Chapter 7.-Other Issues

In this chapter the Panel makes firm recommendations, or in some cases sets forth general proposals, on several additional issues. These issues are:

1. The earnings test
2. Actuarial benefit reduction at early retirement
3. Benefit increment upon delayed retirement
4. Tax rate for the self-employed
5. Universal coverage
6. Establishment of earnings records for all potential beneficiaries
7. Income taxation of benefits
8. Size of Trust Fund
9. Benefit computation in event of prolonged recession

1-3. Earnings Test, Benefit Adjustments for Early or Late Retirement

The earnings test is controversial. Its provisions are accepted reluctantly even by many who clearly recognize that the system is an earnings replacement instrument, and that imposition of the test permits greater benefits than otherwise could be paid to those who have experienced earnings decline as a consequence of retirement.

The difficulty in formulating a suitable and acceptable earnings test is that there are several quite different personal circumstances to which it will apply. There are people whose choice is between complete dependence upon the benefit and finding part-time work. There are people whose Social Security benefit is relatively large but whose income decline upon retirement would be so large that for them there are major living standard adjustments in store unless the benefit can be supplemented. There are people whose incomes from private pensions and personal savings are so substantial that it would be unreasonable for a social insurance system to permit material employment earnings as well as providing cash benefits. There are people willing and able to stay in the labor market provided the terms on which this can be arranged appeal to them as reasonable in contrast to their resources in retirement.

A companion difficulty lies in the changing conditions of the national economy. At some times more than at others there will be special advantages to society to encourage elderly people to exercise their productive capacities.

Any test of current earnings in the determination of benefits creates some degree of incentive for the recipient to retire, fully or nearly so. Benefit design must attempt to strike the best balance between greater benefits to those unable to supplement their income and a wider spread of benefits among all the elderly. Unfortunately too little is known of the manner in which those affected by the earnings test arrive at their decisions to seek or not to seek employment.

Because benefit levels are related to the age at which benefits start, the formulas for determining benefits in event of early or late retirement are intertwined with the earnings test. At present, each month of continued work beyond age 62 increases the benefit by somewhat less than 1 percent until age 65, apart from benefit changes due to the additional years of earnings. For someone not claiming benefits between ages 65 and 72 each month of deferment creates a retirement increment of 1/12th of I percent beyond the age 65 value. These two provisions generate incentive to continue working which partially offsets disincentives of the earnings test. Again, very little is known about how workers would respond to different percentage increases in benefits as a consequence of additional months of work.

These issues are important and will become even more so early in the next century when the ratio of retired people to workers is expected to increase sharply. It is necessary, if the benefit provisions of Social Security are to fit the needs of society, to discover how and to what extent decisions of the elderly to withdraw from and return to the labor market are affected by those provisions. We need to know, first, the influence of Social Security on the decision to retire, and, second, the effect of the earnings test on the decision whether to keep one's income below a specific level or to seek and accept employment opportunities after qualifying for the retirement benefit.

Efforts to throw light upon these questions have been made many times. Alicia H. Munnell[1] has listed the evidence assembled through surveys and by statistical procedures, has found the results puzzling and conflicting, has emphasized the hazard of relying upon interview results, and has cited general support for the idea that the provisions determining benefits have had impact on the supply of labor of older workers. It is fair to suppose that historical studies have shown lower impact than applies today and will apply in the future because benefits have grown much larger than was the case earlier. In the past five years the average benefit being paid to a retired worker has grown from $118 to $207; that to a wife or husband from $59 to $105.

Hence we urge that more information be gathered on the determinants of retirement. We consider this an area in which a social experiment would be rewarding, following the experiments made to learn about negative income tax and health insurance.[2]

THE PANEL'S RECOMMENDATION: That Congress fund a "social experiment" financed by the OASI Trust Fund to examine responses of older workers to different earnings tests, different sizes of actuarial reduction for early retirement, different delayed retirement increments, and variations in other benefit provisions that may influence retirement decisions.

While the Panel has not designed such an experiment, we envision it as being along the following lines. A random sample of Social Security numbers stratified by age and sex for people ages 57 to 60 years would be selected. Those chosen and their 'spouses would be offered the opportunity to participate permanently in the social experiment. This participation would have to be made attractive to generate participation. Questions about personal, financial, health, and work circumstances would have to be answered. In this way several designs could be tried, and their effects examined. Information would begin to be available by the mid-1980's, giving ample time to redesign these provisions before the expected drastic rise in the ratio of retired people to workers early in the next century.

We recognize that some important influences upon retirement status, such as mandatory retirement ages, would limit the freedom of decision generated by this social experiment. Nevertheless, much useful data could be expected from it.

Revealing the effects of strengthening or weakening particular present benefit provisions would be the first task of the social experiment. In addition, however, it affords opportunity to test alternate designs. Possibilities include the following: Consequences of providing part of benefits without any earnings-test limitation could be discovered. Responses to taxation of all or part of retirement benefits could be ascertained. Another possible experiment would be replacing the present abrupt removal of the earnings test at age 72 by a gradual easing of the test during the ten years through which it now operates. The benefit might be related to the size of the decline in earnings as well as to their level.

This Panel concurs in the recommendation of the latest Advisory Council that the earnings test should be annual, not monthly. We believe that the purposes served by the monthly test are insufficient to offset the unfairness that arises because some people have greater opportunities than others to time their

[1] *The Future of Social Security,* Alicia H. Munnell, Boston (forthcoming from Brookings Institution).

[2] Discussions of social experiments can be found in (1) J. A. Pechman & P. M. Timpane: *Work Incentive and Income Guarantees: The New Jersey Negative Income Tax Experiment,* (Brookings Institution), (2) E. M. Grambich 2 P. P. Koshel: *Educational Performance Contractors: An Evaluation of An Experiment,* (Brookings Institution), (3) John P. Gilbert, Richard J. Light & Frederick Mosteller: Assessing Social Innovations-An Empirical Base for Policy" in *Benefit-Cost and Policy Analysis, 1974,* (Richard Zeckhauser *et al,* Editors).

earnings to their own advantage. We note also that useful administrative simplicity can be accomplished by the recommended change.

A pair of different questions about the early retirement adjustment are (a) whether the "5/9 of 1 percent per month" actuarial reduction ratio needs to be changed, and (b) how a cost-of-living increase should be computed for people whose benefits have been subjected to the actuarial reduction. The Panel has looked at both these questions.

With respect to (a), we recognize that there are philosophical and mathematical considerations involved. We propose that the former be explored through the social experiment and that the latter be examined in conjunction therewith.

As to (b), it seems to us that a change in the present method of granting cost-of-living benefit increases to people whose benefits began before age 65 is desirable on equitable grounds and in the interests of simplicity. The present rule is that the original benefit before actuarial reduction is increased proportionately to the increase in CPI, and then the original *amount* of actuarial reduction is subtracted. We propose instead that the original reduced benefit be increased proportionately to the increase in CPI, an arrangement consistent with the Panel's general recommendation that purchasing power of benefits be maintained.

4. Tax Rate for the Self-Employed

When the self-employed were first included under Social Security, they were subject to a tax equal to three-quarters of the combined employer-employee rate. Under present law, the self-employed are, and will continue to be, subject to an OASDI tax rate of 7 percent, which is somewhat less than three-quarters of the total rate applicable to employee earnings. For reasons to be discussed, we join the Advisory Council in urging a restoration of the three-quarters relationship.

THE PANEL'S RECOMMENDATION: That the tax rate for the self-employed be three-quarters of the combined employer-employee tax rate. Our analysis leading to this conclusion is limited to OASDI, but we see no reason why the three-quarters rate should not apply to hospital insurance also.

Ideally, the Social Security system should treat the self-employed comparably to employed workers, recognizing a self-employed person is both employer and employee. When the payroll tax and current personal and corporate income taxes are considered together, this is approximately achieved by the three-quarters rule, but is not achieved by the present 7 percent tax rate. To see this, let us examine the tax treatment of the payroll tax for an employed worker. Assume that an individual's wage is w (which is below the maximum taxable earnings base). Assume that the employee pays a payroll tax at the rate t. Then tw is collected in Social Security contributions from the employee and the amount w is subjected to the personal income tax. The employer also pays a tax of tw. For the employer's income tax (whether personal or corporate) the total expense, $(w+tw)$, is deductible as a business expense. Thus, if s is the employer's income tax rate, then the cost (net of income tax) of the two parts of the payroll tax is $w[+(1-s)t]$.

Now let us consider a self-employed person with self-employment income w, i.e., the same earnings for the year. He is subject to a self-employment tax of t' and all his income w is subject to the personal income tax. If the labor of each of these two individuals is to be subjected to the same tax burden, then we need t' to equal $t+(1-s)t$. At present, while the income tax rate for the employers of most employees is close to 50 percent, the proposed rule approximately achieves the desired even treatment.

Admittedly this approach does not provide the Social Security Trust Funds with the same income on behalf of employees and self-employed, but that is an issue between the Trust Fund and the Treasury, not between the Trust Fund and the self-employed.

5. Universal Coverage

It is widely accepted that low-paid people have the greatest replacement needs. This Panel has followed the existing Social Security system in recommending that benefits relative to earnings decrease as earnings increase. This being the case, it is a serious weakness when these relatively larger benefits accrue to workers who have small earnings records only because they have worked in uncovered employment for most of their careers. It is estimated that 40 percent of persons receiving Civil Service Retirement Benefits are currently receiving benefits under Social Security. [3]

RECOMMENDATION: This Panel adds its voice to the widespread call for universal coverage. Particularly, government employees should be included in Social Security.

A paper prepared for the latest Advisory Council pointed out that in December, 1973, there were an estimated 8.7 million jobs not covered, 10 percent of the total. Of these, 0.4 million people were in Federal employment, and 4.2 million were in job categories for which coverage continues to be optional .[4] The most urgent need is to remove as rapidly as possible the opportunities for people to stay out of the system while qualifying for other forms of government pension, and then, having so qualified, to enter the system for a relatively brief time, reaping the special benefit advantages that were intended for, and can be justified only for, low-paid workers.

6. Earnings Records for all Potential Beneficiaries

This Panel proposes that consideration be given to establishing individual records for potential beneficiaries who are not in covered employment.

The primary but not the sole value of such records is for the equitable arrangement of benefits after divorce.

We have recommended in Chapter 5 that benefits n a family be double those that would emerge if each of the couple had developed one-half the *sum of the average earnings* of the members of the couple. We had rejected as an alternative the averaging of their combined earnings taking each year separately through the averaging period. The following are primary reasons for rejecting this alternative.

Consider the simplest case-a couple with just one earner. Suppose that the wife has worked in covered employment while the husband has not. Presumably benefits should start when the wife retires.

But if earnings have been divided annually and the husband is older than the wife, benefits often would start before the wife has retired. Conversely, if the wife were older than the husband, her retirement would result in benefits based on only one-half her earnings records, which by definition would be inadequate replacement for her earnings until her husband also has reached retirement age. This flaw, which arises whenever husband and wife have different earnings records and different ages or times at which they must or would like to retire, seems sufficiently serious to rule out annual division of earnings records for married couples.

It is possible, although the Panel has no present recommendation in this area, that the existence of records for all potential beneficiaries could lead to a system for taxing those not in covered employment in order to generate suitable benefits therefrom.

A possible form of this proposal may be stated thus: Every married person under age 65 and not retired (or disabled) would be assumed to earn at least half

3James R. Storey: Public Income Transfer Programs: The Incidence of Multiple Benefits and the Issues Raised by Their Receipt, Paper prepared for Subcommittee on Fiscal Policy of the Joint Economic Committee.

4 See p. xvi of the *1975 Advisory Council Report.* The Council estimated extension of compulsory coverage to Federal Civil Service and non-covered State and local employees would result in a reduction in taxes of about 0.25 percent of taxable payroll for OASDI and 0.10 percent for the Hospital Insurance program.

the taxable earnings of his or her spouse. If assumed earnings exceed actual covered earnings, the excess would be taxed[5] just as if the person were self-employed. The earned income credit of the personal tax could be expanded to offset these additional taxes for low income families and to cover childless families as well as those with children. (It should be noted that this proposal does not call for taxing spouses according to some measure of the value of household services rendered; the purpose in taxing them is purely to finance a suitable level of benefits.)

7. Income Taxation of Benefits

At present, Social Security benefits are free of income tax. This Panel believes that greater fairness in treatment of different people could be accomplished if benefits were to be partially taxed, the revenue therefrom reverting to the Trust Funds to permit payment of larger benefits.

It has been drawn to our attention that very few among a long list of countries exempt social insurance benefits from income taxation.

The point is that the benefit structure itself is and can be only partly successful in giving relatively larger benefits (per dollar of contribution) to low income people. This failure arises partly because some people are in covered employment during only fractions of their careers, partly because outside wealth is not taken into account, partly because some are and some are not beneficiaries of private pension plans.

The income tax and the social insurance system both attempt to discriminate according to relative abilities to contribute to government revenues, and each by itself is only partly successful in doing so. Close examination of the possibilities may show that combining the two methods of evaluating who is rich will give a better measurement than the sum of these two currently unrelated measures.

The Panel does not propose that benefits for those already retired be taxed; furthermore, imposition of taxes on benefits of those retiring in the future should in our opinion be coordinated with the benefit formula so as to accomplish the increased equity that this proposal contemplates.

8. Size of the Trust Fund

Two separate issues arise in determination of the desired pattern for the OASDI Trust Funds. One issue is whether a large permanent fund should be built to encourage capital formation in the economy. This Panel doubts that the Social Security program is an appropriate vehicle for managing capital formation in the United States. A second issue is whether a fund should be built up in advance of the demographic swing next century to cushion a large increase in the payroll tax. The Panel believes that such a fund is justified and probably will result from the 10.2 percent payroll tax rate we are recommending.

The current Social Security program doubtless has had some effect on the accumulation of capital in this country's economy although the magnitude is unclear. If benefits were fully funded, the Trust Fund would, we understand (by one definition of the words "fully funded"), approximate 2.4 trillion dollars. This represents considerably more savings than workers would have voluntarily undertaken.

Absence of such a fund reflects the size of the benefits that have been granted to beneficiaries (past, current and future) over and above their contributions in taxes. Thus, the system has operated, and will continue to do so, as a transfer mechanism of immense size affecting private consumption and individual savings.

Nevertheless, any decline in capital formation as a consequence of this mechanism is a legitimate result of society's role in aiding the elderly, not a situation for which the Social Security system should be criticized. If there is too little capital accumulation, solutions can be sought through a mixture of fiscal

[5] Whether such tax would be required or optional is one of the questions that would arise.

and monetary measures unassociated with the social insurance system. A flat payroll tax levied for the sole purpose of inducing capital formation would be unduly regressive.

This Panel expresses no opinion on the adequacy of the current and prospective levels of capital formation, but takes this occasion to draw attention to some useful references on this important subject.[6]

This Panel's payroll tax recommendation is for scheduling a level tax rate of 10.2 percent into the indefinite future even though figures suggest that rates somewhat below this may be sufficient to pay retirement benefits having purchasing power as great as or greater than those now being paid. This means that between now and the end of this century the OASDI Trust Funds may experience considerable growth unless benefits are increased. Studies should be undertaken to show what measures by way of benefit increase may be appropriate in the interests of the beneficiaries and to prevent inordinate Trust Fund growth. It should be recognized that a purpose of the Trust Funds is to make abrupt changes in tax rates unnecessary.

9. Benefit Computation in Event of Prolonged Economic Decline

In Chapter 3, this Panel's recommendation of a price-indexed benefit structure was tempered by the observation that such a system would be stable and within financial capability only if wage increases in general outstrip price increases in the economy of the country. We now offer a suggestion on what measure should be taken if that condition does not exist, i.e., if a prolonged recession results in material excess of price over wage increases, generally described as negative real wage growth.

There are two decisions to be made in prescribing for such an eventuality in the Social Security law. The first is to define the circumstances under which a change in the benefit formula ought to be made. The second is to state the nature of the benefit formula change.

RECOMMENDATION: This Panel's recommendation is that changes in (a) the provision for benefit increases to people already retired and (b) progression of the formula bend-points,[7] should be provided for if economic conditions become such that in a period of five consecutive years the ratio of the national wage index to the Consumer Price Index is less than the same ratio of the immediately preceding year at least four times.

If the condition just described occurs, and while it continues, our proposal is that these increases be limited to the proportion of the rise in the national wage index instead of to the proportion of the Consumer Price Index rise. This proposal is meant to cover a period long enough for redesign of the system in the light of events occurring and foreseen at the time.

[6] a. Feldstein, Martin: "Toward A Reform of Social Security," *The Public Interest,* summer 1975.
b. Munnell, Alicia *H.: The Future of Social Security,* Chapter VI. (Forthcoming from Brookings Institution).
c. Lesnoy, Selig D. & Hambor, John C.: "Social Security, Saving, Capital Formation," *Social Security Bulletin,* July 1972.

[7] And the associated benefit constants.