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Issues in Social Security Financing

By Paul N. Van de Water

In social security, unlike any other government program, there is a significant relationship between the taxes an individual pays and the benefits for which he and his family will be eligible. Each worker pays taxes on his or her covered earnings and receives important insurance protection for the family against loss of income due to the retirement, death, or disablement of the wage earner.

While the contributory concept has traditionally been a source of strength for social security, it may now be adding to public dissatisfaction with the system. The myth that each worker has a numbered account in which his taxes are deposited is no longer widely held. But it has not been replaced with any more profound understanding of how social security works. . . .

As a result, 80 percent of Americans, according to a recent Harris survey, have "less than full confidence" in the social security system, and 40 percent, particularly younger workers, say that they have "hardly any confidence at all." Social security is no longer generally viewed as a dramatic social achievement for which support is automatic. The payment of benefits in the long run is regarded as uncertain. Together with the pressures of inflation on taxpayers, these factors have led to a decreased tolerance of the taxes required to finance the system.

An absolute necessity for rebuilding confidence in social security is to keep the social security trust funds from being exhausted during the next two years and to allow the funds to be built up to an appropriate contingency reserve level. . . .

Congress moved courageously in 1977 to ensure the financial stability of the system, but the bulk of the additional tax revenues which the Congress enacted will not begin to come in until 1981. As a result, the assets of the retirement and disability insurance trust funds will continue to decline through the end of next year. The com-

This Issue In Brief

In 1977, Congress moved "courageously" to ensure the long-run financing stability of the social security system, but most of the added tax revenues will not begin to come in until 1981, writes Dr. Paul N. Van de Water in this issue of *Tax Review*.

The scheduled tax increases can be forestalled only by cutting benefits or by using non-payroll tax revenues, he holds.

Dr. Van de Water examines the financial outlook for social security over the next five years and over the next 75 years and weighs alternative solutions. "...Financial problems facing social security are not without solutions," he writes. "The challenge is to engage in a reasoned public debate that will help choose those solutions which best meet the evolving needs and desires of the American people."

This issue is excerpted from a speech delivered by the author at a recent Tax Foundation seminar.

Note: This paper is not a statement of official policy. The views expressed are personal and not necessarily those of the Department of Health, Education, and Welfare or the Tax Foundation, Inc.

bined old-age and survivors insurance and disability insurance balance will fall by about $2 billion in absolute terms to a point where it will represent only 24 percent of a year's outlays. Since a balance of 10 percent of annual outlays is necessary at the start of a year simply to meet the program's cash flow needs, the projected 1981 reserve will provide a rather slim margin against a possible downturn in the economy.

I have argued elsewhere that the social security trust funds should, in good times, maintain a contingency reserve of at least 60 percent of annual outlays. The 60 percent figure was derived as the level necessary to enable the social security system to survive a recession slightly more severe that that of 1974-75 without having to raise taxes until unemployment falls below 6 percent. Under current government economic projections, which assume no recession in the interim, the OASDI trust funds will not reach the 60 percent level until 1988. In the meantime, the financial health of the social security system must be watched with some care.

A corollary of this point is that the 1981 payroll tax increase can be avoided only by cutting benefits or by using non-payroll tax revenues to support the system. There is simply no room for cutting payroll taxes without making up for the lost revenues in one way or another.

The amount of money needed to forestall the scheduled tax rate increases for retirement and survivors, disability, and hospital insurance is quite large. The tax hikes from 6.13 percent today to 6.65 percent in 1981 and 6.70 percent in 1982 represent an overall increase in the rate of almost one-tenth for both workers and their employers. In 1981 and 1982 terms, that represents $14 or $15 billion.

Paul N. Van de Water, acting director of Policy Analysis, Social Security Administration, U.S. Department of Health, Education, and Welfare, directs long-run policy planning and analysis of proposed policy changes. He was formerly an economist in the Office of Income Security Policy at HEW.

A National Science Foundation Fellow and Honorary Woodrow Wilson Fellow, Dr. Van de Water received his Ph.D. in economics from the Massachusetts Institute of Technology.

He has published numerous articles and papers on the social security insurance program.

The Carter Administration this year proposed a package of selective benefit reductions whose enactment, together with hospital cost containment, would allow the 1981 payroll tax increase to be substantially reduced—perhaps even deferred for several years. . . .

A coalition of special interest groups, banded under the name of Save Our Security, has expressed vehement opposition to the Administration's proposals. This organization takes the position that, once a social security benefit has been enacted, any attempt to repeal or restructure that benefit represents a breach of promise to the American people. . . .

While one may disagree with the Administration's proposals on their merits, the view of social security as sacrosanct seems to me untenable. In this period of inflation, when both household and government budgets are tight, we cannot afford to spend large sums solely because of tradition. If an element of social security has outlived its usefulness or has ceased to be a high-priority item, it should be phased out. . . .

On the other hand, people who are making important decisions based on the expectation of certain benefits should not have their plans disrupted by sudden, unexpected changes in social security. For this reason, it is generally agreed that changes in social security benefits should usually apply only to those who are not yet on the benefit rolls. . . .

The need to institute benefit cuts prospectively makes it very difficult to make significant cuts in social security quickly....Thus, even though the Administration's proposals would reduce future retirement and disability insurance outlays by about 2½ percent in the long run, *they would save only about ½ percent of the program costs in their first full year.*

A number of members of Congress—responding to the public outcry over rising payroll taxes—have indicated that benefit reductions should be seriously considered as a way to hold the line on payroll taxes. . . .

The alternative to benefit reductions is, as I said earlier, general revenues, and I would now like to comment on the forms of general revenue financing which I find appealing and those which seem less attractive to me.

One type of very limited general revenue financing that deserves a new look is a countercyclical payment, which would be triggered only by a downturn in the economy. . . .

Another possible use of general revenues, endorsed by the 1975 Advisory Council on Social Security and introduced in bill form by several Republican members of the House, is to finance the hospital insurance or medicare program. This approach is a particularly attractive way of infusing a significant amount of general revenues into social security, since medicare is the one element of social security in which benefits have absolutely no relation to earnings. . . .Financing half of medicare with general revenues is roughly what would be required to forestall the 1981 payroll tax rate increase.

A related proposal that I think has relatively little merit is to finance the disability insurance program with general revenues. The advocates of this scheme misunderstand, I think, the nature of disability insurance. . . .

Another possible source of general revenues for social security is to subject all or part of social security benefits to the personal income tax and to channel the additional Federal revenues back into the trust funds. . . .

General revenues might also be channeled into social security on a temporary basis in conjunction with selective benefit reductions. . . .General revenues could be used to finance social security benefits which the Administration and the Congress have decided to phase out. Such a move would reflect a judgment that certain benefits are no longer appropriately financed through the social security payroll tax but that people now receiving these benefits should not have them suddenly and unexpectedly cut off. . . .

A variant of this scheme is to provide for permanent financing of the so-called "welfare" or non-wage related elements of social security out of the general funds. While the designation of the "welfare" elements of social security would necessarily be somewhat arbitrary, likely candidates include all dependents' benefits and that portion of primary benefits for which replacement rates exceed the average level. A major concern with this approach, as with full general revenue financing of medicare, is that general revenue financing of specific benefits might lead to their being paid only with a means test. This concern is reflected in a proposal by organized labor that one-third of social security be financed through general revenues. The one-third of benefits that would be financed by general revenues may be loosely thought of as the "welfare" elements, but no specific benefit would be singled out, and none would thereby become a special candidate for means-testing.

In the medium run, the whole approach to general revenue financing could change if the structure of benefits were substantially altered. One alternative, advanced by Alicia Munnell in her 1977 Brookings Institution volume and by the Federal Tax Division of the American Institute of Certified Public Accountants, would be to make social security a strictly proportional earnings replacement program and to rely on supplemental security income to achieve social adequacy goals. As a concomitant of this, the amount of payroll taxes needed to finance social security would decline and the amount of general revenues needed for supplemental security income would rise.

Another structural alternative, recently surfaced in HEW's report on *Social Security and the Changing Roles of Men and Women*, is the so-called double-decker. In a double-decker, all aged and disabled individuals, whether or not they ever worked, would receive the Tier I benefit—a flat amount or demogrant. In addition, people who worked in employment covered by social security would receive a Tier II benefit equal to a constant proportion of their average earnings.

The double-decker is of particular interest because—when combined with a 50-50 split of earnings at divorce and the inheritance of a deceased worker's earnings by the surviving spouse—it goes a long way towards addressing the issues raised by the changing roles of women in our society. In addition, the Tier I benefit is an obvious candidate for general revenue financing. For both of these reasons, I think that the double-decker approach will be the subject of considerable attention in the years ahead.

Let me move now to the longer-run issues in social security financing. After the mid-1980s, the retirement and disability programs are projected to be in good financial shape for 30 or 40 years. The current tax rate schedule, which includes further payroll tax rate increases in 1985, 1986, and 1990, will cause the OASDI trust funds to build up substantial balances through the early part of the 21st century. According to current projections, the combined OASDI balance will rise to over three times annual outlays by the year 2010. After that point, it would be gradually drawn down, until the funds would approach exhaustion around the year 2030.

While a balance of three times annual outlays is nowhere near as large as Martin Feldstein would recommend to encourage capital formation, it is clearly much larger than what is required as a contingency reserve. One does not have to be much of a prognosticator to suggest that the Congress will not actually allow the trust fund balances to get that large. Either the scheduled tax rate increases will be held down, or else the annual surpluses will be spent to finance improvements in the social security benefit package, possibly including higher benefits for single workers and two-earner couples and disability protection for homemakers.

Viewing retirement and disability insurance in conjunction with medicare, social security is projected to be in approximate actuarial balance for the next 25 years. The surplus in OASDI during that period is roughly offset by a comparable deficit in HI. The reason for this large HI deficit is an assumed continuation of runaway increases in hospital costs. While the fraction of aged and disabled persons in the population is projected not to increase, the cost of medicare as a percent of taxable payroll is projected to more than double.

While exponential increases of this sort cannot continue for another 25 years....the figures do bring home the importance of some form of hospital cost containment to social security.

My final point is that, even over the next 75 years, the financing of social security does not pose an insurmountable problem. We must begin to think about ways of adjusting to a population with a larger fraction of older people, but we should not assume that the currently projected deficits will necessarily come to pass. If the fertility rate and rate of growth in productivity turn out to be somewhat higher than now projected, the system could show a surplus over the 75 years.

Even if fertility rates remain low, there are several ways of dealing with the resulting deficit. Until recently, I had thought that trying to raise the social security retirement age is going against the tide, in light of the trend towards more liberal early retirement provisions in private pensions and the increase in early retirement under social security. But the recent Harris survey, which I cited earlier, finds that 51 percent of employees say they want to continue working, either full-time or part-time, beyond the normal retirement age. According to pollster Harris, this is the first time that the majority has expressed such a desire. I should note, however, that later retirement will help keep down payroll taxes only if people work *instead of* drawing benefits. If people are allowed to work and draw social security benefits as well, the thrust of the recurring proposal to eliminate the earnings test, the pressures on the trust funds will remain acute.

Across-the-board cuts are also problematic, given social security benefit levels that in many cases are not particularly high. If long-run actuarial balance were to be produced without raising taxes above the scheduled 1990 level, it would be necessary to reduce projected benefits by about a quarter in the early 21st century. A cut of this magnitude would reduce the benefits of the average single worker from about 40 percent of prior earnings to only about 30 percent.

Inflation is another factor militating against an across-the-board cut in social security benefits. While inflation erodes the real value of pension benefits and private saving, social security is the only major form of retirement income which is indexed for inflation. Unless inflation is controlled or private retirement income is inflation-proofed, there will be significant pressures to increase rather than reduce the role of social security.

Finally, the possibility of simply living with higher payroll taxes should not be ruled out. The cost of the old-age, survivors, and disability insurance programs in the middle of the 21st century is estimated to be a bit over 16 percent of payroll, which could be financed by a tax of 8 percent each on employers and employees. Including medicare, the needed tax rate would probably be slightly over 10 percent each. While these figures may be in excess of what we as a society consider appropriate, they are well within the levels prevailing today in many countries.

In saying this I do not wish to minimize the difficulty and complexity of the financing issues facing social security over the next five years and over the next 75 years. But I would like to still those voices who say that social security will no longer be around in 2049, when my daughter retires. I have tried to show that financial problems facing social security are not without solutions. The challenge is to engage in a reasoned public debate that will help choose those solutions which best meet the evolving needs and desires of the American people.