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Many proposals have been offered to deal with the social security funding crisis in both the near and the long term. By combining a number of these proposals, shortfalls in the OASDI trust fund prob-

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Economic Commentary

Social Security: Issues and Options
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bursements are expected to reach almost $171 billion in 1983. HI is pro-
jected to pay out $39 billion in benefits. 2 Medicare is financed through a separate payroll tax that is shared equally by both employer and employee. Many econo-
mists believe the employer's burden of the tax is shifted to consumers through higher prices and/or to wage earners through lower wages. The combined tax rate currently is 13.4 percent, levied on the first $35,700 of wage and salary income. Primarily because of this maxi-

mum wage and salary level, individuals above the cutoff level pay less social security tax, expressed as a percentage of their incomes, than individuals below the cutoff. Moreover, the tax discrimi-

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1. Supplemental medical insurance (SMI), or medi-
care, part B) pays doctors' and other medical fees. Because SMI is financed through premiums and general revenues, it will not be discussed further in this article.


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<td>$1,184</td>
<td>$3,021</td>
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<td>1970</td>
<td>$99,654</td>
<td>$7,311</td>
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<td>1980</td>
<td>$90,937</td>
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Table 1. Current Value of Social Security Benefits and Contributions

For average single male earner retiring at age 65


The pay-as-you-go system works well enough to cover benefit disbursements in trust funds, which have provided a reserve against fluctuations in benefits and/or receipts. Because the trust funds are invested in interest-bearing U.S. government securities, they also help finance the federal budget deficit. The pay-as-you-go system works well as long as receipt growth matches benefit growth, but nothing intrinsic to the system guarantees that this would occur. Benefit payments are not constrained to past or present levels of receipts. For the past eight years, the OASDI fund has paid out more than it has taken in; under reasonable economic assumptions, this fund will be unable to make payments by mid-1984.

Table 1 Estimated OASDI and HI Costs

As a percent of payroll and scheduled tax rates, 1980-2055
Percent of taxable payroll

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<tr>
<td>1980</td>
<td>3.6</td>
<td>0.5</td>
<td>0.1</td>
<td>2.1</td>
<td>1.4</td>
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<tr>
<td>2000</td>
<td>12.4</td>
<td>0.9</td>
<td>0.3</td>
<td>9.5</td>
<td>4.4</td>
</tr>
<tr>
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<td>0.5</td>
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<td>6.4</td>
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Financing Options

There have been many suggestions of ways to restore the financial soundness of the social security system, but none of the specific proposals alone is sufficient to close the OASDI funding gap. Some proposals would primarily ease the near-term deficit; others would focus on long-term issues. Most observers agree that to cover projected costs, an HI payroll tax of about 9 percent rather than 2.9 percent would be needed by the year 2030. Given reasonable assumptions about long-term real wages, unemployment, inflation, and birth rates, the cost of the total social security program by the year 2030 could exceed 25 percent of taxable payroll. Many observers question the willingness and the ability of future generations to pay such high taxes in view of the tax burdens already placed on the elderly. At the federal, state, and local governments.

est growing federal revenue over the last ten years, in fiscal year 1982 they were larger than all other federal revenue sources except individual income taxes.

Social security benefits under OASDI are loosely related to workers’ past contributions to the system. The level of benefits is calculated as a percentage of a worker’s average monthly earnings. In this aspect, social security resembles an insurance program. The percentage paid back, however, varies so that low-wage earners receive a higher percentage of their pre-retirement income than high-wage earners. In this aspect, social security resembles an income-transfer program, relating to economic conditions. The average retiree, both past or present levels of receipts. For the past eight years, the OASDI fund has paid out more than it has taken in; under reasonable economic assumptions, this fund will be unable to make payments by mid-1984.

Financial Problems

Social security’s funding problems are relatively recent, resulting from the benefit structure and from economic conditions. The average retiree, both now and in the future, will receive far more than his contributions to the system.

4. In 1981 the Congress authorized the system’s three trust funds to borrow from each other up to six months in advance to cover future cash needs. The borrowing authority, which expired December 31, 1982, enabled OASDI to cover its cash shortfall through June 1983. In the future, if the borrowing authority were to be extended indefinitely, it is estimated that trust fund balances would sufficient to cover OASDI obligations through mid-1984.

5. This scheme is affordable when the economy or work force is experiencing rapid growth, such as existed until the mid-1970s. In 1972, the Congress enacted legislation to raise the level of benefits and to provide for automatic cost-of-living adjustments (COLAs). However, subsequent economic events were such that these increases in benefits became difficult to maintain, rising unemployment, lower real wages, and inflation increased benefit disbursements and reduced revenues. As a result, OASDI assets declined from 66 percent of annual expenditures in 1975 to 44 percent in 1977. Removable legislation in 1977, which included payroll tax hikes and an increase in the maximum wage base, proved inadequate as the economy deteriorated. According to the Social Security Board of Trustees’ most recent forecast, the OASDI trust fund will be depleted in mid-1984. The National Commission on Social Security Reform, established by President Reagan in 1981, estimates that approximately $150 billion to $200 billion will be needed in the next seven years to shore up the OASDI fund; these monies can come from increased revenues or from reduced benefit outlays. Social security’s problems extend beyond the next several years, however.

Social Security’s Future

Projections of the Social Security Board of Trustees indicate that the OASDI portion of the social security program would again be in the black sometime after 1990 because of scheduled OASDI tax rate increases (see chart 1). After 2010, however, the 12.4 percent tax rate would not provide adequate funds. The underlying cause of this long-term deficit is demographic in nature. OASDI cash needs are projected to balloon with the aging of the baby boom generation and reductions in mortality rates. The decline in the birth rate that began in the late 1950s will slow the entrance of young people into the labor force. The worker/beneficiary ratio is projected to decline from the current 3.1 to less than 2.1 beginning in 2010. As a result, a payroll-tax rate of at least 16.8 percent would be necessary by the year 2030 if current levels of benefits were to continue. Even if the trust fund were not, of course, include the HI portion of the program, projections for HI indicate that this trust fund would be insolvent after 1987.

The rapid rate of growth in HI outlays can be attributed to escalating medical costs and an increasing number of elderly Americans who require more expensive forms of medical treatment. To cover projected costs, an HI payroll tax of about 9 percent rather than 2.9 percent would be necessary by the year 2030. Given reasonable assumptions about long-term real wages, unemployment, inflation, and birth rates, the cost of the total social security program by the year 2030 could exceed 25 percent of taxable payroll. Many observers question the willingness and the ability of future generations to pay such high taxes in view of the tax burdens already placed on them by federal, state, and local governments.


Financing Options

There have been many suggestions of ways to restore the financial soundness of the social security system, but none of the specific proposals alone is sufficient to close the OASDI funding gap. Some proposals would primarily ease the near-term deficit, others would focus on the long-term shortfall; several would slow the pace of an economic recovery. All of the proposals are based on economic and demographic assumptions that could be too optimistic; consequently, none can guarantee the system’s soundness in the future.

Moving the OASDI and HI tax rates already scheduled for 1985, 1986, and possibly 1990 forward to January 1, 1984, is one option suggested for the short-term funding gap. If the tax increases through 1990 were moved forward, the social security payroll tax rate would rise from 13.4 percent to 15.3 percent—the largest social security tax hike to date. This proposal is attractive, as it would generate large amounts of revenue in a very short period of time. However, the proposal could have some negative effects in the short term—namely, retarding an economic recovery that most economists currently expect to be weak by historic standards. The risks involved in moving the tax hikes forward depend largely on how the tax funds are used. To the extent that
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<td>1%</td>
</tr>
<tr>
<td>2000</td>
<td>10%</td>
<td>5%</td>
</tr>
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<td>2030</td>
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However, to the extent that tax revenues are not immediately paid out to social security recipients but are used to replenish trust-fund balances, the tax would tend to restrain aggregate income growth and slow a recovery. Because the additional trust-fund balances would be invested in Treasury securities and would reduce the deficit, they would tend to help reduce fiscal pressures on interest rates. Nevertheless, the direct re-
strictive impact of higher taxes on income growth would dominate the less

direct stimulative effects of lower interest rates. Because the tax revenues and reducing benefit pay-
ments. Increasing the retirement age would not be necessary until the next
decade and could be done gradually to avoid disrupting the plans of individuals near retirement.

Conclusion

Many proposals have been offered to deal with the social security funding crisis in both the near and the long term. By combining a number of these proposals, shortfalls in the OASDI trust fund probably could be avoided. Yet, as long as the system continues on a pay-as-you-go basis, it will be vulnerable to business-
cycle swings and demographic changes. Should future costs again get out of hand, policymakers will have to decide whether this nation is best served by a social security system that functions primarily as a reliable retirement fund or one that functions as a welfare-transfer system.

NOTE: This is the first Economic Commentary published since November 1.

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Social Security: Issues and Options

by Amy Kerka

If nothing is done to bail out our social security system, by 1986 Americans might not receive continued timely pay-
ments. Early in 1983, the Congress will consider reform measures to restore the financial soundness of the social security system. This Economic Commentary describes social security and its funding problems, summarizes the latest financial projections for the system, and reviews some of the social security reforms that are being proposed.

The Social Security System

The U.S. social security system consists of three programs: old age and sur-
vivors insurance (OASI), which pays monthly cash benefits after a worker becomes disabled; and hospital in-
surance (HI, or medicare, part A), which pays hospital in-
erates against wages and salaries in favor of other types of income, such as inter-
est, dividends, and rents. Nevertheless, social security taxes have been the fast-

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1. Supplemental medical insurance (SMI), or medi-
care, part B, pays doctors’ and other medical fees. Because SMI is financed through premiums and general revenues, it will not be discussed further in this article.