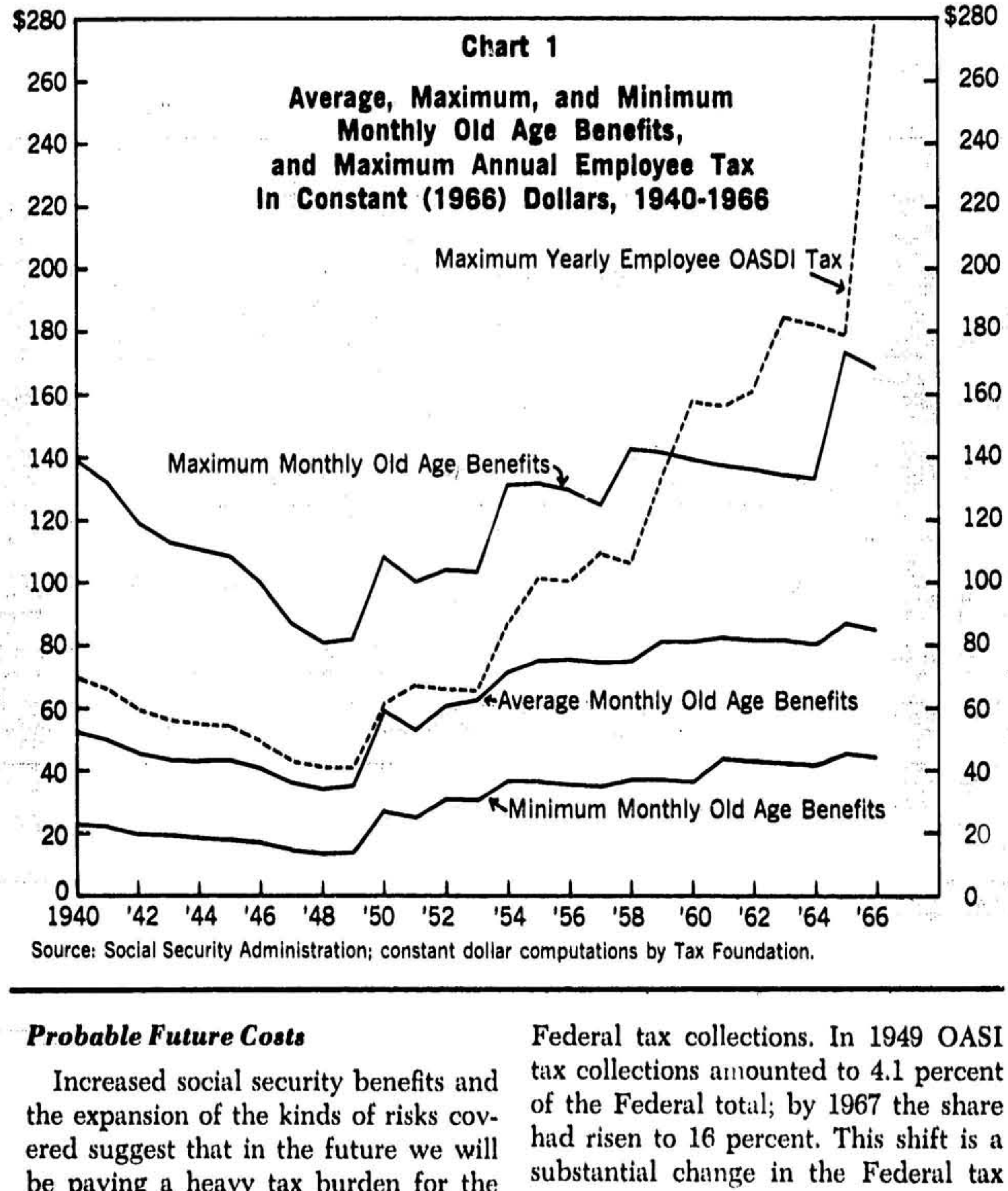


Source: Social Security Administration; constant dollar computations by Tax Foundation.

Probable Future Costs

Increased social security benefits and the expansion of the kinds of risks covered suggest that in the future we will be paying a heavy tax burden for the support of the aged.

The question of the future size of the tax burden for social security type programs is at least as important as the closely related questions of how that burden is to be allocated among different groups of people and types of taxes.

Total social security tax collections have risen rapidly not only in absolute terms but also as a percentage of total Federal tax collections. In 1949 OASI tax collections amounted to 4.1 percent of the Federal total; by 1967 the share had risen to 16 percent. This shift is a substantial change in the Federal tax structure.

Are we likely to see this share continue to rise substantially?

Population Projections. The first step in answering this question is to look at the prospective growth in the aged population as compared with the total population and the labor force. A recent set of charts published by the National Industrial Conference Board shows that as compared with the countries of Western Europe, the United States is in a relatively easy position in the ratio of dependent to working population (Chart 3). Over the next decade and a half the number of people aged 65 and over in the United States will rise almost in the same proportion as those of working age, while the younger age groups will increase less rapidly (Table 4). In Western Europe, by contrast, the population aged 65 and over will increase relatively much more than the working population.

The difference is not quite so significant as these figures would suggest because the increase in the labor force in the United States will consist relatively more than in Western Europe of the younger age groups whose average productivity is lower; indeed, in the United States the number in the group 45 to 65 will scarcely increase at all.

In short, so far as mere numbers are concerned, the problems of meeting the needs of the aged in the United States will be no greater than in the past. There are also other influences working to reduce the public burdens for the aged. One is the expansion of private pension funds and a general improvement in the income and asset position of the aged. On the other hand, the aged represent a large fraction of the "poor" in this country, and efforts to raise their relative, as well as their absolute living standards, could substantially increase the burden.

Official Cost and Benefit Estimates. A chief function of the Office of the Actu-

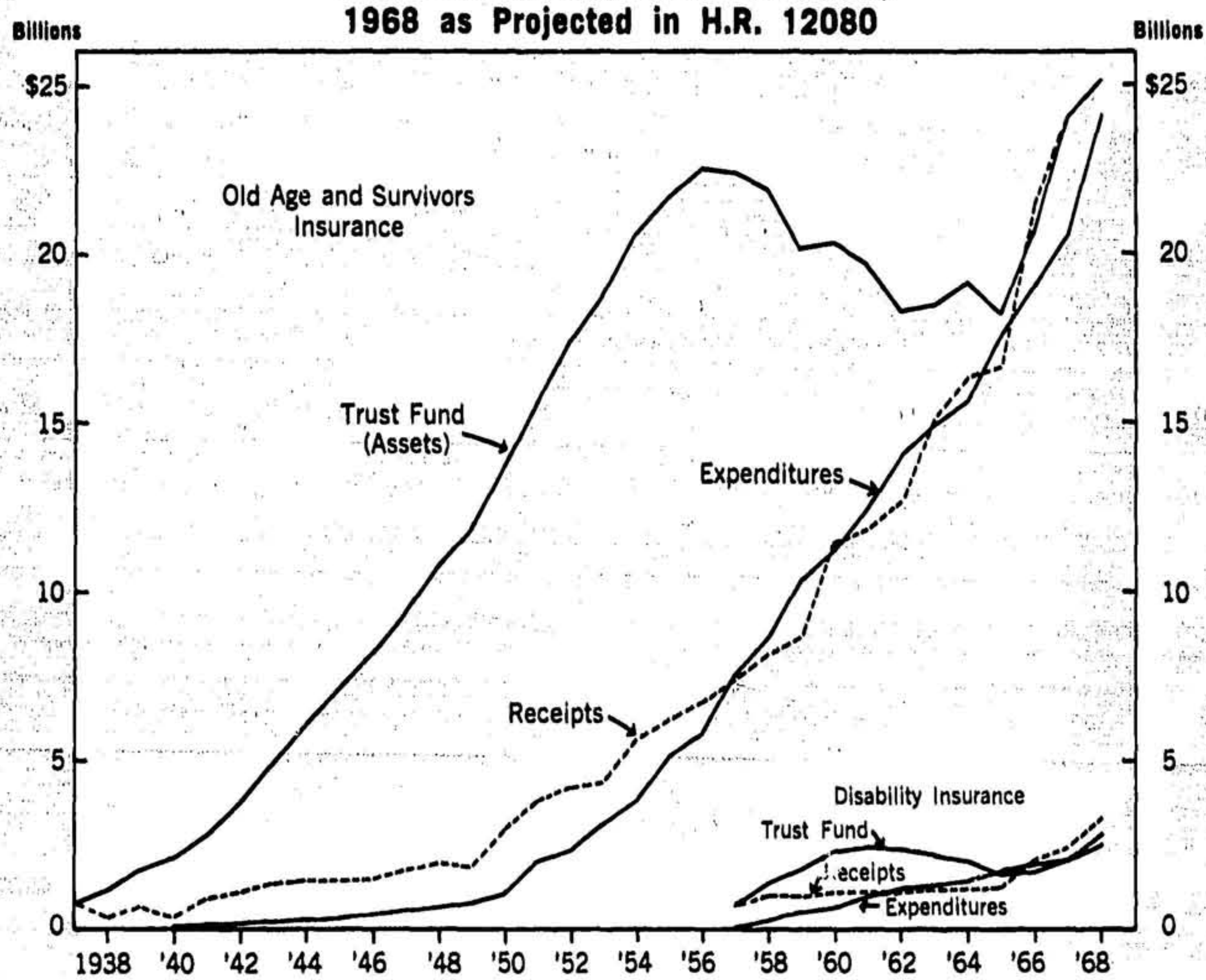
Table 3
Major Changes in Coverage under OASDI[a]
1935-1965

Effective Date	Compulsory coverage added	Elective coverage added
1937	All workers in commerce and industry, except railroads, in continental U. S., Alaska and Hawaii	None
1951	Self-employed (except farm and professional), regularly employed farm and domestic workers, Federal civilian workers not under retirement program, Americans employed outside U. S. by American employers, residents of Puerto Rico and Virgin Islands	State and local government employees not under retirement system, employees of non-profit institutions
1955	Farm self-employed, professional self-employed (except lawyers and medical professionals), most farm and domestic workers	State and local government employees under retirement system, ministers
1956	Lawyers, dentists, optometrists, chiropractors, osteopaths, veterinarians, and other medical professionals (except doctors of medicine), materially participating farm-landlords, Armed Forces	
1961	Residents of Guam and American Samoa, Peace Corps volunteers	
1965	Doctors of Medicine	

a. OASI only prior to 1956.
Source: Social Security Administration and Tax Foundation, **Economic Aspects of the Social Security Tax** (New York: 1966)

Chart 2

OASDI Trust Fund Receipts, Expenditures, and Assets 1937-1966 Actual, 1967 Estimated, 1968 as Projected in H.R. 12080



Source: Social Security Administration.

ary in the Social Security Administration is to make both long and short range estimates of future benefits, administrative costs, and contributions under social security programs.[3]

These estimates are usually made on the basis of the existing level of wages and the level of benefits under existing or proposed legislation. On the "level-wage" assumption (i.e., the general level of wages is assumed to stay constant), account is taken of projected changes in population by age group and the likely numbers of beneficiaries and their average benefit levels.

The latest projections show a sizable increase in the OASDI trust funds. On the basis of these projections, there have been proposals to limit increases in benefits in the near future to levels that would merely use up the prospective growth in contributions as the population increases, and involve no tax rate or maximum wage base increase.[4]

While the "level-wage" assumption is the actuarial procedure officially sanc-

3. The latest of these studies is *Long-Range Cost Estimates for Old-Age Survivors, and Disability Insurance*, 1966, Actuarial Study No. 63, January, 1967.

4. The U. S. Chamber of Commerce and the National Association of Manufacturers took this position in statements before the House Ways and Means Committee in 1967.

tioned for long-range estimates, it obviously leaves open the questions of what the effects will be of rising wage and price levels, and of increased levels of benefits that very likely will be adopted in the future.

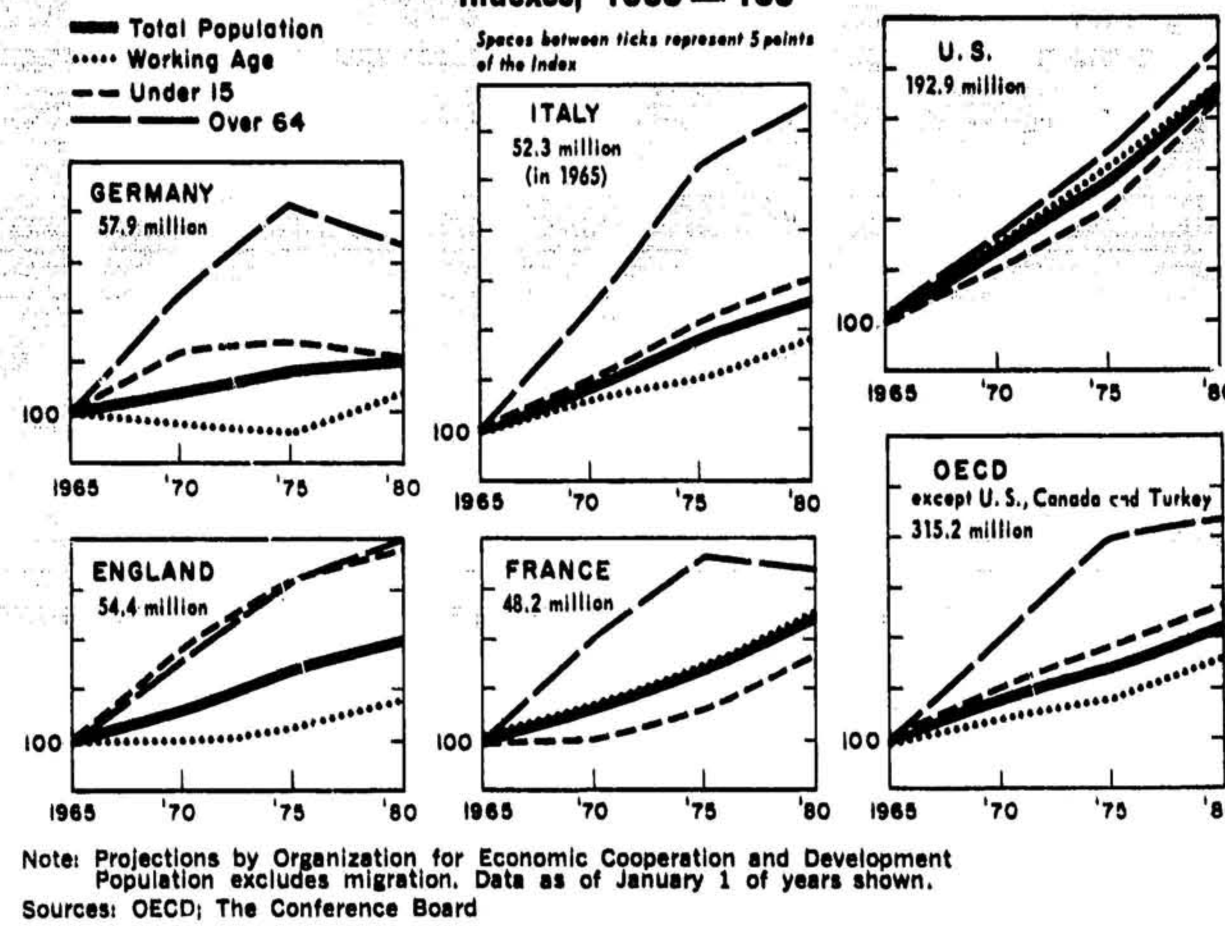
Short and intermediate-range projections are made on the assumption of increasing wage levels, but for the purpose of estimating fiscal effects rather than determining contribution rates. The short-range estimates are important for purposes of economic policies affecting stability and growth in the near future. The long-range estimates affect primarily the determination of contribution rates and the distribution of the costs or burden of the program.[5]

The level-wage assumption builds a moderate safety factor into the cost estimates. More importantly, it is argued that long-range cost estimates (in the United States) are for a fixed schedule of benefits related to current economic conditions. Consequently, it would be illogical to use an increasing earnings assumption without also using a "dynamic" assumption about benefit levels; and to do this would involve the actuary in the difficult task of projecting future legislative changes in benefits. An increasing earnings assumption would be

5. For further discussion see Henry Aaron, "Benefits Under the American Social Security System," in Otto Eckstein, ed., *Studies in the Economics of Income Maintenance*, (Washington, D.C.: The Brookings Institution, 1966), pp. 53-61. For an explanation of the long-range methodology see Robert J. Myers, *Social Insurance and Allied Government Programs*, (Homewood, Ill.: Richard D. Irwin, Inc., 1965), Chapter VIII.

Chart 3

Growth in Population
U. S. and Key European Countries
Indexes, 1965 = 100



Note: Projections by Organization for Economic Cooperation and Development
Population excludes migration. Data as of January 1 of years shown.
Sources: OECD; The Conference Board

appropriate only if the benefit schedule in the law were also "dynamic" (i.e., automatically adjusted for changes in earnings levels).[6]

However, for at least two reasons use of the level-wage assumption may be questioned. The first is that recent economic and legislative history shows that realistically a "dynamic" benefit structure might be taken into account. It can be argued that the most relevant set of assumptions for actuarial analysis of social security financing — and thereby for determining the allocation of costs — is the "dynamic" set which takes account both of increasing wage levels and prospective increases in benefit levels (see Appendix).

The second reason is that since more and more economic policy decisions, both public and private, are based on long-range projections that take account of likely price increases as well as growing levels of "real" income, it is impor-

6. Robert J. Myers, "The Applicability of Projected Economic-Trend Assumptions in Medium and Long-Range Actuarial Cost Estimates for Pension Systems," reprint from *Actas de La III Conference Internacional de Actuaries y Estadigrafos de la Seguridad Social, Madrid*: November, 1962.

Table 4
Projections of the United States Population by Broad Age Groups
1965-2050

	Population (in thousands)				65 and over as . .	
Year	Under 20	20-64	65 and over	Total	Percent of Total	Ratio of 20-64
			Low-Cost Projection			
1965	80,139	103,209	18,711	202,059	9.3%	.181
1970	82,400	111,500	20,296	214,196	9.5	.182
1975	85,840	121,245	22,016	229,101	9.6	.182
1980	90,313	131,858	24,044	246,215	9.8	.182
1990	106,181	149,144	28,185	283,510	9.9	.189
2000	119,023	174,838	29,577	323,438	9.1	.169
2010	133,672	204,336	31,753	369,761	8.6	.155
2020	151,593	227,542	41,382	420,517	9.8	.182
2030	169,386	255,057	50,437	474,880	10.6	.198
2040	190,189	289,091	54,151	533,431	10.2	.187
2050	213,160	322,410	62,426	597,996	10.4	.194
			High-Cost Projection			
1965	80,139	103,209	18,711	202,059	9.3%	.181
1970	81,868	111,580	20,405	213,853	9.5	.183
1975	83,629	121,439	22,304	227,372	9.8	.184
1980	85,331	132,195	24,585	242,111	10.2	.186
1990	93,489	149,303	29,458	272,250	10.8	.197
2000	98,353	171,142	31,756	301,251	10.5	.186
2010	103,111	193,385	34,706	331,202	10.5	.179
2020	109,756	205,170	45,386	360,312	12.6	.221
2030	115,348	215,544	55,678	386,570	14.4	.258
2040	121,520	229,968	58,470	409,958	14.3	.254
2050	128,087	241,154	63,209	432,450	14.6	.262

Source: Reproduced from **United States Population Projections for OASDHI**, Social Security Administration Actuarial Study No. 62, December 1966.

Table 5

Joint Economic Committee Staff Projections of GNP, Social Insurance Contributions and Benefits, and Total Government Receipts and Expenditures

1965 Actual and 1975 Projected

	Amount in Billions		Percent of GNP	
	1965	1975[a]	1965	1975[a]
GNP	$681.2	$1,205.0		
Personal income	535.1	961.8		
Contributions for social insurance[b]	29.2	66.0	4.3	5.5
OASI	17.4	45.0	2.6	3.7
Unemployment insurance	3.8	6.8	.6	.6
Other	8.0	14.5	1.2	1.2
Government transfer payments to persons	37.1	79.5	5.4	6.6
OASI	18.1	42.7	2.7	3.5
Unemployment insurance	2.3	4.4	.3	.4
Other[c]	16.8	32.4	2.5	2.7
Total government receipts and expenditures				
Federal government				
Receipts under 1965 tax law	124.9	246.9	18.3	20.5
Expenditures[d]	123.4	203.1	18.2	16.9
Surplus or deficit (–)	1.6	43.8	(e)	3.6
State and local governments				
Receipts (less Fed. grant-in-aid)	64.1	131.0	9.4	10.9
Expenditures (less Fed. grants-in-aid)	62.5	130.6	9.2	10.8
Surplus or deficit (–)	1.6	0.4	(e)	(e)

a. Price level for GNP assumed to rise at 1.5 percent per year. Average annual gain in real output per manhour was assumed to be 3 percent. Unemployment was assumed to be 4 percent of labor force. (Projection "B").

b. Under existing legislation with adjustments for scheduled changes in tax rates and wage base.

c. Expenditures under new programs in present legislation extrapolated in part on "a judgmental basis." (See source p. 21.)

d. Assumes some reduction in defense expenditures after 1967, and an increase in Federal grant-in-aid from $11.2 billion in 1965 to $25.0 billion in 1975.

e. Less than .05 percent.

Source: **U. S. Economic Growth to 1975: Potentials and Problems** study prepared for the Subcommittee on Economic Progress, Joint Economic Committee, 89th Cong., 2d sess., 1966, pp. 21, 24, 27.

tant to look at social insurance projections based on such assumptions.

The Staff of the Joint Economic Committee of Congress has recently released a long-range projection entitled, *U.S. Economic Growth to 1975: Potentials and Problems*. This study projects contributions for social insurance under scheduled rate changes but on assumptions of increasing money and real wage levels. It also projects social insurance benefits on the basis of estimates of broadened programs that will affect future payments. These projections suggest a 160 percent increase in the amount of OASI contributions from 1965 to 1975, while gross national product is expected to increase by 77 percent. OASI contributions would go from 2.6 percent of GNP in 1965 to 3.7 percent of GNP in 1975 (see Table 5).

The projections are based on existing programs or programs just adopted. The figures for 1975 could be much larger if average benefit levels were substantially liberalized.[7]

These projections indicate that social insurance programs will continue to rise relative to national income and product. However, the rise will essentially be due to new and expanded programs rather than to growth in the numbers of aged relative to the total or the working population.

Limits to Payroll Tax Financing

The history and scheduled increases in the social security payroll tax are shown in Table 2 (page 17). 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. Under the bill reported by the House Committee on Ways and Means in August 1967 (H.R. 12080), the rate would reach 9.6 percent of $7,600. The scheduled rate in H.R. 12080 will exceed 11 percent of taxable wages by 1973.

The maximum tax for an employee in 1968 would be increased from $290.40 under present law to $334.40 under H.R. 12080. 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 income of $5,000 in 1967 would pay a Federal income tax of $290 (assuming standard deductions). At lower income levels the social security tax for most families would exceed the income tax. If the family had more than one wage earner, its direct payroll tax would substantially 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.[8]

That the payroll tax is reaching very burdensome levels was brought home to many people in 1966 when the maximum tax, as a result of a combined rate and base increase, went up by $103 for the employee alone — an increase of 59 percent in one year. The reaction of organized labor was shown in a recent publication of the AFL-CIO:

> Clearly, the point is nearing when it will be difficult to tax low paid workers at much higher rates. This creates a dilemma. Sooner or later, the principle that payroll taxes shall be the sole source of funding should be modified or goals must be lowered to the less than adequate improvements that can be financed this way.[9]

A combined payroll tax rate at present and currently scheduled levels is likely to have significant effects on business decisions. A ten percent tax on additional labor (at least that involving the hiring of new employees) could well tip the balance in favor of decisions to in-

7. Cost and benefit estimates on increasing earnings assumptions were included in *The 1966 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, February 28, 1966, pp. 39-40. These estimates showed slightly lower level of contributions and benefits for 1975 than the Joint Economic Committee Staff study.
8. There is also the possibility that a portion of the tax may be shifted to profits and rent.
9. Bert Seidman, "The Case for Higher Social Security Benefits," reprinted from the AFL-CIO *Federationist*, January, 1967.

vest further in labor-saving equipment.[10] Moreover, the payroll tax is a relatively heavy tax on lower paid, less skilled labor. The impact may be significant on industries which rely more than the average on such labor. A tax impact which discourages the hiring of unskilled workers goes in the opposite direction to government policies and programs which are designed to relieve the relatively high unemployment rates among unskilled groups.

It is true that other taxes also have undesirable effects. One of the difficult problems of analysis is to compare the effects of current and prospective payroll taxes with those of other taxes. Income taxes are not neutral in their effects on economic activity.[11]

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 similar benefits would cost if the employee were able to provide them through private forms of saving and insurance.

The payroll tax has now risen to a level such that, on the basis of certain assumptions, the total value (including interest) of *employee* taxes paid over a lifetime on the wages of some people now entering the labor force will exceed the discounted value of benefits to be received by these "new entrants." For example, a calculation by Mr. Ray Peterson, formerly Vice President of the Equitable Life Assurance Society of the United States, shows that the total value of employee taxes paid (under the Social Security Act as amended through 1965) by a *single male* retiring in the year 2010 would exceed his expected retirement benefits by 65 percent.[12]

A calculation by the Chief Actuary of the Social Security Administration shows that the average new entrant into the labor force today would just about pay for his retirement benefits from his own contributions.[13] (The contributions-benefit ratio varies substantially with family status, age of entry into the labor force, age of retirement, and other factors.)

For workers who earn at least the maximum taxable wages, a further increase in the payroll tax could substantially exceed such a limit — because benefits are heavily weighted in favor of those with lower earnings.

It has been argued that a substantial portion of the employer's tax is shifted back to the worker in the form of lower money wages and should, consequently, be taken into account in such comparisons of taxes and benefits.[14] On the other hand, it is argued that, regardless of the incidence of the tax, the employer's portion is a general contribution on behalf of all covered workers and cannot be attributed directly to the employee on whose wages the tax is levied.

The individual employee is likely to be mainly concerned with the size of his own contribution, changes in which have a direct impact on his take-home

10. For further analysis, see Tax Foundation, *Economic Aspects of the Social Security Tax* (New York: 1966), Chapter III.

11. For a discussion of effects, see Elizabeth Deran, "Some Economic Effects of High Taxes for Social Insurance," paper prepared for the Joint Economic Committee Compendium on Old Age Income Assurance, 1967.

12. Tax Foundation, *Economic Analysis of the Social Security Tax*, (New York: 1966), p. 48.

13. Robert J. Myers, "Analysis of Whether the Young Worker Receives His Money's Worth Under Social Security," mimeographed memorandum, Social Security Administration, March 8, 1967. More detailed calculations can be found in *Studies on the Relationship of Contributions to Benefits in Old-Age Benefit Awards*, Social Security Administration Acturial Note No. 20, June 1965.

14. James M. Buchanan and Colin D. Campbell, "Voluntary Social Security," *Wall Street Journal*, December 20, 1966.

pay. From a broader economic point of view, the value of resources diverted to social insurance should be compared with their potential value in private uses. Potential private uses may include not only private personal saving, but also private pension plans largely financed by employer contributions. If the principle of "individual equity" is judged to be of primary importance in social insurance, then employer contributions can hardly be omitted entirely from comparisons of individual tax-benefit ratios.

In summary, the expansion of social insurance programs in the United States is pushing the payroll tax to discernible limits. Views on these limits depend in part on judgments concerning the relative importance of insurance elements versus the objective of "social adequacy." The scale on which both these objectives are being pursued is emphasizing the conflicts between them and the need for re-examining the major policy alternatives. A substantial liberalization of benefits may force modifications in payroll taxation. However, if benefits are held to a "floor of protection," present financing methods may prove adequate without sizeable increases in tax rates.

III.

Financing Principles in Social Insurance

In a short space it is impossible to do justice to the extended analyses and debates that have raged over the financing of social insurance programs.[1] Nevertheless, some review of how we got where we are in 1967 is necessary to an analysis of current policy alternatives.

Shifts in Financing Principles For OASDI

The reports of several Advisory Groups on Social Security programs constitute a record of the "mainstream" of thought on social security financing. The first of these groups, the Committee on Economic Security, provided the initial recommendations for present programs in 1935. Its history, activities and views, have been reviewed by its Executive Director, Edwin E. Witte in *The Development of the Social Security Act* (Madison: University of Wisconsin, 1962).

This committee based its recommendations for old age insurance in part on two general financing principles, one of which was not adopted in the original act, and another which was subsequently sharply modified. Its recommendation for a general revenue contribution to the trust fund in addition to payroll taxes was not adopted. The principle of accumulation of a substantial reserve to meet future liabilities was very much modified by later amendments.[2]

The 1939 amendments included substantial changes in benefits and contributions. The scheduled increase in the tax rates in 1940 was postponed, so that the accumulation of reserves was on a much smaller scale than contemplated earlier. The relationship between individual contributions and benefits was also weakened.

In the 1939 amendments, "proponents of pay-as-you-go financing won a victory but the extent of the victory was uncertain."[3] As shown in Chart 2, contributions continued to exceed expenditures and the assets of the fund grew rapidly.

Few substantive changes were made in social security financing during the 1940's. Scheduled rate increases were further postponed, reducing the rate of accumulation of assets. The Revenue Act of 1943 made provision for a general revenue contribution whenever it might be required, but this provision was removed in 1950 without ever being used.

The postponement of scheduled rate increases meant not only that the assets of the fund grew more slowly, but also that the existing tax rates were far less than would be necessary on an individ-

1. For a summary of the controversies over accumulating a reserve, see John J. Carroll, *Alternative Methods of Financing Old-Age, Survivors, and Disability Insurance*, (Ann Arbor: University of Michigan, Institute of Public Administration, 1960), Chapter III.
2. The extent to which the Committee and the original Social Security Act embraced a reserve financing principle was obscured in part by attempts to deal with problems of constitutionality (Witte, *op. cit.*, pp. 146-149). In the Ways and Means Committee Report on the Social Security Bill, old age benefits were projected at $2.2 billion for 1965 and reserves at $30 billion (House Report No. 615, 74th Cong., 1st sess., April 5, 1935, p. 6), thus indicating a substantial reliance on the reserve principle.
3. Carroll. *op. cit.*, p. 24.

ual contributory basis, or an individual actuarial rate basis, to provide for the cost of benefits to individuals covered by the system. An individual actuarial rate has been defined as a rate "sufficiently high to cover the full cost of benefits for a person who pays it for his full working lifetime"[4] taking account of interest. Such an actuarial rate basis would primarily reflect the "individual equity" principle, as contrasted with the principle of "social adequacy":

> Individual equity means that the contributor receives benefit protection directly related to the amount of his contributions — or, in other words, actuarially equivalent thereto. Social adequacy means that the benefits paid will provide for all contributors a certain standard of living. The two concepts are thus generally in direct conflict, and social security systems usually have a benefit basis falling between complete individual equity and complete social adequacy.[5]

The late 1940's appear to have been the last time that the individual equity principle was specifically considered in planning social security amendments. The 1948 report of the Advisory Council on Social Security put considerable emphasis on this principle:

> The Council favors as the foundation of the social security system the method of contributory social insurance with benefits related to prior earnings and awarded without a means test. Differential benefits based on a work record are a reward for productive effort and are consistent with geneal economic incentives, while the knowledge that benefits will be paid — irrespective of whether the individual is in need — supports and stimulates his drive to add his personal savings to the basic security he has acquired through the insurance system. Under such a social insurance system, the individual earns a right to a benefit that is related to his contribution to production.[6]

The 1948 Report also repeated the recommendation for a general revenue contribution:

> The Council believes that old-age and survivors insurance should be planned on the assumption that general taxation will eventually share more or less equally with employer and employee contributions in financing future benefit outlays and administrative costs. Under our recommendations, the full rate of benefits will be paid to those who retire during the first two or three decades of operation even though they pay only a fraction of the cost of their benefits. In a social insurance system, it would be inequitable to ask either employers or employees to finance the entire cost of liabilities arising primarily because the act had not been passed earlier than it was. Hence, it is desirable for the Federal Government, as sponsor of the program, to assume at least part of these accrued liabilities based on the prior service of early retirants. . . . Such a contribution is particularly appropriate in view of the relief of the general taxpayer which would result from the substitution of social insurance for part of public assistance.[7]

Congress, however, rejected the recommendation for a general revenue contribution.

The 1950 amendments substantially liberalized benefits and increased the taxable wage base, as well as providing a new schedule of future increases in payroll tax rates. Extensions of coverage and

4. *Ibid.*, p. 29.
5. Robert J. Myers, *Social Insurance and Allied Government Programs*, (Homewood, Ill.: Richard D. Irwin, Inc., 1965), p. 6.
6. Advisory Council on Social Security to the Senate Committee on Finance, *Recommendations for Social Security Legislation* (Senate Doc. No. 208, 80th Cong., 2d. Sess., Washington, D.C.: 1949), p. 1.
7. *Ibid.*, p. 13.

liberalizations of benefits further weakened the relation between contributions and benefits. Substantial increases were provided for those already receiving retirement benefits. In general, benefits were to be computed on recent post-war levels of earnings, regardless of the fact that the individual's lifetime contribution reflected in part the much lower levels of pre-World War II wages and salaries. Inflation almost inevitably forced a shift in emphasis to "social adequacy" for older workers and those already retired.

The Social Security Act Amendments of 1956 empowered the Secretary of Health, Education, and Welfare to appoint periodically an Advisory Council on Social Security to review existing law and programs. The first Advisory Council was appointed in 1957 and made its report on January 1, 1959. The second Advisory Council was appointed in 1963 and made its report on January 1, 1965.

The reports of these two Advisory Councils marked a change in emphasis in financing methods. Both Councils emphasized their belief in the principle of "self-support," in other words, continued payroll financing without a general revenue contribution. Both also emphasized a belief in the "current principles" of the system. However, the content, wording and emphasis of the recommendations indicated a substantial change from the Report of the Advisory Council of 1948.

One change was a virtual acceptance of the principle of pay-as-you-go financing. While this shift was not stated outright in the texts, the recommendation on the role of the trust funds in the 1959 Report was as follows:

> The Council approves of the accumulation of funds that are more than sufficient to meet all foreseeable short-range contingencies, and that will therefore earn interest in somewhat larger amounts than would be earned if the funds served only a contingency purpose. The Council concludes, however, that a "full" reserve is unnecessary and does not believe that interest earnings should be expected to meet a major part of the long-range benefit costs.[8]

The Council expressed the belief that "the trust funds are and will continue to be larger than would be required for contingency purposes alone."

The 1965 Report of the Advisory Council on Social Security recommended that:

> The contribution rates now scheduled in the law should be adjusted to avoid the rapid increase in trust fund assets that will otherwise begin with the rate increases scheduled for 1966 and 1968.[9]

The virtual acceptance of pay-as-you-go and changes in the benefit structure marked a further departure from the individual equity principle in social security financing. The relation between the individual equity principle and pay-as-you-go financing is not a simple one. It is possible to have a social insurance system related to "individual equity" with or without the accumulation of a reserve fund. However, when the Advisory Councils "reaffirmed" the principle of "self support" (in that payroll taxes should provide sufficient revenue in the

8. The 1959 *Report of the Advisory Council on Social Security Financing*, reprinted in William Haber and Wilbur J. Cohen, *Social Security, Programs, Problems, and Policies, Selected Readings*, (Homewood, Ill.: Richard D. Irwin, Inc., 1960), p. 149.

9. *The Status of the Social Security Program and Recommendations for Its Improvement*, (Washington, D.C.: 1965), p. 18.

long run, with little accumulation of reserve funds, to meet benefit payments and administrative costs), they failed to spell out the implications for the individual.

There were critics and students of the social security system who did emphasize these implications. Robert M. Clark, who made a detailed study of the British and American social security systems for the Government of Canada, noted in 1959 that:

> The critical test of the actuarial soundness of the [OASI] Program is . . . yet to come. . . . This is readily apparent from the fact that by 1969 the tax rates for [OASI] will have to be raised from the combined rate . . . of four percent in 1958 to 8½ percent . . . Sooner or later voices are likely to be raised in the Congress saying that the burden of contributions for the Program is becoming too heavy for a significant fraction of the self-employed, or for the lower income groups. Some will demand a subsidy from general revenues, others a change in the tax structure to reduce the burden on those with relatively low incomes.[10]

The implications were further developed by Mr. Ray Peterson in a paper for the Society of Actuaries in 1959.[11]

The questions involved here are difficult ones which have not really been subjected to sufficient economic and actuarial analysis appropriate to a wealthy and growing economy with substantially full employment. Certain problems of individual equity in a pay-as-you-go social insurance system are examined in the Appendix. These problems are reflected in the concept of "actuarial soundness."

The Concept of "Actuarial Soundness"

As the social security system has developed in the United States, the concept of "actuarial soundness" used by the Social Security Administration has been reduced to the single question of whether expected revenues from contributions and interest will be sufficient to meet expected benefit payments and administrative costs. To quote one description by the Division of the Actuary:

> The concept of actuarial soundness as applied to the OASI program differs to a considerable extent from this concept as it is applied to private insurance. Certain points of similarity exist, especially in comparison with private pension plans. The most important difference arises because OASI can be assumed to be perpetual in nature, with a continuing flow of new entrants resulting from the compulsory nature of the program.
>
> Accordingly, it may be said that the OASI system is actuarially sound if . . . future contribution income plus future interest receipts will support the outgo for benefits and administrative expenses over the long-run. . . .[12]

This aggregative concept might more accurately be called a concept of fiscal control. This is because the main effect of the principle is to ensure that revenues will be forthcoming to meet expected benefits. The principle does not ensure that individuals now entering the labor force will necessarily "get their money's worth."

An essential purpose of standards of "actuarial soundness" is to ensure that funds will be available to meet claims and benefits. This purpose may be consistent with various contribution schemes

10. *Economic Security for the Aged in the United States and Canada*, A Report Prepared for the Government of Canada (Ottawa: Queen's Printer, 1960), Vol. I, p. 155.
11. "Misconceptions and Missing Perceptions of Our Social Security System (Actuarial Anesthesia)," *Transactions of the Society of Actuaries*, Vol. XI, Meeting No. 31, November 1959, pp. 812-919.
12. *The Financial Principle of Self-Support in the Old-Age and Survivors Insurance System*, Social Security Administration Actuarial Study No. 40, (Washington, D.C.: 1955), p. 8.

and financing methods. In private individual insurance, the relation between an individual's contributions and his expected benefits is necessarily an important element in "rate making," the equivalent of tax rates in social insurance.

The declining importance of the individual equity principle in OASDI is reflected in the infrequent use of the "actuarial rate" in discussions of the cost of social insurance. On the basis of private individual insurance, ". . . the actuarial rate expresses the value of the benefits to the individual."[13] With the weighted benefit schedule of the OASDI system, such an actuarial rate would be a group rate:

> Low wage earners get larger benefits in relation to their contributions than do high wage earners, and the actuarial rate represents the average value of the benefits for persons in each age group that has the opportunity to contribute over a working lifetime.[14]

Just how much redistribution from higher to lower wage earners is consistent with such a group "actuarial rate" has never been specified. The differentials in contribution-benefit ratios vary not only with earnings levels but also with marital status, retirement age, and other factors. Neverthless, the expected (discounted) value of a typical individual's benefits or "protection" could hardly be allowed to fall below the value of the individual's own contributions without causing legitimate protests on equity grounds. Moreover, if the whole social insurance system is to be justified substantially as a wage-related, contributory system, a similar limit must apply in some degree to the employer's contribution.

This review of financing principles indicates that the principle of "individual equity" in OASDI programs needs detailed re-examination.

13. Robert M. Ball, "What Contribution Rate for Old-Age and Survivors Insurance?" *Social Security Bulletin*, July 1949, p. 4.

14. *Ibid.*

IV.

Major Alternatives in Financing Social Insurance

The conflict between the objectives of "social adequacy" and "individual equity" was notably illustrated in 1967. The Administration's proposed Social Security amendments (contained in H.R. 5710) were designed largely to make the OASDI programs a more effective instrument in the "war on poverty."

The President's Message on Older Americans (January 23, 1967) said:

> Although Social Security benefits keep five and one-half million aged persons above the poverty line, more than five million still live in poverty.
>
> A great nation cannot tolerate these conditions. I propose Social Security legislation which will bring the greatest improvement in living standards for the elderly since the act was passed in 1935.

The adequacy objective was reflected in the large increase in the maximum tax base (which raises the tax relatively more than benefits for those with earnings near or above the maximum), in the increase in minimum old age retirement benefits from $44 to $70 per month, in the special provisions for those with 25 years or more of coverage, and in other provisions. The proposed 60 percent increase in the minimum old age retirement benefit was intended particularly to provide more adequate benefits to low-paid and irregularly employed workers, whose contributions, even under the proposed increases in tax rates and the maximum tax base, would by no means provide for such benefits. "Every insured worker retiring at or after age 65 would be paid at least $70, regardless of how long he worked under the program."[1]

The concern of the House Ways and Means Committee with maintaining a wage-related system was evident in the questioning of Administrative officials and elsewhere.[2] In answering questions on the proposed minimum old age benefit before the Committee, Mr. W. J. Cohen, Under-Secretary of the Department of HEW, admitted that:

> . . . perhaps there is some modification in policy that is embodied in this proposal. We think the system should be consistent with the philosophy of a wage-related system and still make a substantial contribution to the reduction of poverty; we think that those two objectives should be kept in mind but always balanced so that people who have higher earnings and who contribute more get more.[3]

1. U.S. House of Representatives, Committee on Ways and Means, *Section-by Section Analysis and Explanation of Provisions of H.R. 5710, The "Social Security Amendments of 1967"* as introduced on February 20, 1967, (prepared and furnished by the Department of Health, Education, and Welfare), Committee Print, 90th Cong., 1st sess., p. 22.
2. In a letter to the *New York Times*, dated August 9, 1967, Representative Barber B. Conable, Jr. (R, N.Y.), a member of the House Ways and Means Committee, said: "Social Security has had wide acceptance and strong support because through it a man can invest in his retirement, rather than simply suffer another form of taxation. . . . Social Security must remain a substantially wage-related supplement if it is to continue as a valuable and widely supported aid to the working man . . ." (*New York Times*, August 14, 1967).
3. Quoted in American Enterprise Institute, *Legislative Analysis, Proposed Social Security Amendments of 1967* (Washington, D.C.: 1967), pp. 25, 26.

The concern of the Ways and Means Committee was evident also in the sharp cutbacks in proposed increases in benefits and payroll taxes in the bill (H.R. 12080) reported by the Committee on August 7, 1967 (see Table 1, above p. 8).

Recent debates and current pressures for change suggest various alternatives or possibilities for the future financing of OASDI programs.[4] Four alternatives, illustrating the major value judgments and economic issues involved, are examined here: (1) to continue approximately the present balance between the objectives of social adequacy and individual equity; (2) to provide a general revenue contribution to OASDI trust funds; (3) to modify the payroll tax to reduce the burden on low income groups; and (4) to divide the benefit schedules into two portions, one of which would be based on "adequacy," and one which would directly reflect individual contributions, and to finance each portion separately by different forms of taxation.

Maintaining the Present Balance of Objectives

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. Indeed, some such balance may be taken as one of the distinguishing features of "social insurance."

The Committee on Social Insurance Terminology of the American Risk and Insurance Association, in its most recent redrafting of the definition of "social insurance," listed as one of the conditions or characteristics of such insurance the following:

> The benefits for any individual are not usually directly related to contributions made by or in respect of him but instead usually redistribute income so as to favor certain groups such as those with low former wages or a large number of dependents.[5]

The extent of redistribution consistent with "social insurance," however, is largely a matter of value judgments. The current balance in objectives is being strained as the payroll tax burden grows. In the view of one member of the House Committee on Ways and Means, a substantial increase in the redistribution of income in favor of low income groups under social insurance programs:

> . . . would remake our Social Security System into an extension of the welfare programs. We would then be in the position of requiring greater contributions for welfare from the wage earner than from the general taxpayer.[6]

It is also argued that the present financing system, relying only on payroll taxes, provides a restraint on expenditures that would be removed by a shift to general revenue financing. Representative Wilbur D. Mills, Chairman of the House Ways and Means Committee, once said:

> I do not believe there should ultimately be a contribution from general revenues. If there is such a contribution, there is no real deterrent to demand for extremely high payments.[7]

4. Hospital insurance and the voluntary medical supplementary insurance adopted in 1965 are not separately examined here. They involve another range of issues in addition to the fundamental issues of objectives in the older "insurance" programs. The innovations in financing health insurance, including a general revenue contribution for SMI, nevertheless serve to illustrate problems in financing the older programs.

5. Unpublished mimeographed draft dated Spring, 1967. For the full definition, see below p. 39.

6. Representative Barber B. Conable, Jr., *New York Times*, August 14, 1967.

7. Statement in an interview quoted by Robert M. Clark, *Economic Security for the Aged in the United States and Canada*, A Report Prepared for the Government of Canada (Ottawa: Queen's Printer, 1960), Vol. 1, p. 153.

The present system of payroll tax financing contains an important fiscal control device. Whenever increased benefits are proposed, the House Ways and Means Committee, under whose jurisdiction social security falls, must also consider the long-range financing of such benefits as well as administrative costs. When the benefits schedule is revised, the contributions schedule is also revised to ensure that sufficient revenues will be forthcoming to meet all benefits and other costs. This is a device that does not operate in the general budget, although similar procedures have been proposed for administrative budget programs.

The effectiveness of this fiscal control on the level of expenditures in the past may be questioned. Other countries have social insurance systems in which the same type of fiscal procedure operates except that a general revenue contribution is a part of the additional levy that goes with increased benefits. A recent study comparing social insurance systems in different countries shows that partial reliance on general revenues in social insurance systems is not associated with higher expenditures: ". . . the proportion of national income devoted to social security is higher in some of the countries that rely less on general revenues for financing these expenditures."[8]

Over the last two decades in the United States, the tendency of social security benefit increases to be associated with election years suggests that the benefit increases have been of more concern to the public than the payroll tax increases. Until recently the payroll tax was relatively small, and people appear to have had an exaggerated idea of the extent to which they were paying for their own benefits. After surveying the opinions of various groups in the United States, Robert M. Clark concluded:

> Most Americans are enthusiastically in favor of Old-Age, Survivors, and Disability Insurance. They feel that this is their Program and not something the Government does for them . . . most people have a highly exaggerated idea of the extent to which they have or will have paid for their benefits.[9]

The small extent to which benefits have been "prepaid" is shown in an estimate by the Chief Actuary of the Social Security Administration: "For those now on the rolls [1964,] it is likely that they would have paid, at most, for about 10 percent of the benefits actually payable to them."[10]

As indicated in Section II, the tax-benefit ratios have changed drastically for new entrants to the labor force. The ratio of the value of the employee's tax payments to the expected value of his benefits under existing legislation would be nearly tenfold greater for persons retiring in 2010 than for those retiring in 1965.[11] If people have had illusions in the past about the degree to which they were paying for their own social security, these illusions are likely to be dispelled in the future. The impact of payroll taxes at current and prospective levels will almost certainly generate opposition to increased social security benefits.

8. Henry Aaron, "Social Security: International Comparisons," in Otto Eckstein, ed., *Studies in the Economics of Income Maintenance*, (Washington, D.C. The Brookings Institution, 1967), p. 20.

9. *Op. cit.*, p. 179.

10. Statement quoted in American Enterprise Institute, *Legislative Analysis, Proposed Social Security Amendments of 1967*, (Washington, D.C.: 1967), p. 41.

11. Tax Foundation, *Economic Aspects of the Social Security Tax*, (New York, 1966) p. 48. Comparisons were based on an interest rate of 3½ percent, and assumed that the individuals earned the maximum taxable wage or more.