Chapter 2.-Introduction

A specific task given the Panel was to examine the financing and benefit consequences of alternative benefit formulas. Such formulas include those built on the real wage and the relative wage approaches, as well as those related to earnings of a brief period such as the highest five years in the benefit computation period. For each of these, evaluation was to be made of (1) the levels of initial benefits payable to various categories of current and future beneficiaries, (2) the changing patterns of these benefits over many years, (3) cost impacts, and (4) the funding patterns and required financing. Because of time limitations, the Panel concentrated its study on the structure of retirement benefits. Our analysis covered the financing of survivor and disability benefits, but did not examine their benefit structures. We understand that other outside consultants have been engaged to investigate the disability program, and we recognize the need to consider appropriate changes in survivor benefit structures.

THE NATURE OF THE MAJOR ISSUES

1. *Benefit formula.*-The present social security benefit formula, legislated in 1972, adjusts benefits automatically to reflect changes in the Consumer Price Index. In addition, the automatic provisions cause the taxable earnings base to rise as average wages under covered employment increase. Both of these indexing provisions were introduced to provide a more orderly and timely means of adjusting benefit levels in response to inflation. But while automatic mechanisms for this purpose are commendable, it is essential that they operate rationally and predictably.

One, but not the only, measure of a formula's rationality is the so-called "replacement ratio". This is simply the ratio of benefits awarded at retirement to workers' taxed earnings before retirement. The general levels of these ratios-how they vary for workers whose earnings histories differ or who retire at different times, and how they vary under different economic conditions-are among the important indicators of how well the program is achieving its intended purpose.

As reported by both the Panel on Social Security Financing and the 1974 Advisory Council on Social Security, the present benefit formula is hypersensitive to changes in the price level. The current automatic provisions act to increase replacement ratios when certain relationships between wage and price increases occur, and to decrease them under other relationships. Large changes in replacement ratio can arise from quite conceivable differences in these relationships. Of course, large changes in the replacement ratio imply large changes in the taxes needed to finance the program.

The operations of the present formula lead easily to situations in which replacement ratios for many workers approach and even exceed 100 percent. In many of such cases the result is a standard of living that is higher after than just before retirement. The frequency of this anomaly is further increased by the existence of the spouse's benefit.

2. *Serious financial deficits over the short-range and long-range of the program.* -The current excess of outgo over income, threatening exhaustion of the OASDI Trust Funds, is largely due to adverse economic conditions of recent years, i.e., the high rates of inflation and of unemployment. The automatic provisions operate to increase benefits according to the Consumer Price Index. On the other hand, revenue for the program is directly related to the total employment rate and to wage levels in the economy. Latest estimates warn that, if no corrective action is taken to prevent it, the Trust Fund will be exhausted by the early 1980's.

The expected long-range financing difficulty of the OASDI program is attributable to both (a) an anticipated increasing ratio of the OASDI beneficiaries to working contributors, and (b) the nature of the benefit formula. It appears that each of these factors may account for about half the problem's magnitude.

3. Changes in other income maintenance programs.-The original intent of the social security cash benefit program was that widespread economic dependency be prevented, rather than alleviated once it had occurred. Congress has repeatedly reaffirmed this principle. Prevention was to be based on a three-tiered income maintenance system for those reaching retirement age.

The first tier, established in 1935 and changed extensively in 1972, has been a system of federally matching grants for state old-age assistance programs. Payments are based on need and are subject to a means-test. The assistance program aims to provide subsistence income to recipients. The second tier is the OASDI program which relates benefits to a worker's earnings and, partially, to the amount he or she contributed to the system. Benefit payments, based on earned "rights" rather than on need, are envisaged as providing a "floor of protection" that would supply income adequate for needs for people above the subsistence level. The third tier is the income created through personal savings and non-OASDI pensions.

A problem with the assistance (first-tier) program has been that eligibility requirements and payments have been far from uniform among States. In some cases, the assistance payments have been far below those required for minimum subsistence. Making up the shortage became more and more *a de facto* responsibility of the second-tier social insurance program. As a consequence the OASDI program established a minimum benefit which has been raised substantially to a current level at $101.40 per month.

In 1972, Congress enacted legislation that enables the first tier to provide uniform and adequate subsistence income. The newly created Supplemental Security Income Program (SSI) provides a flat means-tested benefit established by the Federal Government. States whose old-age assistance benefits are greater than those under the new scheme are obligated to maintain benefits at their own higher level. Other States can supplement the basic amount voluntarily. The current (February, 1976) SSI amounts of $157.70 for a single person and $236.60 for a couple approximate what are needed to meet Federal poverty standards; in the numerous cases of State supplementation they bring payments close to or even above recognized poverty standards. The resulting return in responsibility for basic subsistence from the second to the first tier permits drastic reduction, even elimination, of the role that the social insurance system has played in this area.

Of comparable impact upon the third (non-governmental) tier has been the recent passage of ERISA legislation. This law has set minimum vesting, portability, and fiduciary standards for private pension plans, and can be counted upon to raise the assurance of financial protection supplied by corporate pension plans. But perhaps the most immediate result of the ERISA legislation has been widespread use of its provision allowing individual retirement accounts (IRA) for those who are not protected by an employer-financed pension plan. Employees may set aside a portion of their earnings in an IRA account, the incentive being that such contributions and the investment earnings thereon are not subject to current Federal income tax.

Developments in these other programs are themselves cause for substantial revisions in the OASDI structure.

4. Changes in the female labor participation rate.-Forty years ago, most nonfarm families depended for income upon the earnings of only one member. In but a few cases were both spouses employed continuously. This social condition gave rise to a benefit structure that took into account, through a spouse's benefit, the greater financial needs of a family with two adults. Because two-worker families were few, equity between one-worker and two-worker families (i.e., the relation between the individual's total contributions and the total expected benefits) was not of great concern.

But the situation has changed. Many more married women remain employed throughout a major portion of their working lifetimes. Consequently, inequities in the benefit structure are increasingly common. For example, if both husband and wife are employed, and one spouse has average annual earnings of, say, $12,000 while the other one has average earnings of $3,600, and both must pay social security taxes on their earnings, their total retirement benefits will be 150 percent of the benefit calculated on only the first spouse's average earnings of $12,000. Yet if only one spouse is working and earning the $12,000 average amount, that family receives the same retirement benefit. The first family's contributions to the social security system are 30 percent greater than the second family's, but the retirement' benefits are identical. A comparable inequity between single workers and workers with families is observable.

PRINCIPLES GOVERNING THE SOCIAL SECURITY PROGRAM

Over the years, Congress has adhered to three fundamental principles to guide its social security decisions. These principles-(1) individual equity balanced with social adequacy, (2) controllability and long-run stability, and (3) economic efficiency-continue to be perceived as necessary to and consistent with the overriding goal of the system: to provide economic security to American workers and their families in the event of lost income due to retirement, disability, or death. This goal was stated in the original report of the President's Committee on Economic Security, and has been widely accepted ever since by Congress and the general public.

These three principles help to explain the nature of the legislative policy decisions through the years. Because they are the criteria by which any new legislation will be judged, they provide a frame of reference for evaluation and comparison of alternative solutions.

1. Individual equity and social adequacy. -Equity and adequacy are bound to be competing objectives. Enhancement of one tends to cause diminution in the other.

Individual equity can be identified as the degree to which an individual's benefit rights are reflected by the contributions he or she has made to purchase those rights. A program in which individual equity is the overriding goal-personal insurance, for example-requires that each individual's benefit amount be based on the actuarial value of that individual's contributions. In a program that completely disregards individual equity, benefits can be unrelated to contributions. Such a program might not even require contributions, but instead be financed from general government revenues. This is the case with the SSI program.

Social adequacy is a welfare objective in which an individual's benefit amount is determined, not by his or her contributions, but by (a) appropriate transfer of income from affluent to needy groups, and (b) a minimum standard of living beneath which society decides that no individual should fall. The Social Security Act of 1935 represented a compromise between equity and social adequacy within a system that was designed to build at least a part of the actuarial reserve that would be necessary to fund a comparable privately operated program. But amendments to the Act steadily shifted the emphasis more in the direction of social adequacy by weakening the relationship between benefits and contributions.

Although the benefit formula emphasizes social adequacy, the benefit level, for all workers already retired and for most who will retire during a long future period, is higher than the level that could be paid from the accumulated value of lifetime contributions by and on behalf of the worker. (The exceptions are the benefits for unmarried workers whose earnings have always been close to the

[1] Survivor and disability benefits are not identical, but this offset is frequently overlooked, particularly when these contingencies have not occurred.

maximum taxable earnings base (MTEB), and the benefits for two-worker families both of whose earnings are near the maximum.) This situation has developed for two reasons: the maturing of the system, and the "pay-as-you-go" method of financing.

Any pension program, public or private, takes forty years or more to reach maturity. At the beginning of the program, it is often decided to extend full benefit rights to those who are close to retirement age, even though their contributions will have been very small. A worker reaching age 60 in the first year of such a program might be granted full benefits after only five years' contributions, while a worker reaching age 20 in the same year might be required to make 45 years of contributions to qualify for the same benefit. This condition, to a large extent, describes the OASDI program.

This discrepancy rises to its maximum under "pay-as-you-go" financing, a method in which each year's contribution rate is required to be high enough to finance only that year's current benefits. At present, the ratio of retired persons to workers is moderate, hence the required contribution rates are moderate. But this ratio will increase as demographic changes result in a greater percentage of the population at or above retirement age. Consequently, if the present system continues unchanged, the current generation will have made contributions that are less than those required to finance its future benefits.

Moreover, whenever there is growth in working population and in wage rates, the taxable wages will also be increasing. Increasing taxable wages produce greater income to the system. During a period of growth, then, a worker's contributions into a pay-as-you-go system need not be as large as will be required when the growth is no longer occurring.

All of these relationships affect the degree of inter-generation equity as well as of equity among members of each generation. Complete equity between generations demands that those different generations receive comparable benefit amounts in return for comparable contributions. Ultimate equity within a generation exists only if workers' benefits are directly proportional to the amounts of their contributions. No social insurance program can achieve ultimate equity and social adequacy. The objective can only be to do justice to both.

2. Controllability and long-run stability.-Individual participation in the social security program extends over a long period, a worker can easily have made contributions for forty years before he or she is eligible for benefits. Thus, public acceptance and confidence in the program depend largely on the existence of long-term stability. Fortunately, in this respect, the social security program has so far proved successful. The credit for this goes to careful supervision and wise legislation on the part of Congress and to sound recommendations by the administrators of the system and its many advisors and students.

Two important measures have assured the long-run integrity of the program: the regular testing of equivalence of taxes and benefits up to a 75-year period horizon, and the inclusion of a margin of safety in the annual cost estimates. Many provisions in a social security system that have little effect in the first years after their enactment can have serious impacts in later years. The 75-year projection gives Congress a much needed measure of the fiscal health of the system. Furthermore, cost estimates have, until recently, contained an added measure of conservatism because no allowance was being made for the effects of the growth of faster-rising earnings over more slowly rising benefits. Congress has used the resulting surplus to increase benefits, but only after, not before, such a surplus has emerged.

It cannot be stressed too strongly, however, that it is impossible for even the best of forecasts to give a precise and reliable indication of what will happen. Future events are largely unpredictable, particularly in an era when the pace of change in economic and demographic conditions has accelerated. Social conditions are changing, and these too have serious impacts on social security.

Consequently, any alteration in the social security benefit structure and financing arrangements should leave opportunity for future Congresses to make periodic adjustment in the light of then current economic, demographic and social conditions. This belief is a cornerstone of this Panel's recommendations.

3. Economic efficiency.-Although social security's main benefit to society is its help to the well-being of its beneficiaries, its magnitude causes it to have other social and economic implications. Important among these are the effects on individual economic incentives-how the benefit structure and financing influence savings behavior, work incentives, and employment opportunities. Recently, savings behavior has been of particular concern. Many believe that if there were no social security program, workers would save a larger portion of their current earnings to provide retirement income. Under a pay-as-you-go system, contributions collected by the program are paid out immediately as benefits, i.e., no sizable fund accumulates. Consequently, the presumed decline in personal savings is not offset by accumulating national trust funds. The net decline tends to produce scarcity of capital, and thus to increase the prevailing interest rate. To the extent this happens, borrowers have to pay more and capital investments by corporations and individuals decrease.

On the other hand, if the social security program encourages voluntary and earlier retirement, this may have a positive effect on savings: people may see a realizable goal in combined social security, private pension and personal savings, and may save more to make that dream come true. Also, the knowledge that benefits are payable only if retirement occurs may lead some to save more so as to be able to retire sooner.

Another question is the impact on work incentives. If, as is sometimes the case for low-income workers, the benefit approaches or even exceeds the amount of a worker's net annual wage before his retirement or disability, then the incentive to stop working and collect the benefits becomes large. Moreover, work incentive is affected after retirement by the provisions of the retirement test. The current requirement that a beneficiary below age 72 whose earnings exceed $2,760 per year must refund 50 cents on every dollar earned in excess of that amount is equivalent to an income tax surcharge at a 50 percent rate which may well discourage elderly persons from augmenting their retirement incomes through full- or part-time jobs.

For younger workers, however, work incentive is affected by the view taken about their contributions to the system. Workers who see the contribution as a tax are likely to make their decisions by measuring the attractiveness of the take-home pay, which may adversely affect work incentive. But those who picture the system as a compulsory savings program in which portions of current income are being set aside for use after retirement may retain a work incentive only mildly influenced by the size of the payroll tax.

SECONDARY CONSIDERATIONS

An important requirement of any program as large as social security is that it be understandable. Contributors and beneficiaries alike must know their rights and obligations under the system. In addition, the advantages of supplementing, through private provision, the basic protection offered by the system must be visible. The tax incentives involved must be clear to see.

Another consideration that arises when the benefit formula is to be changed is what special treatment is appropriate for people close to retirement time. Correction of the technical flaw discussed earlier should not be at the expense of benefit expectations on which those people have made their plans. This calls for a phasing-in provision that introduces the new benefit calculation over a period of several years. Transitional provisions must be simple enough to avoid administrative confusion and well enough designed to minimize benefit costs; sharp changes that depend upon the retirement date selected must be avoided.

METHOD FOR ANALYZING ALTERNATIVE BENEFIT FORMULAS

To provide a comprehensive analysis of alternatives, the Panel surveyed the benefit formulas used in the social insurance systems of other industrialized nations as well as those used in the private pension field. In essence, there are five major types of benefit structures that appeared of sufficient merit to warrant a closer examination. They were:

1. *A flat benefit formula*-the retired worker receives an established amount regardless of need or contributions.

2. *Money purchase plan*-each contribution paid by or on behalf of a worker is used to purchase a deferred annuity. This type of benefit is frequently found in union-negotiated plans for hourly-paid workers.

3. *"High-5" plan*-the benefit is a percentage of the worker's average earnings in his highest five years. The percentage would depend on the number of years the worker has contributed to the plan. This type is sometimes used in employer-sponsored pension plans. The formula tends to produce stable replacement ratios (benefits to pre-retirement wages) from year to year.

4. *Wage-indexed formula*-the benefit is based on a long averaging period of each worker's wage history. For benefit determination the earnings of each year are adjusted proportionately to the average wages of all workers in the social insurance system for that year.

5. *Price-indexed formula*-the benefit is based on a long averaging period of each worker's wage history. Those wages, however, are restated in terms of their purchasing power rather than of their value in units of the national currency.

Each benefit formula has its strengths and its weaknesses. For example, if the sole purpose of the social security program were to stabilize replacement ratios, then the "High-5" method might be the preferred choice. But, as we have seen, there is a plurality of objectives, each of which must be weighed. Thus, certain specific criteria were established by this Panel to evaluate the alternative possibilities. These were:

1. *Adequacy.*-Apart from the weighting of the benefit formula in favor of lower-paid workers, there are two contrasting measures of adequacy. One is the purchasing power of the benefits promised to comparable workers retiring in different years. Another is the replacement ratio, i.e., the ratio of retirement benefit to preretirement earnings. The Panel found that an unexpectedly large proportion of workers experience declining wages in the few years just before retirement. In such cases earnings in the years close to retirement may not be appropriate for calculating the replacement ratio. The purpose of a yardstick like the replacement ratio is to approximate the standard of living to which a person has become accustomed and which the retirement benefit will replace. The Panel selected as its measure of the preretirement living standard an average calculated as follows:

> List the earnings subject to social security tax during the last ten years before retirement. Index each of these by the Consumer Price Index. Eliminate the figures for the one year of highest, and two years of lowest indexed earnings.[2] Divide the sum of the remaining values by seven.

2. *Benefits and costs.*-It is a simple task to design an optimal benefit formula if one can ignore its cost. Under the current-cost financing arrangement, future benefits for each generation of workers depend entirely on the willingness of the next generation to pay the required taxes. If workers lose confidence that their benefits will be paid, a breakdown will occur. In examining the various alternatives, the Panel has considered benefits and costs as an integral whole.

3. *Equity.*-Social security is an earnings-related program. Equity is an important consideration. The Panel examined benefit alternatives in light of three

[2] The reason for eliminating the two lowest but only the one highest was that our inspection of earnings patterns of workers above age 55 persuaded us that abnormal earnings occur much more frequently on the low than on the high side.

types of equity: horizontal, vertical, and inter-generational. "Horizontal" equity means that similar situations are treated similarly; "vertical" equity means that different situations[3] are treated differently.

4. Effects upon workers with varying earnings patterns.-*As* noted in Appendix A of this report, the Panel has noted wide variations in wage patterns. Surprisingly, few workers enjoy constant steady rise in wages over their working lifetimes. It is unsafe to assume that a benefit formula that works well for persons with steadily rising wages will be appropriate for those whose wage patterns are irregular.

5. Tendencies to influence worker behavior.-*A* benefit formula that markedly encourages people to take unusual steps to augment their benefit amounts (e.g., by earning or reporting exceptionally large incomes at certain times) is generally less fair and desirable than a formula devoid of such features.

6. Insurance elements.-*Any* security program, as distinct from a savings plan, should, to the extent reasonable, provide benefits upon the occurrence of contingencies (such as cessation or abnormal decline of earnings) that create need that would not otherwise exist.

[3] That is, at one particular time-not inter-generational.