Financing Old-Age, Survivors, and Disability Insurance: Report of the Advisory Council on Social Security Financing

The Advisory Council on Social Security Financing submitted its report to the Board of Trustees of the old-age and survivors insurance and disability insurance trust funds on January 1, 1959. The Council had been appointed, in the fall of 1957, by the Secretary of Health, Education, and Welfare in accordance with the 1956 amendments to the Social Security Act.[1]

The Council held its first meeting in November 1957 and concluded its work with a sixth meeting in December 1958. Early in its deliberations, the report states, the Council had tentatively decided "that there was need for improvement in the financing of the program. Action by the Congress in 1958 made changes in the financing along lines that the Council endorses . . . This report is concerned solely with the law as amended."

All findings, conclusions, and recommendations of the Council were unanimous. They are reprinted in full in the following pages.

I. Introduction

The old-age, survivors, and disability insurance program provides a continuing income for individuals and families who have lost income from work on account of death, retirement in old age, or permanent and total disability after age 50. Under the program, employees (with matching contributions from employers) and self-employed people, while they are working, pay a percentage of their earnings into a fund. Payments are made from the fund to the contributors and their families to replace a portion of the income lost when these risks materialize.

About 12½ million people are now drawing monthly benefits under the program, with payments for 1959 estimated at $10 billion; more than 72 million people are insured under the program; and some 75 million workers are currently contributing toward future benefits. About 9 out of 10 of the Nation's workers are covered, and about 9 out of 10 of its mothers and children can look to the program for continuing income if the family earner dies.

The financing of this program is the largest financial trusteeship in history. It involves in varying degree the personal security of practically all Americans—not only those who have retired or are nearing retiring age but those just starting to work, those who are children today, and the generations of the future. For millions of Americans the social security benefit will spell the difference between deprivation, on the one hand, and an assured income provided on a basis consistent with self-respect and dignity, on the other. Involving practically all the people, as old-age, survivors, and disability insurance does, the program's financial operations are large. It is very important that the program be adequately financed and that orderly provision be made to assure the discharge of its obligations.

The social security system has created for millions of Americans expectations regarding their future place in economic society. These expectations could be defeated by discharging the system's obligations in dollars having a substantially lesser command of goods and services than the beneficiaries have come to count upon in their personal planning. The Council believes that the trusteeship is so large and the number of people involved so great that the defeat of beneficiaries' expectations through inflation would gravely imperil the stability of our social, political, and economic institutions.

Although the security of the individual depends in part on programs such as old-age, survivors, and disability insurance that assure a source of income when earnings stop, security depends even more fundamentally on the continued ability of our society to produce a large volume of goods and services under conditions of economic stability. The Council has not considered it part of its task to evaluate in detail the effect of this system of social insurance on the stability and productivity of the economy. Our judgment is, however, that the program, if maintained on a sound basis, can be of great benefit to the economy as well as to the individual citizen. We believe that the almost universal acceptance of this program of social insurance is well-deserved and that it is a permanent institution in American life.

II. The Major Finding

The method of financing the old-age, survivors, and disability insurance program is sound, and, based on the best estimates available, the contribution schedule now in the law makes adequate provision for meeting both short-range and long-range costs.

The Council finds that the present method of financing the old-age, survivors, and disability insurance program is sound, practical, and appropriate for this program. It is our judgment, based on the best available cost estimates, that the contribution schedule enacted into law in the last session of Congress makes adequate provision for financing the program on a sound actuarial basis.

The Council has studied the estimates of the short-range and long-range costs of the old-age and survivors insurance program, the various demographic and other assumptions on which they are based, and the

[1] See the *Bulletin*, December 1957, pages 25–26.

basic techniques used in deriving the estimates.[2] The Council believes that the assumptions are a reasonable basis for forecasts extending into the distant future, and that the estimating techniques are appropriate and sound. The Council endorses the present practice under which both the estimating techniques and the assumptions are reexamined periodically to take account of emerging experience and changing conditions.

It is our judgment that the program is in close actuarial balance since the level-premium equivalent of the contribution rates varies from the estimated level-premium cost by no more than 1/4 of 1 percent of covered payroll.[3] There is no advantage in trying to achieve a closer balance between estimated long-range income and outgo, especially since those estimates are subject to periodic review and such review encompasses the testing of the adequacy of the schedule of contribution rates. If earnings should continue to rise in the future as they have in the past, the level-premium cost of the present benefits, expressed as a percentage of payroll, would be lower than shown in the cost estimates we have used.

The Council is also pleased to report that under the new schedule of contributions and benefits not only is the system in close actuarial balance for the long run, but after 1959 the income to the system is estimated to exceed the outgo in every year for many years into the future. We believe that it is important that income exceed outgo during the early years of development of the system as well as that the system be in close actuarial balance over the long range.

We have no suggestions for basic changes in the present plan of financing. We do, however, have certain specific recommendations which we believe will strengthen the plan.

III. Summary of Other Findings and Conclusions

The Council's recommendations are designed to supplement, not to alter, the basic provisions of the existing financing plan. Specifically, the Council endorses the contributory principle, an interest-earning fund on a limited basis, investment of the funds solely in United States Government obligations, and the other major features of the present financial arrangements.

The Council anticipates that further changes in the social security program will be needed as changes occur in the labor force, wage levels, and doubtless in other factors that in a dynamic economy will affect the appropriateness of the program. Because of these changes and such changes as may occur in the factors which enter into the actuarial cost estimates, we believe there is a need for periodic scrutiny of all factors which in any way affect the financing of the program. These factors include the maximum earnings base for determining benefits and contributions. This maximum determines the proportion of the Nation's payrolls available to finance the program and is a major factor in determining the extent to which the program pays benefits reasonably related to the past earnings of the individual. As a whole, our recommendations look toward a continuing review of the financial arrangements so that they, along with the other provisions of the program, can be kept sound and workable in a changing economy.

At this time we recommend no change in the contribution schedule. It is not certain, however, that the ultimate rate should go into effect in 1969, as provided in the present law. A sound decision on whether there should be a change in the amount or timing of the increase scheduled for 1969 can best be made in the period just before 1969 after the advisory council then serving has evaluated the question.

The Council suggests that greater emphasis be given in the future to estimates of the probable course of the income and outgo of the system over the then ensuing 15 or 20 years. As the program reaches a greater degree of maturity and the contribution rate approaches the level of a reasonable minimum estimate of the costs over a period of many decades into the future, it will be appropriate, as it has not been in the past, to base financial decisions largely on what may be expected to take place during the period of 15 to 20 years thereafter. Estimates showing the relationship of income and outgo over the very long-range future have been and will continue to be important as a guide to policy and necessary as a brake against making commitments which, though inexpensive today, may have substantially greater costs in the long-run future. As the system matures, however, forecasts of what will happen during the shorter run will become progressively more significant and useful.

The Council recommends certain changes in the provisions governing the interest rate on the special obligations issued for purchase by the trust funds, and also certain other changes in the management of the funds that are designed to bring their earnings more nearly into line with earnings of private investors in long-term Government bonds.

IV. The Plan of Financing Old-Age, Survivors, and Disability Insurance

The plan of financing the old-age, survivors, and disability insurance

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[2] See sec. VII B for a discussion of the estimates. The estimates referred to throughout this report are the official estimates of the Social Security Administration. The latest estimates are contained in *Actuarial Cost Estimates and Summary of Provisions of the Old-Age, Survivors, and Disability Insurance System as Modified by the Social Security Amendments of 1958* (Washington: U.S. Government Printing Office, 1958). The Report of the Board of Trustees for the fiscal year 1958 will be submitted to the Congress by March 1, 1959, and will contain both the detail of the cost estimates and a reprint of this report of the Advisory Council.

[3] The "level-premium cost" is the percent of covered payroll that, if charged from now on indefinitely into the future, would produce enough contribution and interest income to the fund to meet the cost of the benefit payments and administrative expenses. The "level-premium equivalent of the contribution rates" is the percent of covered payroll that, if charged from now on indefinitely into the future, would produce the same amount of income to the fund over the long-range future as will be produced by the graded schedule of contribution rates. The level-premium cost of the OASI part of the program is 8.27 percent of payroll on the basis of the intermediate-cost estimates; the level-premium equivalent of the contributions is 8.02 percent of payroll. The level-premium cost of the disability insurance part of the program is 0.49 percent of payroll; the level-premium equivalent of the contributions is 0.50 percent of payroll.

program is as follows: Employees pay taxes on their annual earnings up to a maximum amount—$4,800 beginning in 1959. Each employer pays taxes at the same rate on the first $4,800 paid to each of his employees in the year. Year-by-year costs will grow for many years, and the law provides that tax rates will gradually increase from a combined employer and employee rate of 5 percent in 1959 to an ultimate rate of 9 percent, to be reached in 1969. The self-employed pay at a rate equal to one and one-half times the rate paid by the employee.

The contribution rates now scheduled are intended to provide enough income to meet all of the costs of the system into the indefinite future. Funds collected in the early years of the program and not needed for immediate benefit payments are invested in United States Government obligations. The interest earnings on these obligations are available to help pay for the larger cost of the system in later years. The scheduled contribution rates include a fixed ½ of 1 percent combined employer-employee contribution for disability benefits for workers and their dependents (⅜ of 1 percent for the self-employed) and the proceeds of this tax are held in a separate fund. The administrative expenses of the system, as well as the benefits, are paid from the taxes established to finance the system.

In the following pages the Council reports on each aspect of the financing plan described above: Contributions by Employees, Employers, and the Self-Employed; the Earnings Base for Contributions and Benefits; the Schedule of Contribution Rates; The Role of the Trust Funds; and The Management and Investment of the Trust Funds.

V. Contributions by Employees, Employers, and the Self-Employed

A. *The Council believes that, as provided in present law, a substantial part of the cost of this program should be borne directly by those who benefit from it.*

The fact that the worker pays a substantial share of the cost of the benefits provided, in a way visible to all, is his assurance that he and his dependents will receive the scheduled benefits and that they will be paid as a matter of right without the necessity of establishing need. The contribution sets the tone of the program and its administration by making clear that this is not a program of government aid given to the individual, but rather a cooperative program in which the people use the instrument of government to provide protection for themselves and their families against loss of earnings resulting from old age, death, and disability. The Council also believes that the direct earmarked tax on prospective beneficiaries promotes a sense of financial responsibility. It is very important that people see clearly that increases in protection necessarily involve increases in costs and contributions.

We believe that the experience of the last 22 years has shown the advantages of contributory social insurance over grants from general tax funds. It is true that, up to the present time, workers as a group have not contributed a large share of the cost of their own protection. Most workers covered in the early years of the program will contribute during only a part of their working lifetime, and, under the graduated schedule in the law, contribution rates have been low relative to the value of the protection provided. But this situation is changing. Young workers starting out under the system in recent years will contribute a substantial part of the cost of their protection.

B. *The Council believes that it is also appropriate for a substantial part of the cost of the program to be borne by an employer contribution and for the self-employed to pay a rate equal to one and one-half times the employee rate.*

Protecting the members of the labor force and their dependents against loss of income from the hazards of old-age retirement, permanent and total disability, and death is, at least in part, a proper charge on the cost of production. Moreover, business enterprises have a significant stake in assuring that orderly provision is made to meet the needs of their employees and their families for income when their working lives are over. The earmarked contribution for social security is a recognition of this stake. The direct contribution gives employers status in the program and a clear right to participate in the development of the program and in the formation of policy.

The rate for the self-employed—one and one-half times the rate paid by the employee—is a recognition of the fact that the self-employed person, in respect to his own employment, has some of the characteristics both of employee and employer. The Council has found no reason for a change in this rate.

VI. The Earnings Base for Contributions and Benefits

In an economy characterized by rising wages and salaries it is necessary to give periodic review to the maximum amount of earnings subject to contributions and credited toward benefits, since this maximum determines the proportion of the covered payrolls available to finance the program and is a major factor in determining the extent to which the program pays benefits reasonably related to the past earnings of the individual.

The Council believes that it is an essential part of the contributory concept to have the worker pay contributions on the same amount of earnings as the amount that is credited to him for benefit purposes. Since, under a plan designed for broad social protection, it has not been considered appropriate to cover the full earnings of very high-paid employees and self-employed persons and to pay correspondingly high benefits, there has always been a maximum on the amount of earnings subject to tax and creditable toward benefits. Exactly where this maximum should be set is a difficult question. It is complicated by the fact that over the years wages and living levels tend to rise, so that any particular maximum set in the law may be soon outdated.

When the old-age and survivors insurance program first went into operation in 1937 the maximum earnings base was $3,000, and it remained at that level until 1951. In 1938, the first year for which adequate data are available, the full earnings of 97 percent of all covered employees, and of 94 percent of regularly employed men, were included under that maximum. As wage levels rose, the percentage of workers who had all their wages credited under the program declined; thus, by 1950, instead of the highest-paid 6 percent of regularly employed men having a part of their wages excluded, 57 percent had some of their wages excluded.

The maximum earnings base was raised to $3,600, effective in 1951; to $4,200, effective in 1955; and to $4,800, effective in 1959. In 1959, it is estimated, 75 percent of the workers covered under the program, and 50 percent of the regularly employed men, will have their full earnings covered for both contributions and benefits.

Insofar as the maximum contribution and benefit base is not increased as earnings rise, the proportion of payrolls in covered employment that is taxed declines. For example, between 1938 and 1950 the proportion dropped from 92 percent to 80 percent. The proportion taxed in 1951 after the increase in the maximum to $3,600 was 84 percent. It is estimated that the proportion taxed in 1959 will be about 83 percent.

Benefits are a higher proportion of earnings at lower earnings levels than at the higher levels. Hence raising the maximum contribution and benefit base without change in the benefit formula results in a reduction in the percentage of covered payroll needed to meet the long-range cost of the system. The cost estimates underlying the contribution schedule can be interpreted to imply that if earnings rise there will be an upward adjustment of benefits and of the earnings base. However, the tax rates required for the support of the adjusted benefits would be higher than those in the present contribution schedule if the earnings base is not increased as earnings rise.

The Council is of the opinion that there should be a maximum on earnings taxed and credited toward benefits; that the contribution should be levied on the same amount of earnings as the amount that is credited for benefits; and that the maximum should be increased from time to time as wages rise.[4]

Although there is no definitive logic supporting $4,800 as the correct amount—i.e., neither too high nor too low—for the maximum contribution and benefit base, we do not recommend any further change in the base at this time, since the change to $4,800 is just going into effect in 1959. We assume that further consideration will be given to this maximum after the effect of the $4,800 figure has been evaluated.

VII. The Schedule of Contribution Rates

A. *The Council endorses the contribution schedule in present law*[5] *on the basis of the cost estimates we have reviewed. We believe that the 1959, 1960, and 1963 rate increases should go into effect as scheduled and that conditions will probably warrant the 1966 rate increase as well. The last increase—that scheduled for 1969—will need to be evaluated in the light of the conditions current at that time and in the light of the cost estimates then available.*

As a result of the amendments of 1958, the contribution schedule in the law has been speeded up and the rates increased. The present schedule, covering both old-age and survivors insurance and disability insurance, is as follows:

Year	Contribution rate (percent)		
	Employers	Employees	Self-employed
1959	2½	2½	3¾
1960-62	3	3	4½
1963-65	3½	3½	5¼
1966-68	4	4	6
1969 and thereafter	4½	4½	6¾

The Council is agreed that a graded contribution schedule is sound policy. It is true that the ultimate rate is somewhat increased by the loss of interest on funds which would otherwise have been accumulated by the application of an earlier high, level rate. We believe, however, that this loss is of far less significance than would be the effect of the sudden imposition of the full rate necessary to support the program.

The Council is also agreed that the rates should be high enough in the early years of the program to cover at least year-by-year disbursements. Disbursements will ultimately be substantially greater than they are now, and we believe there is no justification for current contributors paying less than enough to cover current disbursements. Moreover, many people were disturbed to have the outgo from the old-age and survivors insurance trust fund greater than the income in 1957 and 1958, and in prospect in 1959. We are therefore in complete accord with the action taken by the Congress, to increase the rates in 1959 and 1960. These changes are necessary to avoid an excess of outgo over income in 1960 and in the next several years.

The Council also believes that the rate increase provided by the new schedule for 1963 is justified by all the evidence now available. Although it might prove possible to postpone the 1963 increase for a year or two, it is nevertheless clear that a rate increase will be needed soon after 1963, if not in that year, to prevent outgo from again exceeding income. We believe that there is merit in main-

[4] The Council believes it desirable to call specific attention to the fact that in the relation between the tax on earnings and the benefits paid under the old-age, survivors, and disability insurance system there is an element of progressive income taxation. Covered workers who, together with their employers, pay taxes on the higher ranges of the creditable earnings base receive less than proportionate benefit rights. This serves to make possible more than proportionate benefits for those paying taxes on the lower range of the creditable earnings base.

[5] As indicated in the description of the financing plan, the scheduled contribution rates include a fixed ½-of-1-percent combined employer-employee contribution for disability benefits for workers and their dependents (⅜ of 1 percent for the self-employed). The questions discussed in the next several pages relate largely to the old-age and survivors insurance program only and grow out of the gradual imposition of the ultimate rate for that program.

taining the schedule in the law unless and until there is a strong case for change.

Probably the increase scheduled for 1966 will not be necessary at that time to provide income in excess of outgo. Its effect, unless significant changes occur, will be to increase fund accumulation.[6] Although the Council does not regard building of a large fund as a primary goal, we nevertheless believe that it will prove desirable to have the 1966 rate go into effect. It will further the objective that the person who gets the protection should pay a substantial part of the cost of the protection. It will hasten the approach to the payment of the full rate necessary to support the system and will increase public understanding of its costs. It will reduce the shifting of costs to future members of the system. Before the 1966 rate is scheduled to go into effect, however, other advisory councils will have the opportunity to consider the timing of the introduction of this rate in the light of cost estimates and conditions current at that time.

Under the set of cost estimates we used for evaluating the contribution rate schedule, if the employer-employee contribution rate of 8 percent for the combined old-age, survivors, and disability insurance system scheduled for 1966 goes into effect in that year the income to the old-age and survivors insurance trust fund will exceed outgo until 1982. Under other sets of estimates that we examined, such income will exceed outgo for a period of from 12 years after 1965 (under estimates showing high costs) to about 80 years (under estimates showing low costs). In view of the likelihood that an increase above the 1966 rate will not be needed to cover the year-by-year costs of the program for a considerable period of time, we are doubtful whether the 9-percent rate should go into effect as scheduled, in 1969.[7] However, we are not recommending that any change be made now in the schedule of contribution rates in present law. Instead, we recommend that future advisory councils, in the light of conditions current at the time of their inquiries, give study to the timing and level of any contribution rate increase to be made after the one bringing the rate to 8 percent.

Once the rate currently charged approaches the level of a reasonable minimum estimate of the costs over a period of many decades into the future, decisions about the imposition of further rate increases should be guided, in our judgement, largely by conditions expected in the 15- or 20-year period immediately ahead, including the size of the trust fund. Under such a plan a judgment of whether the last step-up in the contribution schedule should go into effect in 1969 can be best made just prior to that time.

B. *The Council believes that the establishment of a contribution schedule in the law based on the concept of long-range actuarial balance is sound policy and should be continued. However, future decisions concerning the financing of the program should increasingly take into account estimates of trust fund income and outgo over the ensuing 15 or 20 years based on expected earnings and employment levels and on demographic developments.*

The Council endorses the long-standing practice adopted by Congress of including in the law a contribution schedule which according to the cost estimates places the system substantially in actuarial balance into the indefinite future. We believe this procedure to be the best way of making people conscious of the long-range cost of the current provisions of the program and of the cost of proposals to modify the present program.

The long-range estimates of the cost of the program are presented in the form of a range, showing the effect of assumptions resulting in high costs, and other assumptions resulting in low costs. Reflecting the great uncertainties attached to costs that may develop in the more distant future, these estimates indicate a broad spread in the possible range of program costs toward the end of the present century and in the first half of the next century. For purposes of financial planning, the practice has been to take an average of the high-cost and low-cost estimates to obtain so-called intermediate-cost estimates. On the basis of these intermediate-cost estimates a schedule of contribution rates is developed to provide contribution income sufficient to meet the costs of the system as they fall due from the present into the long-range future. The Council has examined these estimates and believes that the assumptions on which they are based are reasonable and that the methods used in making them are sound.

The long-range cost estimates, based as they are on assumptions reflecting the possible variations in long-range trends in such cost factors as fertility, mortality, retirement rates, and family composition, while producing a wide range in possible costs several decades ahead, show a fairly narrow range in possible costs in the shorter-run future. This is because the economic factors which may show significant ups and downs in the short run are assumed in the long-range estimates to have a smooth trend. Thus, for example, the estimates assume that the volume of employment will average out over the long run somewhat below full employment. The estimates also assume that average annual earnings

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[6] Some have argued that an excess of income over outgo may have bad economic effects. Whether the economic effects are good or bad will depend on the general economic situation at the time and on the fiscal policies of the Government. In any event, the amounts by which the fund is increased in any year would in all probability be too small to have any effects on the economy that would be serious or that could not be readily compensated through other governmental action.

[7] It is recognized, of course, that if the long-range estimates were to remain unchanged but the imposition of the ultimate rate were postponed beyond 1969, a contribution schedule showing the system in actuarial balance would, because of this delay, have an ultimate employer-employee rate above the 9 percent in present law for the combined old-age, survivors, and disability insurance system. For example, if the 1969 rate increase were postponed until 1982, when, according to the cost estimates we have used for evaluating the contribution schedule, an increase would be needed to prevent disbursements from exceeding income, then a 9.89-percent rate would be needed in 2025 and thereafter to produce the same degree of long-range actuarial balance as the schedule in present law.

will remain level.[8] However reasonable these assumptions may be for the long-range estimates, they cannot be used for estimates designed to show expected operations over a short-run period. Here the possible variations arising from the economic factors will be very significant, and the Council believes that there is need for cost estimates that take these economic factors into account.

As stated above, the Council believes that when the contribution rate approaches the level of a reasonable minimum estimate of the costs over a period of many decades into the future, decisions about the imposition of further rate increases, if needed, should be guided largely by estimates covering a period of 15 or 20 years. Like the estimates covering the period of 5 future years that are presented in the Annual Reports of the Board of Trustees, these 15- or 20-year forecasts should be based on assumptions which take into account future developments with respect to economic as well as population changes.

VIII. The Role of the Trust Funds

A. *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.*

Income not currently needed for benefits is held in two trust funds—the old-age and survivors insurance trust fund and the disability insurance trust fund. These trust funds serve two primary purposes: (1) they are contingency reserves for use in temporary situations when current income is less than current outgo; and (2) they are a source of investment income which helps pay the benefits and administrative costs of the program.

As contingency reserves, the assets of the trust funds are available, when needed, to supplement current receipts in periods when disbursements may temporarily rise above income. The Council believes the trust funds are and will continue to be larger than would be required for contingency purposes alone. Both the trust funds are expected to grow for many years and should remain well in excess of foreseeable contingency needs.

Although larger than needed for contingency purposes, the trust funds will continue to be considerably less than would be required under "full reserve" financing, often used for private pension plans. The "full reserve" basis contemplates the accumulation during an initial period of very substantial funds which, if the pension plan were to cease operating, would be available to discharge existing liabilities. These are liabilities to the then current beneficiaries and the liabilities accrued to date for those still in active employment. In a national compulsory social insurance program it can properly be assumed that the program will continue to collect contributions and to pay benefits indefinitely into the future. The old-age, survivors, and disability insurance program therefore does not need a full reserve. It may be considered to be in actuarial balance when estimated future income from contributions and from interest on the investments of the accumulated trust funds will, over the long run, support the estimated disbursements for benefits and administrative expenses.

Although the old-age and survivors insurance trust fund will be only a fraction of the "full reserve," as defined above, it will grow to considerable size and play a significant role as an interest-earning fund. Interest will, of course, be available to help pay benefit costs and to some extent will make later contribution rates lower than they would otherwise have to be. Interest earnings since the program began, in 1937, have already totaled over $5 billion.

In a dynamic system of social insurance, the significance of the role played by an interest-earning fund is quite different from what it would be under a static system. If benefits are adjusted upward as earnings levels rise, then the interest earnings on a fund of any given size will meet a decreasing proportion of benefit costs. In the light of potential increases in earnings and benefits as decades pass, we believe it unwise to count on interest to meet a major part of the costs of the program in the far-distant future.

We see no merit in the provision of present law which requires the trustees to report to the Congress whenever, in the course of the next 5 years, it is expected that either of the trust funds will exceed three times expenditures in any one year. The implication of the provision is that the trust funds should not be allowed to exceed the result of this formula. We do not believe that the trust funds should be held to any arbitrary relationship to expected annual expenditures, and we recommend that the provision be repealed.

B. *The investment of the trust funds in United States Government obligations is a proper use of the excess of income over outgo for the benefit of the contributors to the funds. The trust funds are properly kept separate from the general fund of the Treasury and have the same lender status as other investors in Federal securities.*

The Council is aware that there is some misunderstanding concerning the nature of the trust funds of the program and their distinct separation from the general Treasury account. The members are in unanimous

[8] The assumption that average earnings will remain level is not, of course, in accord with what has been happening in this country throughout its history. If average earnings do in fact continue to rise and if no changes are made in benefit levels, the costs of the program, expressed as a percentage of payroll, will be lower than those shown in the estimates. In this sense it can be said that the estimates overstate the costs of the benefit provisions now in the law. As a practical matter, however, it may be expected that, as average earnings continue to rise, there will be an upward adjustment of benefits. If the added cost resulting from such adjustment is sufficient to balance the reduction in the cost of the program that results from rising average earnings, the level-premium cost of the program, expressed as a percentage of payroll, will be the same as is shown in the estimates.

agreement with the advisory councils of 1938 and 1948 that the present provisions regarding the investment of the monies in these trust funds do not involve any misuse of these monies or endanger the funds in any way, nor is there any "double taxation" for social security purposes by reason of the investment of these funds in Government obligations.

Each of these trust funds is kept completely separate from all other funds in the Treasury. The income and disbursements of the old-age and survivors insurance trust fund and the disability insurance trust fund are not included in the administrative budget of the Government. Instead, the President reports their operations separately in his Budget Message to Congress. The debt obligations held by the trust funds are shown in Treasury reports as part of the Federal debt, and interest payments on these obligations are regularly made by the Treasury to the trust funds. The securities are sold or redeemed whenever necessary to obtain cash for disbursement by these funds.

When the trust fund receipts not needed for current disbursements are invested in Government securities, the funds are lenders and the United States Treasury is the borrower. The trustees of the funds receive and hold Federal securities as evidence of these loans. These Government obligations are assets of the funds, and they are liabilities of the United States Government, which must pay interest on the money borrowed and must repay the principal when the securities are redeemed or mature.

The marketable securities held by the funds are identical in every way with Federal bonds bought and sold on the open market by other investors in Federal securities. The special obligations issued directly to the funds are public debt obligations backed by the full faith and credit of the United States. Interest on, and the proceeds from the sale or redemption of, securities held by each of the two trust funds are credited to and form a part of each fund. Thus the trust funds are completely separate from the general fund of the Treasury and have the same status as lenders that other investors in Federal securities have.

The confusion that there is "double taxation" for social security purposes arises because, in addition to paying social security taxes, people must also pay taxes to pay interest on, and repay the principal amount of, the obligations held by the trust funds. But the taxes that must be raised to pay interest on these obligations, or to repay the principal, are not levied for social security purposes. They are levied to meet the costs of the defense program and the other purposes for which the borrowed money was expended by the Treasury in accordance with congressional appropriations. If the trust funds did not exist, money for these purposes would have been borrowed from other sources, and in this case, too, taxes would have to be raised to pay interest and principal on the borrowings. The purchase of Government obligations by the trust funds is financially sound in relation to both the social security program and the fiscal operations of the Federal Government.

IX. The Management and Investment of the Trust Fund

A. *The investment of the trust funds should continue to be restricted to interest-bearing obligations of the United States Government or to obligations guaranteed as to principal and interest by the United States.*

The Council recommends that investment of the trust funds should, as in the past, be restricted to obligations of the United States Government. Departure from this principle would put trust fund operations into direct involvement in the operation of the private economy or the affairs of State and local governments. Investment in private business corporations could have unfortunate consequences for the social security system—both financial and political—and would constitute an unnecessary interference with our free enterprise economy. Similarly, investment in the securities of State and local governments would unnecessarily involve the trust funds in affairs which are entirely apart from the social security system.

B. *The investment of the trust funds should be in obligations having maturities which reasonably reflect the long-term character of the funds.*

The bulk of the assets of the trust funds will be on continuous loan to the Federal Treasury, and therefore the funds' investments are essentially long-term in character. The maturities of special issues should reflect this fact. Before the 1956 amendments to the Social Security Act, the law included no provision regarding the maturities of special obligations issued for purchase by the trust funds. Up to that time, special issues had been 5-year notes or 1-year (or less) certificates of indebtedness. The 1956 amendments added the provision that special issues shall have ". . . maturities fixed with due regard for the needs of the trust funds . . . ." This requirement has been interpreted by the Managing Trustee to mean maturities of 5 years or longer. Accordingly, he inaugurated a program to lengthen gradually the maturities of special obligations issued to the trust funds. The special issues held by the funds on June 30, 1958, consisted of 1-year certificates, 2- to 5-year notes, and 6- to 10-year bonds.

C. *Each special obligation issued for purchase by the trust funds should carry a rate of interest that, in principle, equals the rate of return being realized by investors who purchase long-term Government securities in the open market at the time the special obligation is issued.*[9]

The Council believes the rate of return on trust fund investments in special issues should be comparable to what the Treasury would have to pay for long-term money if borrowed from other investors. Such a rate of return seems to us the way to avoid either a financial advantage or disadvantage to the funds. Such a rate on special issues would go a long way toward eliminating any conflict of interest that might be encountered by the Secretary of the Treasury, acting both as the principal fiscal officer

[9]It is recognized that the Managing Trustee may need to keep a minor part of the funds in short-term securities, at an interest rate appropriate thereto, to meet immediate prospective needs.

of the Government and as manager of the trust funds, in deciding whether to invest trust fund assets in marketable obligations or in special issues.

The provision in the present law for setting the interest rate on the special issues needs revision in order to make possible the attainment of this policy. The present law requires that special obligations issued for purchase by the trust funds bear interest at a rate equal to the average rate of interest, computed as of the end of the month preceding the date of issue, on all marketable interest-bearing public debt obligations that are not due or callable until after the expiration of 5 years from date of original issue. The interest rate on special obligations issued to the trust funds at the beginning of the fiscal year 1959 was 2⅝ percent. During recent years about nine-tenths of the old-age and survivors insurance trust fund investments have been in special obligations; on June 30, 1958, about 95 percent of the disability insurance trust fund investments were in special obligations.

The Council endorses the policy in present law which relates the interest rate on special obligations to the interest rate on long-term marketable obligations. This policy correctly identifies the special obligations as being primarily long-term investments.

We recommend, however, that two changes be made in the law in order that the rate of return on special obligations be as nearly as possible equal to the rate being realized by investors who purchase long-term Government securities in the open market at the time such a special obligation is issued. The rate on each special obligation should be made equal to the average *market yield* on long-term marketable Federal obligations outstanding when the special obligation is issued, rather than to the average *coupon rate* of such marketable obligations. This change would cause the interest rate on the obligations issued for purchase by the trust funds to reflect the market rate of return prevailing at the time of issuing any given block of securities to the trust funds. The average yield should be computed on the basis of market quotations in a recent past period, such as the month preceding the special issue, and, as at present, the average so computed should be rounded to the nearest ⅛ of 1 percent.

The second change we recommend is that the interest rate fixed for a special obligation should be based on the average rate of return on all outstanding marketable Federal obligations that will mature more than, say, 5 years after the date of the special issue, rather than on all bonds that are not due or callable until after 5 years from the date when they were originally issued.[10] This change is necessary to eliminate from the computation those bonds which have in fact become short-term obligations.

In adjusting to the proposed new statutory formula, we believe a gradual and orderly transition over a period of several years would be desirable. We recommend, therefore, that before the new formula becomes effective the present maturity distribution of the special obligations held in the funds be reviewed and, if need be, adjusted to carry out this broad objective.

D. *Investment of the trust funds, as at present, should be either in special issues or in public issues, but the statute should be amended to provide that public issues may be acquired only when they will provide currently a yield equal to or greater than the yield that would be provided by the alternative of investing in special issues.*

With the adoption of a statutory formula giving to the trust funds a return based on market rates of interest, we believe it is proper for the bulk of the funds to be invested in special obligations. Investment in special issues has the great advantage of avoiding disturbances of the capital market. At the same time, the Council believes that it would be desirable to continue to allow the Managing Trustee to invest in public issues when he finds that it is in the public interest to do so, provided such investment would involve no sacrifice of income to the funds.

[10] See footnote 9.

From time to time, circumstances arise in which investment of trust fund assets in public obligations may be in the public interest. At a time of declining bond prices, for example, purchase of public issues on the open market may help preserve the asset value of Federal securities held by private investors. It may also assist the Treasury Department in the sale of new issues of Federal securities at a time when the market for Government bonds is unfavorable.

We recognize that it has been the practice of the Managing Trustees to purchase marketable obligations for the trust funds only if the current yields on the marketable obligations exceed what would be obtained by purchasing special obligations. The Council believes, however, that it would be desirable to make this practice a statutory obligation. The Council therefore recommends adoption of a provision allowing purchase of marketable securities only when such purchase is in the public interest and would provide currently a yield equal to or greater than the alternative of investing in special issues. This provision would supersede the present statutory provision that special issues shall be purchased only if it is not in the public interest for the trust funds to purchase other Federal securities.

E. *The law should be amended to state that the Board of Trustees as a whole has the responsibility to review the general policies followed in managing the trust funds, and to recommend changes, as needed, in the provisions of the law that govern the way in which the trust funds are to be managed. In keeping with the nature of its responsibilities, the intervals between meetings of the Board should be not more than 6 months.*

The Council believes that the present statutory provision giving full authority for management of the operations and investments of the trust funds to the Secretary of the Treasury as Managing Trustee is sound. Generally the Secretary of the Treasury, by reason of his position and experience, is the person in the Government who is best equipped for this responsibility. However, the

Council believes that all members of the Board of Trustees should participate in the review of the general policies followed in the management of the trust funds. We, therefore, recommend an amendment to the law to give more specific recognition to the responsibility of trusteeship of all members of the Board and to require that the intervals between meetings be not more than 6 months.

F. *The Council has examined the way administrative expenses are charged to the trust funds and the financial provisions relating to the railroad retirement account and to the coverage of the members of the Armed Forces and believes that the arrangements are fair.*

The Council believes that the trust funds should be treated in all respects as funds held in trust, bearing their proper share of expense but not operating so as to subsidize other activities of government.

The Council did not look, in great detail, into the question of the charging of administrative expenses, but we believe that with relatively minor exceptions all administrative costs are being charged to the trust funds. These include the administrative expenses of the Bureau of Old-Age and Survivors Insurance, the expenses incurred by the Internal Revenue Service in the collection of social security taxes, and expenses incurred by other units of the Department of Health, Education, and Welfare and of the Treasury Department in connection with old-age, survivors, and disability insurance. The administrative expenses of the total program, although charged to the respective trust funds, are subject to the regular appropriation procedures of Congress.

Under the 1951 amendments to the Railroad Retirement Act, wage credits accumulated under the railroad retirement system by workers who die or retire with less than 10 years of railroad employment are transferred to the workers' accounts under the old-age, survivors, and disability insurance program. Benefit payments are made by the old-age, survivors, and disability insurance program on the basis of the combined earnings records. Retirement and disability benefits are payable under both programs to workers with 10 or more years of railroad service who also qualify under old-age, survivors, and disability insurance. The survivors of workers with 10 or more years of railroad service receive benefits under one program or the other based on combined wage records. Each year the two agencies jointly determine the amount of money which, if transferred from the railroad retirement account to the old-age and survivors insurance trust fund or vice versa, would place the trust fund in the same position it would have been in if railroad employment had always been covered under the Social Security Act. The amount so determined is transferred. There is provision for similar annual interchanges between the railroad retirement account and the disability insurance trust fund beginning with the fiscal year 1958. This is an arrangement which seems to us to be fair to both programs.

Beginning January 1, 1957, contributory coverage was extended to members of the uniformed services. Noncontributory wage credits of $160 a month have been provided to persons who served in the Armed Forces from September 16, 1940, through December 31, 1956. In addition, provision had been made for noncontributory survivors insurance protection for certain World War II veterans for a period of 3 years following their discharge from the Armed Forces. The old-age and survivors insurance trust fund received reimbursements from the general fund of the Treasury for the additional costs of these survivor benefits paid before September 1, 1950. Under the 1956 amendments, the additional costs of the survivor benefits after August 31, 1950, and all past and future expenditures arising from the contributory military wage credits, will be met by reimbursements from the general fund to the appropriate trust funds. These reimbursements should not be regarded as a Government contribution or as a departure from the policy of self-support. Instead, these contributions are made by the United States Government from general funds in its capacity as employer of the members of the Armed Forces.

X. Conclusion

In conclusion, the Council would reiterate what we have said earlier in this report: In a dynamic society a program of old-age, survivors, and disability insurance requires periodic review of its operations to assure that its effectiveness is maintained. The Council is pleased to report that according to the best cost estimates available the contribution schedule now in the law makes adequate provision for meeting the cost of the benefits provided. We have found that the method of financing is sound and that no fundamental changes are required or desirable. Our recommendations are intended to strengthen the measures necessary to carry out the basic principles inherent in the program.