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1994 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS

COMMUNICATION

FROM

THE BOARD OF TRUSTEES, FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS

TRANSMITTING

THE 1994 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND THE FEDERAL DISABILITY INSURANCE TRUST FUNDS, PURSUANT TO SECTION 201(c)(2) OF THE SOCIAL SECURITY ACT, AS AMENDED

APRIL 12, 1994.—Referred to the Committee on Ways and Means and ordered to be printed

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LETTER OF TRANSMITTAL

BOARD OF TRUSTEES OF THE
FEDERAL OLD-AGE AND SURVIVORS INSURANCE
AND DISABILITY INSURANCE TRUST FUNDS,
Washington, D.C., April 11, 1994

HONORABLE Thomas S. Foley
Speaker of the House of Representatives
Washington, D.C.

HONORABLE Albert Gore, Jr.
President of the Senate
Washington, D.C.

GENTLEMEN: We have the honor of transmitting to you the 1994 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund (the 54th such report), in compliance with section 201(c)(2) of the Social Security Act.

Respectfully,

Lloyd M. Bentsen, *Secretary of the Treasury, and Managing Trustee of the Trust Funds.*

Robert B. Reich, *Secretary of Labor, and Trustee.*

Donna E. Shalala, *Secretary of Health and Human Services, and Trustee.*

Stanford G. Ross, *Trustee.*

David M. Walker, *Trustee.*

Shirley S. Chater, *Commissioner of Social Security, and Secretary, Board of Trustees.*

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I. OVERVIEW

A. INTRODUCTION

The Old-Age, Survivors, and Disability Insurance (OASDI) program in the United States provides protection against the loss of earnings due to retirement, death, or disability. The OASDI program consists of two separate parts which pay monthly benefits to workers and their families. Under the Old-Age and Survivors Insurance (OASI) program, monthly benefits are paid to retired workers and their families, and to survivors of deceased workers. Under the Disability Insurance (DI) program, monthly benefits are paid to disabled workers and their families.

Under the Social Security Act, a Board of Trustees is established to oversee the financial operations of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. The Board is composed of five members, three of whom serve automatically by virtue of their positions in the Federal Government: the Secretary of the Treasury, who is the Managing Trustee, the Secretary of Labor, and the Secretary of Health and Human Services. The other two members are appointed by the President and confirmed by the Senate to serve as public representatives: Stanford G. Ross and David M. Walker are currently serving 4-year terms that began on October 2, 1990.

The Social Security Act requires that the Board, among other duties, report annually to the Congress on the financial and actuarial status of the OASI and DI Trust Funds. This annual report, for 1994, is the 54th such report.

B. HIGHLIGHTS

The more important developments since the 1993 Annual Report was issued are shown below:

- During calendar year 1993, OASDI benefits amounting to $302.4 billion were paid to retired and disabled workers and their families, and to survivors of deceased workers.

- The number of persons receiving monthly OASDI benefits at the end of December 1993 was 42.2 million.

- In 1993, an estimated 135 million people worked in jobs covered by the OASDI program and paid OASDI contributions on their earnings.

- Income to the combined OASI and DI Trust Funds amounted to $355.6 billion in calendar year 1993, and expenditures were $308.8 billion. The assets of the combined funds, therefore, increased by $46.8 billion, from $331.5 billion at the end of December 1992 to $378.3 billion at the end of December 1993.

- Assets at the beginning of the year, as a percentage of expenditures during the year, increased from 107 percent at the beginning of 1993 to an estimated 116 percent at the beginning of 1994, for the combined OASI and DI Trust Funds.

- Interest earnings on the invested assets of the combined OASI and DI Trust Funds were $27.9 billion in calendar year 1993. This represented an effective annual interest rate of 8.3 percent, earned by the combined assets during calendar year 1993. During the same period, the average interest rate on new securities purchased by the trust funds was 6.1 percent.

- Administrative expenses for the OASDI program were $3.0 billion in calendar year 1993, or about 1.0 percent of benefit payments in the year.

- An automatic benefit increase of 2.6 percent, reflecting the lowest rate of increase in the cost of living since 1986, became effective for December 1993. The OASDI contribution and benefit base was increased from $57,600 for 1993, to $60,600 for 1994.

The major findings of this report are summarized below:

- In the short range, the assets of the OASI and DI Trust Funds, if combined, would be expected to increase from the current level of $378.3 billion, or 116 percent of annual expenditures, to $1,048 billion, or 197 percent of annual expenditures, at the beginning of the year 2003. This expected growth is based on assumed economic and demographic changes that are considered to be the most likely to occur and that are described later in this report as "intermediate" assumptions. However, the OASI and DI programs are financed by separate contribution rates specified in the law. As a result, separate estimates are required for each trust fund.

- The OASI Trust Fund is expected to increase rapidly during the next 10 years, from 129 percent of annual expenditures at the beginning of 1994 to about 259 percent of annual expenditures at the beginning of the year 2003, based on the intermediate assumptions.

- The assets of the DI Trust Fund are expected to decline steadily from $9.0 billion at the end of 1993 until the fund is exhausted in 1995, unless corrective legislation is enacted promptly to strengthen the financing of the DI program. As noted elsewhere in this report, the Board of Trustees is again recommending a reallocation of contribution rates between the OASI and DI Trust Funds to remedy the expected financial shortfall in the DI Trust Fund.

- In the long range, income and expenditures are generally expressed as a percentage of the total amount of earnings subject to taxation under the OASDI program (referred to as "taxable payroll"). Summarized income and cost rates over the 75-year long-range period are determined through present-value calculations and by taking into account actual beginning fund balances and targeted ending fund balances (or reserves) of 100 percent of annual expenditures.

  Overall, for the period 1994-2068, the difference between the summarized income and cost rates for the OASDI program is a deficit of 2.13 percent of taxable payroll based on the intermediate assumptions. This is a substantial increase over the estimated deficit of 1.46 percent of taxable payroll shown in the 1993 Annual Report for the period 1993-2067, based on the intermediate assumptions. The increase in the deficit is attributable to a number of factors, including an increase in the estimated level of future average benefits, a decrease in the assumed ultimate level of average real-wage gains in the future, an increase in the assumed ultimate levels of disability incidence rates, and the change in the 75-year projection period to include the relatively large annual deficit for the year 2068.

- On a combined basis, the OASDI program is not in close actuarial balance over the next 75 years. In addition, the individual OASI and DI Trust Funds are not in close actuarial balance. These results are the same as those shown in the 1993 Annual Report.

- Income from OASDI payroll taxes represents 12.4 percent of taxable payroll—made up of the 6.2 percent tax rate paid by employees and a matching amount paid by their employers. (Self-employed workers pay OASDI taxes at the combined employee-employer rate.) Since these tax rates are not scheduled to change in the future under present law, OASDI payroll tax income as a percentage of taxable payroll remains constant at 12.4 percent.

  Before 1994, up to one-half of a beneficiary's OASDI benefits were subject to Federal income taxation, for beneficiaries above certain fixed income thresholds. Beginning with benefits paid in 1994, up to 85 percent may be subject to taxation. The income tax revenues that result from taxing up to one-half of the benefits are transferred to the OASI and DI Trust Funds and are currently equivalent to about 0.2 percent of taxable payroll. (The additional revenues resulting from taxing more than one-half of OASDI benefits are transferred to the Hospital Insurance (HI) Trust Fund.) Adding the OASDI income from the taxation of benefits to the income from payroll taxes yields a total "income rate" of 12.6 percent. This rate is estimated to increase gradually to 13.3 percent of taxable payroll by the end of the 75-year projection period based on the intermediate assumptions. The growth is attributable, in part, to increasing proportions in both the number of beneficiaries and the amount of their benefits subject to taxation in the future. These proportions will increase because the income thresholds, above which benefits are taxable, are not indexed to future increases in average prices or average income.

- OASDI expenditures for benefit payments and administrative expenses currently represent about 11.6 percent of taxable payroll. This "cost rate" is estimated to remain below the corresponding income rate for the next 19 years, based on the intermediate assumptions. With the retirement of the "babyboom" generation starting in about 2010, OASDI costs will increase rapidly relative to the taxable earnings of workers. By the end of the 75-year projection period, the OASDI cost rate is estimated to reach 18.9 percent under the intermediate assumptions, resulting in an annual deficit of about 5.6 percent.

- Under the intermediate assumptions, the excess of OASDI tax revenues over expenditures for the next 19 years, together with interest earnings on the trust funds, will result in a rapid accumulation of assets for the combined OASI and DI Trust Funds during this period. However, total income is estimated to fall short of expenditures beginning in 2019 and continuing thereafter, under the intermediate assumptions. In this circumstance, trust fund assets would be redeemed to cover the difference. The assets of the combined OASI and DI Trust Funds are estimated to be depleted under present law in 2029 based on the intermediate assumptions.

  The assets of the trust funds are generally invested in special securities of the U.S. Treasury. The initial accumulation of assets will result in a substantial cash flow from the trust funds to the general fund of the Treasury, and the amount of special securities held by the combined trust funds will increase. The subsequent redemption of securities will cause this cash flow to reverse. The magnitude and pattern of these cash flows have important public policy and economic implications that extend beyond the operation of the OASDI program itself.

- Because the OASDI program is not in close actuarial balance, the long-range deficits of both the OASI and DI Trust Funds should be addressed. It is recommended that the Advisory Council on Social Security conduct an extensive review of Social Security financing issues and develop recommendations for restoring the long-range actuarial balance of the OASDI program.

C. TRUST FUND FINANCIAL OPERATIONS

The various sources of income to the OASDI program, and categories of expenditures, can be illustrated by reference to the actual transactions during calendar year 1993. The following table summarizes these transactions.

Type of income or expenditure	Amount in calendar year 1993 (in billions) OASI	DI	OASDI
Total income	$323.3	$32.3	$355.6
Payroll taxes	290.9	31.2	322.1
Taxation of benefits	5.3	0.3	5.6
Interest	27.0	0.8	27.9
Total expenditures	273.1	35.7	308.8
Benefit payments	267.8	34.6	302.4
Railroad Retirement financial interchange	3.4	0.1	3.4
Administrative expenses	2.0	1.0	3.0

Note: Totals do not necessarily equal the sums of rounded components.

1. Income

Most OASDI income consists of the taxes paid by employees, employers, and the self-employed on earnings covered by the OASDI program. These taxes (also called contributions) represent a portion of the payroll taxes collected under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA). The balance of the FICA and SECA contributions are used to finance the HI program, commonly referred to as "Part A" of Medicare. The taxes for the OASDI program are paid on earnings up to a specified maximum annual amount (the "contribution and benefit base"). Prior to 1994, HI taxes were also paid on earnings up to a maximum amount each year. As a result of Public Law 103-66, HI taxes are now paid on total covered earnings, without limitation. The following table shows the OASDI contribution and benefit base and the allocation of the FICA and SECA tax rates by program for 1994.

For 1994...	OASI	DI	OASDI	HI	Total for OASDI and HI
Maximum taxable amount of earnings	$60,600	$60,600	$60,600	—	—
Tax rate for employees and employers, each (in percent)	5.60	0.60	6.20	1.45	7.65
Tax rate for self-employed persons (in percent)	11.20	1.20	12.40	2.90	15.30

The tax rates for OASDI and for HI are not scheduled to change from their current values under present law. The maximum amount of earnings subject to OASDI taxes increases automatically each year, based on the increase in the average wage for all workers. In calendar year 1993, OASDI payroll tax income amounted to $322.1 billion, representing 91 percent of the total income received under the OASDI program during the year.

Beneficiaries whose "adjusted gross income" exceeds certain threshold amounts must pay income taxes on a portion of their annual OASDI benefits. The revenue from this requirement and related provisions is credited to the OASI and DI Trust Funds and totaled $5.6 billion in 1993.

The final source of income to the trust funds is from interest on the invested assets of the funds. By law, these investments must be in interest-bearing securities of the U.S. Government or in securities guaranteed by the United States. Interest from investments in 1993 amounted to $27.9 billion.

2. Expenditures

In 1993, benefit payments totaling $302.4 billion were made to retired and disabled workers and their families, and to survivors of deceased workers. Such payments represent 98 percent of all expenditures by the OASDI program. An additional $3.4 billion was transferred from the OASI and DI Trust Funds to the Railroad Retirement program in 1993, under provisions of the law requiring a financial interchange between the two programs. The cost of administering the OASDI program in 1993 was $3.0 billion, or about 1.0 percent of total benefits paid during the year.

3. Trust Fund Assets

In 1993, total income was $355.6 billion and total expenditures were $308.8 billion. The assets of the OASI and DI Trust Funds therefore increased by a net total of $46.8 billion during the year, from $331.5 billion to $378.3 billion. The invested assets of the trust funds are backed by the full faith and credit of the U.S. Government, in the same way as other public-debt obligations of the United States.

If income to a trust fund is inadequate to defray expenditures, the fund's assets serve as a contingency reserve to cover the shortfall temporarily. For example, the expenditures of the DI Trust Fund exceeded income to the fund in 1993, necessitating a redemption of assets to cover the difference. In the event of recurring shortfalls, the availability of trust fund assets allows time for the enactment and implementation of legislation to restore financial stability to the program.

Conversely, when program income exceeds expenditures, the trust fund serves as a vehicle to help fund a portion of the program's accruing financial obligations in advance. In particular, as invested assets continue to increase over the next 20 to 30 years, interest earnings will become a larger share of total trust fund income. In 1993, interest income to the combined OASI and DI Trust Funds represented 7.8 percent of total OASDI income. On a combined basis, interest income in 2003 would represent an estimated 10.8 percent of total income.

D. INTRODUCTION TO ACTUARIAL ESTIMATES

The financial and actuarial status of the OASDI program is traditionally evaluated for both the "short range" (the next 10 years) and the "long range" (the next 75 years). The various income and expenditure items described in the previous section are estimated separately, and then combined to form estimates of the future level of trust fund assets.

A period of 75 years is used to evaluate the long-range actuarial status of the OASDI program in order to obtain the full range of financial commitments that will be incurred on behalf of all current program participants. For example, a group of workers now entering the labor force at age 22 will work and pay OASDI taxes for the next 45 years before reaching age 67. At age 67, the surviving workers may retire and begin to receive full benefits (i.e., not reduced for early retirement). Some of these workers might live and receive benefits for as long as 30 years or more. Thus, a 75-year projection period will include the entire working and retired life span of the great majority of workers now contributing to the program, as well as those now receiving benefits.

Because of the inherent uncertainty in estimates for as many as 75 years into the future, projections are shown in this report under three alternative sets of assumptions regarding future economic and demographic trends. Designated as alternatives I, II, and III, the assumptions range from low cost (alternative I) to high cost (alternative III), with alternative II representing the intermediate cost assumptions. The low cost set is more optimistic from the standpoint of OASDI financing and the high cost set is more pessimistic. In the tables in this report, the intermediate estimates, which the Trustees regard as the "best estimates," will be shown first followed by the low cost and high cost estimates.

From the estimated income, expenditure, and asset amounts, a number of different measures are calculated for use in evaluating the financial status of the program. Because of the difficulty in comparing dollar values from one period to another, these measures are generally based on relative scales (although financial operations in nominal and inflation-adjusted dollar amounts are also available). These measures include (1) the annual amounts of future income and outgo as a percentage of the amount of earnings subject to the OASDI payroll tax, (2) the annual differences between these income and outgo figures, and (3) comparisons of these figures summarized over various periods. The level of trust fund assets relative to annual expenditures and the year in which the trust fund is projected to be exhausted are additional measures for evaluating the financial status of the program. Careful review of these measures provides a reasonably complete picture of the financial outlook for the OASDI program.

The program is also subject to two explicit tests of financial status (see section II.F)—a short-range test and a long-range test. The purpose of these tests is to provide objective criteria for determining whether or not the projected financial status of the OASDI program is considered satisfactory in each time period. The tests help highlight the need for corrective action when they are not met.

As with the analysis of any complex subject, these summary tests should be used in conjunction with a full understanding of the year-by-year patterns, trends, and other financial characteristics revealed by the underlying actuarial projections.

E. ECONOMIC AND DEMOGRAPHIC ASSUMPTIONS

Actual future income from OASDI payroll taxes and other sources, and actual future expenditures for benefits and administrative expenses, will depend upon a large number of factors: the size and composition of the population which is receiving benefits, the level of future benefit amounts, the size and characteristics of the work force covered under OASDI, and the level of workers' earnings in the future. These factors will depend in turn upon future marriage and divorce rates, birth rates, death rates, migration rates, labor force participation and unemployment rates, disability incidence and termination rates, retirement age patterns, productivity gains, wage increases, cost-of-living increases, and many other economic and demographic circumstances affecting the OASDI program.

While it is reasonable to assume that actual trust fund experience will fall within the range defined by the three alternative sets of assumptions used in this report, no definite assurance can be given that this will occur because of the uncertainty inherent in projections of this type and length. In general, a greater degree of confidence can be placed in the assumptions and estimates for the earlier years than for the later years. Nonetheless, even for the earlier years, the estimates are only an indication of the expected trend and general range of future program experience.

The assumptions vary, in most cases, from year to year during the first 5 to 25 years before reaching their ultimate assumed values for the remainder of the 75-year projection period. The following table summarizes the ultimate values assumed for the key economic and demographic factors underlying the actuarial estimates shown in this report. These ultimate values apply for years after 2015, with the exception of life expectancy which is assumed to continue improving throughout the projection period.

Ultimate assumptions	Intermediate	Low Cost	High Cost
Percentage change in:			
Average wage in covered employment	5.0	4.5	5.5
Consumer Price Index (CPI)	4.0	3.0	5.0
Real-wage differential (percent)	1.0	1.5	0.5
Unemployment rate (percent)	6.0	5.0	7.0
Interest rate (percent)	6.3	6.0	6.5
Fertility rate (children per woman)	1.9	2.2	1.6
Life expectancy at birth in 2070 (combined average for men and women, in years)	80.9	78.0	84.8
Annual net immigration (in thousands)	850.0	1,100.0	700.0

These key assumptions for the 1994 Annual Report are similar to the assumptions used in the 1993 report. The most significant change in an ultimate economic or demographic assumption is a decrease in the annual rate of change in the real average wage. The assumed real-wage differential is reduced from 1.1 percent in the 1993 report to 1.0 percent for the intermediate set of assumptions in this report, from 1.7 to 1.5 percent for the low cost set of assumptions, and from 0.6 to 0.5 percent for the high cost set of assumptions. These reductions in the ultimate assumed rates of growth in the average wage reflect the expectation that many of the factors which have contributed to slower growth over the past 30 years (0.8 percent per year, on average, from 1962 to 1992) than for the prior 10 years (2.6 percent per year, on average, from 1952 to 1962) are likely to continue for the foreseeable future.

Revisions of other economic and demographic assumptions for the early years of the projection period, based on data collected since the 1993 report, had little effect on these ultimate annual rates, with the exception of life expectancy. Data obtained since last year's report indicate that life expectancy in recent years was somewhat higher than was estimated a year ago. Projected values for life expectancy through the year 2070 are thus somewhat higher than estimated a year ago because the assumed ultimate rate of improvement in mortality was not changed for this report.

These assumptions reflect a careful assessment of past data and future prospects. No major changes in ultimate economic or demographic assumptions, other than those made for the real-wage differential and life expectancy, were deemed necessary to ensure that the financial projections continue to be based on the most plausible range of economic and demographic conditions. Other changes in assumptions and methods reflected in the estimates in this report are discussed in section II.F.

F. SHORT-RANGE ACTUARIAL ESTIMATES

The financial status of the OASDI program during the next 10 years (1994-2003) is measured by the estimated level of trust fund assets. Because of inflation, economic growth, and growth in the OASDI program, asset levels expressed in nominal dollar amounts are not comparable over long periods of time. For this reason, it is more informative to consider a relative measure of the program's financial condition.

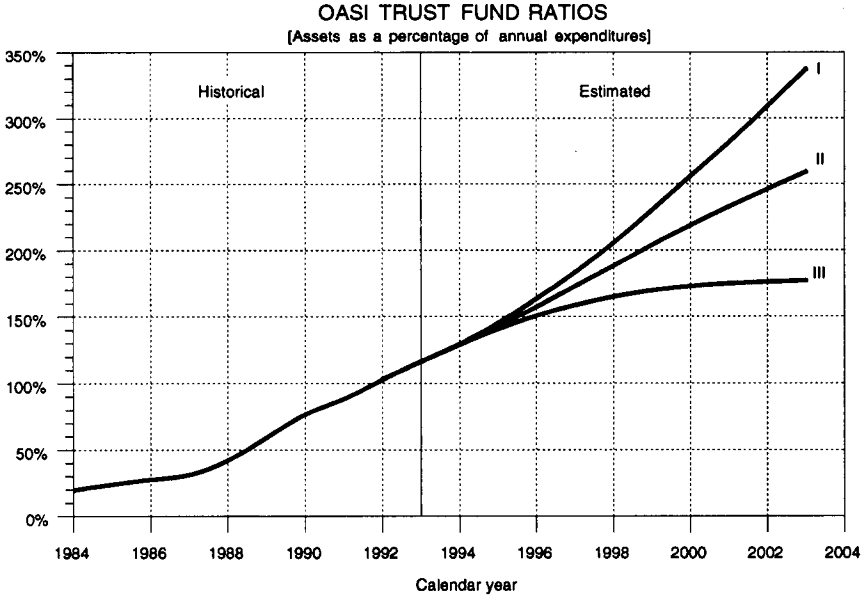
For example, OASDI assets at the beginning of calendar year 1994 amounted to $378 billion, while assets at the beginning of 1960 were $22 billion. The asset level in 1994 would be sufficient to cover almost 14 months of expenditures in the absence of other income. Assets in 1960, although much smaller in nominal dollars, could have covered about 22 months of expenditures and thus represented a somewhat stronger contingency reserve.

The ratio of trust fund assets at the beginning of a year to expenditures during the year is termed the "trust fund ratio." This ratio serves as the primary measure of the fund's financial adequacy in the short range. It is also used when applying an explicit test of short-range financial adequacy.

1. OASI Trust Fund

The chart shown on the following page presents historical trust fund ratios for the OASI Trust Fund in 1984-93 and estimated ratios for 1994-2003 based on the alternative sets of assumptions.

As shown in the chart, the OASI trust fund ratio is estimated to increase from 129 percent at the beginning of 1994 to 259 percent by 2003, based on the intermediate (alternative II) assumptions. The ratio is also estimated to increase during the next 10 years under both the low cost (alternative I) and high cost (alternative III) assumptions. Because OASI assets are estimated to exceed 100 percent of annual expenditures throughout the next 10 years, the OASI Trust Fund meets the requirements of the Trustees' formal test of short-range financial adequacy. (This test is described in detail in the section entitled "Actuarial Estimates" later in this report.) Thus, the financing scheduled under present law for the OASI Trust Fund is



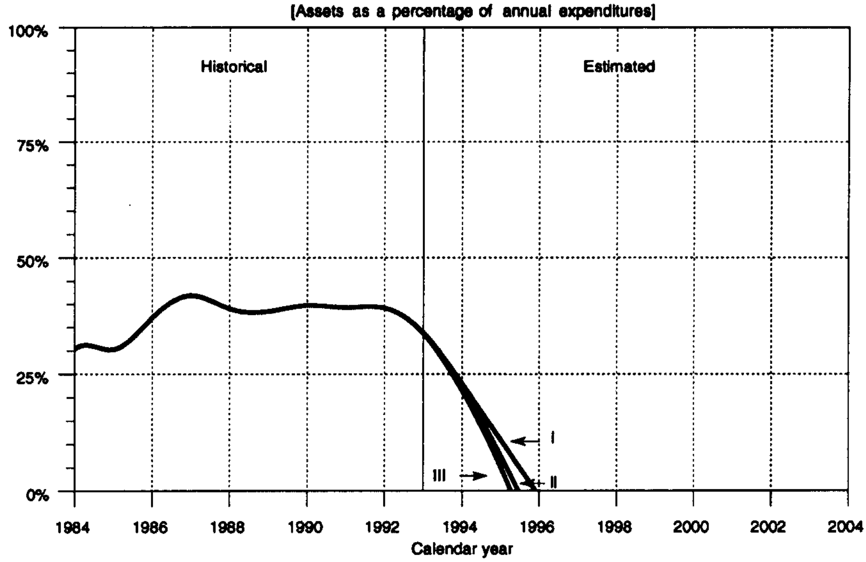
considered fully adequate to meet future expenditures over this period and to provide for an adequate contingency reserve.

2. DI Trust Fund

The DI Trust Fund, on the other hand, is *not* adequately financed in the short range. At the beginning of 1994, the assets of the DI Trust Fund represented only 23 percent of estimated expenditures in 1994. As shown in the next chart, without corrective legislation the assets of the DI Trust Fund will be exhausted in 1995.

The imminent exhaustion of the DI Trust Fund was reported in 1992 and 1993 (and warnings of possible depletion were made as early as 1985). The financial problem reflects an increasing trend since 1982 in the proportion of workers who are awarded disability benefits and a decreasing trend since 1970 in the proportion of beneficiaries whose disability benefits terminate as a result of recovery, death, or attainment of age 65. In particular, the annual number of new disability awards has increased very rapidly in the last several years,

DI TRUST FUND RATIOS
[Assets as a percentage of annual expenditures]



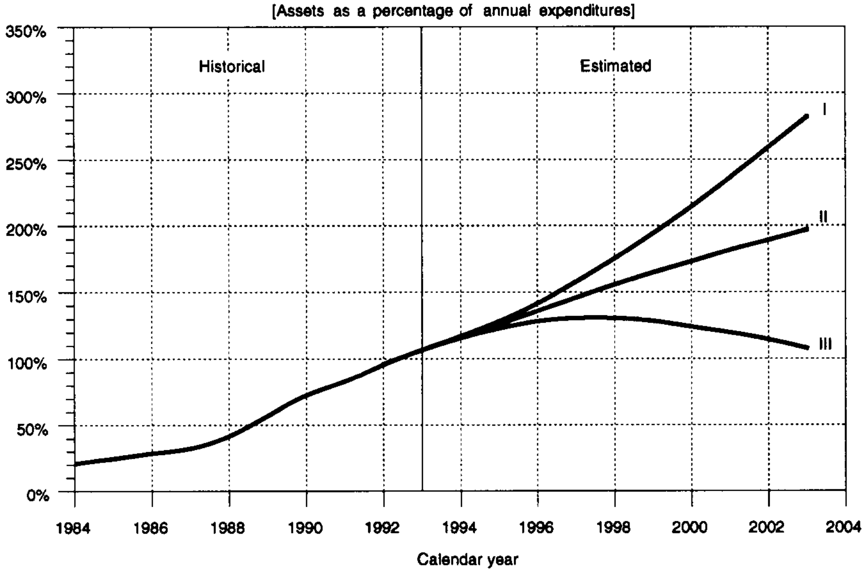
from 415,000 in 1988 to more than 640,000 in 1992. In 1993, benefit awards declined slightly. The backlog of pending disability applications increased substantially, however, indicating that there was a delay in awards from 1993 to later years, rather than a true decrease.

Because DI assets are expected to be depleted in the immediate future, the DI Trust Fund does not satisfy the short-range test of financial adequacy. It is imperative that legislative action be taken as soon as possible this year to strengthen the financial position of the DI program. As noted in other sections of this report, the Board of Trustees recommended such action to the Congress in 1992 and again in 1993. The DI Trust Fund will be exhausted in 1995 and benefit payments will cease unless Congressional action takes place.

3. OASI and DI Trust Funds, Combined

The following chart summarizes the trust fund ratio for the OASI and DI Trust Funds, combined, in the recent past and estimates for the next 10 years.

TRUST FUND RATIOS FOR OASI AND DI TRUST FUNDS, COMBINED
[Assets as a percentage of annual expenditures]



As shown, the trust fund ratio for OASI and DI on a combined basis is estimated to increase from 116 percent at the beginning of 1994 to 197 percent by 2003, based on the intermediate assumptions. While the ratio would also increase throughout the 10-year period based on the low cost assumptions, it would begin to decline under the high cost assumptions (but would remain above 100 percent throughout the short range).

Because the trust fund ratio for the combined funds is estimated to remain above 100 percent under the intermediate assumptions, the combined funds meet the short-range test of financial adequacy. Thus, the imminent depletion of the DI Trust Fund could be avoided through a reallocation of tax rates between OASI and DI without jeopardizing the short-range financial status of the OASI Trust Fund. Such a reallocation would, however, worsen the long-range financial outlook for OASI.