in the table:

Table 1

Values of Selected Economic Factors

	Percentage increase in average annual:			
	Wages in covered employment		CPI	
	original estimate 1/	current estimate 2/	original estimate 1/	current estimate 2/
1979	7.8	8.3	5.3	11.4
1980	7.1	9.1	4.7	11.8
1981	6.4	8.9	4.1	9.2
1982	6.0	10.1	4.0	8.2
1983	5.75	9.6	4.0	7.4
1984	5.75	9.1	4.0	6.8
1985	5.75	7.9	4.0	6.1
1986	5.75	6.9	4.0	5.4
1987	5.75	6.7	4.0	5.0
1988	5.75	6.5	4.0	4.6
1989	5.75	6.2	4.0	4.2

1/ Committee on Ways & Means, House of Representatives, Actuarial Cost Estimates for the Old-Age, Survivors, Disability, Hospital, and Supplementary Medical Insurance Systems, as Modified by Public Law 95-216. 95th Congress, 2d Session, Print #95-68, March 3, 1978. Prepared by the Office of the Actuary, Social Security Administration, Intermediate assumptions.

2/ Social Security Administration, Office of the Actuary, Based on the 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee.

I am not criticizing the forecasters. The most careful forecaster could not have foreseen, in 1977, the rapid rate at which OPEC would increase the price of oil and the Federal Reserve would increase the price of money.

Social security income is extremely sensitive to unexpected changes in general economic conditions. The most important element is the relationship of annual increases in covered earnings to annual increases in the Consumer Price Index. The current tax schedule was based on the assumption that earnings will rise faster than prices. If this had been the case, the current financing problems would not have developed, but the reverse occurred, and the financial status deteriorated. Moreover, this relationship seems likely to continue through 1981.

In 1977 Congress enacted legislation which was designed to provide adequate financing throughout the remainder of this century. By acting quickly and decisively, any possible threat of a decline in public confidence in the system was averted. But recent reports of an upcoming cash-flow problem in the Old-Age and Survivors Insurance Trust Fund, beginning as early as 1981, are again threatening public confidence. The funding schedule that was supposedly in repair seems to be out of repair again. Public opinion polls conducted for this Commission and for other groups have found that the public has been affected by these pessimistic reports. The polls show that about half the public has little or no confidence that social security will have the funds to provide them benefits upon retirement.

Too many people depend upon social security for their daily needs and for their peace of mind about the future, for more of these shocks to occur. Unless workers are absolutely certain, as they have been in the past, that their benefits will be there when they become eligible, they could develop a real reluctance to pay the additional taxes that will be needed to guarantee benefits. For these reasons, the Commission believes that it would be advisable to develop mechanisms, both short and long-term, that are flexible enough so that social security does not have to go through a crisis of confidence every time the economy acts in an aberrant manner.

The current cash-flow problem is limited to the OASI trust fund. Benefits are paid out monthly, and if one assumes an even distribution of monthly payments, 8.3 percent of annual expenditures is the bare minimum needed to assure that benefits will be paid on time. People familiar with the program and the cost estimates indicate that when the estimated start-of-year balance in a trust fund is less than 15 percent of expenditures there can be no assurance that benefits will be paid timely. Under the current economic assumptions prepared for your Committee, the OASI fund will, under its present financing, drop below the 15 percent danger point in 1980 and will become totally exhausted in 1982.

The balance in the disability trust fund, as estimated for your Committee, is well beyond cash-flow needs. It is estimated at 35 percent of current outgo this year, rising to 279 percent in 1989. Under our proposal, a portion of the DI tax would be permanently allocated to the OASI fund. The estimates we used last fall when we were preparing our recommendation now seem to have been somewhat optimistic regarding the OASI program and pessimistic regarding the DI program. As a result, the precise reallocation needs to be reevaluated. The Social Security Administration actuary prepared, at our request, a new schedule of allocations to the Disability Insurance program designed to leave each fund, OASI and DI, with a balance of about the same percentage of outgo at the start of each year. Table 2, attached, shows the reallocation under this plan and Table 3 shows the change in the DI tax rate. Tables 4, 5, and 6 show the progress of the OASI and DI funds under the reallocation. (Also attached are Tables 7, 8, and 9 showing estimated operations of the Trust Funds under present law, using your staff assumptions.)

If this permanent reallocation is insufficient to maintain an OASI balance of 15 percent—and the estimates indicate that for the period beginning in late 1980 and continuing through 1987 it would be—we proposed that the Managing Trustee of the trust funds be given by law the flexibility of loaning money from one fund to another when needed to pay benefits, as long as such loans do not endanger the fund from which the loan is taken. If the projections prove accurate, such a loan might be made from the Health Insurance fund to the OASI fund and DI fund beginning in 1983, or possibly earlier.

There is always the possibility that interfund transfer cannot be made without depleting the other funds beyond the margin of safety. If the downward trend in the number of disability claims in recent years suddenly reverses itself, or if medicare costs increase more rapidly than anticipated, the relatively healthy balances in these funds, which allow them to be tapped under this borrowing plan, may fall below the safety margin. In that case, the Commission feels that, as a last resort, interest bearing loans from the Treasury are the best way of insuring that benefits will be paid on time.

When we prepared our recommendation we had thought that the loan authority should expire March 31, 1985 and that all of the loans should be repaid by the end of 1988. The current estimates suggest that the loan authority may be needed for a slightly longer period and that it may be 1989 before the loans could be repaid. A thorough month-by-month analysis of the estimated cash-flow is needed to determine exactly what loans might be needed, and to show what repayment schedule seems possible.

There is one other recommendation dealing with short-term financing that we made in our interim report. A number of proposals have been made to postpone the effective date of the payroll tax increase now scheduled for January of next year, or to roll it back to 1980 levels, as an anti-inflation measure. We are currently studying the question of how inflationary payroll taxes are, compared with other financing devices. We offer no opinion on that at this time. But we do believe that at a time when the income and outgo of the programs are so delicately balanced, the system should not be deprived of revenue on which it depends for its solvency.

The tax increase scheduled for next January is a relatively large one, but every bit of it will be needed to pay the benefits anticipated for future years. For example, if the tax rate were held constant at the 1980 levels and if there were no changes in the base scheduled under present law, income to the OASDHI program would decline by $12.4 billion in 1981 and $16.5 billion in 1982.

No matter what arguments might be made for repeal on economic grounds, it is evident that reductions of this magnitude cannot be made without either a new revenue source for social security, or making major cuts in benefits. Thus, we urge that the increases in the tax rates and in the maximum taxable earnings base go into effect in 1981 as scheduled in present law, unless appropriate methods to generate the necessary additional income to maintain the financial soundness of the system can be enacted this year.

May I remind you in conclusion that these recommendations deal only with the short-term financing problem. The Commission in its final report next January will make recommendations on financing the long-range cost of the program, after the year 2000, when demographic trends, such as the declining ratio of workers to beneficiaries, may join with the economic uncertainties to create an even more difficult situation than we face now. We shall do this in the confidence that the Congress will face up to the long-term as well as the short-term challenge, so that the public confidence so vital to this program will be restored to the level of the past, and so that social security can continue indefinitely to play its important part in assuring the well-being of the American people.

Table 2.--Contribution rates for OASI and DI under present law and under a reallocation of the combined OASDI tax rate beginning in 1981

Calendar years	Present law			Reallocation		
	OASDI	OASI	DI	OASDI	OASI	DI
	Employees and employers, each					
1979-80	5.08	4.330	0.750	5.08	4.330	0.750
1981	5.35	4.525	.825	5.35	4.875	.475
1982	5.40	4.575	.825	5.40	4.750	.650
1983	5.40	4.575	.825	5.40	4.725	.675
1984	5.40	4.575	.825	5.40	4.750	.650
1985-89	5.70	4.750	.950	5.70	5.000	.700
1990 and later	6.20	5.100	1.100	6.20	5.310	.890
	Self-employed persons					
1979-80	7.05	6.0100	1.0400	7.05	6.010	1.0400
1981	8.00	6.7625	1.2375	8.00	7.2875	.7125
1982	8.05	6.8125	1.2375	8.05	7.0750	.9750
1983	8.05	6.8125	1.2375	8.05	7.0375	1.0125
1984	8.05	6.8125	1.2375	8.05	7.0750	.9750
1985-89	8.55	7.1250	1.4250	8.55	7.5000	1.0500
1990 and later	9.30	7.6500	1.6500	9.30	7.9650	1.3350

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Table 3.--Contribution rates for DI under present law and under a reallocation of the combined OASDI tax rate beginning in 1981

Calendar years	Present law DI	Reallocation DI	Reduction in DI Tax rate
		Employees and employers, each	
1979-80	0.750	0.750	-
1981	.825	.475	0.35
1982	.825	.650	.175
1983	.825	.675	.150
1984	.825	.650	.175
1985-89	.950	.700	.250
1990 and later	1.100	.890	.21
		Self-employed persons	
1979-80	1.0400	1.0400	-
1981	1.2375	.7125	.525
1982	1.2375	.9750	.2625
1983	1.2375	1.0125	.225
1984	1.2375	.9750	.2625
1985-89	1.4250	1.0500	.375
1990 and later	1.6500	1.3350	.315

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Table 4.--Estimated operations of the OASI and DI trust funds, combined, under a reallocation of tax rates between OASI and DI, on the basis of the President's 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee, calendar years 1978-89

(Amounts in billions)

Calendar year	Income	Outgo	Net increase in funds
1978	$91.9	$96.0	-$4.1
1979	105.8	107.4	-1.7
1980	119.8	124.2	-4.5
1981	136.9	143.0	-6.1
1982	155.4	161.3	-5.9
1983	174.9	179.3	-4.4
1984	195.8	197.9	-2.1
1985	226.8	216.8	10.0
1986	247.5	234.7	12.8
1987	267.8	252.6	15.1
1988	289.0	270.6	18.4
1989	310.1	288.5	21.6

Calendar year	Funds at end of year	Funds at beginning of year as a percentage of outgo during year
1978	$31.7	37%
1979	30.1	30
1980	25.6	24
1981	19.5	18
1982	13.6	12
1983	9.3	8
1984	7.1	5
1985	17.2	3
1986	30.0	7
1987	45.1	12
1988	63.5	17
1989	85.1	22

Note: Totals do not necessarily equal the sum of rounded components.

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Table 5.--Estimated operations of the OASI trust fund, under a reallocation of tax rates between OASI and DI, on the basis of the President's 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee, calendar years 1978-89

(Amounts in billions)

Calendar year	Income	Outgo	Net increase in fund
1978	$78.1	$83.1	-$5.0
1979	90.1	93.2	-3.1
1980	101.8	108.3	-6.5
1981	123.9	125.2	-1.3
1982	136.9	141.5	-4.5
1983	153.0	157.4	-4.4
1984	172.0	173.9	-1.8
1985	198.9	190.3	8.6
1986	217.0	206.1	10.9
1987	234.7	221.8	12.9
1988	253.3	237.2	16.1
1989	271.8	252.4	19.5

Calendar year	Fund at end of year	Fund at beginning of year as a percentage of outgo during year
1978	$27.5	39%
1979	24.5	30
1980	18.0	23
1981	16.7	14
1982	12.2	12
1983	7.8	8
1984	5.9	4
1985	14.5	3
1986	25.3	7
1987	38.3	11
1988	54.4	16
1989	73.8	22

Note: Totals do not necessarily equal the sum of rounded components.

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Table 6.—Estimated operations of the DI trust fund, under a reallocation of tax rates between OASI and DI, on the basis of the President's 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee, calendar years 1978-89

(Amounts in billions)

Calendar year	Income	Outgo	Net increase in fund
1978	$13.8	$13.0	$0.9
1979	15.6	14.3	1.4
1980	17.9	15.9	2.0
1981	13.0	17.8	-4.9
1982	18.5	19.8	-1.4
1983	21.9	21.8	.1
1984	23.7	24.0	-.3
1985	27.9	26.5	1.5
1986	30.5	28.6	1.9
1987	33.1	30.9	2.2
1988	35.7	33.4	2.3
1989	38.3	36.1	2.2

Calendar year	Fund at end of year	Fund at beginning of year as a percentage of outgo during year
1978	$4.2	26%
1979	5.6	30
1980	7.7	35
1981	2.8	43
1982	1.5	14
1983	1.5	7
1984	1.2	6
1985	2.7	5
1986	4.6	9
1987	6.8	15
1988	9.1	20
1989	11.3	25

Note: Totals do not necessarily equal the sum of rounded components.

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Table 7.--Estimated operations of the OASI and DI trust funds, combined, under present law and present regulations, on the basis of the President's 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee, calendar years 1978-89

(Amounts in billions)

Calendar year	Income	Outgo	Net increase in funds
1978	$91.9	$96.0	-$4.1
1979	105.8	107.4	-1.7
1980	119.8	124.2	-4.5
1981	137.0	143.0	-6.0
1982	155.5	161.3	-5.8
1983	174.9	179.3	-4.3
1984	195.8	197.9	-2.1
1985	226.9	216.8	10.1
1986	247.6	234.7	12.9
1987	267.8	252.6	15.2
1988	289.0	270.6	18.4
1989	310.1	288.5	21.6

Calendar year	Funds at end of year	Funds at beginning of year as a percentage of outgo during year
1978	$31.7	37%
1979	30.1	30
1980	25.6	24
1981	19.6	18
1982	13.8	12
1983	9.4	8
1984	7.4	5
1985	17.5	3
1986	30.3	7
1987	45.5	12
1988	63.9	17
1989	85.5	22

Note: Totals do not necessarily equal the sum of rounded components.

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Table 8.—Estimated operations of the OASI trust fund under present law and present regulations, on the basis of the President's 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee, calendar years 1978-89

(Amounts in billions)

Calendar year	Income	Outgo	Net increase in fund
1978	$78.1	$83.1	-$5.0
1979	90.1	93.2	-3.1
1980	101.8	108.3	-6.5
1981	115.4	125.2	-9.8
1982	130.7	141.5	-10.8
1983	146.7	157.5	-10.8
1984	163.8	173.9	-10.1
1985	186.5	190.4	-3.9
1986	202.7	206.2	-3.5
1987	218.6	221.9	-3.3
1988	235.2	237.3	-2.'
1989	251.6	252.5	-.9

Calendar year	Fund at end of year	Fund at beginning of year as a percentage of outgo during year
1978	$27.5	39%
1979	24.5	30
1980	18.0	23
1981	8.1	14
1982	-2.7	6
1983	-13.6	(1/)
1984	-23.6	(1/)
1985	-27.5	(1/)
1986	-31.0	(1/)
1987	-34.3	(1/)
1988	-36.4	(1/)
1989	-37.3	(1/)

1/ The fund is exhausted in 1982.

Note: Totals do not necessarily equal the sum of rounded components.

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Table 9.--Estimated operations of the DI trust fund under present law and present regulations, on the basis of the President's 1981 Budget assumptions, modified in 1984 and 1985 and extended through 1989 as requested by the staff of the Senate Finance Committee, calendar years 1978-89

(Amounts in billions)

Calendar year	Income	Outgo	Net increase in fund
1978	$13.8	$13.0	$0.9
1979	15.6	14.3	1.4
1980	17.9	15.9	2.0
1981	21.6	17.8	3.8
1982	24.8	19.8	5.0
1983	28.3	21.8	6.5
1984	32.0	24.0	8.0
1985	40.4	26.4	14.0
1986	44.9	28.5	16.4
1987	49.2	30.8	18.4
1988	53.8	33.3	20.5
1989	58.3	35.9	22.6

Calendar year	Fund at end of year	Fund at beginning of year as a percentage of outgo during year
1978	$4.2	26%
1979	5.6	30
1980	7.7	35
1981	11.4	43
1982	16.5	58
1983	23.0	76
1984	31.0	96
1985	45.0	117
1986	61.3	158
1987	79.8	199
1988	100.3	240
1989	122.9	279

Note: Totals do not necessarily equal the sum of rounded components.

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Senator NELSON. Our final witness today is Mr. Robert Ball, senior scholar, National Academy of Sciences, and former Commissioner of the Social Security Administration.

Mr. Ball, the committee is pleased to have you appear again today. Your statement will be printed in full in the record and you may present it however you desire.

STATEMENT OF ROBERT BALL, SENIOR SCHOLAR, INSTITUTE OF MEDICINE, NATIONAL ACADEMY OF SCIENCES AND FORMER COMMISSIONER OF SOCIAL SECURITY

Mr. BALL. I am submitting my entire statement for the record and will summarize it orally. [The statement appears on p. 137.] I should make it clear that I am appearing entirely as an individual. I believe you have heard already from the Chairman of the Advisory Council on Social Security. I was a member of that council, and although I generally agree with the financing recommendation, I do not feel a need to defend the exact recommendations.

It has been said to you again and again that under the new, more pessimistic economic assumptions, Old Age and Survivors Insurance has a short-term financing problem whereas disability insurance, both short and long term, seems to be adequately financed. Hospital insurance in the short term is adequately financed but 10 years or so from now that program will probably need additional financing.

In view of this situation, the administration proposes interfund borrowing as its solution to the short-term problem. I think that is a good idea. I think it is minimal, however.

Senator NELSON. You think it is what?

Mr. BALL. Minimal. I think that is the very least that should be done, and I would favor doing it.

But even in a minimal plan, Mr. Chairman, I would propose that you do a couple of other things. I think it would be desirable to actually combine the OASI and the DI funds into a single fund. I think borrowing between those two funds does not make a great deal of sense.

They are both cash-benefit, wage-related programs financed in the same way and the reasons for the original separation no longer apply.

Senator NELSON. You would combine all three?

Mr. BALL. No; I would combine just the cash benefit funds—OASI and DI. If that is not satisfactory for the immediate future, I would at least, in addition to interfund borrowing, have a reallocation of the contribution rates between disability and old age and survivors' insurance, plus interfund borrowing.

The size of the interfund borrowing is going to be very large, if that is all you do, because the OASI fund is very substantially underfinanced and the DI fund is in very good shape. A reallocation, along with interfund borrowing, would seem to me to be a very sensible thing to do.

A mistake was made in 1977 in the rates that were allocated to the two programs and that should be corrected.

Now, personally, I would like to go beyond a minimal plan. I recognize that this year the Congress may not feel—for general economic reasons—that this is the time to make fundamental

changes in the way the various parts of social security are financed. But whenever there is a tax cut, it seems to me that there is a great deal to be said in favor of not having the deductions from workers' earnings and the payroll taxes on employers go up as they are now scheduled to do in 1981.

If you came to the conclusion later this year that less in the way of taxes is desirable for 1981, that would be very convenient for the social security system because then you would not have to have that rate increase for 1981, or the base increase, and I would propose a substitute source of income in that case.

If not, if general economic policy is such that you feel that you cannot increase the deficit next year and those rates need to go into effect, it has a disadvantage from the social security standpoint. If you do allow the rate in 1981 to go up and then at the time you do want to have a tax cut, you select social security taxes as the right place to make the cut, then you have to bring the rates down again, and I think there is a good case for social security taxes being the right place to make a cut, whenever a cut is made.

Senator NELSON. But under current projections, the rate and base increases scheduled for 1981, plus a transfer of funds, interborrowing of funds, are necessary to meet the obligations of the fund.

Without that, where are you going to get the money?

Mr. BALL. Without a substitute source of income, of course, that——

Senator NELSON. Well, what are the substitute sources for that?

Mr. BALL. That is of course, correct, Mr. Chairman.

What I would propose is essentially what the Advisory Council proposed, and that is that you use the employer payroll tax and the deductions from workers' earnings—that is social security taxes—solely for the cash benefit program from here on out. And that you design a different way of financing the medicare program, which is not a wage-related program. I would support the Advisory Council idea which is to have an earmarked portion of the income tax substitute for the present employee's contribution to medicare and then a general revenue contribution, which would be derived from the corporation income tax as the other part of financing hospital insurance under medicare.

That leaves you with the present social security tax rate, 6.13 percent, entirely for the cash program. That is a very large increase over the present schedule for the cash program. Under present law, it goes to 5.35 next year, and then it goes to 5.4 in 1982, to 5.7 in 1985 and ultimately to 6.2 in 1990.

If you left the 6.13 that is now being charged and used that entirely for the cash benefit program, under the central assumptions that the trustees have made for the long term and using the budget assumptions in the near term, you would not need to make any other changes in financing cash benefits under social security for the rest of this century—considerably into the next century, actually. You would be building large-scale surpluses in the cash benefit program later in this century.

Senator NELSON. I have not tried to compute it, but you would have to have a significant increase in the income tax.

Mr. BALL. I think Mr. Chairman, that what I am saying is not feasible unless you have decided, on other grounds, to have a cut in overall taxes—which you will have to do at some point.

Senator NELSON. That would not be a cut. This aspect would be an increase.

Mr. BALL. No, what I am saying is that at the time you would otherwise make a cut in the income tax, you take it first from the so-called payroll tax, the social security tax, and you would dedicate a portion of the income tax for medicare. The net result is that you would have a cut in total taxes.

Senator NELSON. Do you mean the portion of the income tax which is now going to the general fund, or that you would not increase the income tax?

Mr. BALL. I do not think it is feasible———

Senator NELSON. Then it is a general fund transfer into medicare, right?

Mr. BALL. Right, except that I would have an earmarked portion of income taxes for medicare purposes for reasons I would be glad to get into.

But to finish the point you and I are on at the moment and make that clear, I do not, as the Advisory Council more or less implied, feel that it is feasible that you could do this unless there was going to be a cut in the total level of taxes.

If you decide that there is going to be an overall tax cut—and if not this year, then there is going to be one in the year after or the year after that, sometime, because everybody is moving into higher income tax brackets, so you have to have a cut at some point—then I am saying that there is good reason to make your first priority cut a cut in payroll taxes. I would hope that what you would do is leave the rate where it is today at 6.13 and the cut in payroll taxes would then be the failure to increase it as scheduled for next year.

Now, you substitute for that loss of income an earmarked portion of the income tax. It is an overall cut, but the cut comes from the payroll tax.

Have I made myself clear—I do not mean whether it is persuasive, but whether what I am saying is clear?

Now, I feel and the council felt that if you go in this direction you ought not to finance medicare from undifferentiated general revenues, but rather in part from an earmarked portion of the income tax for two reasons:

One is the fear that unless the individual sees he is paying for half of medicare in this direct way you lose some of the fiscal control that you now have in the present way of financing medicare by an earmarked portion of the social security tax.

The other reason is that paying in an earmarked way for part of the benefit helps prevent the introduction of new conditions of eligibility—say an income test or a means test—or a major reduction in benefits, because everybody with taxable income will have been paying throughout his life toward this medicare protection.

So I would like to retain the concept of earmarked financing for medicare, but there are good reasons not to have payroll taxes as high as now planned. There are reasons from the standpoint of inflation—as far as the employer's tax is concerned the cost, at least in its first impact, is probably to a considerable extent passed

forward in prices. There are reasons from the standpoint of the individual because social security taxes fall heavily on the lower-income person.

Using the income tax as a partial substitute for planned social security taxes but picking out hospital insurance for income tax financing you get a more progressive and less inflationary way of financing.

Now, I assume, Mr. Chairman, that my full statement will be printed in the record, so I have been trying not to repeat what other witnesses have already said, but I do want to add just a couple of other points and then I would be glad to get into any of these matters to whatever extent you and Senator Danforth wish.

If it is too radical a proposal to finance medicare all at once this year in a completely different way, I think a very good step would be to finance say half of the hospital insurance part of medicare out of general revenues—undifferentiated general revenues in this proposal. Just take half of the cost out of general revenues.

I believe there is a lot more support for the use of general revenues in hospital insurance than there is in the cash benefit program; it is less controversial.

This way you would have substituted general revenues for the social security rate increases that are scheduled for 1981. It would be just about a trade-off if you took half the cost of hospital insurance out of general revenues and rescined the contribution rate increases scheduled in 1981.

Such a substitution would add about $9 billion to the deficit in 1981. The issue toward the end of this year will be whether in overall economic terms it is better to have a somewhat higher deficit versus letting the overall social security contribution rates go into effect. There would be less objection from many people to financing one-half of hospital insurance from general revenues than going all the way with the Advisory Council and financing all of hospital insurance in a new way.

In summary, I would suggest that you put into law all of the long-range back-up points that the Advisory Council suggests and that the administration suggests. I would think it is wise to have inter-fund borrowing authority. I think it is wise to have countercyclical general revenue financing. I think it is wise to have the right to borrow from the general fund under certain circumstances.

But I do not like the idea of having to turn to these back-up methods to meet fundamental financing problems that can be foreseen right now. I think these proposed addition to the law should be treated as fallback safety devices to avoid problems that you cannot foresee.

But we have a problem now and we know that it is significant. If you could get into the cash program the full 6.13 rate now being charged, I believe it would be a great relief, not only to the country, but everybody involved in policymaking for social security in the executive branch and in the Congress. This way you could forget about cash benefit financing for at least the next 25 years.

That is why I say the full 6.13. The Council said 5.6. I think 5.6 is too close to the line; 6.13 has a substantial margin.

So I would modify the Advisory Council proposal that way, and then, as I said, along with them, I would think it would be good to

combine the two cash benefit funds. If you cannot, all at once, change hospital insurance financing as fundamentally as the Council suggests, you might consider the step of partially financing hospital insurance from general revenues and freezing the overall social security tax rate. This move requires a decision that it is preferable not to have the increased rates go into effect next year even at the cost of having a somewhat larger deficit in the unified budget.

Senator NELSON. Would you agree or disagree with Dr. Hsiao's proposal to tie benefits to prices instead of wages, phased in some time in the future, starting in the late 1980's or early 1990's?

Mr. BALL. I would strongly disagree, Mr. Chairman. I have examined the proposal carefully since the days it was first made—and before that, as a matter of fact. All it is is a proposal to shrink the role of the social security system in the future.

The result of that proposal is that, instead of an average replacement rate as it is today for the single worker of around 41-percent or 42-percent benefit of recent earnings under the Hsiao Panel proposal, in the next century, around 2010, the replacement rate drops to 30 percent on the average and by 2050 to 25 percent.

Senator NELSON. For a single person?

Mr. BALL. Yes, on the average for a single person. Everything is half again as much again, of course, for a couple.

There are various ways to cut benefits and therefore save money. I happen to be opposed to all of them. I think social security benefits are not too high and that the role of social security in the future is not too big and I do not want to shrink it.

But if one wants to cut benefits, indexing by prices instead of wages is just one of many kinds of cuts that can be made. It is just a cut.

Senator NELSON. As you know, he testified on that point in 1977 and we did not adopt his replacement rate schedule. You have seen the charts on what that schedule would show.

Mr. BALL. Yes.

Senator NELSON. I did not realize it would go from 40 to 25, but he argues that historically—I did not ask him how far back he went—wages have stayed ahead of prices. Now, that has not been so for the past couple of years.

But if it is retirement benefits you are looking at, is not the price of things a more accurate reflection of need-than wages?

Mr. BALL. Well, as you know, Mr. Chairman, the present approach is to relate benefits to wages for the people who are still contributing. The benefits are updated and kept in accord with the rising level of living in the community as a whole up to the time of retirement.

So it is indexed to wages only to that time and then it is indexed to prices thereafter.

Personally I would be glad to index to wages after retirement too, but it is very expensive on the assumption that wages are going to run ahead of prices and I think we have to make that assumption in the long run—that we are not going to have on the average over a long period of time a situation in which we have actually declining levels of living in the country.

I think wages will once again run somewhat ahead of prices. The argument is how much?

You now have an automatic system that follows the level of living of current wage earners wherever it goes. If it should go up, benefits rights go up. If by any chance the current level of living of wage earners should go down, then the social security benefit rights would go down.

The key reason I favor sticking to indexing to wages for the current worker, is that the measure of whether a retirement system is adequate—and I would say this is true of private or public plans—is what proportion of the level of living you have obtained while working does your retirement pay equal—that is, the question of the replacement rate.

And if it is 41-percent or 42-percent replacement for the average worker today, the average worker in the year 2010—these young people who are now paying—should have a 41-percent or 42-percent replacement, too.

Indexing to prices for the current worker is just a way of reducing that percentage replacement.

It is also, from a fiscal conservative's point of view, a somewhat deceptive arrangement. I know my former colleague, Robert Myers, strongly supports the present system of indexing to wages partly because in his judgment under a price-indexing system there would be a series of ad hoc increases in social security. The system would look cheaper if you index to prices. And yet, since it would be continually falling behind the level of living of current workers, the Congress would be moving in with ad hoc increases that look cheap. You would be keeping up with wages, but you would not be anticipating the cost of keeping up with wages.

So from a conservative fiscal standpoint, I think there is a strong argument for the present approach as well. Changing to price indexing shows up as if it were a big saving but if, in fact, you move in and make the changes by special legislation, it is not a saving.

Senator NELSON. Senator Danforth?

Senator DANFORTH. When Mr. Hsiao testified he stated that the shortfall that we would have to make up in OASI over the next 5 years should be about $65 billion. Is that about right, in your opinion?

Mr. BALL. Well, I think it depends upon—is he talking about all three funds together?

Senator DANFORTH. I think it was just OASI.

Mr. BALL. Just OASI alone?

Senator DANFORTH. Yes.

Mr. BALL. I have no reason to disagree with it offhand, Senator Danforth. I would be glad to correct for the record. I just do not have the figures in my mind. The material requested follows: Under the assumptions used by the Senate Finance Committee in preparing recent data for that committee, you would need about $45 billion more than is provided by present law to cover the cost of OASI benefits during the next 5 years, but the OASI fund would stay at a dangerously low level.

Senator DANFORTH. Looking at all three trust funds together, what is the situation over the next 5 years if we are going to be responsible, if we are going to have an adequate reserve?

Are we going to have to come up with more money, or what?

Mr. BALL. I think that——

Senator DANFORTH. He said $65 billion just to maintain the adequate reserve in OASI and he said, in his opinion, maybe we could borrow half of it from other funds but he did not even recommend that.

Mr. BALL. I would think, Senator Danforth, that looking at all three funds together, the administration's proposal to just do interfund borrowing, or any proposal which does not increase the income to the total system, runs pretty close to the line.

I am not saying that you might not make it, but it is quite close.

If you put all three funds together, the net increase in the funds, the excess of income over outgo, in 1981 under the assumptions used by the Senate Finance Committee staff is $1.4 billion; in 1982, $3 billion; in 1983, $5.7 billion; in 1984, $8.8 billion; and in 1985, $22.8 billion.

Now, the funds are growing if you put them all together, so with a borrowing device or a reallocation plus a borrowing device, we could make it if these assumptions are correct.

The issue arises, however, whether, particularly beyond 1983, the economic assumptions are not a little optimistic and whether the reserve funds are not dangerously law.

Senator DANFORTH. Well, in your view, just planning responsibly for the future, do we need more or less revenues? Right now, you know what is projected to come in through social security taxes into these three programs and what is projected to go out. Just looking for a responsible system, can we limp along as we are just borrowing from one fund to another or is it necessary to either increase the revenues or reduce the benefits or somehow make an adjustment so that, in the aggregate, we are in a sounder position?

Mr. BALL. Senator, I am sticking only on your word "necessary." I think it would be highly desirable to not have these recurring crises that arise from unforeseen economic conditions and therefore my basic proposal is to very substantially increase the rate that is going into the cash programs. Going from next year's 5.35 to, in effect, the full current rate of 6.13.

So I am saying I think it is highly desirable to have much more money.

Senator DANFORTH. Well, a lot of things are desirable, but you think it is not only desirable, it is responsible?

Mr. BALL. Yes. I think it is desirable and responsible and——

Senator DANFORTH. The fact that we now have an 18 percent annualized rate of inflation, you cannot assume that we are going to have a 4- or 5-percent rate of inflation and plan the future that way, right?

Mr. BALL. I would feel much more comfortable by more money being dedicated to the cash program as I have testified. I just do not want to say that you might not make it solely by interfund borrowing. I think that is possible.

Senator DANFORTH. Sure. You could put a blindfold on and cross the highway and maybe you will make it, but trying to be responsi-

ble and make your plans for the future, what I would like to know is, looking ahead 5 years, if you want it to be responsible and design a sound program, what net changes would be required either by reduced benefits or increased revenues for these three programs combined?

OASI, DI, and HI, looking at it from all?

Mr. BALL. All right.

First thing I would recommend, Senator Danforth—although obviously it is not the only approach that would be sound—but what I would like to see is that the social security tax rates, the amount now charged for all three programs, be used entirely for the cash program.

In other words, that the 6.13 rate that people are paying this year go entirely into the cash program. Now, that gives you a big surplus in the next several years, and even more into the future.

Senator DANFORTH. I understand, but what would that work out to in dollars?

Mr. BALL. In dollars in the first year, it would probably be——

Senator DANFORTH. Over a 5-year period of time. We know under present law how much the three programs will raise. So if you shift anything from HI into the other two, you are going to have to make that up.

So either way you look at it, if you need more revenues, you should be able to figure out how much more revenue do you need, or how much less benefits do you need, or what kind of combination do you need that would come up with a sound program. That is what I would like to know.

Mr. BALL. Well, I am suggesting an increase in the cash benefit program in 1981 of around $17 billion. The difference between the rate in present law and the rate that you get from 6.13 is about $17 billion. Now, that does not all go out in benefits. It starts to build the trust funds.

I think the OASI trust fund is much too low. So this $17 billion is more than you need just to get by, but you start to build the funds back to a ratio that is safe.

Senator DANFORTH. Let me see if I can restate the question.

Mr. BALL. I did not finish the part about medicare. That is additional money.

Senator DANFORTH. Yes, but what I would like to know is, over a 5-year period of time, what dollar number do we have to come up with to put these three programs on a sound basis over what is now projected in the present law, whether it is the present rate or the future rate?

I mean, you can compute what we project under present law; how many more dollars do we need?

Mr. BALL. Under the proposal that I am suggesting, there would be an increase of about $100 billion for the 5 years for all three funds combined.

Now, the reason I am sounding somewhat difficult to you, Senator Danforth, is that I do not want to say that you have to have that amount. The reason I am making it so large is because we then would be building the trust funds and we would have a cushion. It is more than the estimated amount necessary to pay benefits. That would be much less.

Senator DANFORTH. But to have a sound, solvent program that you can count on in good times or in bad times, considering the fact that we have a volatile economy, you need to start with the dollar figure that we now project under present law over the next 5 years and add to it somewhere in the neighborhood of $100 billion to have a responsibly funded program.

Mr. BALL. I want to get back to a ratio of the trust funds that are 75 percent of the next year's outgo as soon as possible. Now, you do not have to do it as fast as I am saying if you do not want to. I am hesitating therefore, to say this is the only responsible thing you can do.

Senator DANFORTH. I understand it is a matter of opinion, but that is all I want. Your opinion as to how much more revenue we need, or how much less benefits we need, or how much of a combination.

Mr. BALL. I would like to see somewhere in the neighborhood of $100 billion for all three funds which is about what you get out of the proposal which I made. This provides for a major increase in the size of the trust fund.

Senator DANFORTH. Let me just tell you the problem that I have with your system—let me say it is wonderful, because we are doing nothing that is unpopular and you have come to the right audience to do nothing that is unpopular. We hate to do things that are unpopular.

Mr. BALL. I hate to have you.

Senator DANFORTH. But you are saying, raise $100 billion and no reduction in benefits, no change in the indexing formula. Nothing with respect to age of retirement. No problem with changes in benefits. No proposal for universal coverage, which is always very unpopular.

Mr. BALL. Yes, I would favor universal coverage be glad, but not for financing reasons——

Senator DANFORTH. Yes, but that is not part of this program.

Mr. BALL. That is not a financing issue——

Senator DANFORTH. Well, it is—I do not want to get off on that, right now, but that is unpopular and some people have suggested it.

And no increase in social security taxes over what is now planned, over the present rate. That is, you do not even go to the programed increase.

So that the beneficiaries are perfectly happy because they are going to get everything and the social security taxpayers, as such, as social security taxpayers, are happy because they do not have to pay their planned increase.

And so all of this is being taken care of by simply borrowing from one fund or another, or not even a general tax increase, but simply taking it away from a future tax reduction.

And I understand what you are saying, but I am just saying that the problem is that it seems to me to be not exactly straightforward—it is a kind of something for nothing type of thing.

Mr. BALL. Let me state my position again, Senator Danforth, on this point. This is not done with mirrors.

At some point down the road—we might differ when it will be—we are going to have to make a reduction in the general income

tax. Even if inflation rates which are much lower than today, people will be moving into higher and higher brackets and at some point taxes have to be cut.

All I am saying is that at the time when you do cut taxes, instead of cutting the income tax rate as much as you otherwise would, there are good economic reasons and good reasons from a distributional standpoint to first make the cut in the payroll tax and then you make up for it by not decreasing the income tax rate as much as you otherwise would.

Senator DANFORTH. Yes.

Mr. BALL. That is what it would amount to.

Senator DANFORTH. I understand exactly what you mean.

Mr. BALL. Now, if it is painless, or not as painful as something else, that does not make it less desirable, as long as it accomplishes the purpose.

Senator DANFORTH. But the whole reason for any kind of a general tax reduction is that the Government is increasingly taking more and more out of the economy and you do not want to take so much out.

So you have a tax cut to make up for that and all you are saying is that you do not want to make that adjustment completely. You simply want to transfer more in effect out of general revenues.

Well, there is nothing unpopular about that, but I do not know how long we can continue telling people that everybody is going to be happy. I do not think they are very happy. We have got an 18-percent general inflation rate.

Mr. BALL. This plan does not primarily address the issue of the 18-percent inflation rate. But I think it is important enough to mention, and that is, although there are arguments among economists as to whether a reduction in the social security payroll tax would actually reduce the inflation rate, I think there is quite general agreement that among ways of reducing taxes, reducing the Social Security tax would probably have either the best inflationary impact, if you are one group of economists, or the worst if you are another.

In other words, the reduction in the cost of doing business that comes from the reduction in the employer's part of the payroll tax, has a positive good effect on the rate of inflation.

This is partly offset by the increase in purchasing power from the reduction on the employee's side, and if you increase the deficit at the same time, then there is an argument whether that offsets the good effect still further.

But when it comes to choosing which way to make a cut, if you are going to make a cut, I think you get fairly widespread agreement that social security taxes ought to be high on the list for a way to make it.

Senator DANFORTH. I am not going to draw it out any longer, but what you are saying is not only that you would make a cut in the social security tax by not—not a cut, it is just not going through with the planned increase.

Mr. BALL. It is if you do it this year.

Senator DANFORTH. But also then, in effect, you transfer what would otherwise be a general tax cut into the social security fund.

Mr. BALL. Into the medicare part.

Senator DANFORTH. Yes.

Mr. BALL. That is right. I would finance medicare that way, although I would want to earmark a portion of the income tax for one-half the medicare cost.

Senator NELSON. Well, I have only known a very few people in my life who relished doing things that were unpopular, and I did not like a single one of them.

Senator DANFORTH. I do not relish doing anything that is unpopular, but at a time when everybody says well, let's bite the bullet, it is nice to be told that there is no bullet to bite.

Mr. BALL. Senator Danforth, I am sure you understand what I am saying and there is a bullet to bite—that is, the income tax reduction that would otherwise come will not be as large by the amount of supporting the medicare program through an earmarked portion of the income tax.

That is the bullet, if that is the way to say it.

Senator DANFORTH. The politics of joy.

Mr. BALL. Aside from how much pain or lack of pain it causes, there seems to me very sound economic and social security reasons not to have the entire cost of all three parts of this system entirely on the payroll tax and there seems to be a much greater willingness to finance some part of general revenue—I mean, some part of hospital insurance from general revenue rather than in the cash program.

So in this way, you can leave the cash program entirely free of any general revenues and then devise a new earmarked way of financing the medicare system.

Senator NELSON. I suppose that—I was not here—but I supposed that in 19—disability went in in 1965?

Mr. BALL. I believe 1956 was disability and——

Senator Nelson: And medicare?

Mr. BALL. In 1965.

Senator NELSON. I suppose the argument could have been made at that time not to compromise the system by introducing a program that is not wage related and that, therefore, you should not put medicare into the social security system. If you had not, the social security system would not be having this particular problem but of course you would be getting it out of the general fund, or some other kind of a tax.

But I do not remember any argument like that being made at the time. It would have been a perfectly logical argument to be made by anyone who supported a wage-related system and did not want it in any way corrupted by introducing elements that were not related to wages.

Furthermore, if we had had a national health insurance program prior to that, then, of course, we would not have medicare in this system either.

But it is just a question, Do you want to maintain benefits at this level? If so, then how do you want to do it? Do you want to raise the taxes, the base, some more, or do you want to go to the general fund, or if you do not want to do either of those, do you want to reduce the benefits in order to——

Mr. BALL. Could I make one point about this matter of reducing benefits?

I am sure it is clear to you that this shortrun problem of social security financing cannot realistically be addressed by a reduction in benefits. You cannot conceive of making cuts of the size that would be necessary to meet this short-range problem. That is because I am sure that the great majority of people would want to protect the rights of those already drawing benefits.

Therefore, when you make a cut, it is just for the people who are coming on the rolls and to have any short-term sizable effect the cuts would have to be enormous. They have to be very drastic, since you are only cutting the benefits of new people coming on the rolls, if you are going to guarantee the rights of those who are already drawing.

Now, for the long run, if you are talking about really longrun problems of social security, obviously there is a real policy choice to be made as to whether people want to pay the costs of a reasonably adequate social security system or whether they do not—whether they want to start to shrink social security.

I would argue that it is not an extravagant system, that it is about minimal and that I would prefer to take the side of the argument that says we ought to finance it rather than even in the long run, reducing the role of the system.

Senator DANFORTH. Let me just add this. I happen to represent the fourth oldest population in the country, the State of Missouri. The fourth oldest.

I certainly want an adequate and sound social security system. I do not want to cut benefits either. I am very, very sympathetic to older people and recognize the problem that they have.

I think my general concern is broader and that is that we have now an 18-percent inflation rate. It is simply not right to blame it all on OPEC. That may be 3 percentage points of it. And I think that we are so busy telling people here that everything can be done with mirrors.

That is to say, we are not going to have tax increases, we are going to have tax reductions; we are not going to reduce any benefits for anybody, maybe even increase them. And just have a little borrowing here and a little drawing from this fund there and forego some future tax increase which we may have down the road, and that it just seems that we never, ever say to anybody, hey, you know, things are going to be tough and we are going to have to buckle down and we are going to have to get our feet on the ground and get some sort of responsibility back into our economy.

And I do not think we ever really do that. We are just so busy saying to everybody, we are for you.

Mr. BALL. I am not saying that. I do not have to be concerned about that.

I am saying that the cash benefit program ought to get the equivalent of 6.13 percent of payroll. That is a big increase for the cash benefit program.

Then I am saying, the hospital insurance plan, which is now running around $24 billion a year, would come out of general revenues, in effect—an earmarked income tax.

That means that you folks out there cannot have as big an income tax cut as you otherwise would. That is what it amounts to.

I do not think that is mirrors, Senator. I think that is a realistic way to do it.

Senator NELSON. Thank you very much, Mr. Ball. We appreciate your taking the time to come today.

Mr. BALL. Thank you, Senator.

[The prepared statement of Mr. Ball follows:]

STATEMENT OF ROBERT M. BALL

Mr. Chairman and members of the committee, my name is Robert Ball and I am now a Senior Scholar at the Institute of Medicine of the National Academy of Sciences. From April 1962 until March 1973 I was Commissioner of Social Security and prior to that served for approximately 20 years in various positions in the Social Security Administration and its predecessor organization, the Social Security Board. I am testifying today as an individual and my opinions do not necessarily represent those of any organization with which I am associated. Although I was a member of the most recent Advisory Council on Social Security and agree generally with the financing recommendations of that Council, I am testifying today solely as an individual and not as a representative of the Council.

As the Administration has testified, new, more pessimistic assumptions about the performance of the economy now make it appear that there is a need for prompt congressional action to avoid a short-term financing problem in the old-age and survivors insurance part of the social security program. While the disability insurance fund is growing rapidly and is expected to more than double in the next two years, the old-age and survivors insurance fund, under present law and the economic assumptions in the budget will be clearly inadequate by the beginning of 1982. Even if the funds are combined—since the obligations of the OASI fund are so much larger than those of the disability insurance fund—the funds are too low by the beginning of 1983. Since the hospital insurance fund appears to be in good shape over the next several years, the Administration proposes to meet the short-term financing problem by inter-fund borrowing. The plan requires that the presently scheduled contribution rate and wage base increases for 1981 be allowed to go into effect and even then the plan runs pretty close to the line.

The Administration's plan appears to me to be minimal. I would think that the Congress should clearly do this much at the very least. Personally I would prefer, even in a minimal plan, handling the matter somewhat differently. Although I believe it is desirable to introduce the idea of inter-fund borrowing as the Administration has suggested, one could reduce the extent of the borrowing either by just combining the OASI and DI trust funds into a single fund, as recommended by the Advisory Council, or if this is not acceptable, there could be a reallocation of rates between OASI and DI. In the 1977 amendments apparently too much money was allocated to the disability insurance fund and not enough to the OASI fund. This should be corrected even if the borrowing authority is provided at the same time.

Personally, I would like to go beyond a minimal plan. Even though the long-range cost estimates for social security show the cash benefit system—OASI and DI combined—soundly financed for at least the next 50 years, it is very disturbing to beneficiaries and contributors alike to keep running into these short-term crises because of an insufficient margin in the short-term rates. I would like to see the entire proceeds of the social security tax rate—now 6.13 percent of earnings up to a maximum this year of $25,900—devoted exclusively to the cash benefit program and have the Medicare program financed in an entirely new way as recommended by the Advisory Council.

This would allow us to avoid the scheduled increases in both rate and base for 1981 and would finance the cash benefit part of social security without any further rate increases well into the next century. It would be very good for social security—and for all those involved in making government policy—if we could have a stable rate for the next 25 years or so and avoid all social security rate increases, except, of course, those that might be called for by program changes. If the present rate for the cash benefits and hospital insurance combined of 6.13 went entirely to the cash benefit program, this goal would be accomplished.

Dedicating the entire 6.13 rate to OASDI has several advantages:

1. It removes any possible concern about the sufficiency of short-term OASI financing. The ratio of the OASI trust fund to the next year's projected outgo is now so low—estimated to be about 14 percent at the beginning of 1981—that steps should be taken to build up this fund. It is estimated that the trust funds need to be about 9 percent of the estimated outgo in the following year in order to have enough

funds—without some special intervention by the Congress—to pay current benefits as due. The percentage for the OASI fund (but not the DI fund) is estimated to fall as low as 6 percent at the beginning of 1982. Even under a combined OASI and DI fund, the percentage is estimated to drop to 8 percent by the beginning of 1983. Under present law, the combined contribution rate for OASDI is 5.08 this year, 5.35 in 1981, and 5.40 from 1982 through 1984. It then goes to 5.70 in 1985, and 6.20 in 1990. A 6.13 rate would start building the funds up immediately and clearly carry the program well into the next century.

2. The quick build-up in OASDI trust funds that would result from a 6.13 rate would make it unnecessary to meet the short-term concerns about financing through a variety of special and non-traditional means. In addition to inter-fund borrowing, other methods which have been proposed include: (a) combining the OASI and DI trust funds; (b) authorizing borrowing from the general fund; (c) introducing a counter-cyclical financing formula that would provide limited general revenue support for the program during periods of relatively high unemployment; and (d) putting back into the law a general revenue guarantee contained in the statute from 1944 to 1950 as follows: "There is also authorized to be appropriated to the trust fund such additional sums as may be required to finance the benefits and payments provided under this title."

Personally I support all these proposals as reasonable additions to the law, designed to meet unexpected emergencies over the long run, but I recognize that they are controversial and it certainly would be best not to have to rely on them in the near future to provide assurance that all benefit payments would be made as due. If resort to these methods is said to be necessary to meet short-run problems, it adds to the impression that social security is not well enough financed.

3. The 6.13 rate for the cash benefit part of social security is sufficiently high so that the ad hoc increase in the maximum earnings base now scheduled for 1981 could be rescinded. Instead the maximum earnings base for 1981 could be allowed to rise only to the same extent that average earnings in the country rise. This is the method of adjusting the maximum earnings which keeps the base at the same relative point it is today and is both the method used in the recent past and the one which under present law would be applied after 1981.

The scheduled ad hoc increase in the maximum earnings and benefit base is controversial because it increases payments to social security disproportionately for those who earn above the $25,900 maximum in effect this year. While everyone earning below $25,900 will pay on higher earnings as earnings go up, under present law those at the upper end will pay proportionately more. The law specifies that in 1981 the maximum earnings and contribution base will rise to $29,700, whereas it is estimated an adjustment to increases in earnings would raise the base to only $28,200.

The ad hoc increase is also controversial because in the long run it increases benefits for the higher-paid more than would otherwise be the case, and, therefore, in the opinion of some, undesirably enlarges the scope of social security at the expense of the role of private pensions and private voluntary savings.

4. Based on current-cost financing principles, there would be no need for the increase in the OASDI rate to go up in steps as now called for in 1981, 1985, and 1990. The 6.13 rate would be building surpluses throughout the rest of this century and a further increase would not be needed for at least 25 years or so, if at all.

5. I agree with the Advisory Council that it would be desirable to have a social security tax schedule in the law that would fully finance the program according to the best estimates available over the entire 75-year period for which the long-range estimates are customarily made. It is the absence of such a schedule which now causes journalists and editorial writers to emphasize that social security does not have enough financing to cover all costs in the long run. The facts that the deficit is not estimated to occur for 50 years and that estimating costs some 50 years from now is a highly speculative business are frequently lost on the reader; the story just comes out that social security is underfinanced. For the cash benefit program, a contribution rate of 6.13 well into the next century, and a rate of 7 to 7.5 from then on would meet the costs as now estimated over the whole 75-year period. I believe this is worth doing even though it is true, of course, that as one approaches the effective date for the higher rate it would need to be modified. First of all, if present estimates were exactly correct, it would undoubtedly still be desirable to stretch out the increases in terms of a current cost financing formula, just as we have in the past, rather than have such an abrupt rise in rates and a big jump in trust fund accumulations. Secondly, it would become clear as one nears the turn of the century that the actual long-range costs of the program would be somewhat different than

are presently estimated, either higher or lower. (I happen to think they would be somewhat lower but others disagree.)

Although it is not possible to predict accurately what the rates should be in the next century, it nevertheless seems to me important to alert people to the tax consequences of the expected changes in the demographic situation some 25 to 50 years from now and to indicate to the country that in a self-financed system a rate of 7 to 7.5 percent on employers and 7 to 7.5 percent on employees would, according to the best estimates we can make, be sufficient to meet all benefit and administrative costs for the whole 75 years over which the estimates are made. I think this is the responsible thing to do even though the next generation may turn to alternatives to raising the rate, such as the introduction of other sources of revenue.

Because under this plan hospital insurance is no longer financed by social security taxes, it is possible to include this balancing rate of 7 to 7.5 for the cash benefit program and still have the ultimate social security tax rate less than the 7.65 rate now scheduled in 1990 for OASDI and HI combined.

In summary, while reducing the overall tax on earnings because of the substitution of a new financing method for Medicare, the plan would strengthen the financing of social security cash benefits by quickly getting the trust funds back to a reasonable ratio to the next year's outlays and would stabilize the financing of the system into the next century by rescinding all earnings tax increases now scheduled. The plan eliminates the uneasiness about the adequacy of social security financing both in the short and the long run and does not depend upon a commitment to use general revenue financing in the cash benefit program of social security.

Moreover, while solving the social security financing problem, both short and long range, avoiding an increase in social security tax rates next year directly and immediately reduces the cost of doing business and thus some of the pressure on prices, and it has a direct stimulating effect on employment by reducing the cost of labor.

A NEW METHOD OF FINANCING HOSPITAL INSURANCE UNDER MEDICARE

At the present time, the hospital insurance part of Medicare (Part A) is financed almost entirely from a tax on employers' payrolls and deductions from workers' earnings, as in the case of cash benefits under social security. There are minor contributions from general revenues, for example, to pay for non-contributory credits for military service and for hospital insurance benefits paid to people uninsured under social security at the time the hospital insurance program began. On the other hand, about 70 percent of the costs of Supplementary Medical Insurance (Part B) under Medicare, which reimburses for the cost of physicians' services, is paid from general revenues. If both Parts A and B of Medicare are looked at together, about 20 percent of the revenues come from general taxes.

Perhaps because Part B of Medicare already has the major part of its cost covered by general revenue financing, and perhaps also because the benefits in both parts of Medicare are not geared to past earnings as they are in the cash benefit program, there has been less reluctance to move away from an earnings or payroll tax in Medicare as compared with OASDI. Nevertheless it seems to me important that any new method of financing Medicare continue the advantages of the present method of financing a substantial part of the cost from a designated tax which is both visible to the individual and which rises as the cost of the program rises. I believe this is important both from the standpoint of fiscal discipline—so that people know that if the cost of benefits increases, or if more protection is provided, they have to pay more—and from the standpoint of the protection of benefit rights. I would be concerned that the full financing of hospital insurance under Medicare by undifferentiated general revenues (or for that matter any specified benefit in the social security program) might, over time, result in the introduction of a test of means for that benefit. It seems to me that the best guarantee that promised benefits will be paid and paid under conditions which do not deny benefits to people who have managed to save on their own (and thus do not meet a test of means) is to have the great majority protected by the plan either pay specifically toward the benefit or be the dependent of someone who does. I would argue, therefore, that one important principle in designing a substitute method for financing Medicare is that a substantial and important part of the new financing be from a visible, dedicated tax paid by the individual.

I agree with the Advisory Council that one-half of the hospital insurance program under Medicare be financed in the future by a portion of the individual income tax, with the amount of the individual's payment toward Medicare shown on a separate line on the return. This could be either a dedication of a portion of the income now

derived from existing rates or a special calculation worked out at the time when income tax rates are lowered. I would also propose that the maximum amount paid for Medicare under this new proposal not exceed the maximum amount that the individual would pay under present law (perhaps twice the maximum for a joint return) when currently scheduled hospital insurance rates are applied to the maximum earnings bases under the cash benefit program.

I believe that the amount charged individuals under this approach should cover one-half the costs of the estimated outgo for benefits and administrative expenses in the following year plus a small additional amount to maintain the hospital insurance trust fund at a reasonable ratio to the next year's outgo so that the fund would continue to be an adequate contingency fund. The present ratio of the hospital insurance trust fund is now around 54 percent and it seems to me that it would be adequate if the fund were raised gradually to 75 percent or so and maintained at that level.

The advantages of shifting from taxes on employees' earnings to a portion of the individual income tax is that it makes the financing more progressive. The amount to be paid under the plan would be related not only to earnings but to income from interest, rents, and profits, and the amount of the payment would be related to family size. People with very low total income in a particular year would be excluded from payment altogether. Also, to a limited extent, even with the maximum proposed, the progressive rates of the income tax would apply also to this new Medicare financing method.

At the same time, dedication of a portion of the income tax to Medicare would, in my judgment, adequately protect the Medicare program against major reductions in future benefits or the introduction of a test of need. This is true because all regular wage earners and income receivers would be paying a special tax for the Medicare benefits and they would be the very ones who would lose protection if a test of means are later to be introduced. All people over 65 resident in the country for over five years or United States citizens, and all those drawing social security disability benefits for two years or more (as under present law) would have Medicare protection. The relatively few older people who over a lifetime would have paid nothing, or very little, in earmarked taxes for Medicare would receive free or subsidized protection.

I would propose that the other half of the cost of the hospital insurance program under Medicare be met from the proceeds of the corporation income tax. As I indicated earlier, the economic advantages of a reduction of the pressure on prices and the promotion of employment comes from the reduction in employer payroll taxes which reduces the costs of doing business. The Advisory Council would make up for this reduction by matching what the individual pays for Medicare by a lump-sum payment from the Treasury to the hospital insurance fund, with the payment to be derived from the proceeds of the corporation income tax. This is not a proposal to increase the present rates of the corporation income tax nor to ask employers to identify the amount paid for Medicare on the forms they file, but rather to transfer a part of the proceeds of the present tax to the Medicare program.

All in all, and in summary, the Advisory Council plan, modified as I suggest, seems to me to have the following advantages:

1. It avoids the 1981 scheduled increase in social security taxes and allows all increases to be postponed until well into the next century at the very least.

2. It protects Medicare against the introduction of a test of means and preserves the "fiscal discipline" inherent in an earmarked tax.

3. It avoids the need for any general revenue financing in the cash benefit program of social security, while, of course, not ruling out the possibility that a later Congress might decide in favor of some general revenue financing for part of OASDI also.

4. It eliminates the uneasiness about the adequacy of social security financing, both for the short and the long run.

5. It can be combined readily with a tax cut with all or most of the cut coming from social security taxes.

6. It can be combined with rescinding the 1981 ad hoc increase in the maximum benefit and contribution base in present law.

7. It can be combined with a plan for self-financing the present social security cash benefit program for the full 75 years over which actuarial estimates are made and without exceeding the maximum social security tax rate in present law.

8. The cut in the social security tax rate would be very welcome. It would reduce the cost of doing business and thus the pressure on prices, have a stimulating effect on employment by reducing the cost of labor, and increase the progressivity of Medicare financing.

9. Many who are opposed to the use of general revenues in the cash benefit part of social security are not opposed to financing Medicare, all or in part, from general revenues, particularly if the individual share of the cost continues to be earmarked.

If general economic conditions permit, it would be desirable for the Congress to act on a plan along these lines this year so that it could be effective in January 1981. Early adoption would reassure the country about the continued financial stability of both the social security cash benefit program and the Medicare program.

Should this proposal of the Advisory Council—modified so as to keep the presently charged social security tax rate of 6.13 percent—seem like too major a change to adopt this year all at once, a good step forward would be to finance one-half the hospital insurance program out of general revenues. The rate for hospital insurance for next year could be 0.53 percent on the employee, 0.53 percent on the employer, and an amount from general revenue equivalent to 1.06 of covered payrolls. You would then have a choice on what to do about the cash benefit program. Even without the scheduled rate increases for 1981, there would be 5.6 percent for the cash program—i.e. the present rate of 6.13 minus 0.53—which would provide considerably more income for the cash program than the 1981 scheduled rate of 5.35. Looking at all three funds on a combined basis—OASI, DI, and Hospital Insurance—what this approach does is to substitute general revenue financing for approximately the amount which would be raised by the presently scheduled 1981 social security tax rate increases—0.52 on the employer, and 0.52 on the employee. In general, this plan provides for approximately as strong financing as the plan recommended by the Administration. The issue is then one of whether it is desirable or not to hold off on the scheduled social security contribution rate increases and increase the deficit. The increase in the deficit under this plan for fiscal year 1981 would be about $9 billion.

A variation of this approach would be to have some, but not all, of the social security rate increase go into effect in 1981. It might, for example, be possible to adopt the permanent approach of having one-half of hospital insurance financed out of general revenues, but instead of having a rate of only 5.6 percent for OASDI, have a rate of, say, 5.8, with an overall increase of 0.20 in the contribution rate as compared with the scheduled 0.52.

In any event, sooner or later, there will once again need to be a cut in Federal tax rates. Otherwise inflation, even at rates much more modest than we are currently experiencing, by pushing people into higher income tax brackets would greatly increase the proportion of personal income going to the Federal government. Even those who believe that the Federal tax share should grow would have to agree that at some point a tax cut will be necessary. At that time, it seems to me, it would be desirable to change the method of financing Medicare and to retain the tax on earnings solely for the cash benefit program of social security.

I recognize it is unlikely that the 1981 social security tax increases will be rescinded unless there is support on more general grounds for a 1981 tax cut. In terms of social security policy it would be desirable if such a cut did seem later this year to be in line with overall economic policy. It would be confusing, to say the least, in the kind of long-range program of social insurance that social security is if contribution rates were allowed to go up in 1981 and then shortly thereafter cut back again. If it is desirable to prevent the rates from going higher than those currently being charged, I would hope that you could take the action this year and freeze the rates at present levels.

Senator NELSON. The subcommittee will now stand in recess.

[Thereupon, at 4:30 p.m., the subcommittee recessed, to reconvene subject to the call of the chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

TESTIMONY OF MICHAEL J. BOSKIN, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, AND DIRECTOR, SOCIAL INSURANCE RESEARCH PROGRAM, NATIONAL BUREAU OF ECONOMIC RESEACH

ALTERNATIVE APPROACHES TO SOLVING THE SOCIAL SECURITY CRISES

INTRODUCTION

The Social Security System—perhaps the most popular, and in many ways the most successful, government income security program in the United States—is in serious trouble today. Although it is the major source of retirement income for

millions of Americans, and an important source for millions more, it also imposes the largest part of the tax burden for many American families. While there are substantial short-term problems affecting the funding of Social Security over the next several years, these problems pale before the pending long-term financial crisis facing Social Security. Put simply, when the post-World War II baby boom generation retires early in the next century, the ratio of retirees to workers in our society will increase from one retiree for every three and one-quarter workers to one retiree for every two workers Combined with other economic factors, this creates a long-term funding deficit in the Social Security System (including Medicare) of hundreds of billions of dollars. The chief actuary of the Social Security System estimated in 1978 that early in the next century, Social Security tax rates would have to rise by almost eight percentage points as a fraction of payroll above and beyond the fifteen percentage points they are scheduled to reach later in this century. Such an abrupt increase in taxes, if we maintian the current benefit promises implied by current legislation, would lead not only to a severe disruption of our economy, but to an unprecedented polarization of our society between those paying the taxes to finance such benefits and those receiving them. I believe this would be a crisis of unmitigated proportions. But it need not occur. Sensible advance planning, and concomitant fiscal action, can do much to mitigate unnecessay increases in taxes, rationalize and render more cost effective future benefits, and do much to strengthen the long-run fiscal integrity of the Social Security System. I believe that a combination of two crucial policy reforms will help solve a wide variety of Social Security's problems: its long-term funding crisis; its apparent inequities; and some of its potential adverse effects on the overall economy. This can be done in an environment which guarantees that Social Security will continue to play a vital element in our income security system for the elderly. In the next section I would like to discuss these two policy proposals in more detail, and in the following section I will discuss some other proposals which have been made which I believe are at best only a short-term stopgap solution to the short-run problems of Social Security and at worse, will aggravate Social Security's financial problems.

TOWARD SOLVING SOCIAL SECURITY'S LONG-RUN FINANCIAL PROBLEMS

The old age component of Social Security is intended to achieve two major goals: to replace income lost at retirement and to provide minimujm income support for the aged. The second of these, sometimes called the transfer or welfare goal of the System, aims at providing some socially adequate level of support; the first is an attempt to provide social insurance against the vagaries of macroeconomic fluctuations, imperfections in private insurance markets, and imperfect foresight regarding future income, inflation, life expectancy, health, and the like. These conditions may lead many citizens to undersave for retirement, forcing them on the public as general charges via welfare or other government transfer payment programs. Each of these goals enjoys wide public support, but in attempting to meet both with a single program, the Social Security System is not doing the best job possible in achieving each.

Various studies have shown that as a result of poor planning or unanticipated events, a large proportion of the elderly might find themselves destitute in the absense of the Social Security System. What sort of return can each generation expect from this implicit forced saving program? Since tax contributions by current workers are used to pay benefits to current retirees, with an implicit promise that the next generation of workers will pay taxes to finance retirement years of the current generation of workers, the pay-as-you-go nature of the system prevents the development of a real trust fund and the formation of real capital. If the Social Security tax rate remains constant, as the base upon which taxes are levied grows (because of increases in the working population or in real per capita income due to technological change), retirees will obviously receive much more than they paid in taxes when they are working. The ratio between the total benefits received and the total taxes paid, discounted to the present, can be regarded as an implicit rate of return on Social Security taxes. The tax base will grow at a rate that is the sum of the growth rates of the population and of real wages: about 3–4% on the average over the last half century. However, the annual rate of return earned on investments in private capital has apparently substantially exceeded this return. This has led several critics of Social Security to argue that Social Security is a bad deal for the young. Given the pay-as-you-go nature of the System, we are in a fundamental dilemma: if we decide to shift to a fully funded system, or to some other method of financing the retirement benefits of the elderly, the population working at that time will have to pay twice—once to finance their own retirement and once to take care of the current retirees.

In brief summary, Social Security as a forced saving program has been a mixed success; the benefits are tied only loosely to past earnings, and a variety of changes in the economy make the implicit return lower than could be obtained on alternative investments; but there is evidence that some of the elderly would undersave in its absence, and therefore a forced saving program of some sort is required.

The second goal of Social Security, that of achieving minimum income support for the elderly, has also met with mixed, but greater, success. Social Security benefits account for about one-third of the money income of elderly individuals and families. Many Social Security recipients would be destitute without Social Security. It is not true, however, that the total income of the elderly, as a group, or as individuals, has increased by amounts equal to total, or per capita, Social Security benefits payments. This is because Social Security does not take place in a vacuum, but occurs in a broader context of private intrafamily and intergenerational transfer payments and may merely substitute for some other income sources (for example, continued earnings, private intrafamily transfers of income, and greater private saving for retirement).

Therefore, each of these purposes of Social Security should be continued in a major government program.-However, progress toward improving the cost effectiveness and target effectiveness of the benefit payments is seriously impeded by attempting to combine both goals into a single program. One may decompose any individual's or family's Social Security benefit payment into two components: contributions paid in by the worker and his or her employer, plus interest, on the one hand, and transfer payments from current workers on the other. Current retirees receive back approximately five times on average what they paid in plus interest. This fraction will diminish through time, and by the time we have examined the expected future financial situation for young workers, they can expect to receive back less than they have paid in plus any reasonable rate of interest. It would not be a difficult matter to split Social Security's program in two: into an earned entitlement program and a transfer payment program. We already have substantial elements of both mixed together in our current Social Security System. I would propose separate, but parallel, programs.

First, an earned entitlement program should be based on an actuarially fair computation of lifetime benefits paid in plus interest. In such a forced savings program, it does not make very much sense for different groups in the population to be treated differently. Everyone ought to receive the same rate of return on their total lifetime contributions. This would eliminate all of the problems of inequity based on calculations of different groups in the population receiving different returns on their contributions, for example, working women versus nonworking women; men versus women; etc. This program should be funded out of payroll taxes.

Second, a transfer payment program should be created, along the lines of SSI, but taking all of the current Social Security Program. This transfer payment program should be based exclusively on income adequacy criteria, should be income tested, and should be the sole program for which various claims for benefits aside from an actuarially fair return on the earned entitlements program, should be arbitrated and discussed by the general polity. Among concerns with the current program, for example, are that retired wealthy people may receive substantially more in Social Security benefits than persons who "need" the funds much more; persons with relatively short covered earnings histories who have paid in substantialy less than those with lower wages who paid in over a much longer period, may receive greater benefits, etc. All such inequities would be removed by the dual program proposed here. Everyone would get their actuarially fair return on their earned entitlements based on contributions over their lifetime; and everyone would be treated along general income transfer rules and criteria in the social adequacy, or income transfer, program. I would gradually shift such benefits to general revenues.

In a forthcoming paper, I have estimated the aggregate amount of taxes, benefits, and transfers under a variety of alternative scenarios with respect to productivity, inflation, and retirement patterns. I would like to make two points concerning these intergenerational transfers. First, their aggregate amount is enormous. For persons not currently retired, for the base case assumptions generally used by the Social Security Administration concerning inflation and productivity growth, total transfers to persons not yet retired will amount to almost two trillion discounted 1977 dollars. These transfers obviously are a substantial component of the benefits paid to current retirees who paid much lower tax rates of a much lower tax base during their working lives than current workers are paying. My estimate is that people over 65 have transfers as a percentage of total benefits of almost 87 percent; the corresponding figures for younger workers projected into the future declines to 39 percent for 45-54 year olds, becomes negative to persons under the age of 35, and a

very large negative number for persons under 25. Hence, we really are talking about a major structural change in Social Security which would substantially strengthen the earned entitlement function and provide a much fairer and much more open means of adjudicating claims for income adequacy in the transfer payment component of the System.

The second fundamental reform which is absolutely crucial is to gradually raise the age at which benefits under Social Security may be collected. We continue to view 65 as a "normal" retirement age. In fact, more people collect their first Social Security check at age 62 than at age 65. The labor force participation rate of men over the age of 65 has fallen from about one-half in 1948 to only one-fifth today; a similar, although not quite so severe, decline has occurred for men age 55-64. This explosion in earlier retirement has been partly caused by a variety of features of the Social Security System. A number of studies, including several of my own, have documented this fact. At the same time that retirement at an earlier age is becoming a widespread phenomena, the life expectancy of the elderly has been increasing dramatically since 1960. This increase in life expectancy has been about three years for women and a year and a half for men. Combined with earlier retirement, we have seen a lengthening of the typical retirement period of approximately 30-35 percent. This obviously places greater stress on not only Social Security but private saving and intrafamily intergenerational support patterns in order to provide any given level of income annually for a much longer period of time during retirement.

But much has changed since we adopted such retirement ages. The labor force has gradually shifted out of physically demanding and dangerous jobs (e.g., out of agriculture and heavy industry into light industry and services); the increased life expectancy and improved health of the elderly have been well documented; workers are entering the labor force later; and the long-term financial integrity of Social Security is in doubt. For all of these reasons, and others, I strongly favor a gradual phasing-in of an increased retirement age at which people could collect full Social Security benefits from the current 65 years of age to 68 years of age. I would do so one year per decade for each of the next three decades. To give some idea of how important the length of the retirement period is to the long term financial status of Social Security, and hence its ability to provide any given level of annual resources to the elderly at given tax rates, I have simulated the impact of the proposal to gradually raise retirement age. Such a proposal would not only reduce total benefit payouts by some six hundred billion discounted 1977 dollars (out of a total of four trillion), but would leave Social Security with a very modest surplus under the base case assumptions (a point I will return to in a moment).

The long-term deficit of the Social Security System, as noted above, would require enormous tax increases early in the next century to meet current benefit plans or a substantial reduction in benefits. I believe that an intelligent combination of reducing benefits by paying them for a slightly shorter retirement period, decreasing markedly the necessary tax rate increases, and restructuring the benefits along the lines of the dual program mentioned above in order to help contain benefit costs and provide fair income adequacy, will remove any long-term fiscal problem facing Social Security. I believe it is extremely important to point out how sensitive the long-term fiscal problems of Social Security are to modest changes in the length of the retirement period, changes in the rate of productivity growth. An interrmediate set of assumptions of the SSA usually use an annual productivity growth rate of 1.5 percent. While our recent productivity growth has been substantially below that, indeed has been negative in the very recent past, I do not think such a growth rate is unobtainable with a substantial improvement in our monetary and fiscal policies, reduction in our inflation, and restoration of private incentives to save, invest, and generate new research and technology.

But, I do want to point out that for each one-half of one percent that productivity growth falls short of the projected 1.5 percent total tax collections under Social Security would decrease by about five hundred billion discounted 1977 dollars, whereas total benefit payments would decrease by only about four hundred billion. That is, for each one-half of one percent decline in productivity growth below the 1.5 percent base estimate, the deficit will increase by $100 billion or so in present value terms; and for each one-half of one percent of productivity growth above and beyond the 1.5 percent intermediate estimate, the deficit will decline by a similar amount.

Even more striking, for each year decline in the length of the retirement period over which Social Security benefits are paid, the deficit will decline by about $250 billion. This occurs mostly because benefits decline, being paid over a smaller number of years at the same annual rate, but also slightly because tax revenues will increase a modest amount due to the increased working life.

In brief summary, the long-term financial status of the Social Security System is precarious. If we wait and attempt to provide the benefits currently being planned under the Social Security System, we face the most massive tax increase in the history of the United States, one that is sure to test the fabric of our society, jolt our economy, and wrench our political system. A more sensible course of action would be to gradually raise the age at which full Social Security benefits may be collected, and combine this with a separation of Social Security's two goals into a twin program, each of which could be made fairer and more cost effective in meeting its target.

OTHER CONSIDERATIONS

I would like to take this opportunity to respond to some of the other questions raised in Senator Muskie's letter of February 7, 1980. I would like to make the following points:

(1) I agree with the Administration that there will be an inadequate amount in the OASI Trust Fund by the early 1980s. I also believe that interfund borrowing, or other short-term stopgap measures so long as they do not become a continual attempt to avoid a permanent solution to the problem are desirable while we work out the long-term problems of Social Security. Let me repeat that if the short-term financial status of Social Security is a problem, its long-term financial situation is tantamount to a crisis.

(2) I believe it is important to realize that the scheduled Social Security tax increase for 1981 occurs at the same time as inflation is driving people into higher tax brackets, there will be a huge net revenue gain from the "windfall" profits tax, and substantial gains in revenues due to increased Federal royalties due to energy decontrol. I believe that a substantial fraction of those tax revenues should be returned via general tax cuts, especially designed to promote saving and investment and, hence, productivity and future wages, in our economy. I do not believe that eliminating scheduled Social Security tax increases for 1981 would be preferable to a substantial reduction in these other taxes.

(3) Since the overwhelming bulk of our earnings are already covered by the current ceiling of the Social Security tax, I believe that any substantial gains in revenue must come from tax rate, rather than base, increases. However, I believe that the arguments pertaining to the ceiling in the Social Security tax, having unfavorable effects on the distribution of the tax burden are misplaced. If one examines the taxes paid and benefits received similtaneously, Social Security is overwhelmingly the single most improtant vehicle for redistributing income in our society. I believe that examining any one of its components with respect to its effect on the income distribution misses the entire point of the Social Security System.

I have already addressed some of the key issues in discussing the long range financial soundness of the Social Security program. I believe the separation of the transfer and annuity goals is crucial, but especially we must reexamine the length of the retirement period we deem appropriate in light of changes in our economy and the demographic and household structure of the population, and we need to examine the effects of inflation on the real incomes of the elderly and on real tax burdens and of productivity growth on the future tax base and benefit payments.

(5) I believe the case for extending mandatory Social Security coverage to Federal, state and local government employees is somewhat overstated. Many people have argued for "universal" coverage as a means for solving Social Security's financial problems. Clearly, the only way such a program could benefit Social Security's real problem, the long-term funding crisis, is to bring such employees into the System in an unadvantageous way. They obviously can be expected to resist having that done to them. Perhaps a useful compromise would be to gradually phase out separate treatment of these employees. Better still, adoption of the dual program I have described above, would leave them with their own pension programs as a substitute for the Social Security earned entitlement program and they would be paying taxes in the future to fund the income adequacy program described above.

CONCLUSION

I believe I have outlined a simple and direct approach to solving a large number of the problems plaguing Social Security. Gradually raising the retirement age, combined with separating the dual purposes of Social Security into two programs will do an enormous amount to solve Social Security's long-term funding crisis, apparent inequities, and provide renewed incentives in our economy. I believe this is the only sensible way to strengthen the earned entitlements portion of the program, provide continued substantial incentive for private provision for old age, and pro-

vide a mechnaism for getting Social Security benefits and taxes under control and paid in a more cost effective and equitable manner.

A COMMENTARY ON THE 1979 ADVISORY COUNCIL REPORT ON SOCIAL SECURITY BY A. HAEWORTH ROBERTSON, VICE PRESIDENT, WILLIAM M. MERCER, INC., WASHINGTON, D.C., AND CHIEF ACTUARY, U.S. SOCIAL SECURITY ADMINISTRATION, 1975-78

If there was ever a time when Social Security needed an impartial and fundamental analysis, it is now. Much of the public views the present tax rates as too high, yet if the program is not revised the tax rates will probably double during the working lifetime of today's youth. Social Security benefits are widely perceived as unfair, yet the present generation of youth entering the job market will receive far less value compared with their tax payments than did prior generations. The public is worried about Social Security's present financial condition, yet these problems are insignificant when compared with the potential financial problems of tomorrow. There is widespread misunderstanding about every aspect of Social Security, a condition which must be remedied if we are to achieve a closer fit between the public's expectations and the realities of Social Security.

Accordingly, it is quite appropriate that several groups are studying Social Security from different points of view. The principal study groups include the following:

1. 1979 Advisory Council on Social Security appointed by the Secretary of HEW to study Social Security. The final report was issued December 7, 1979.
2. National Commission on Social Security appointed by the President and the Congress (in accordance with Public Law 95-216) to study Social Security. The final report is due January 10, 1981.
3. President's Commission on Pension Policy appointed by the President to study national pension policy including the role of Social Security. The final report is due February 23, 1981.
4. Universal Coverage Study Group appointed by the Secretary of HEW to study the feasibility and desirability of mandatory coverage of government and nonprofit workers by the Social Security program. The final report is overdue and is expected to be issued approximately June 1980.

The purpose of this commentary is to review the first final report of these study groups, the one released on December 7, 1979 by the 1979 Advisory Council on Social Security. This review is critical, perhaps even harsh. As indicated in the opening paragraph, however, this is a crucial time for Social Security and our expectations for advisory groups should be high. We have a right to an impartial, fundamental, perceptive analysis of Social Security. Unfortunately, this is not what the 1979 Advisory Council on Social Security gave us.

One of the major weaknesses of the Report is that it cannot be taken at face value, but must be read with care and skepticism. This makes it very difficult for the reader—even the most informed—to separate the facts from the propaganda and thus derive any benefit from the Report. Here are a few examples of the equivocation with which the reader must cope throughout the Report.

SECURITY OF BENEFITS

The basic job of the Advisory Council is to identify problems of the Social Security system and propose solutions. The Council has assumed another duty, namely to assure the public that all is well with Social Security. The Council went overboard in this latter role in attempting to assuage the public's growing fears about Social Security.

Page 1 of the Council's Report contains this reassuring statement: "After reviewing the evidence, the council is unanimously convinced that all current and future social security beneficiaries can count on receiving all the benefits to which they are entitled."

Not only does this statement sound good, it is literally true. But the Council failed to point out that Congress can change the benefits to which beneficiaries "are entitled" on a moment's notice. The Council also failed to note at this point two major deliberalizations in benefits which it suggested later in the Report and which vitiate this statement of reassurance:

On page 74: "A majority of the Council recommends that half of social security benefits be included in taxable income for federal income taxes."

On page 177: "A narrow majority of the Council urges that serious consideration be given to enactment now of an increase in the normal retirement age under social security that would be effective at about the turn of the century."

So, what the left hand giveth, the right hand taketh away. Page 1 assures us we will get everything to which we "are entitled" but pages 74 and 177 suggest that our entitlement be reduced. Such duplicity can hardly be expected to engender confidence in the findings and recommendations of the Advisory Council.

Although the Council made no definite recommendations for significant reductions in future benefits (apart from the two effective reductions already mentioned), the Council did suggest that such reductions may be necessary early in the next century. References were made to

"* * * reducing the growth of scheduled benefits."

"* * * benefit reductions as a means for achieving financial balance in the system."

"* * * reduction in the rate of growth of real benefits."

"* * * if these projections are borne out, social security revenues would have to be increased or benefits would have to be cut . . ."

This is surprisingly realistic talk by the Council. Unfortunately these comments are so subtly presented that the average reader will have difficulty in ferreting them out. It is almost as if the Council did not want to be associated with fiscally responsible talk about reducing future benefits.

FINANCING THE PROGRAM

Social Security has financial problems that are relatively minor now but that will become significant in the future. The Advisory Council followed a path that has been used all too often as the high costs of Social Security have become more apparent: First, attempt to hide the cost; if that fails, attempt to minimize the significance of the cost; and if that fails, apologize for the cost.

The Council managed to ignore the long-range future cost of Supplementary Medical Insurance just as it (and the Congress) have done in the past. The Council took one look at the serious financial problems of the Hospital Insurance program and devised a scheme which it apparently believes will enable everyone to ignore its high future costs—and, worse yet, perhaps postpone payment of those costs until a later generation. The Council made a half-hearted attempt to solve the long-range problems of the Old-Age, Survivors, and Disability Insurance programs but postponed the real solutions for another day and another advisory group.

All the while that the Advisory Council was avoiding making any hard decisions about how to handle the high future costs of Social Security, it kept assuring the reader that such high future costs would not materialize or, if they did, they would not really cause any problem. For example, the Council stated:

"* * * the costs of social security will not become an intolerable burden on taxpayers in future years. If the projections turn out to be inaccurate, the costs of the system may turn out to be slightly greater or less than we now think, but the projected costs are unlikely to diverge from the actual (sic) to such an extent that major, unexpected tax increases will be required."

"The scheduled cost . . . in the middle of the twenty-first century could easily be met by a payroll tax rate well below the levels prevailing in many industrialized countries today."

These statements of assurance are grossly misleading. The total cost of Social Security (Old-Age, Survivors, Disability, Hospital and Supplementary Medical Insurance programs) was equivalent to about 13 percent of taxable payroll in 1979. Projections by Social Security's actuaries indicate that this cost will rise to some 26 percent of taxable payroll within 45 years; that is, during the working lifetime of today's new entrants in the work force. This is according to "intermediate" assumptions about future events. As pointed out in the Council's report, future costs "may turn out to be slightly greater or less than we now think" but the Report does not say how much greater or less.

Under more pessimistic, but not unlikely assumptions, the costs could rise to an estimated 36 percent of taxable payroll within 45 years. This is almost three times the present costs of 13 percent of taxable payroll. Even under optimistic assumptions, total costs are projected to rise to about 20 percent of taxable payroll. This is almost 50 percent higher than present costs.

In view of these rising costs, it hardly seems an appropriate time to relax and give the public a false sense of security. It seems more like a time for straightforward, truthful and open discussion.

SPECIFIC RECOMMENDATIONS OF ADVISORY COUNCIL

The following sections consider the specific recommendations made by the Advisory Council. In some cases the recommendation is stated without comment. With

respect to the major recommendations, however, the presentation is divided into three parts as follows:

Recommendation

A brief statement of the recommendation itself, rephrased in some instances so as to be more understandable.

Supplemental information

A statement of facts and figures that help clarify the recommendation as well as the consequences of its adoption. Sometimes this information was taken from other sections of the Council's Report but frequently it had to be obtained from other sources. In some cases this section is omitted.

Commentary

Opinions of the author about the Council's recommendation and/or the method of presenting such recommendations.

This method of considering the findings and recommendations of the Advisory Council is being used to help the reader distinguish between the Council's recommendation and the author's opinion so the reader can more easily form his or her own opinion.

HOSPITAL INSURANCE FINANCING

Recommendation

Finance the Hospital Insurance (HI) program (Part A of Medicare) entirely from earmarked portions of the personal and corporation income taxes, rather than from payroll taxes.

While the Report does not specify the exact nature of the federal income tax financing, it appears to contemplate the use of existing general revenue rather than the imposition of a special additional tax.

Supplemental information

The HI tax rate in 1980 is 1.05 percent for the employee and 1.05 percent for the employer, a total of 2.10 percent of taxable payroll.

Under present law the total tax rate is scheduled to increase to 2.60 percent in 1981, 2.70 percent in 1985, and 2.90 percent in 1986, remaining level thereafter. These tax rates are inadequate and projections indicate that the total tax must rise to about 5.0 percent by the year 2000 and 7.5 percent by the year 2025 when the majority of the children born during the post-World War II baby boom have reached age 65.

Commentary

Since the Council did not propose any change in HI benefits, the total taxes required to support the program are not reduced in any way by shifting from payroll tax to general revenue. On the other hand, the amount of taxes paid by individual taxpayers would change. If general revenue is used, highly paid individuals will pay a larger share of the tax since income tax rates increase with income but the Social Security payroll tax rate is constant (and is zero for income in excess of the maximum taxable amount). Similarly, general revenue financing would reallocate the employer share of Social Security taxes, shifting it toward the more profitable corporations. Furthermore, under the Advisory Council proposal everyone who pays personal income taxes would support Medicare whether or not a recipient of its benefits, and noncorporate employers would not support Medicare even though their employees may benefit from it. It is not clear whether this is what the Council meant when it said the change would "improve the equity of the system."

The Advisory Council's recommendation that the HI program be financed by unscheduled general revenue instead of scheduled payroll tax was momentous (one member described it as a "quantum break with past practices"). In arriving at this recommendation, the Council appears not to have known and considered the possible future cost of the HI program. If the Council was aware of the future cost, it chose not to include such information in its Report and thus alert the public to the onerous burden which lies ahead. (This cost information is contained in the immediately preceding supplemental information section.)

The only clue to the level of general revenue that will be required to finance the HI program is found in footnote 8 on page 40 of the Report. This footnote relates to the personal income taxes needed; a matching amount from corporate income taxes would also be required.

"For example, the amount of revenue needed in 1981 could be raised by a tax of 1.23 percent of taxable personal income up to $27,000 for single individuals and $54,000 for married couples. Alternatively, the revenue could be raised through a

personal income surcharge of 6.7 percent, with a maximum payment of $400 for single individuals and $800 for married couples."

Here is what the Advisory Council said, in part, about the HI program:

"Although it reviewed medicare benefits only briefly, the council spent considerable time in its study of medicare financing . . . Of obvious concern is the status of the hospital insurance trust fund. As indicated in "The 1979 Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund," present projections show that the hospital insurance trust fund is able to pay for services in the short run, but that the trust fund will be depleted by about 1992 under current financing arrangements. Our recommendation to change the way in which the hospital insurance program is financed would resolve this problem."

It is dismaying that the Council would state that the way to resolve the problem of a serious deficiency in scheduled HI payroll taxes is to substitute unscheduled general revenue, that is, "earmarked portions of the personal and corporation income tax." The significance of the "earmarking" procedure is not clear. It does not appear to be intended to ensure the collection of adequate general revenue, but rather to put taxpayers on notice that a portion of their general taxes is used for the HI program. Ideally, the earmarking would ensure that general revenue is in fact collected and that this is not a ruse for deficit financing. There is nothing in the Council's report, however, to suggest that deficit financing cannot be used. In fact, one of the Council members stated "Although I do not object to earmarking taxes for the hospital insurance program, I believe it is mere window dressing."

There is another aspect of this recommendation that is so subtle it may be overlooked. Millions of retired persons who paid HI taxes in the past thought their financial obligation to support the program was discharged; many of them now find, under the Advisory Council recommendation, that they must pay for the HI program again—this time through increased personal income taxes. Alternatively, this may be viewed as a benefit reduction for those having to pay additional personal income taxes to support the HI program.

Please note that it is not the author's view that general revenue financing is inappropriate in all situations. It is simply that the use of general revenue is offensive if it is a ruse for deficit financing or if it is used to camouflage the emerging cost of benefits; and it seems quite clear that this is precisely what is intended based upon the information that is included, as well as not included, in the Report.

SUPPLEMENTARY MEDICAL INSURANCE FINANCING

Recommendation

No recommendation was made by the Council.

The Council's findings on Supplementary Medical Insurance (SMI) were limited to the following commentary:

"The supplementary medical insurance program, part B of medicare, is financed from the general revenues and from premiums paid by participants. Supplementary medical insurance cost estimates are made, and revenues provided, only on a current basis; income and expenditures are not projected for more than two years. The council finds that for fiscal years 1979 and 1980 trust income from part B premiums, along with anticipated appropriations from the general fund, are sufficient to finance total program costs."

Supplemental information

Long-range cost projections have been made by Social Security actuaries for several years now. If these costs are expressed as a percentage of the payroll that is taxable for Hospital Insurance tax purposes (solely to place them in a meaningful frame of reference), they are estimated to increase from 0.90 percent of taxable payroll in 1979 to 2.35 percent within the next 45 years; that is, within the working lifetime of those entering the workforce today. In 1979, 70 percent of this cost was paid from general revenue; within 45 years more than 90 percent will be paid from general revenue.

Commentary

The finding of the Council that everything is satisfactory for fiscal years 1979 and 1980 is little comfort to those who are aware of the steadily rising costs of SMI.

The Advisory Council apparently did not even look into the matter of SMI costs. It did not ask why "income and expenditures are not projected for more than two years." It did not ask what the future costs may be and whether it is reasonable to assume there will be adequate general revenue to pay for this increasingly expensive segment of Social Security.

If the Council thought that general revenue for the HI program should be "earmarked," why did it not recommend that general revenue for the SMI program be similarly "earmarked"?

The public was shocked over the increase in the Social Security payroll tax rate from 6.05 percent in 1978 to 6.13 percent in 1979, as well as the scheduled increase from 6.13 percent to 6.65 percent in 1981; yet the public (and evidently, the Council) are not even vaguely aware of the current SMI cost, much less the substantial increases which will be necessary in future years. It is not a coincidence that this lack of awareness is associated with a program financed principally by general revenue. Furthermore, it is not a coincidence that the Council recommended general revenue financing for the HI program which has experienced runaway cost increases in the past and which is expected to have serious financial problems in the near future. The camouflage of high future costs worked for SMI so why not try it for HI before the program exhibits obvious financial difficulty. If camouflage of HI costs was not the intent, why did the Council fail to indicate the cost of the HI program beyond the year 1981 when the financial problems will become more severe?

TAX RATE FOR OLD-AGE, SURVIVORS, AND DISABILITY INSURANCE

Recommendation

Increase the payroll tax for the Old-Age, Survivors, and Disability Insurance (OASDI) program: from 5.08 percent of 5.60 percent in 1980, and to 7.25 percent in 2005. This would be the tax rate payable by an employee; a matching amount would be paid by employers.

Supplemental information

The following table compares the future tax rates under present law and the Council's recommendation. The last column of the table shows the tax rate that would be necessary to pay benefits if there were no significant trust fund (the figures were derived from Table 1, page 33 of the Council's Report).

OASDI TAX RATE

[Employer and employee each]

Calendar year	In percent: Present law	Council recommendation	Required for projected expenditures
1979	5.08	5.08	5.18
1980	5.08	5.60	5.28
1981	5.35	5.60	5.20
1985	5.70	5.60	5.25
1990	6.20	5.60	5.35
2005	6.20	7.25	5.42
2020	6.20	7.25	7.15
2035	6.20	7.25	8.29

The Council did not comment specifically on the tax rate for self-employed persons; presumably it would follow the present law and be one and one-half times the tax rate for employees.

Commentary

It is not immediately obvious from the description in the Council's Report that it is proposing a tax rate increase for the OASDI program. After outlining all of their financing proposals for the OASDI and HI programs, the Council states:

"The combined effect of these recommendations would be a significant reduction in the social security taxes scheduled to be paid in the next few years . . . the total tax rate for employers and employees (each) could be set at 5.6 percent. Under present law, the rate for OASDI is scheduled to be 6.13 percent in 1980 and 6.65 percent in 1981."

While this statement is literally true, it fails to mention that general revenue will be required in addition to the payroll tax, and the total taxes will be higher under the proposed financing plan. The Report does not state how much higher the total taxes would be, but it appears they would be about 4 percent to 5 percent higher during the next three years (assuming that no deficit financing is used).

The first increase in the tax rate recommended by the Council for OASDI (from 5.08 percent to 5.60 percent in 1980) is to reflect adverse economic conditions expected in the near term. Even so, full recognition is not given to the anticipated economic picture during the next few years and it is likely that still further increases will be required in the near term. The Council commented on this subject as follows:

"The council recognizes that the future direction of the economy is uncertain at the time this report is being prepared. If, at the time the Congress is considering action, economic projections are less favorable than those in the 1979 trustees' report, the appropriate OASDI tax rate may be somewhat higher than 5.6 percent."

The second increase (from 5.60 percent to 7.25 percent in the year 2005) is apparently to recognize the anticipated increase in the retired population which will begin at about that time. Children of the post-World War II baby boom will begin reaching age 60 in the year 2006, and this will result in a larger ratio of retired to active workers.

The Council, in proposing this arbitrary and rather abrupt increase in taxes in a single year, does not appear to have been trying to solve Social Security's financing problems. Instead, the Council appears to have been trying to assuage the public with a little mathematical manipulation—by proposing a tax increase which the Council does not believe would be implemented but which will enable the Council to state that everyone can relax since future income and outgo are in balance. The Council's statements on this subject are as follows:

"The council also recommends that the social security cash benefit programs be brought into long-run actuarial balance by scheduling a payroll tax rate of 7.25 percent in the year 2005 and thereafter. Scheduling this rate would remove any basis for questioning the financial soundness of social security and show that the program can be financed for the foreseeable future without an undue burden on payroll taxpayers."

"There are two reasons, however, that this rate increase would probably not go into effect in precisely this form. First, the 7.25 percent rate is a level rate designed to balance the system over the 50-year period from 2005 to 2055. The rate necessary to finance the system on a current-cost basis would be less than 7.25 percent early in that period and more than 7.25 percent later on. Second, the social security system could equally well be brought into balance when the time comes through other means, such as the use of general revenues or reductions in the rate of growth of real benefits."

It is a rather glib statement that a tax rate increase from 5.6 percent to 7.25 percent in one year does not impose "an undue burden on payroll taxpayers." A tax rate of 7.25 percent is almost 30 percent higher than a tax rate of 5.6 percent. It is an increase of 1.65 percent of taxable payroll for the employee and an increase of 1.65 percent for the employer. For self-employed persons it is an increase of 2.48 percent of taxable payroll.

Based on recent experience with more modest increases, such a large tax increase would be out of the question in one year and would be exceedingly difficult to absorb over a period of less than ten years or so. The mode of thinking the past few years has been that taxes cannot be increased when the nation is entering a recession, recovering from a recession, or during an election year. The advancement of such an absurd proposal by the Council creates real doubt about the Council's intent to resolve the long-range financing problems.

The Council mentioned two reasons the tax rate increase would probably not go into effect. It failed to mention a more important reason: The possibility that later retirement ages will be implemented by that time.

It seems clear that the payroll tax will not be permitted to exceed the amount required to meet expenditures except by small amounts. This means that the payroll tax must increase steadily from about 5.4 percent to 8.3 percent during the 30-year period from 2005 to 2035. This is a relative increase of 54 percent in the tax rate and cannot be described accurately as not being "an undue burden on payroll taxpayers." It is equally misleading to say the increase will probably not be necessary because general revenues will be introduced. General revenues are also taxes. It is also misleading to say the increase will probably not be necessary because benefits will be reduced. Benefits will probably not be reduced; but if they are, the tax rate relative to the benefits paid will be increased just as much as if benefits were not changed and tax rates were increased.

As indicated earlier in this review, the entire Council Report is rife with statements designed to hide the future cost, or minimize its significance, or apologize for it.

EARNINGS BASE REDUCTION

Recommendation

Repeal the ad hoc increases in the earnings base scheduled for 1980 and 1981. After 1979, increase the earnings base only to reflect increases in the level of average wages.

Supplemental information

Following is a comparison of the maximum earnings base under present law and the Council's recommendation as contained in the Report.

EARNINGS BASE

Calendar year	Present law	Council recommendation
1979	$22,900	$22,900
1980	25,900	24,900
1981	29,700	27,000
1982	32,100	29,100

Commentary

The 1979 earnings base results in about 87 percent of aggregate covered earnings being subject to tax. The Council recommendation would retain this relationship, while the present law would result in 89 percent of aggregate covered earnings being subject to tax in 1981 and later. On this point the Report states:

"Raising the earnings base for employees beyond this level (87 percent) will cause an undesirable intrusion into areas better left to private saving and pensions."

This statement sounds reasonable until one reflects upon it and asks if coverage of 89 percent of aggregate earnings would be an undesirable intrusion, is not 87 percent also such an intrusion?

TRUST FUND STABILITY

Recommendation

Make payments to the trust funds from general revenues during periods of high unemployment if trust fund balances are less than 60 percent of annual outlays.

Authorize the trust funds to borrow from the general fund if reserves fall below 25 percent of annual outlays (with various provisions for repayment).

Combine the Old-Age and Survivors' Insurance trust fund with the Disability Insurance trust fund to permit revenue transfers between the two programs.

Supplemental information

The role of the trust fund is frequently misunderstood by the public. The trust fund is not a guaranty fund; rather, it is a contingency fund to accommodate temporary differences in income and outgo. Each of the four major parts of Social Security has its own trust fund; hence, when one of the trust funds runs low it is a warning the taxes should be increased or benefits should be decreased.

Commentary

These recommendations make no substantive improvements and do nothing but give the public a false sense of security about the financial soundness of Social Security. The recommendations, taken together, remind one of the proverbial shell game—shuffling funds from one place to another, transferring nonexistent funds to cover losses elsewhere.

There is no money in the general fund since the nation is usually operating at a deficit. This would almost certainly be the case in adverse economic times when the recommended shuffling provisions would be called into play. How, then, can money be transferred from the general fund either as a loan or a gift? The answer is, it cannot; the transfer merely represents an increase in the national debt. In other words, the recommendation is that if Social Security trust funds run low the nation can just boorow some money and then give it or loan it to the trust fund. Such transactions are only cosmetic and of no substance. They simply increase the national debt which mut be paid by future generations; interest is payable, of

course, until the debt is paid. Interest on the national debt now comprises 9 percent of the federal budget. The earlier analogy to a shell game was probably unfair to the shell game, since it has a real pea under one of the shells.

The consolidation of trust funds is equally ill-advised. There were good reasons to establish separate trust funds in the first place and those reasons still exist.

The Council noted that the present procedure requires Congress to legislate increases or decreases in the payroll tax rate and that "this procedure is cumbersome and can cause needless public worry about the financial integrity of the social security system." Some observers believe that it is quite appropriate for Congress to be required to take specific action and for the public to know about it when tax rates prove to be inadequate. In fact, this is one of the dangers of using general revenue: no one knows that costs are getting out of hand, no one does anything, deficit spending results, and inflation is aggravated—all this on the pretext of avoiding "needless public worry about the financial integrity of the social security system."

TAXATION OF BENEFITS

Recommendation

Include half of all social security benefits in income of a couple or of an individual that is subject to federal income taxes.

Supplemental information

Presumably this recommendation applies only to cash benefits paid under the OASDI program and not to benefits paid under the Medicare program. This may not be clear to the reader who pays Social Security taxes (contributions), a portion of which is used to finance the Hospital Insurance program (Part A of Medicare).

Commentary

The Council makes the proposed taxation of benefits sound almost innocuous: "* * * almost no persons or couples over age 65 today would pay any additional income tax under the council's proposal if social security were their only source of income."

"If the couple's only income (in 1979) were from social security, its benefits would have to exceed $14,800 before any tax would be payable. This is an amount higher than any couple retiring at age 65 in 1979 can receive."

On a later page, however, a Council statement makes it apparent that at least a few persons would pay added taxes and thus have their benefits effectively reduced.

"Estimates based on 1978 data indicate that . . . taxing half of the benefits would affect 10.6 million tax filing units (those with the highest taxable incomes) of the 24.2 million who received social security cash benefits. The average tax increase for those tax units with an increase would be about $350, and the total increase in federal tax collections would be $3.7 billion."

The effect of the recommendation is to reduce Social Security benefits for the more highly paid and for persons with other sources of income after retirement, whether it be supplemental pension income or income from private saving and investment. Viewed alternatively, the recommendation shifts more of the cost of Social Security to those participants with larger retirement incomes. Unfortunately the Report neither highlights nor analyzes this redistributive effect of the recommendation.

It is not clear when the Council recommendation would go into effect. At least one Council member wanted it to be introduced gradually. To do otherwise would clearly be to take away benefits which had been promised. Some Council members were opposed to taxing benefits, others thought that 83 percent (not 50 percent) of the benefits should be taxed.

It seems totally inappropriate to tax arbitrarily one half of Social Security benefits and attempt to justify it by some flimsy rationale. Instead, it would be preferable for the Council to define its objectives and then accomplish them directly. If the objective is to reduce benefits for the more highly paid, the benefit formula should be revised accordingly. If the objective is to shift the tax burden toward the more highly paid—active as well as retired—the method of assessing taxes should be revised.

INCREASE NORMAL RETIREMENT AGE

Recommendation

No recommendation was made to increase the normal retirement age; however, a narrow majority of the council believed serious consideration should be given to enacting in the near future an increase in the normal retirement age to become effective after the turn of the century.

An example of the kind of change that the majority believed deserves consideration is a gradual increase in the normal retirement age from 65 to 68 during the period from 2003 to 2021.

Supplemental information

Advocates of raising the normal retirement age have generally been concerned about the consequences of presently projected trends, particularly increases in life expectancy and the continuation of present low fertility rates. These trends imply that the cost of retirement and survivor benefits will rise sharply early in the twenty-first century if the normal retirement age is not increased. The cost of Medicare will increase similarly unless the eligibility age is raised.

The ratio of persons aged 65 and over to persons aged 20 to 64 is currently 0.19; that is, there are about 5 people aged 20 to 64 for every person aged 65 and over. Under the "intermediate" assumptions used by the Trustees, this ratio is projected to be about 0.35 by the middle of the next century; that is, about 3 people aged 20 to 64 for every person aged 65 and over. Under more pessimistic assumptions used by the Trustees, this ratio will be 2 to 1; even under the optimistic assumptions it will be 4 to 1. There is no doubt that the proportion of aged in the population is going to increase, it is only a question of how much.

Commentary

A change in the retirement age is neither desirable nor necessary until early in the next century—some 25 years hence. But at that time it is absolutely necessary if substantially higher taxes are not to be imposed (assuming, of course, that benefits remain at the same relative levels).

The persons who would be affected by such a change comprise the 57 percent of the population born after World War II, persons now less than age 34. If these persons are going to have to retire later than today's retiring generation—and they are—they should be told now, not later.

Some Council members made this obvious observation, but others maintained we should wait "until jobs for older workers are more abundant and until the health of older persons has improved." By that time, the post-World War II generation will be so close to "normal retirement age" that it will be too late to make a change. Besides, if health improves over current levels the retirement age will need to be increased even further.

It is rather disappointing that more Council members were not willing to advocate a higher normal retirement age to become effective 20 to 30 years from now. The Council may have given a higher priority to this change if only it had paid more attention to the projected cost of Medicare (both HI and SMI) in the next century.

EXEMPT EARNINGS

Recommendation

Increase the amount of exempt earnings for those under age 65 to the same level as for those aged 65 and older.

Supplemental information

Social Security was originally intended to replace a portion of any reduction in earned income. This provision has been quite unpopular and over the years has been amended to permit beneficiaries to have larger and larger amounts of earnings which are exempt for purposes of determining whether Social Security benefits will be payable. The 1977 Amendments to Social Security increased the "exempt earnings" amount for persons aged 65 and over, but not those under age 65.

Commentary

The Council "found little justification for the continued application of an earnings test to those younger than 65 different from that applied to those older than 65" and observed that "having two different tests for two different age groups further complicates both its presentation to the public and its administration by SSA." Accordingly, the Council recommended liberalizing the earnings test for those under age 65 (instead of restricting it for those age 65 and older).

This is a classic example of "incrementalism" in operation.

The recommended increase in the exempt earnings amount has an effect (achieves an objective?) the Council did not comment upon. It results in a shift of benefits toward the lower wage earners. This is because the increased exempt earnings amount results in larger benefits payable to lower wage earners who continue to work but does not result in larger benefits payable to higher wage earners who continue to work. The net result of this is to promulgate an effective retirement age

among those who continue to work after age 62 which is lower for the lower wage earners than it is for the higher wage earners.

REVISE BENEFIT FORMULA

Recommendation

Alter the social security benefit formula so that workers with a long history of low wages will receive a benefit sufficient to keep their incomes above poverty thresholds and so that high wage workers will be assured a benefit that provides a more generous return on taxes they pay than they receive under current law.

Supplemental information

Table 4 on page 70 of the Report compares the benefits under present law and the proposed formula for a worker retiring at age 65 in 1982. As the following extract from the table indicates, benefits are increased for low wage earners, reduced or maintained for middle wage earners, and increased for high wage earners.

Percentage benefit increase of proposed over present formula

Average indexed monthly earnings:	
$265 [1]	19
$400	18
$459 [2]	9
$600	5
$800	2
$847 [3]	1
$918	0
$1,000	-1
$1,085	-2
$1,155	0
$1,200	1
$1,258 [4]	3
$1,400	6
$1,600	10
$1,800	14

[1] A worker with an AIME below this level is unlikely to have been a long-term worker. An AIME of $265 would result from working 35 years at 60 percent of the Federal minimum wage or 30 years at 70 percent of the Federal minimum wage. The poverty line for a single aged person in 1982 is projected to be about $347.

[2] AIME of career Federal minimum wage earner at age 65 in 1982.

[3] AIME of career average earner age 65 in 1982.

[4] AIME of career maximum earner age 65 in 1982.

Commentary

The percentages increase in benefits appears to be more in favor of the lower paid worker than the higher paid worker, the Council's rhetoric notwithstanding. The maximum increase for a high wage earner retiring in 1982 is 3 percent. The higher percentage of 6 percent, 10 percent, and 14 percent apply to persons retiring many years after 1982 with higher average earnings. But in the future, half the benefits would be taxable and this effective reduction in benefits would apply only to persons with above average wages. The Council did not comment upon this, but an anaylsis of the net effect of the recommendations to tax benefits and revise the benefit formula would almost certainly indicate a shift of benefits toward the lower wage earners, i.e., a further downward redistribution of income.

The Council Report did not discuss whether or not this shift was desirable or even intentional. In fact, the shift was not acknowledged and the language of the Report may have led a casual reader to conclude the shift was in favor of the higher wage earners.

WOMEN'S BENEFITS

Recommendation

Begin to update the way in which women are treated under social security to take account of the massive increase in female labor force participation and in divorce since the present structure of social security was developed in 1935 and 1939.

Specifically, the Council recommends that persons divorced after at least 10 years of marriage receive retirement benefits based on shared earnings and that aged widows and widowers receive survivors benefits based on their own earnings plus the earnings of their deceased spouse.

Supplemental information

The Council decided that a plan to compute benefits for husbands and wives on the basis of half the couple's combined earnings for the years of marriage represented "the most promising approach" to the concerns of homemakers, working women, divorced women, and widows. Nevertheless, the Council majority was not willing to recommend implementation of a full-scale earnings sharing system because of the need for fuller debate and broader understanding and because some benefits would be less than they would be under the current law. In particular, the Council noted that under the recommended change:

"Divorced women generally would receive higher retirement benefits and divorced men lower benefits on the basis of their shared earnings than they would receive under present law."

Commentary

The Council is reported to have devoted more time to these issues than any other, an indication of the importance placed on the isues as well as the difficulties in resolving them.

The women's issue is often misunderstood. Social Security does not discriminate against women. In commenting on this the Council stated:

"The social security law is largely sex-blind. With few exceptions (which the Administration and the council recommend be eliminated), benefits are not paid on the basis of sex, but rather on the basis of labor force attachment and family status. The council also notes that as a group, women get as good a return on the social security taxes they pay as do men. Indeed, if separate systems are established for men and women, women workers would have to pay social security taxes that are about 9 percent higher than men would pay. Because the average wages of women are lower than men's, a greater portion of their wages is replaced by benefits because of the weighting in the formula for low-income workers. Also, because women tend to live longer, they collect more benefits than men. These two factors outweigh the fact that more dependents' benefits are paid on the basis of men's wage records than are paid on the basis of women's wage records."

Nonetheless, when viewed from a broader perspective Social Security does not uniformly meet the needs of women. Social Security was first designed in an era when women played a different role in the social and economic structure than they do now. Today, approximately one-half of married women are in the paid work force. It should be no surprise, therefore, that Social Security does not appropriately meet the needs of women occupying these two completely different roles.

The Advisory Council was well-advised not to recommend implementation of a full-scale earnings sharing system until its implications are better understood. On the other hand, the introduction of some earnings sharing seems to assume that full-scale earnings sharing will someday be appropriate. This is not necessarily true and other options are available, including the "double-decker plan" which the Council considered and rejected. Such a plan was described by the Council as one under which each aged and disabled person and surviving child would receive a flat grant paid from general revenues, with an additional benefit—directly proportional to past covered earnings—paid to social security contributors, but not to their dependents or survivors.

The Advisory Council would have been well-advised to consider more fundamental changes in Social Security as we try to anticipate and meet the emerging needs of the work force during the twenty-first century. Gradual changes in the existing system may not be adequate, particularly when we have been so slow to begin adapting the system thus far.

MANDATORY COVERAGE OF GOVERNMENT AND NONPROFIT WORKERS

Recommendation

Extend social security coverage to federal employees either through mandatory coverage for new hires or through a transfer of credit plan. Extend social security coverage to newly hired state and local employees and newly hired employees of nonproft organizations.

Until such time as all workers are covered by Social Security, the Council recommended several interim steps, including the following:

"All current and future agreements implementing coverage for state and local workers be made irrevocable." (If this is not adopted, terminations should only be permitted after a vote of affected employees.)

Supplemental information

The Social Security Act originally exluded all state and local government employees from Social Security coverage because of the question of whether the federal government could legally tax these employers. Workers for certain nonprofit organizations that are traditionally exempt from taxes were excluded. Employment with the federal government was originally excluded because of the existence of the civil service retirement system, established in 1920.

Legislation enacted in 1950 (and later) provided that employees of state and local governments and nonprofit organizations could be covered by Social Security on a voluntary basis under certain conditions. Approximately 75 percent of the 13 million state and local employees, and 90 percent of the 4 million employees of nonprofit organizations are now covered by Social Security.

Commentary

Based upon the present design of Social Security, there should be no optional participation: everone should participate in both the payment of its taxes and the receipt of its benefits, direct and indirect. If it is desired that participation be optional, one of the following types of change should be made:

The Social Security program should be redesigned so that the benefits paid to each group of workers are approximately equivalent to the taxes paid by such group, or

The provisions regarding optional participation should be revised so that a group of workers electing first to participate and then to opt out would receive benefits more closely related to the taxes paid during their period of participation in Social Security.

Unless one of these basic changes is made, there can be no satisfactory basis for optional participation. On the other hand, compulsory participation of all federal, state, and local government employees and employees of non-profit organizations does not appear likely in the near future because of the strong opposition to mandatory participation by most of the government employees not now participating, as well as legal questions as to the constitutionality of mandatory participation of state and local government employees. Accordingly, the debate over this issue can be expected to become more and more heated and confused and acrimonious. This issue cannot be resolved to the mutual satisfaction of everyone involved.

For some reason, the Council did not address the question of the constitutionality of mandating coverage for state and local government employees (although it was mentioned as a historical reason for the exclusion of such employees). It was surprising that the Council could so easily recommend that existing agreements between the states and the federal government be changed unilaterally so as to be irrevocable. It was clearly a mistake to give a group that elects to enter Social Security the right to later withdraw. But it seems rather harsh, if not illegal, to abrogate such an agreement once it has been consummated.

In a supplementary statement three Council members had this to say about the Council's recommendation:

The Universal Coverage Study Group which was appointed by the Secretary of HEW for the precise purpose of providing the essential information without which responsible recommendations cannot be made has not yet completed its report. . . . We find it very difficult to understand why the council felt called upon to make a recommendation for mandatory coverage without having the essential information or being able to assess the impact of its recommendations."

DISABILITY BENEFITS

Recommendation

The Council made four recommendations which would increase the cost:

Liberalize the definition of disability for older workers by applying to people aged 55 through 59 the same criteria that are now applicable to people aged 60 through 64.

Reduce the waiting period for disability benefits from five months to three months.

Allow disabled persons to perform more work without losing their disability benefits—as a means of encouraging them to return to work.

Provide benefits for disabled spouses of disabled or retired workers, and increase benefits for disabled widows and widowers.

The recommendations which would decrease the cost:

Impose a limit on family disability benefits "no more stringent than a maximum of 90 percent of the workers highest five consecutive years of wage-indexed earnings."

Perform a stepped-up review of the continuing eligibility of disability beneficiaries who have impairments that may improve.

Commentary

The net effect of these recommendations is an increase of about 7 percent in the benefits and in the cost of the Disability Insurance program. It is remarkable that the Council would recommend such a liberalization at a time of general concern about the rising cost of Social Security, and in the face of proposals being considered by Congress and the Administration to reduce the cost of the Disability Insurance program.

PRIVATE PENSIONS

Recommendation

Although the basic job of the Council was to study Social Security, it made some observations on private pensions which should be noted.

The social security programs are but one part of a complex set of public and private approaches to income maintenance. Support is available from four basic sources when earnings stop: social security based on past earnings; savings, insurance, annuities, and other voluntary personal arrangements; private pensions; and public programs based on current need. The Council believes that the social security program must always be viewed in the context of these other important elements of the income maintenance system. For that reason, the council also recommends that serious consideration be given to improving the private pension system. It is particularly concerned about the problems of adequacy of coverage under private plans, the portability of pension rights, the updating of pension credits from prior employment, and the updating of pension benefits to take account of inflation after retirement."

Commentary

These observations by the Council should be pondered They may be intended as a warning that if these improvements are not made in the private pension system, some kind of governmental action will be taken: further expansion of social security, perhaps, or extended regulation of private pensions.

There is obviously an interrelationship between social security and the private pension system, as well as the other sources of income maintenance. It seems gratuitous, however, for the Council to have made these allegations—almost threatening warnings—about the private pension system without considering the detrimental effect on the normal development of private pensions being exerted by Social Security; federal governmental laws, rules, regulations and attitudes; government-spawned inflation; and numerous related factors The interrelationship of all these factors deserves careful study (and other groups are supposedly making such studies), and it could be considered unwarranted for the Advisory Council to scratch the surface of these issues by a facile "throw-away section" inserted in the final chapter of their report.

MISCELLANEOUS RECOMMENDATIONS

The Council reported miscellaneous other findings and recommendations covering a broad range of subjects. For example, the Council:

Opposed most of the cost-saving proposals made by the Administration in January 1979 for the Old-Age and Survivors' Insurance program.

Recommended semiannual cost-of-living increases during periods of high inflation.

Rejected the use of a valued-added tax to finance Social Security.

Recommended that workers be allowed to drop one year from the averaging period for each six years elapsing between age 22 and the age of eligibility for benefits.

Recommending that the value of food stamps be paid in cash and that total benefits for Supplemental Security Income (SSI) recipients be increased to the poverty line. Recommended that the value of household goods and personal effects, including the value of automobiles, be disregarded in determining SSI eligibility.

Recommended that the ceiling on the lump-sum death payment be increased from $255 to $500.

Considered but did not recommend a proposal for a one-time 10-percent benefit increase, over and above cost-of-living increases, at age 85.

Recommended that employers be required to pay employer social security taxes on the full amount of tips received by their employees.

Commentary

This is not an all inclusive list of items considered by the Council. Some of the Council's recommedations dealt with relatively insignificant matters which would have been better left to lesser study groups—particularly since the Council noted a lack of time to study adequately some of the larger problems.

There is no evidence that the Council devoted much time to studying the use of a value-added tax yet in a single paragraph the Council dismissed its use as totally inappropriate. A more complete study of this issue, or its avoidance altogether, would have seemed more appropriate.

It seems inappropriate to comment on each of the relatively minor recommendations, just as it seems inappropriate for them to have been considered by the Council in the first place. The situation is somehow reminiscent of the fabled navigator of the Titanic who spent his time rearranging the deck chairs instead of heeding the icebergs.

CONCLUDING COMMENTARY

The 1979 Advisory Council Report contains valuable information for anyone interested in Social Security. The findings and recommendations are frequently couched in obscure language, however, since the Report is essentially a compromise of various viewpoints. To avoid being misled, one must be very selective in drawing information from the recommendations, footnotes, and supplementary statements (sometimes clarifying and sometimes dissenting) made by individual members of the Council. In particular, it would be ill-advised for Social Security to be revised solely as a result of recommendations contained in a Report that in no way represents the last word on how to perfect the Social Security program. In some cases the Council members were divided in their viewpoints, in some cases there was not adequate time to study the subjects thoroughly, and for some, if not most, of the questions considered there is not an obviously right or wrong answer.

Although the Council perceived restiveness among the public about various aspects of Social Security, it did not take this uneasiness seriously enough. Instead of facing up to the rising costs of Social Security and promising mitigating changes, the Council recommended a further expansion of the program at increased costs—and then tried to devise ways to camouflage those costs even more than they are now. In the face of a public mood for closer correlation between taxes paid and benefits received, the Council actually moved further away from this principle of "more fairness", but all the while paying lip service to it.

In spite of the public uneasiness about rising taxes (of all kinds), the Council still seemed preoccupied with expanding the benefits and meeting the needs of the unfortunate. Equal recognition should be given to the taxpayer who makes all these benefits possible. The needs of 35 million persons receiving benefits must be considered, but so should the needs of 110 million persons paying Social Security taxes. It is unfair, and unrealistic, to assume that these active working taxpayers will continue to pay unquestioningly for an ever-expanding level of benefits that inactive persons (and planners) believe they need or are entitled to.

People do not have an inalienable right to retire in their early sixties and be supported by those who are still working. We should constantly remind ourselves that before one dollar can be paid in benefits to a person not working, it must first be earned and paid in taxes by a person who is working. And we must remember that under a long-range system of pension benefits where promises are made now to pay benefits as much as 75 years in the future, it is entirely possible to promise more than can be delivered.

It appears that rational solutions to the problems of Social Security are not going to be developed until there is a louder public outcry for reform. If you have an interest in the insolvency of Social Security, the soundness of the nation's economy, and the long-term well-being of America's citizens, you should review the recommendations of the 1979 Advisory Council and begin to participate in the debate. Social Security will move ahead with or without your participation. Its direction of movement will be improved by an investment of your time and effort.

STATEMENT BY MERTON C. BERNSTEIN, COLES PROFESSOR OF LAW, WASHINGTON UNIVERSITY

SOCIAL SECURITY: AMERICA'S BEST BET

Given the utter unreliability of pension plans and the scarcity of private savings, public policy should recognize that Social Security constitutes the principal source of retirement income for the bulk of the American public. The alleged "crisis" in

Social Security derives from a misdiagnosis of the ratios of workers to nonworkers both in the short run and in the long run. Social Security is and will remain the most dependable retirement income maintenance system in the United States.

I. INTRODUCTION—THE STRENGTHS OF SOCIAL SECURITY AND THE WEAKNESSES OF OTHER PROGRAMS SUMMARIZED

A rational, efficient and fair retirement income policy must take account of the many programs that have evolved with little attention to their interrelationship.

For the bulk of the population, the principal question concerns the appropriate mix of Social Security (SS) and private pensions. This memorandum argues that greater reliance should be placed upon Social Security than private (and state and local government) pensions because of the latter's spotty coverage, the gamble they constitute for the bulk of nominal participants, the susceptibility of their reserves to misuse, and—not least—the inability of pension designers to come up with a feasible plan to index benefits to inflation.

For very substantial segments of the population (whose precise dimensions are not known) multiple plan eligibility provides benefits from Social Security, Railroad Retirement, private plans, Civil Service Retirement, state and local retirement program, and military retirement benefits. Indeed, for career military and state and local police and firemen, multiple eligibility is practically assured. In addition, many of these latter progams abuse disability retirement provisions to enhance benefits. As a result, many such programs are severely underfunded. Ironically in their efforts to maximize benefits, the non-participation of some state and local officials in the SS system denies revenue to the federal program. Yet, if state and local programs cannot honor their obligations—as may well occur—cries will go up for a federal government rescue operation. (The Railroad Retirement System grew from the ashes of the bankrupt railroad private pension plans in the mid-thirties.)

Moreover, the non-SS programs are notably weak in benefits for spouses and children who survive the employee both before and after retirement age and are not indexed at all or only partially.

The present unrationalized welter of plans produces multiple benefits to the canny and the lucky while those with but single program coverage tend to receive benefits that fall short of assuring against a serious drop in their living standards.

In contrast, the Social Security system covers the bulk of the population (and could and should cover all working people—except, perhaps, for Congress), provides substantial protection to spouses and other survivors both before and after retirement, has proven immune to abuse of its reserve funds, its outcomes are predictable, and the federal government (and apparently it alone) can assure indexed benefits. In sum, Social Security is reliable in every way that private (and state and local government plans), are unreliable. This presentation deals with the alleged infirmities of Social Security and argues that the asserted crisis in Social Security in bogus.

II. THE INCURABLE DEFECTS OF PRIVATE PENSION PLANS

Private pension plans are seriously deficient in that:

(1) Private pension plans cover no more than half the private work force; no one has a plan to spread coverage without compulsion; no source exists from which to pay for compulsory coverage;

(2) Most private plan participants have absolutely nothing to say about plan design; about half are under plans in non-unionized firms, so that employers decide the crucial plan elements; in bargained plans, unions participate or even dominate—their institutional interests favor high apparent benefits, which require difficult eligibility standards; unions favor long term employees who remain members in preference to employees who are separated and become ex-members;

(3) Only a minority of plan members achieve pension eligibility; only a portion of working life results in effective pension credits; hence even for the lucky minority, benefits are surprisingly small and—not least—unpredictable;

(4) Pension arrangements favor owner-stockholders, managers, and higher pay personnel who tend to have longevity on the job and who most influence plan design; present arrangements discriminate against women and minorities who tend to work in low-pay uncovered jobs; women are more concentrated in part-time work, where achieving pension eligibility is still more difficult; women and minorities tend to have shorter job tenure and so less chance to qualify for vesting, which usually requires 10 years service under one plan;

(5) Most private plans provide no assured protection for spouse survivors; divorced spouses usually have no protection; only a few community property states require that spouses share benefits creditable to years of marriage; ERISA did not make

any substantial improvement in this realm despite the fact that the oldest and poorest of the old are—and will continue to be—women;

(6) Even those who achieve vested credits only to be separated from the pension-covered job find that inflation erodes the value of the benefit even before retirement;

(7) No systematic method exists for indexing private plan benefits; the federal labor law does not require employers to bargain about changes in benefits for those already retired;

(8) According to Congressional Budget office estimates, private plans result in an annual tax expenditure of $15 billion. (This amount surely must be growing rapidly with the heavy advertising for Individual Retirement Accounts, whose advent was a major reason for small firms to abandon or not start group employee pension plans.) In my judgment, such a public subsidy for so discriminatory and undependable a system is not warranted and should be reduced—better, phased out. That would provide $15 billion annually toward meeting the needs of the Social Security system;

(9) Large amounts of pension funds continue to be misused; the burdensome and expensive reporting requirements of ERISA cannot stem such misuse;

(10) The Pension Benefits Guarantee Corporation device has proven more expensive than predicted; guaranteed amounts are dangerously large and impose a burden on soundly financed plans—or at least large ones. It seems unlikely that it will prove possible to extend reliable guarantee protection to those under multiemployer plans although such legislation seems slated for enactment by Congress.

III. THE ARGUMENTS AGAINST COMPULSORY "TWO TIER" COVERAGE

Proposals to require employers to provide a second tier of private arrangements to augment Social Security undoubtedly have appeal. However, four major reasons counsel against such a course:

(1) No source exists for the vast sums required to find plans to cover half the private work force—present reserves of present plans for the half with plan coverage stand at roughly $250 billion; existing plans were the easiest to install; the remaining half lack coverage because of the difficulties of providing coverage;

(2) Their benefits take too long to realize and adjust to changing conditions;

(3) Private plans cannot be indexed;

(4) Private plans cost more to install and administer (involving promotional costs and commissions of sellers, substantial charges by lawyers, actuaries, accountants, and investment counselors, and commissions and fees for trustees) than Social Security, whose non-benefit costs are in the 2-3 percent range.

By the time a two-tier system came off the drawing board it would be a three-tier system. The second tier would be a modest compulsory supplement and the third tier would contain all the uncertainties and unfairness of present private plants.

Perhaps—just perhaps—a reasonable two tier system could have been installed in the 1950's or 1960's. In the mid-1960's, I certainly thought a voluntary second tier was desirable. But current circumstances make such an enterprise impossible. The proposal has all the charm of nostalgia, a yearning for the good old days when insurance company shares quintupled in value within a decade, the heady days when Xerox shares (I intend no sarcasm, just a sober assessment) floated new fortunes. No one foresees a repeat of those marvelous days that launched and expanded pension plans of seemingly unlimited promise. (If the Commission ignores this excellent advice, I urge its study of the proposals of the Social and Economic Policy Commission (SER) a tripartite official advisory body in the Netherlands. Its excellent proposals for a mandatory second tier has not been implemented and is not under serious consideration because, all sectors agree, the Dutch economy, which seems more prosperous than ours, can discover no means of financing the second tier.)

IV. THE FALSE ASSUMPTIONS UNDERLYING THE ALLEGED SOCIAL SECURITY FINANCING "CRISIS"

A. Questionable population assumptions

Concern over the long range solvency of Social Security derives from the reasoning that currently the ratio of the actively working population to the aged dependent population is approximately 3:1; in contrast, by the second decade of the next century it will be roughly 2:1. These relationships derive from the age distribution of the current population. Several commentators say that that distribution is a known factor which cannot be changed.

But that basic assumption is quite wrong: the ratio can be readily changed by immigration.[1] Moreover, the significant ratio is between the working population and all dependents—and currently the ratio of dependents to working population is greater than it will be during the next 50 years!

(1) Immigration's potential

Oddly, the forecast of rising dependency completely ignores the history of the United States; it completely ignores our population potential. In fact, the United States in 2010 can have almost any population and age distribution that it desires: by immigration. If, in fact, our concern is too few working age people to contribute payroll taxes, we can solve that problem whenever we want in whatever numbers we want. Mexican immigration, almost single handedly, could do the job. We could draw any given number of people of whatever ages we specify with whatever skills we desire from just about any area of the globe. The lure of American freedom and opportunity remain undiminished. Given the rates of political and economic progress throughout most of the world, the United States probably will remain a magnet with incomparable pulling power.

Recent experience teaches that we draw immigrants of great talent and energy. The Hungarians, the Cubans, and the Vietnamese have impressive records of adjustment and economic activity despite the tremendous problems of language and culture that confront any transplanted people. Reportedly illegal Mexican entrants are at work within two weeks of their arrival in the United States. That's why they come—to work. What little information we have indicates that they go to work in large scale agriculture, light manufacturing and service occupations—all covered by Social Security.

We know, too, that immigrants willingly take some jobs shunned by Americans already on the scene—a phenomenon already notable in Western Europe. Proposals to regularize Mexican immigration, with appropriate priority for the domestic unemployed, might alleviate anxiety about displacing domestic population seeking work. But, looking ahead, if indeed we have a working population shortage in the next century as projected, we can alleviate it by immigration. If the problem that underlies concern over the future solvency of Social Security is a shrinking working age population, that problem is readily solved—relax immigration barriers. And, if that is indeed a pressing problem, current objections based on apprehension of unemployment will disappear. Let us hope that past discriminations based upon geographical origin will have disappeared entirely. If we need young Asians to support older Americans, the odds are that even bigots will see them in a new and favorable light.

It may be instructive that in a recent year for which data exist immigrants in the prime work years, 16-44, constituted 60 percent (59.3 percent) of all immigrants; 27.7 percent were under 16; only 13 percent were 45 or older.[2]

(2) Current dependency rates less favorable than those projected—contrary to the popular impression

The proper ratio to measure the ability of our economy (rather than a particular program) to support non-working persons is to compare all working persons to all non-working persons. (The terms dependent/non-dependent appall me. When we are too young to work, we train to work—we are the future supporters. When we no longer work, we are the former providers. Just about all so-called dependents should be recognized as persons who will or have supported their fellows. Their current claim upon society's productivity thereby should not be regarded as inferior to that of current producers. And all of us who are current producers must recognize that our future claims upon society's production rests upon the precedents we create.)

Roughly speaking, persons in non-producing age groups currently exceed non-producers now and will do so for the next 50 years!

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[1] I am indebted to a former colleague, Prof. Howard P. Fink of the Ohio State University law faculty, for this insight.

[2] 1974 Statistical Abstract of the United States 100 (Table No. 158) data for the year 1979.

POTENTIAL DEPENDENT POPULATION AS A PERCENT OF THE POTENTIAL WORKING POPULATION

[100 = equal numbers of dependent and nondependent]

	Aged dependency[1] times 100	Total dependence[2] times 100
Actual:		
1930	9.1	67.8
1940	10.9	59.7
1950	13.4	64.4
1960	16.8	81.6
1970	17.5	78.0

	Series II	Series III	Series II	Series III
Projections:				
1980	18.4	18.4	64.3	63.2
1990	20.0	20.0	63.5	58.7
2000	19.9	20.2	53.2	56.5
2010	20.2	21.2	59.4	52.8
2020	26.0	28.6	67.2	60.5
2030	31.8	37.6	73.8	70.3
2040	30.6	39.0	71.8	71.5

[1] Population 65 yrs and over divided by population 18 to 64 years.
[2] Population 65 yrs and over and 0 to 17 divided by population 18 to 64.

Source: Bureau of Census, "Current Population Reports," Series P-25, No 704, July 1977 (President's Commission on Pension Policy "Demographic Shifts and Projections The Implications for Pension Systems" p 28 (1979).)

As the Commission's working paper summarizes the foregoing table: "When both the young and the old are counted as dependents, the net effect of the shifts in both of their populations tends to be small. But the highest level of total dependency in the 1960's and 1970's will not be reached again in the foreseeable future. Ibid, p. 29.

Money income to support a young person generally is less than that required by a retired person. But, when the costs of educating and training the young are added—the largest non-defense, non-transfer cost of our society—the dollar difference pretty much disappears.

Currently our economy supports a larger total dependent population than we face over the next four decades. However, the population age distribution does have special significance for the financing arrangements of particular systems. If the dependent young become a much smaller portion of the population—as projected—much of society's wealth now directed to their education and training—roughly $100 billion annually in the mid-1970's—can be redirected to the retired population without producing net tax burdens to the producing sector of society.

3. *Productivity—the key factor*

But the key factor to the future of Social Security financing is productivity. Obviously today the entire nation has an unprecentedly high level of real income despite the steadily smaller number of hours most people work as compared with the 1930's and 1940's and, for growing numbers of people, longer delays in entering the labor market due to greater educational demands and efforts.

S.S. benefits (and payroll taxes) increased painlessly until the creditable wage base was dramatically changed upward in the 1970's. (Then upper middle class taxpayers, aware of a new and substantial bite out of pay checks—clearly registered on pay check forms, began to howl. Many do not realize the very substantial benefits SS provides and that the higher base increases benefits.)

Past increases derived from drastically increased productivity—whose rate of improvement forecasters repeatedly underestimated. Obviously, these increased living standards came from the fabulous growth in GNP during the 1940's, 1950's and 1960's and—yes—the 1970's. Obviously, the person-hours worked do not alone determine the real wealth produced; the more important variable is productivity—the amount of real wealth produced per work hour. At present, the productivity

outlook is not encouraging due to the shocking increases in the price of oil and oil derivatives, including plastics. Some economists, including Milton Friedman, say that this factor may have been overemphasized. And it remains uncertain how safe nuclear energy will be (it also seems to be more costly than predicted) and the extent to which solar energy (including wind and biomass) will help meet our needs.

This situation provides a strong additional argument for pressing more vigorously than currently the exploration and development of solar potential. Before resigning ourselves to a lowered standard of living, we should press harder in research and development so that flagging industries may once again flourish.

Moreover, we are at the threshhold of the exploitation of sea bed wealth which cannot help but amplify our productive potential. In terms of dollars alone, a portion of this untapped and uncommitted wealth could be earmarked for Social Security. However, many SS supporters resist earmarked taxes. Whether sea bed extraction tax revenues go into general revenues or directly into SS hardly matters; what counts is that the nation has in prospect a new, additional, uncommitteed and vast source of real wealth.

B. The falsity of the crisis

In order for the "crisis" in Social Security financing to ripen into a dread reality, three or four decades from now, all of the following must take place:

The nation rejects augmented immigration although it would solve the gas imbalance.

Our heretofore amazingly inventive, innovative and vast scientific-engineering-technical community fails to break through our present energy limitations

The shrinkage in the 30-55 age population does not produce more and attractive work opportunities for older people thereby reducing the burdens upon Social Security

The seabed fails to produce its anticipated wealth

Such a combination of disappointing developments, made explicit, seems quite unlikely. Thus, it seems to me utterly premature to conclude that energy limitations consign us to a lower standard of living three decades from now.

C. If the choice is forced, the majority may choose ample retirement benefits.

But should the worst seem imminent, if the nation faces reduction in per capita resources, it does not follow that the majority would opt to reduce Social Security benefits, raise normal retirement age, or a combination of such measures. The growing proportion of older citizens would not endorse such a decision. And the remainder of the voting population should be confronted with the choices to be made. Many of the younger people would opt for not reducing benefits for their parents and grandparents, for not reducing their own prospective benefits. Opting for such choices does involve a present sacrifice (if productivity improvement foresakes us); but that sacrifice for the currently employed would constitute a smaller proportionate reduction in income than the reduction in Social Security would constitute for the elderly.

Politicians do not relish dealing in such stark choices. But the President's Commission on Pension Policy and the President's Commission on Social Security can and should make clear the choices to be made and their costs. Then, perhaps, the politicians will take up the debate after others bring the bad tidings.

A majority might very well prefer small present sacrifices to avoid more hurtful reductions for their elders and themselves when they become elderly.

V. CHANGES IN RETIREMENT AGE—A PLEA FOR INDUCEMENT RATHER THAN COMPULSION

Of course, retirement age constitutes a major variable. In my 30's I staunchly advocate flexible retirement and opposed compulsory retirement. (See Chapter 8 of my book, The Future of Private Pensions, Free Press: 1964) I remain of that view. But at age 57 I am a bit more aware of the tendency of older equipment to break down or wear out. (Older members of the Commission, people of unusual energy and toughness, should not use their own work potential to judge the potential of others.)

While I applaud the amendment of the Age Discrimination in Employment Act to prohibit compulsory retirement prior to age 70, I think we must sharply distinguish the needs of the bulk of the population under Social Security from those of the lucky minority with good health and skills in current demand. The hearings chaired by Representative Pepper, himself a prodigy, presented a parade of people of towering talent and energy. Putting them on the shelf constitutes terrible waste. But we should not be misled—the population at large does not consist of an endless stream of Casals, Horowitzs, Leinsdorfs, and Rubinsteins. Rather, these are our geniuses;

strength and energy constitute a major part of their special endowment. Perhaps, also, they show that continued work and recognition contribute to continued vigor.

But we cannot blink at the fact that more than half of those retiring under Social Security do so before age 65. Indeed, 60.7 percent of retired workers in 1978 received reduced benefits due to retirement before age 65. In 1972, 50.3 percent were in that category.[3] Indeed, 70 percent of awards "moving to payment status in 1978", (68 percent of the awards to men and 73 percent of the awards to women) were for reduced benefits (Ibid, Table Q-6).

Earlier studies showed that a great majority of "early retirees" ascribe their decision to poor health and a substantial portion had been unemployed. The proposition that benefits lure people from the active work force lacks persuasive power; it seems highly unlikely that actuarially reduced benefits averaging $239.97 would have that effect. (Those on unreduced benefits averaged only $299 in late 1978.) Bear in mind that unlike those 65 and over, pre-65 retirees are not eligible for SSI.

Rapid technological change also means that substantial numbers do not possess marketable skills. And "Manpower" programs (that description has yet to be de-sexed) concentrate on younger persons. Some specialists explain this, in part, because the longer period of payout for updating skills of the young makes for a better cost/benefit relationship. And, I have no doubt that bias plays a part.

A. Raising retirement age—a newly proposed inducement

Undoubtedly both Social Security and private pensions would have more manageable burdens if more people began receipt of benefits later rather than earlier. Inducements to do so seem desirable—but the methods chosen should not impose burdens on those who cannot respond affirmatively. Raising normal retirement age would reduce the benefits of retirees even more than the current reduction (20% for those retiring at age 62) does. Yet, many—very possibly a majority of retirees—cannot continue work until age 65, let alone some higher age. For them, a normal retirement age about 65 would constitute a deprivation; and they could not respond to the inducement.

But inducements for those who could respond should be tried. I propose favorable tax treatment for those who work beyond age 65 consisting of Social Security benefits if they had retired. The general fisc may be no worse off than if such people did retire, in that a like amount would not be taxable. Indeed, the fisc might be better off to the extent of their other taxable earned income. (Not everyone who retires is replaced.) The Social Security fund would be decidedly better off for not having to pay their cash benefits. This device has the effect of a partial general revenue supplementation without actually tapping general revenues. However, general revenues would decline because of the non-taxation of income earned by those who would work and earn without the inducement. In any event, this device seems preferable to a relaxation in the retirement test. Indeed, it might be put to work as a partial substitute for past relaxations of the test. Such a move warrants exploration.

B. Augmenting training

The government should attempt to determine what training programs and other devices might enable more people to work beyond the ages at which so many now retire with the aim of raising the average above age 65. Perhaps we can shift average retirement age upward. It is surely worth a try in the interests of not only reducing the burden on the Social Security program and private pensions, but also the living standards, dignity, and health of many people with the potential.

The current shift to more use of human labor as a response to high priced energy may supply additional opportunities. However, those concerned with the employment problems of younger people must be reassured that expanded opportunities for those 65 and over do not come out of jobs that otherwise would go to younger workers. (Perhaps these incentives should be triggered on and off according to rates of unemployment—as with supplementary employment insurance benefits.)

At least one factor should reassure them: avoiding higher payroll taxes should improve employment opportunities.

VI. 20 AND OUT; 25 AND OUT; 30 AND OUT ABUSES OF DISABILITY IN THE ARMED SERVICES AND PROTECTION SERVICES

The armed services and state and local protective services (police, fire, state patrol) originated the policy of 20-and-out at half pay on the theory that such jobs required a high state of physical fitness that soldiers, police and firemen no longer possessed after 20 years in such work. These assumptions must be reassessed,

[3] 42 Social Security Bulletin, 76, Table Q-3, June 1979.

especially in view of the high cost of such benefits, the common pattern of full time employment most such retirees pursue—often as civilians with their former service, the greater longevity enjoyed by the populace at large, and possibly reduced physical requirements of such jobs.

Moreover, such "retirees" are able to obtain current and full insurance status under Social Security and benefit eligibility under another public or private retirement system—although retirement at half pay greatly exceeds the benefits payable to many, possibly most, other retirees.

Even worse, many of these programs abuse provisions for disability, which frequently pays even more substantial benefits and still carries favorable tax treatment, despite "repeal" of such tax exemption several years ago. A few years ago the Senate Subcommittee on Government Efficiency documented widespread abuses in police and fire pensions. When I served on the Ohio Advisory Commission on Pensions, the chief executive officer of the statewide police and fire pension fund confided that the disability route was gravely abused there. And who can forget the New York fireman retired for "disability" who won a race to the top of the Empire State Building?

Protective services retirement benefits, which can run as high as 80 percent of former salary for the "disabled", do not seem justifiable. Moreover, no way exists to maintain such funds on an actuarially sound basis. Actual disability retirements often grossly exceed any rate forecast and on a totally erratic basis. Hence, the future ability of many police, fire, and state highway patrol pension funds to make good on their pension promises seems highly questionable.

Little wonder that the GAO reports that many state and local government retirement programs lack adequate funding. Yet their ability to meet ERISA-like funding standards, the GAO reports, is questionable.[4] Averting disastrous consequences in that sector could be advanced by making Social Security coverage universal. With the reduction in importance of state and local plans, Social Security benefits might well be improved.

The desirability and feasibility of early, early retirement in other public employee programs and private plans also require critical analysis. Such provisions improve heavy costs on the retirement programs and raise the cost of the goods and sources involved. In a time of hard choices among desirable alternatives, these special early retirement provisions appear less justifiable than in the past.

VII. QUESTIONABLE FEDERAL AUTHORITY TO SET STATE AND LOCAL GOVERNMENT PENSION STANDARDS/BUT SOCIAL SECURITY COVERAGE READILY REQUIRED

Since the Supreme Court's decision striking down minimum wage standards for state and local government employees in National League of Cities v. Usery, 426 U.S. 833 (1976), many question the authority of Congress to impose ERISA-like standards on state and local governments.[5] So that avenue of reform seems open to serious question. Some raise similar questions in regard to requiring state and local governments to provide Social Security coverage for their employees. I think this latter problem is more readily solved and the constitutional questioned avoided: continue to leave state and local government participation optional but change the law to require all wage and salary earners not so covered to participate themselves, possibly using the kind of earnings tax paid by the self-employed or even requiring such employees to pay the equivalent of the employer and employee payroll tax. It would not take long for all governmental units to be pressed by their employees, and for such employees to vote, for Social Security coverage.

VIII. THE SPECIAL CASES OF MEDICARE AND DISABILITY INSURANCE—A PROPOSAL TO TAX HEALTH-INJURIOUS ACTIVITIES TO CONTRIBUTE

While the contributory principle seems desirable here, exclusive financing by employees and employers alone seems highly questionable.

Nothing in our legal system or social insurance arrangements requires three major health impairing activities to make any contribution to the treatment of those affected. Cigarettes, (and other tobacco materials), alcohol (beer, wine and liquor) and air and water pollution all cause illness and tend to shorten life. None of these activities makes any contribution to the people affected or to the institutions (private and public) that bear the costs of treating the diseases and providing income to their victims and their survivors. Estimates of these costs have been

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[4] Comptroller General Report to the Congress, "Funding of State and Local Government Pension Plans: A National Problem" (1979)

[5] See for example the discussion in Comptroller General's Report to the Congress, "Funding of State and Local Government Pension Plans: A National Problem" 30-32 (1979).

made, but they are quite approximate; they run to the billions of dollars every year. Fairly recently a method of estimating the health damage of some air pollutants has been devised. That suggests that somewhat more accurate estimates can be made for other health-impairing activities.

A federal health cost tax on cigarettes, cigars, pipe tobacco, beer, wine and liquor and polluting activities would have several salutary effects. It would for the first time require those activities to pay for some of the damage they cause. In effect, users of such products would be paying additional health care taxes more in line with the risks they run and to which they subject others, e.g. by smoking and by driving under the influence.

The cost of health damage should be regarded as a proper market cost of the activity, just as other activities which directly and identifiably inflict harm must insure to pay damages to the individual victims (for example, casualty insurance carried by trucking firms). In a free market economy, such costs should be registered in prices so that less health-imparing alternatives that have lower costs may be chosen. In additions, by imposing a price disadvantage, the health-impairing activities have an incentive to reduce the damage they cause—if the reduction registers in reduced taxes, as they should. Reduced consumption of cigarettes and alcohol would produce both less health damage and less revenue, while the reverse would be true; hence the activity and damage would move in tandem.

I have long advocated such a course. DOL and HEW reportedly are considering such an approach to occupational disease, now so inefficiently covered under workers' compensation. Senator Danforth and Representative Gehpardt introduced bills in the last session along these lines for tobacco and alcohol.

The funds generated should be plugged into Medicare, Medicaid, Social Security Disability, and the Social Security fund to help pay survivor allowances.

IX. PRIVATE PENSIONS AID CAPITAL FORMATION—AN UNPROVEN CLAIM

A major justification for continued governmental support of private pensions has been that they aid capital formation. Such advocates point to the massive (estimated) reserves of private plans (often including state and local retirement program reserves) and point out that plans hold enormous amounts in stocks and bonds. They assume that lesser amounts would flow into private investment were pension funds not in existence and growing.

The Commission's working paper, "Private Pensions and Capital Formation", summarizing the studies of very talented economists, concludes that we have no clear evidence that private plans do increase savings. Rather, considerable evidence points just the other way—that private plans reduce savings. The current paucity of private savings tends to buttress that view.

(Moreover, one of the two primary studies, that by George Katona, used a biased population—members of the Consumers Union, a group not at all typical of the population at large; by definition, they are worriers who put a high priority on security. If anyone has a propensity to save, CU members would. In addition, the period studied (1958-59)—one of rapidly increasing real income and fabulous returns on investment—could not help but stimulate enthusiasm for savings.)

Indeed, the form of pension investments (stocks, bonds, even mortgages) and, even more, the methods by which pension fund managers invest (buying outstanding securities rather than acquiring original issues) suggests that very little, if any, of such funds, find their way into venture capital.

X. THE PUBLIC LACKS ADEQUATE INFORMATION ABOUT SOCIAL SECURITY PROTECTION AND BENEFITS

Judging from newspaper and magazine articles and innumerable ocnversations with well-educated persons, it seems fair to say that public understanding of Social Security is inadequate. Recently the Social Security Administration announced plans to increase its informational activities.

The President's Commission on Pension Policy and the President's Commission on Social Security have the visibility to explain and assess Social Security's indispensable role and importance. I urge them to do so in addition to discussing the problem areas. If only the latter receive mention, the larger points of the unique contributions of the Social Security system and its inherent soundness may be obscured—again.

XI. CONCLUSION—SOCIAL SECURITY IS OUR BEST BET

The proper goal of national retirement policy should be the maintenance of pre-retirement living standards for the bulk of the population. Very few now achieve that standard.

Personal savings contribute little beyond (for some) a home (which may or may not be mortgage free, which may or may not fit a retired couple or individual, which may or may not be maintainable by older people).

Private pensions and state and local government programs are unreliable; they are weakest where Social Security needs supplementation—support for survivors. Their tax advantages are unfair to the non-covered. Indeed, their tax advantages are unfair to the non-covered. Indeed, their tax advantages are unfair to participants who never achieve benefits and participants, because of "integration" favoring the high paid, derive disproportionality small benefits.

Social Security is in place. Its basic design is sound and fair (but we must solve the problems of divorced women, working couples and quite elderly survivors.) Social Security's financial difficulties have been gravely overstated. Society can readily manage future burdens of a different age distribution which, for the next 30 years, presents no larger ratio of employed to the not actively employed than that which exists today. If and when an imbalance does develop, it can be readily offset by augmenting immigration.

Social Security is America's best bet. Other retirement systems are hazardous gambles. We ought to put our money on Social Security.

SUPPLEMENT TO STATEMENT OF MERTON C. BERNSTEIN

THE LITANY OF LOST JOBS—AND PENSION EXPECTATIONS

Plant shutdowns—plan failures

At this date, no one needs to tell or be told that plants, warehouses, stores, even bank and insurance branches shut down stranding employees short of retirement. The litany of plant closing never ends. Even the bastion of American industry—the steel industry—is not immune; far from it. Automobile plants shut down and are replaced, if at all, in distant places, sometimes overseas.

These shutdowns often mean large numbers of employees without any vested pension credits. For example, in the military aircraft and missile industry pension coverage is heavy. But weapons last but a few years and the plants that produce them often shut down within five years of starting up. One does not have to be Norbert Weiner to conclude that under such circumstances almost no employees will qualify for vesting under the common 10 year vesting plans.

And those with vested credits will harvest benefits possibly decades later when they have been eroded by inflation even before payment begins.

Plan failures did not stop with Studebaker. The Pension Benefit Guaranty Corporation certainly helps in such circumstances. But its guarantee does not cover full losses. I think all agree that the PBGC could not bear up under a Chrysler-type shut down. And most with whom I talk feel that effective coverage for multi-employer plans cannot be achieved.

New jobs, one expert observer reports, occur largely in small and young firms—which also die young and do not last long enough to provide vesting.

Just listen to the findings of an MIT study:

To foster job-generation efficiently, there must be understanding of how jobs are created. To this end, the program on neighborhood and regional change, at the Massachusetts Institute of Technology, assembled a sample of 5.6 million business establishments and examined how each one contributed to job growth. This study has uncovered some fascinating things about the job-generation process.

First, there is tremendous turnover in our system. We lose almost half of our job base every five years through businesses folding or contracting. But we make up for those losses by an even greater generation of new replacement jobs. Although many of these jobs will themselves vanish before long, the gains more than outweigh the losses each year.

If the nation is to encourage job replacement, it must understand who does it. Job-creating firms tend to have distinct characteristics. For one thing, they are more likely to be small. Almost two-thirds of the net new jobs generated between 1969 and 1976 in our sample were generated by firms with 20 or fewer employees. Job-generating establishments tend to be young. About 80 percent of all replacement jobs are generated by establishments four years old or younger.

Finally, job generators tend to be in the trade and service sectors, not in manufacturing. Of the 6.7 million jobs generated by firms in our sample during the 1969-76 period, five million of them were in trade or service while manufacturers produced virtually none. (David L. Birch, "Creating Jobs: Think Small", The New York Times, December 3, 1979, page A25.)

In sum, new jobs provide a poor base for private pensions.