Chapter 4.-Financing

That the OASDI system faces serious financial problems is agreed by the Trustees of the system in their 1974 and 1975 Annual Reports, by the Panel on Social Security Financing, and by the Advisory Council on Social Security. There is also consensus that the forces responsible for the excess of expenditure over payroll tax revenue are associated with recession, inflation, and demography.

Maintenance of a social insurance system depends upon the continued willingness of the citizens to support it. The Congress must select among alternative possibilities for achieving the double goal of fulfilling reasonable benefit expectations and tailoring the program to the tax level acceptable to the current taxpayers.

The financial balance of the system may be altered by taking steps affecting its income or its outgo or both. In this chapter we list several possible actions considered by the Panel that might be candidates for remedial Congressional action.

POSSIBLE ACTIONS AFFECTING INCOME

1. *Use general revenues.*-General revenues are already used to finance the Supplemental Security Income (SSI) Program and other income maintenance programs as well as the Medicaid program. These are examples of many programs supported from the general revenues and designed, at least in part, to improve the well-being of elderly Americans.

2. *Raise payroll tax rates.*-The combined payroll tax rate for OASDI has advanced from 2 percent in 1937-49 to the current level of 9.9 percent. Further increase in the payroll tax rate is the most obvious way to strengthen the financing of the system.

3. *Raise the wage base.*-The maximum taxable amount of annual earnings subject to payroll tax has increased from $3,000 in 1937-50 to $15,300 in 1976, the largest increases in this maximum having been made very recently. Nevertheless, the percentage of workers whose entire earnings are within the taxable maximum is lower now than in the early days of the system.

Historical percentages, taken from table 40, *Social Security Bulletin, Annual Statistical Supplement, 1973,* have been as follows: 1937, 96.9; 1940, 96.6; 1950, 71.1; 1960, 71.9; 1970, 74.1; 1973, 79.7. Additional revenue could be produced by increasing the taxable maximum. This would quickly improve the current financial position. However, since benefits are a function of average wages subject to the payroll tax, any increase in the taxable maximum ultimately creates additional benefits. Nevertheless, because of the nature of the existing benefit system, increasing the taxable maximum has the long-range result of moderately strengthening the financing of the system.

4. *Modify the tax free status of benefits.*-Many students of taxation believe that the simplicity and equity of the Federal Income Tax may be improved by minimizing the types of income excluded from the tax base. Those holding this view would conclude that exemption of OASDI benefit payments serves to narrow the tax base and contributes to the problems of creating a simple and equitable Federal Income Tax. In addition, this can modify the extent to which the weighting in the benefit formula helps the genuinely needy rather than those reaping windfalls.

One line of reasoning supporting this exception has been that the beneficiary has made contributions to the system with income already taxed. A second justification, especially relevant before the advent of double personal deductions for the elderly and Medicare, was the presumed special need for income by the elderly. Currently, with several income and service programs designed to help

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the elderly, it may reasonably be asked whether subjecting all or part of the OASDI benefits to Federal Income Tax would promote equity. Directing the extra revenue so generated into the OASDI Trust Fund would strengthen the financing of the system. The Tax Expenditure Estimates by Function, part of the Budget of the United States, estimates that in fiscal year 1977 approximately $4.4 billion of income taxes would be generated if two-thirds of OASDI benefits were subject to taxation.

5. Adjust tax rate of self-employed.-Since 1973 the tax rate on the self-employed has been frozen at 7 percent. Previously it had been set at 75 percent of the combined employer-employee tax rate. If the earlier relationship prevailed, the OASDI tax rate for self-employed would be 7.4 percent. Restoring the historic relationship between the tax rate for employees and for the self-employed would strengthen the financial status of the system.

POSSIBLE ACTIONS AFFECTING OUTGO

1. Modify the basic benefit formula.-Correcting the technical flaw in the 1972 amendments would remove the financial impact of over-indexing. Chapter 3 contains the Panel's recommendations on this issue. Their enactment would go far toward restoring financial balance to Social Security without adversely affecting benefits to those already retired.

2. Raise the retirement age.-The Report of the Advisory Council (Chapter 7, Sec. 6.3) noted the favorable financial impact of increasing the retirement age to 68 by the year 2023. The unanswered questions are whether the individual and institutional changes needed to employ elderly persons productively would be made, and whether undue hardship for many people would be a consequence.

3. Strengthen the retirement test.-The retirement test reduces benefits to those who are only partially retired. Decreasing the limit on earnings before benefits are reduced, or increasing the benefit penalty for covered earnings in excess of the limit, increases the savings to the system. However, the impact of the retirement test on individual decisions to retire and on employment practices for the elderly is far from being understood. For example, it is to be expected that elimination or weakening of the retirement test would encourage more of the elderly to seek employment with a resulting increase in payroll tax income. As a consequence, the net effect of any modification of the retirement test is not obvious. However, removing or weakening the retirement test would have an almost completely predictable impact on the income tax. Removal of a deterrent to earning income can be expected to generate additional Federal income tax.

4. Remove the opportunities for windfall benefits.-The OASDI system has always involved a compromise between equitable benefits (those directly related to taxes paid) and adequacy (benefits designed to assure reasonable living standards for all). Any weight given to adequacy must cause some participants to receive benefits not closely related to their payroll tax payments. However, since the system is wage-related, it cannot be the mechanism for solving all income maintenance problems. Nevertheless, the financial status of the system may be improved by identifying and reducing benefits not needed for social adequacy and bearing no reasonable relationship to past payroll tax payments, and by a move to universal coverage.

5. Modify spouse and dependent benefits.-Although many complications may alter a benefit paid a particular family, the total benefit to a spouse is frequently one-half the worker's benefit unless the spouse is entitled to a larger worker's benefit. In such cases the replacement ratio for a worker with a spouse is 50 percent higher than for a similar worker without a spouse. The financial status of the OASDI system could be strengthened by a reduction of the spouse benefit.

RECOMMENDATIONS

This Panel's major financing recommendations are as follows:

1. The OA SDI system should continue to be financed by a payroll tax. -Reliance on the payroll tax helps to make the public aware of the cost of the system. This awareness encourages thoughtful response to suggestions for revision. Also, the OASDI system provides benefits that are a function of wage histories. Consequently, it seems appropriate that wages be the financing base for the system. It is settled in law (Nestor vs. Flemming) that the right to benefits is not based fundamentally on a history of payroll tax payments. The Congress has the right to change the benefit structure and the financing at any time. However, because many people base their financial plans in part on OASDI, stability is an important requirement of this program. Reliance on the payroll tax contributes to stability of the system, and we recommend its continuation.

If the benefit side is ignored, the payroll tax can be labelled as regressive in that it bears proportionately more heavily on low-income families than on high-income families. However, the real issue in family finance is the *total* federal tax burden carried by low-income families. The problem of taxes paid by low-income families can best be faced comprehensively rather than be considered in isolation in revising the payroll tax supporting Social Security.

For computation of the Federal Income Tax on 1975 income, the Congress has approved an Earned Income Credit. The effect of this credit is to reduce the burden of Federal Income Tax, and even to provide direct cash payments to a group of low-income taxpayers. The taxpayers currently covered are those with both earned and adjusted gross income below $8,000 who have dependent children. The relevance of this to the OASDI system is that the burden of total Federal taxes on some low-income families has been reduced directly. Modification of the Earned Income Credit provides means for directly affecting the Federal tax burden of low-paid workers. This method seems both more comprehensive and administratively simpler than an alteration directed to the same goal in the payroll tax structure supporting OASDI.

Several income and service programs that operate at least in part for the low-income elderly (SSI and Medicaid) are already financed from general government revenues. This Panel (see Chapter 3) is recommending elimination of a minimum benefit from the wage-related OASDI system. This recommendation will probably require in due course increased benefits paid through the needs-related SSI program, which seems a natural division of both the responsibility for benefits and the associated financing.

When one extends this review beyond programs that provide income and direct services to the elderly, one observes a host of social service programs and indirect subsidy programs for institutions serving the elderly that are funded from the general revenues. The Panel approves the use of general revenues in such programs but not for bolstering the wage-related long-term social security cash benefit system.

The principal device for increasing the income of the OASDI system should be to increase the revenue from the payroll tax. Once the decision not to rely on general revenue financing for a significant portion of the benefit cost for the wage-related OASDI system has been made, one is forced to turn to increased tax rates as part of the means for obtaining the income needed to provide benefits.

2. In accordance with this view, the Panel recommends that an increase in the payroll tax of 0.3 percent (0.15 percent each for employers and employees) and an increase in the maximum taxable earnings be enacted.-These actions affecting income will take care of the short-run financial problem faced by the system [1] and will produce a balanced income and outgo *provided (a)* the nation's productivity, i.e., the margin of wage increase over CPI increase, can be maintained at two percentage points, (b) the fertility rate returns to a population replacement level before the end of this century, and (c) other less potent elements of the assumptions used in the 1975 Trustees Report prove to be realized. In Chapter 1 the Panel has emphasized the sensitivity of costs to the trends of economic and demographic influences.

[1] The Panel reminds readers that we have not explored what may be needed to take care of expected additional costs of the disability benefits of OASDI.

As mentioned in Chapter 3, this Panel's emphasis is upon legislating a benefit structure that can be financed by a relatively level prospective tax rate, not a significantly increasing tax rate. Congress can decide to increase benefits and taxes at any time (including now).

The Panel believes that an annual maximum on earnings for the double purpose of payroll taxes and defining benefits should be retained. The Advisory Council (Chapter 7, Sec. 6.2) considered increasing the maximum covered wage to $24,000 in 1976 as a means for strengthening the financing of the system. This action was not recommended because it reduced the long-term deficit by a relatively small amount and becuase a higher maximum might interfere with private savings and pension programs that are planned to coordinate with social security.

This Panel considered the possibility of removing the maximum on the earnings that are subject to the employer's tax. This proposal would strengthen the financing of the system by increasing income without a resulting increase in benefits. We do not recommend this for the following reasons:

(a) Abandoning the limit on earnings subject to employer's share of the payroll tax would give undue advantage to self-employed even if the Panel's recommendation for their tax were to be adopted. (b) Differing limits on wages subject to employer, employee, and self-employed taxes might be self-defeating by generating altered relationships among workers and employers. (c) Removing the maximum on earnings subject to the employer's tax will not solve even the short-term financing problem.

The Advisory Council (Chapter 7, Sec. 6.2) points out the arbitrary nature of the current maximum ($14,100 in 1975, $15,300 in 1976).

3. The Panel recommends that the taxable maximum be increased to the point at which approximately 90 percent of workers have their entire wages covered.-This would mean that in 1977 the taxable maximum would be $18,900.

The maximum will continue to move with average wages as under current law. However, there is no assurance that the percentage of workers whose wages are totally taxed will remain constant. Because of technical statistical problems in estimating these percentages, it is not recommended that the taxable maximum be indexed by statute to this measure. Consequently, Congress should continue to monitor these percentages, which are regularly reported by the Social Security Administration. The objective would be to assure that a shift in wage distributions or some unexpected consequence of the automatic adjustment in the MTEB has not significantly altered the extent of coverage of the system.

4. This Panel recommends that the self-employed tax rate be restored to and maintained at 75 percent of the combined rate for employers and employees.-Chapter 7 analyzes in detail the reasons for this recommendation.

Chapter 3 of this report discusses one of the fundamental recommendations by this Panel, that price-indexed wage histories be used in the benefit formula. In this chapter, devoted to financing, one aspect of this reasoning needs to be emphasized. This is that although a benefit formula based on price-indexed wage histories tends to produce declining replacement ratios if real wages grow, the decline is far from being uniform. There will also be a decrease in the dispersion of these ratios. But real wage growth creates margins that Congress can use to the extent considered needed from time to time to alter the distribution of replacement ratios.

In the absence of real wage growth, replacement ratios will tend to increase, with resulting financial strains on OASDI. But in such a situation many even more serious institutional readjustments will be needed, and the Panel's recommended benefit structure can be suitably altered.

Another subject affecting financing is the selected retirement age. Until we can more clearly understand the consequences of retirement choices, the normal retirement age should, in the Panel's opinion, remain at age 65. The Advisory Council (XVII, Recommendation 3) suggested that serious consideration be given to raising the retirement age early in the next century as a method of managing the long-term financial problem. In Chapter 7, Sec. 6.3 of the Advisory Council Report it is indicated that significant reductions in the tax rate required in the years 2025-2050 could be achieved by raising the retirement age to 68 by the year 2023.

It is important to recognize the arbitrariness of age 65 as the normal retirement age, and also to recognize that early retirement from the work force is often not what elderly Americans desire. Several questions must be faced before recommending raising the normal retirement age. First, studies have shown that elections to retire early are motivated often by poor health and availability of funds (as well, doubtless, as by difficulty in obtaining and keeping jobs) rather than by desire for leisure.

Whatever the reason, in 1974, 48 percent of insured workers aged 62-64 were receiving benefits, the highest level yet reached. In 1973, 61 percent of total retirement benefit awards went to workers aged 62-64. This compares with 54 percent in 1963.[2]

In summary, although the reasons for retirement before age 65 are not clearly known, a great many workers do retire before age 65. To meet the long-term financial problem by increasing the retirement age to 68 may only shift the burden of the demographic change to workers aged 62 to 67 through the medium of reduced benefits. In the absence of knowledge of what motivates workers to retire when they have the option to do so, and of the social needs and opportunities that permit employing those aged 62 to 67 in the work force, we are not recommending increasing the retirement age.

The social experiment outlined in Chapter 7 is proposed to help answer these questions. It is entirely possible that with acceptable changes in employment practices our economy can employ many more of the elderly. It may be that financial incentives to work beyond age 65 will succeed to an extent that the financial balance of the OASDI system may be improved without reducing benefits to those who do retire. If so, these changes should be introduced to encourage the elderly to participate fully in American life, as well as to reduce the financial burden of OASDI.

A retirement test should in our view be retained, its ultimate form to be determined from the results of the recommended social experiment. As long as replacing income lost as a result of retirement, death, or disability is a defined goal of the system, some method for specifically identifying income loss must exist. A major liberalization or elimination of the test is inconsistent with the historical, and in our view appropriate, goals of the system. Elimination of the retirement test would, by current standards, produce "windfall" benefits and add to the system's fiscal difficulties. This Panel endorses the Advisory Council's recommendation that except for the first year of entitlement, the retirement test be based on annual rather than monthly earnings.

FUNDING PATTERNS ARISING FROM THIS PANEL'S RECOMMENDATIONS.

The OASDI system is now financed on a current cost basis. Because of the maturation of the system, the tax rate needed to support the OASDI system has increased at irregular intervals over the history of the system. If the population of the United States were stationary (births equal to deaths and the age distribution stable), one would expect that after forty years required tax rates would stabilize. However, the age distribution of the United States population is far from stable despite the fact that the current fertility rate has fallen below replacement level. Instead, the growth of population in the working ages has made the tax burden of current-cost financing relatively light during most of the history of OASDI. Starting about the year 2010 the demographic situation will enter a dramatically different phase, the elderly population growing much more rapidly than the working population. This will place a strain on current-cost financing.

[2] Tables 52 and *55, Social Security Bulletin, Annual Statistical Supplement, 1973.*

Some of the financing options applicable to the present benefit structure have already been discussed. (1) Benefits could be reduced by raising normal retirement age to age 68 or higher. (2) Tax rates could follow directly current cost reaching perhaps even 25 percent of taxable payroll in 2040. (3) General revenue financing could be resorted to under the theory that the demographic burden may be temporary and will be associated with reduced demand for government services to the young; but supporters of that method should realize that the number of elderly people is reasonably predictable while the number of young is not, and government services for the young are largely a responsibility of state and local rather than Federal authorities. (4) A limited program of advance funding could be started well before fiscal problems are upon us.

Under the benefit structure that this Panel is recommending, a level payroll tax rate shows prospect of generating some advance funding. On the other hand, if the Congress elects to use some of the expected margins to increase benefits, then a series of small increases in the payroll tax might be appropriate with a view to reducing the extremely high tax rates that would be required in the second quarter of the next century.

For such a program of partial funding to succeed in reducing the burden of an unusually high portion of elderly citizens, several conditions would have to be met. First, the temptation to increase benefits during the twenty years when a partial fund would be built up would have to be resisted. Second, if government expenditures remain unaffected by the extra support available from investing OASDI Trust Fund in government securities, the impact would be reduced government demands for funds from the capital markets, perhaps leading to declining interest rates, increased private investment and prosperity which could lighten the burden of the demographic-induced OASDI crisis.

It is premature to recommend the enactment of specific tax rates to accomplish such a program. However, the Congress should be aware of the alternatives to financing the bulge in OASDI benefit payments caused by the country's changing age distribution.

The Panel believes that the payroll tax is not the proper instrument to encourage capital formation in the United States. Nor do we recommend a basic change in the current cost approach to financing. However, the changing age distribution in the United States will require major adaptations by all institutions in our society. The options available in making the required changes should be carefully explored. Painful as some of these choices may be, the citizens of the United States should recognize that unlimited population growth would pose even greater economic and social problems.