

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 8, 1936.To Chairman EcclesSubject: Memo on Monetary Aspects of theFrom Lauchlin CurrieSocial Security Program.

Attached is my suggested draft of a memo on the monetary aspects of the social security program, to go eventually to the Board. I am afraid it is perhaps too technical, but I find it difficult to treat the subject adequately without getting into the rather complicated business of savings and investment. You may find that parts of the treatment might be deleted without loss.

I also prepared & sent off the material Mr Warrant requested.

THE MONETARY ASPECTS OF THE SOCIAL SECURITY PROGRAM

Introduction

Owing to the implicit responsibility the Board shares for the maintenance of stable business conditions, it must of necessity be interested in and concern itself with legislation that has a vital bearing on future business prospects. The Social Security Act falls within this category and, as it is expected to be amended in the coming session of Congress, it appears desirable that the monetary implications of the present Act should be explored.

The present memorandum deals with one aspect only of the Act--old age benefits. The effect of the operation of the unemployment provisions of the Act is expected to be constructive from the monetary point of view. What might be done to make it even more so may be discussed in a subsequent memorandum. The possible effect of the operation of the present old age benefit provisions, however, raises serious problems.

Old Age Benefits and the Reserve Fund

The present old age benefit plan provides for the establishment of a reserve fund to be invested in United States obligations yielding at least three percent, and financed by equal taxes on employers and employees. The scale of taxes is so designed as to yield amounts which together with interest paid to the fund out of general revenues will exceed benefit payments until 1980. Benefit payments are based on taxable wages earned and therefore start at low figures and increase not only with the number of beneficiaries but with a rise in the

average amount to which beneficiaries are entitled. By 1980 it is expected that the interest on the fund of \$47 billion, plus annual taxes, will be sufficient to meet annual benefit payments. In this way the plan as a whole is expected to be self-sufficing in the sense of not requiring a direct subsidy by the Government.

The contributions of employers and employees together start at two percent in 1937 and increase by stages to six percent in 1949. From 1944 to 1970 it is estimated that the reserve fund will accumulate by over a billion dollars annually. Tables showing the scale of contributions, size of benefits, and the annual additions to the reserve fund, are appended.

Monetary Implications of the Continued and Large Excess of Contributions Over Benefits and of the Growth in the Reserve Fund.

From the monetary point of view the important question is whether the excess of contributions and the retirement of publicly-held debt accompanying the accumulation of a huge fund during the thirty or forty year transitional period will make more difficult the attainment of the objective of enduring prosperity. The answer appears fairly definitely to be in the affirmative.

In the first place, there appears to be good reason for thinking that the higher the income of both individuals and the community at large, the greater is the desire and ability to save. Unless, therefore, both the desire and ability to invest increase steadily, or available savings are otherwise disbursed, there is likely to be an

interruption to the monetary stream and incomes will fall. Some writers feel that it may prove difficult to secure an ever-increasing volume of investment in producers' goods to match the growing desire and ability to save. Therefore they urge measures to restrain the growth of saving. By ensuring, for example, that the current expenses of the Government be financed in large part out of funds that would otherwise have been saved, we ensure that those funds will not lie idle and bring about a decline in the monetary circulation and national income. One of the arguments for a tax on undistributed profits is that it will operate to keep up the monetary circulation. The only way the monetary authorities can encourage spending for the production of capital goods is to lower interest rates, and there is some question as to the effectiveness of this method.

Approaching the problem from this point of view, therefore, it is obvious that the present old age benefits plan tends to increase the volume of savings of the community and results in more money that has to be spent in the making of capital goods, or fed into incomes in other ways, if the monetary circulation is not to decline. To this extent, in other words, it intensifies the problem of achieving stable and enduring prosperity. The deduction from wages results in almost a corresponding reduction in purchases of consumer goods and, in so far as the employers' contribution is passed on in higher prices, or back in lower wages, buying power is still further reduced.

It is apparent that the effect of the diminution in consumer buying power arising from an excess of contributions over benefits depends both on the size of the excess and on the phase of the business cycle.

With reference to the magnitude of the excess it may be pointed out that \$1 $\frac{1}{2}$ billion appears substantial when compared to total Federal emergency relief expenditures of \$1.7 billion in the fiscal year 1935, or to the annual addition to the assets of life insurance companies, which averaged around \$1 billion in the Twenties. Assuming an annual average wage of \$1,000, it amounts to a sum equal to the total wages of one and a half million workers.

With reference to the phase of the business cycle, it may be conceded that a substantial diminution of consumer buying may act as a salutary restraint in the event of a threatened excessive expansion of business. At other times, however, as remarked above, such a diminution is likely to make more difficult the problem of maintaining prosperity and most certainly would act to intensify and aggravate a downswing of business.

There is a serious danger that the anticipated excess of contributions over benefits on old age and unemployment insurance account, plus the budgetary surplus on non-social security account, will lead to an excessive rate of retirement of the publicly-held Federal debt. Although estimates in this field must necessarily be highly tentative,

it is at least possible that revenues and expenditures may be such in the next four fiscal years as to permit the retirement of \$9 billion of publicly-held Government obligations.

Whether such an amount of debt retirement would be excessive depends on the course of business. If the rise in incomes and prices is becoming too rapid to be sustained, a high rate of debt retirement would moderate this development by decreasing current spending on consumer goods and perhaps by leading to a contraction of banks' earning assets and deposits. If, on the other hand, business recovery does not generate sufficient momentum, too rapid a rate of debt retirement may prevent recovery from proceeding to a point where full employment is attained. A condition approximating that of England in the Twenties could conceivably arise.

Over a longer term the anticipated retirement of all the publicly-held debt raises serious problems. Short-term Governments are almost indispensable for various types of institutional investors as a source of liquidity and are most suitable for open-market operations on the part of the Federal Reserve System. Consequently the Government and various classes of institutions may be put in the position of bidding securities up to a ridiculous price. An amendment permitting the fund to hold state obligations would alleviate the problem only slightly.

There is, in other words, a possible danger of a superabundance of investable funds that are restricted to high-grade fixed-income yielding securities, while there may be a real scarcity of funds available for more speculative undertakings. A complete or too rapid retirement of the publicly-held Federal debt and the possible competition of the Fund for state and municipal bonds would seriously aggravate this condition and might possibly lead to the non-investment of some of the current receipts of institutions and other restricted buyers. This would interrupt the monetary stream of income and expenditures.

A Desirable Amendment from the Monetary Point of View.

Since the present scales of contributions or benefits, by resulting in too great a diminution of consumer purchases and too great a rate of retirement of publicly-held debt, are expected to make more difficult the attainment of enduring prosperity, the obvious remedy would be to lower the scale of contributions or raise the scale of benefits, or both. Raising the scale of benefits, however, would not result in a significant increase in benefit payments until there were a substantial number of people eligible for benefits, which will not be the case until after a period of years. It would appear, therefore, that regardless of what is done in the way of providing more generous benefits for older people reaching the age of sixty-five in the next few years, the total of annual contributions should be lowered. This could be done by postponing

the application of the higher rates of contribution and lowering the eventual maximum from six to five percent, in line with the proposal originally made by the Committee on Economic Security.

If the present contributions of two percent of payrolls were continued until 1947 and then were raised one percent every five years until the maximum of five percent was reached in 1957, and slightly more generous benefits were provided for people shortly reaching the age of sixty-five, the reserve fund would increase only to a maximum of some $\$11\frac{1}{2}$ billion by 1967. After that date the benefits would begin to exceed contributions, plus interest on the fund, and the Government would have to contribute an annual subsidy to the fund out of general revenues. The maximum annual Government contribution might reach \$1.3 billion by 1980. Of this amount approximately \$1 billion would replace interest charges on a larger fund and \$300 million represents the effect of reducing the final tax rate from 6 percent to 5 percent,

It may be noted that an amendment along these lines would not only meet the monetary and fiscal objections to the present Act, but it would also be supported by general considerations of equity. It was recognized that in the case of older workers and low-paid workers an annuity based solely on the contributions of such workers and their employers would be totally inadequate. Provision was made, therefore, to give such workers more than

was contributed on their behalf. This was the only possible and humane thing to do, and no one will object to it. If, however, the plan as a whole is to be self-supporting, the amount over and above contributions on their behalf which the older and poorer-paid workers receive must result in better-paid workers and workers retiring in later years getting less than the amount which they and their employers contributed. This, in fact, is how the present plan works. It would appear far more just and equitable to place the cost of additional benefits to older and low-paid workers on the general community, in accordance with the principle of ability to pay, rather than on the better-paid workers and on those who will not reach retirement age until later. The acceptance of this principle would permit a lower scale of contributions with no diminution of benefits.

A further advantage in postponing the application of the higher rates of taxes is that it would facilitate the adjustment of employers and employees to the taxes. If incomes continue to increase a four percent rate in 1952 may be no more burdensome than a two percent rate now. In this connection it should not be forgotten that most employers are in addition becoming subject to a three percent unemployment insurance tax on payrolls.

It has been suggested in some quarters that the objection to a rapid retirement of the publicly-held debt could be met by reducing other taxes and by using the money borrowed from the social

security fund for the ordinary expenses of the government.

This course, however, would be objectionable on various grounds.

The bulk of federal revenues is being increasingly raised from taxes on corporations and the higher-income groups. In other words, it represents money the bulk of which would otherwise have been saved. To impose payroll taxes and reduce income taxes would increase the supply of money that had to be invested in the making of producers' goods if the monetary circulation is to be kept up. This course therefore would be open to the same objection made to the present plan. Moreover, it is open to the further objection that it would tend to increase excessive concentration of wealth and economic power.

It is likely that the coverage of old age benefits will be sooner or later extended to agricultural workers and domestic employees. Such an extension under the present program would result in an even larger excess of contributions and a larger reserve fund than are now contemplated. The necessity of postponing the application of the higher rates of contributions becomes, therefore, more urgent.

CONTRIBUTORY OLD AGE BENEFIT PLAN

Estimated Appropriations, Benefit Payments, and Reserve

(In millions of dollars)

Fiscal year ending June 30	Appropriation for reserve		Interest on re- serve	Benefit payments		Added to reserve	Balance in re- serve
	1/	2/		2/	3/		
1937	255.5		0.	1.9		253.7	253.7
1938	513.5		7.6	7.2		513.8	767.5
1939	518.5		23.0	14.5		527.0	1,294.5
1940	662.2		38.8	22.0		679.1	1,975.6
1941	807.2		59.2	29.7		836.7	2,810.3
1942	814.8		84.4	52.8		848.3	3,656.6
1943	970.0		109.8	94.2		985.5	4,642.1
1944	1,126.6		139.3	142.9		1,123.0	5,765.1
1945	1,137.0		173.0	191.2		1,118.8	6,883.9
1946	1,291.4		206.5	249.2		1,248.8	8,132.7
1947	1,447.1		243.9	314.5		1,376.5	9,509.2
1948	1,460.1		285.2	377.4		1,367.8	10,877.0
1949	1,621.1		326.3	442.1		1,505.4	12,382.4
1950	1,783.3		371.5	505.5		1,649.3	14,031.7
1955	1,861.2		615.8	887.8		1,589.2	22,115.7
1960	1,939.1		844.2	1,379.9		1,403.4	29,543.9
1965	2,016.9		1,040.9	1,844.0		1,213.8	35,898.5
1970	2,094.6		1,210.9	2,303.5		1,000.2	41,366.7
1975	2,172.7		1,341.8	2,872.1		642.4	45,368.3
1980	2,180.5		1,406.0	3,511.3		75.2	46,942.7

1/ The column "Appropriation for reserve" represents the estimated net proceeds of the taxes provided for in Title VIII after deduction of the estimated expenses of administering the plan. The appropriation voted by Congress for the fiscal year 1937 is \$265,000,000.

2/ In estimating the taxes (and therefore also the appropriations) and the benefits payable, it was assumed that the average earnings of insurable employees throughout the period covered by the estimates would be \$1,100 per year, exclusive of the amounts by which individual salaries exceeded \$3,000 annually.

3/ In estimating benefits payable it was arbitrarily assumed that the average retirement age would be about 67½ years. Benefits are to be paid only when the employee is not receiving "wages with respect to regular employment."

SCHEDULE OF TAXES (DIVIDED EQUALLY BETWEEN PAYROLLS AND WAGES)

Calendar years:	1937-39	2 percent
	1940-42	3 "
	1943-45	4 "
	1946-48	5 "
	1949-	6 "

Payable on "all remuneration for employment/ in covered occupations/including the cash value of all remuneration paid in any medium other than cash," up to \$3,000 per individual per annum.
(Social Security Act, Title VIII)

APPROPRIATIONS, BENEFITS AND RESERVE FUND UNDER A POSTPONED AND
LOWER SCALE OF TAXES AND HIGHER BENEFITS FOR WORKERS REACHING
SIXTY-FIVE IN THE NEXT FEW YEARS. (IN MILLIONS OF DOLLARS)

<u>Fiscal year ending June 30</u>	<u>Tax rate (per cent)</u>	<u>Appropria- tion for reserve</u>	<u>Inter- est on re- serve</u>	<u>Bene- fit pay- ments</u>	<u>Added to reserve</u>	<u>Balance in re- serve</u>
1937	0-2	255	-	2	253	253
38	2	515	7	153	369	622
39	2	520	18	192	346	968
40	2	520	29	211	338	1,306
41	2	525	39	237	327	1,633
42	2	525	49	270	304	1,937
43	2	530	58	307	281	2,218
44	2	530	67	338	259	2,477
45	2	530	74	369	235	2,712
46	2	535	81	395	221	2,933
47	2-3	690	89	422	357	3,290
48	3	845	99	452	492	3,782
49	3	850	113	480	483	4,265
50	3	855	128	510	473	4,738
55	4	1,210	208	888	530	7,465
60	5	1,600	291	1,380	511	10,218
65	5	1,665	347	1,844	168	11,742
66	5	1,680	352	1,935	98	11,840
67	5	1,690	355	2,025	20	11,860
1968	5	1,705	356	2,120	-59	

Continuation with Subsidy, beginning 1968,
sufficient to keep reserve balance constant

	<u>Tax rate (per cent)</u>	<u>Normal Appro- priation</u>	<u>Inter- est on re- serve</u>	<u>Bene- fit pay- ments</u>	<u>Subsidy appro- priation</u>	<u>Balance in re- serve</u>
1968	5	1,705	356	2,120	55	11,860
1969	5	1,715	356	2,215	144	11,860
1970	5	1,730	356	2,305	219	11,860
1975	5	1,795	356	2,870	729	11,860
1980	5	1,800	356	3,510	1,354	11,860