Future Financing Of Social Security: The Issues
As the financing of the social security system becomes increasingly costly, various proposals are being made for alternative financing methods. This pamphlet summarizes a study analyzing possible courses of action on OASDI financing. Copies of the full study, Issues in Future Financing of Social Security, are available at $1.50 each from the Tax Foundation.

Tax Foundation is a private, non-profit organization founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. It serves as a national information agency for individuals and organizations concerned with government fiscal problems.
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In 1966 a group of Senators introduced a bill providing for a 50 percent increase in old age retirement benefits, and liberalization of other social insurance benefits. This increase would be financed in part by higher payroll taxes coming mainly from a rise in the maximum taxable wage to $15,000. The bill also included a proposal for the use of general revenues to meet a portion of the costs. Eventually over one-third of social security trust fund outlays would be borne by sources other than payroll taxes.

This bill was an indication of current pressures at work to modify social security. It went much further than the Administration’s proposals introduced in January 1967, and these provided for substantial amendments to the Social Security Act. The Administration’s proposals were modified and scaled down in the bill reported by the House Ways and Means Committee on August 7, 1967 (H. R. 12050). This bill provided for a 12½ percent increase in benefits, an increase in the amount an individual may earn and still get full retirement benefits, and various other modifications of benefits. To finance these increased benefits, the taxable earnings base would be increased from $6,600 to $7,600 effective January 1, 1968, and tax rates in future years would be changed as shown in Table 1.

The pressure to liberalize social security benefits is likely to continue, bringing with it a continued increase in social security taxes. This prospect raises important questions which the present study tries to answer at least in part. Among these questions are the following:

1. Is the tax burden of benefits to the aged likely to become unduly heavy?
2. More specifically, is the burden of taking care of the aged likely to strain the limits of the payroll tax? In other words, has the payroll tax about reached the upper limit to which it can be pushed?
3. Have we substantially abandoned the contributory principle in favor of a “social adequacy” concept in OASDI programs?
4. What are the alternatives in attempting to resolve the conflicts between “social adequacy” and the strains of increasing payroll taxation?

These are the major questions examined here. Other questions touched on include the following: Do recent increases in social security benefits call for

2. OASI refers to the Old Age and Survivors Insurance program which dates from 1935 (and the 1939 amendments which included survivors insurance). OASDI includes in addition the Disability Insurance program, which was adopted by the 1956 amendments to the Social Security Act.
Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Maximum Taxable Wage</th>
<th>Combined Tax Rate on Employer &amp; Employee</th>
<th>Tax Rate on Self-Employed</th>
<th>Maximum Taxable Wage</th>
<th>Combined Tax Rate on Employer &amp; Employee</th>
<th>Tax Rate on Self-Employed</th>
<th>Maximum Taxable Wage</th>
<th>Combined Tax Rate on Employer &amp; Employee</th>
<th>Tax Rate on Self-Employed</th>
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<td>6.4</td>
<td>$6,600</td>
<td>8.8</td>
<td>6.4</td>
<td>$6,600</td>
<td>8.8</td>
<td>6.4</td>
</tr>
<tr>
<td>1968</td>
<td>$6,600</td>
<td>8.8</td>
<td>6.4</td>
<td>7,800</td>
<td>8.8</td>
<td>6.4</td>
<td>7,800</td>
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<td>6.4</td>
</tr>
<tr>
<td>1969</td>
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<td>9.8</td>
<td>7.1</td>
<td>7,800</td>
<td>10.0</td>
<td>7.3</td>
<td>7,800</td>
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<td>9.8</td>
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<tr>
<td>1973</td>
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<td>1974</td>
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a. Old Age Survivors, Disability, and Hospital Insurance.
b. Set out in H. R. 5710.
c. Includes portion of rate for hospital insurance (in which no change in the existing schedule was proposed by the Administration in 1967). The hospital portion is scheduled to rise from 1.5 percent in 1967-72 to 1.1 percent in 1973.d. A further increase is scheduled to 11.3 percent in 1987.
e. Further increases are scheduled to 11.6 percent (H. R. 5710) or 11.8 percent (H. R. 12080) in 1987.
Source: Social Security Administration.
a substantial change in the present income tax treatment of the aged? Is it likely that the expansion of social insurance will endanger the growth of private pension plans and private provision for old age through other means? How are OASDI programs to be related to direct welfare programs?

Professor Eveline Burns of Columbia University, in a recent article entitled, “Social Security In Evolution: Toward What?” has distinguished three stages in the evolution of social insurance in most western countries. The first she described as follows:

... the initial form in which social insurance bore everywhere the imprint of its private insurance analogy. Benefits were closely related to contributions; equity, rather than adequacy, which scarcely came into question, was emphasized; coverage was limited

... thanks in large measure to the wide spread of social insurance, there was general acceptance of the doctrine of public assurance, without a means test, of a minimum income for all.

The evolution Professor Burns has described is certainly not immutable. While it is not an exact description of the growth of social security in the United States, her outline does indicate possible directions of change. The present study is mainly concerned with the question of alternatives to following such stages further in the United States.

The changes in social security considered by Congress in 1967 involved a multitude of issues of benefit levels for various groups, changes in the maximum taxable income base, changes in the maximum earnings limit for retirement benefits, and so forth. No attempt is made here to examine all of these issues, or to
population will depend primarily on the extent to which retirement and other benefits to the aged are increased in relation to average wages and salaries. Unlike some other countries, the United States is not currently in the position of having to shoulder an increasing tax burden because of a substantial rise in the proportion of the aged to the working population.

(2) Is the burden of taking care of the aged likely to strain the limits of the payroll tax? Has the payroll tax about reached the upper limit to which it can be pushed?

While the proportion of the aged to the working population will not change substantially in the next few decades, it is likely that Congress will endeavor to liberalize benefits further. Increased benefits could mean increases in payroll taxes in excess of those already scheduled. Besides raising tax burdens, such changes might well limit provision for old age and disability through private alternatives.

Under existing law the combined employer and employee tax rate is scheduled to reach 9.8 percent of taxable wages up to $6,600 in 1969, and under the bill currently pending in Congress (H. R. 12050) the rate would reach 9.6 percent of $7,600. The scheduled rate in H. R. 12050 will exceed 11 percent of taxable wages by 1973. The maximum tax on an employee in 1969 would be increased from $290.40 under present law to $334.40 under H. R. 12050. The maximum combined tax on employer and employee would increase from $580.80 to $668.80.

These are heavy taxes on an income of $6,600 or even $7,600. By way of comparison, a family with two children and an income of $5,000 in 1967 would pay a Federal income tax of $290 (assuming standard deductions). If this family had more than one wage earner, its direct payroll taxes would exceed its income tax.

The employee also bears some part of the employer's portion of the tax whether the tax is assumed to be shifted forward in the prices of goods and services or to be shifted backward in the form of lower money wages. (It is also possible that some portion of the tax falls on profits and other non-wage income.)

Moreover, a combined payroll tax rate at present and scheduled levels is likely to have significant effects on business decisions on investment in capital equipment, and on the hiring of unskilled workers. Such a tax on labor may intensify problems of unemployment or partial unemployment among those groups whose unemployment rate is already high.

The level of the payroll tax may be limited by another type of consideration. It would not be reasonable, in the view of many people, to levy social security payroll taxes at a rate in excess of what benefits of a similar nature would cost if the employee were able to provide them through private forms of saving and insurance.

The payroll tax has risen to such a level that if a young worker today, with earnings at least equal to the maximum taxable base, computed the total of his expected payroll taxes plus interest over his lifetime, the value of his "contributions" would in many cases substantially exceed the discounted value of his expected benefits.

While experts differ in their views of how these calculations should be made, such comparisons suggest a definite kind of limit to payroll taxes. Young workers who begin to find themselves in this
situation can be expected to offer more and more objection to increased payroll taxes.

A general economic question is also involved. It concerns allocating to social insurance, through payroll taxes, resources that would have more value in the purchase of private insurance and pensions.

The significance of such a limitation may be disputed by those who point out that the insurance analogy is a very loose one and the objective of "social adequacy" is more important. This leads to the third major question dealt with in this study:

(3) *Have we substantially abandoned the contributory principle in favor of a "social adequacy" concept in OASDI programs?*

From the beginning, the old age and survivors insurance program was a mixed system aimed in part at relating contributions to benefits ("individual equity") and in part at making benefits "adequate" in terms of rough standards of minimum consumption levels. These two concepts of "social adequacy" and "individual equity" are generally conflicting, because very low income groups cannot be expected to pay a full "price" for the benefits provided under social security.

The old age benefit structure, moreover, is heavily weighted in favor of those with low earnings records. The old age retirement benefit ("primary insurance amount") in 1966 amounted to 62.9 percent of the first $110 of average monthly covered wages, plus 22.9 percent of the next $110 of average monthly covered wages, plus 21.4 percent of the remainder.

In addition, the provisions for minimum amounts of month by month benefits give the system a strong emphasis on social adequacy. The pressure to go further in this direction was illustrated by the 1967 proposal of the Administration to raise the minimum old age retirement benefit from $44 per month to $70 per month. Such an increase would have been almost exclusively based on the concept of social adequacy. In fact, the Ways and Means Committee modified this proposal to provide a minimum benefit of $50 per month, at least partly on the grounds that an increase in the minimum to $70 would be too great a departure from the principle of a wage-related, contributory system.

In short, while we have not entirely abandoned the contributory principle in that benefits and administrative costs in the aggregate are paid for through payroll taxes, the financing of these programs has, in the course of time, put less emphasis on the relation between the individual's contributions and the benefits he will receive.

(4) *What are the alternatives in attempting to resolve the conflicts between "social adequacy" and the strains of increasing payroll taxation?*

Recent debates and pressures for change suggest various courses of action in OASDI financing. Although the following by no means exhaust the possibilities, four major alternatives are examined:

(a) Continue approximately the present balance between the objectives of social adequacy and individual equity.

(b) Provide a general revenue contribution to OASDI trust funds with a probable increase in the emphasis given to social adequacy.

(c) Modify the payroll tax by substantially increasing the maximum taxable wages or by introducing an exemption to reduce the burden on low income groups.
(d) Separate the benefits schedule into two portions, one of which would be closely related to contributions on an individual equity basis, and a second which would explicitly be based on adequacy considerations and be financed separately by general revenues.

The choice among these alternatives depends in part on value judgments concerning the relative importance of the objectives involved. However, technical and economic issues are also involved. The chief issues of both kinds are in brief as follows:

(a) **Maintaining the present system.** Through a long political process the United States has developed a social insurance system that provides a working balance between the objectives of adequacy and individual equity. This balance is being strained as the payroll tax burden grows. Some view this "strain" as a useful restraint on excessive expenditures for benefits.

On a more technical level, the present system of payroll tax financing contains an important fiscal control device. The system requires the levying of additional payroll taxes at the same time that increased benefit levels are adopted, and the taxes are set so as to meet expected benefits and administrative costs over a long period. This is a device that is often absent in the Federal government's general budget, although similar procedures have been proposed for administrative budget programs.

Until recently, however, the payroll tax was relatively low. The increase in benefits may have seemed of more significance to the public generally than the increase in taxes.

The attitude toward payroll taxes could change markedly. At current and prospective payroll tax levels the conflict between the objectives of "more adequate" benefits and "individual equity" is becoming more evident. Benefits might be held to levels that can be financed at present tax rates. If not, problems in present financing methods will demand more attention.

(b) **Providing a general revenue contribution.** Many who argue for a general revenue contribution do so because they want a large increase in social security benefits. They see such a contribution as a means of raising benefits to more "adequate" levels in relation to minimum family budget standards.

Moreover, it is argued that not only is the payroll tax high, but that this is a poor way to finance increases in benefits. If the OASDI system is to become an instrument for preventing or removing poverty, it would hardly be fair to do so with a payroll tax that reaches its maximum at $6,600 or $7,600. An increased emphasis on social adequacy would more logically be achieved through taxes based on "ability to pay."

Historically, another argument has been used for a general revenue contribution. It is that in the transitional stage to a "mature" social insurance system, most people become eligible for benefits even though they have not "contributed" anything like the full cost of those benefits. Until most workers have contributed during a full working lifetime at rates commensurate with the benefits they will receive, there is a large windfall accruing to current beneficiaries. This windfall, it is argued, constitutes an "unfunded liability" the burden of which should be borne by all taxpayers through general revenues rather than through the payroll tax alone. Use of the payroll tax is largely justified by the relation between an individual's contributions and his benefits, so that the "redistribution"
in favor of current beneficiaries receiving windfalls should be met by a general levy.

A general revenue contribution to OASDI trust funds could be fitted into the same type of fiscal control procedure now used. For example, any proposed increased levy for social security could require an increase in income taxes earmarked for OASDI trust funds. Even with such a procedure, benefits might increase faster than with exclusive reliance on the payroll tax both because income tax revenues are more responsive to economic growth and because Congress might be more ready to use an income tax levy than a payroll tax increase to raise the benefit schedule.

(c) Modifying the payroll tax. A closely related proposal is to modify the payroll tax to make it more like an income tax: to allow personal exemptions and to increase substantially the maximum wage base. Such changes would relate the tax burden more closely to "ability to pay." There would be a considerable increase in the extent of redistribution by income class through social security.

A higher maximum wage base would also mean increased benefits. Under the present benefit structure, which is heavily weighted in favor of those with low earnings records, a higher maximum tax base would serve to increase the emphasis on social adequacy. Benefits would go up for those earning as much or more than the maximum taxable wage, but not in proportion to the increase in wages or payroll taxes.

Such an alternative would depart further from the contributory, or "individual equity," basis of financing.

(d) Separating the benefit schedule and its financing into two portions. The conflict between the objectives of social adequacy and individual equity suggests the alternative of separating the major elements in OASDI programs designed to meet these different objectives: one which would emphasize "insurance" elements, and another which would emphasize welfare or adequacy elements.

In the broadest terms, the "welfare" element consists of that part of benefits which is determined primarily on the basis of adequacy—in particular, the minimum benefits which bear no relation to average covered wages of the beneficiary except that covered wages must be very low. The "insurance" element consists of that part of benefits which is, or can be, related to average covered wages. Such a separation would involve a substantial revision of the benefit structure and would raise many problems of defining an appropriate relation between benefits and the individual's contributions.

Isolating an insurance element in social security raises questions of whether there are insurable risks that are unlikely to be met by private enterprise and private saving, and for which compulsory coverage by a governmental system may be justified.

From the beginning of the social security system, compulsory provision for old age has been justified in part by the argument that without such provision many aged would be public charges.

Forcing people to save through social insurance may appear to be an undue interference with individual choice. As yet there is no evidence of payroll taxes checking people's willingness to save for old age or to purchase insurance. However, if social security taxes continue to rise, the ability of people to save in other ways may be limited. Social security would not serve its essential
purpose if it encroached on individual savings in private insurance, investment in homeownership, stocks and bonds, and in private pensions. Public policies should not discourage private provision for old age.

However the arguments may be arrayed on the question of compulsory saving for old age, at least a minimum of such compulsion is accepted in most western countries. Acceptance of such compulsion seems to be a part of the decline of dependence on the family as an old age security system.

Certain limitations of private provision for old age continue to provide a justification for a governmental system. Even though an employee might not choose to save toward his old age, some portion of the cost of a minimum old age pension has come to be regarded as a necessary part of the cost of production of goods and services.

Our social insurance system compels nearly every employer as well as his employee to contribute to OASDI. The employee remains covered and, in a sense, receives credit for his and his employer's contribution no matter how often he changes jobs. These features of quick "vesting" of pension and insurance rights and of "portability" are seldom provided for all employees under private pensions.

In conclusion, the study suggests that a separation of "welfare" and "insurance" elements in OASDI programs would represent a most radical revision in existing financing principles. It would mean a departure from the principle of "self-support" through exclusive reliance on payroll taxes, and from the fiscal control element that goes with this principle. Moreover, the strict application of the "individual equity" principle to the insurance element in a compulsory social insurance system with nearly universal coverage is of dubious practicality.

A general revenue contribution, however set up or rationalized, is likely to remove the necessity for relating the tax levy directly to the benefits to be financed. Moreover, if a general revenue contribution came in substantial part from the corporation income tax, rather than from the individual income tax, there would be little advantage in equity, and hence no justification for such a shift.

Modification of the payroll tax, either by introducing an exemption, or substantially raising the maximum tax base, or both, would retain the fiscal control features of the present system, but would shift a large part of the tax burden to middle and upper income groups, who would benefit least from such a revision. The contributory justification of payroll tax financing would be weakened. In addition, substantially raising the maximum tax base, and thereby benefits as well, would narrow the possibilities for growth in private pension plans.

Maintaining approximately the existing balance between the objectives of "social adequacy" and "individual equity" would, with rising payroll taxes, emphasize the fiscal control feature, and also retain the wage-related, contributory feature in its present form.