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Social Security: Issues and Options

by Amy Kerka

If nothing is done to bail out our social security system, by 1984 Americans might not receive continued timely payments. 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 survivors insurance (OASI), which pays monthly cash benefits after a worker retires or dies; disability insurance (DI), which pays monthly benefits if a worker becomes disabled; and hospital insurance (HI, or medicare, part A), which pays some hospital bills.[1] The OASI and DI programs, which are usually considered together and referred to as OASDI, account for the largest share of our social security system. OASDI disbursements are expected to reach almost $171 billion in 1983. HI is projected to pay out $39 billion in benefits.[2]

Social security is financed through a payroll tax that is shared equally by both employer and employee. Many economists 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 maximum 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 discriminates against wages and salaries in favor of other types of income, such as interest, dividends, and rents. Nevertheless, social security taxes have been the fast-

1. Supplemental medical insurance (SMI, or medicare, 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.

2. Social Security Board of Trustees, *1982 Annual Report*, April 1982.

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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 payback, 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. Under the current tax and benefit schedules, most persons retiring before the year 2030 will receive benefits in excess of their contributions (see table 1). Benefits paid under HI also resemble an income-transfer program, relating to medical needs rather than social security contributions. Coverage is extended to all OASDI recipients plus any voluntary participants not covered by OASDI (for example, state and local government employees).

Table 1 Current Value of Social Security Benefits and Contributions[a]

For average single male earner retiring at age 65

Retirement year	Social security benefits, constant 1982 dollars	Social security contributions, constant 1982 dollars
1960	$49,554	$ 7,311
1970	59,537	18,318
1980	78,804	34,694
1990	63,797	42,395
2010	57,488	55,331
2030	56,938	62,525

a. Table reprinted from the Institute for Socioeconomic Studies, *Socioeconomic Newsletter*, vol. VII, no. 4 (June—July 1982).

The OASDI and HI programs are financed essentially on a pay-as-you-go basis; that is, current payroll taxes are used to make current benefit payments. Any excess of payroll-tax receipts over benefit disbursements is held in trust funds, which have provided a reserve against fluctuations in benefits and/or receipts.[3] 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.[4]

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 sys-

3. There are separate trust funds for each social security program.

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 be sufficient to cover OASDI obligations through mid-1984.

tem.[5] This scheme is affordable when the economy or work force is experiencing rapid growth, such as occurred 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 wage gains, and inflation increased benefit disbursements and reduced revenues. As a result, OASDI assets declined from 66 percent of annual expenditures in 1975 to 47 percent in 1977. Remedial 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 disbursements 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.[6] 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. This does not, of course, include the HI portion of the program.

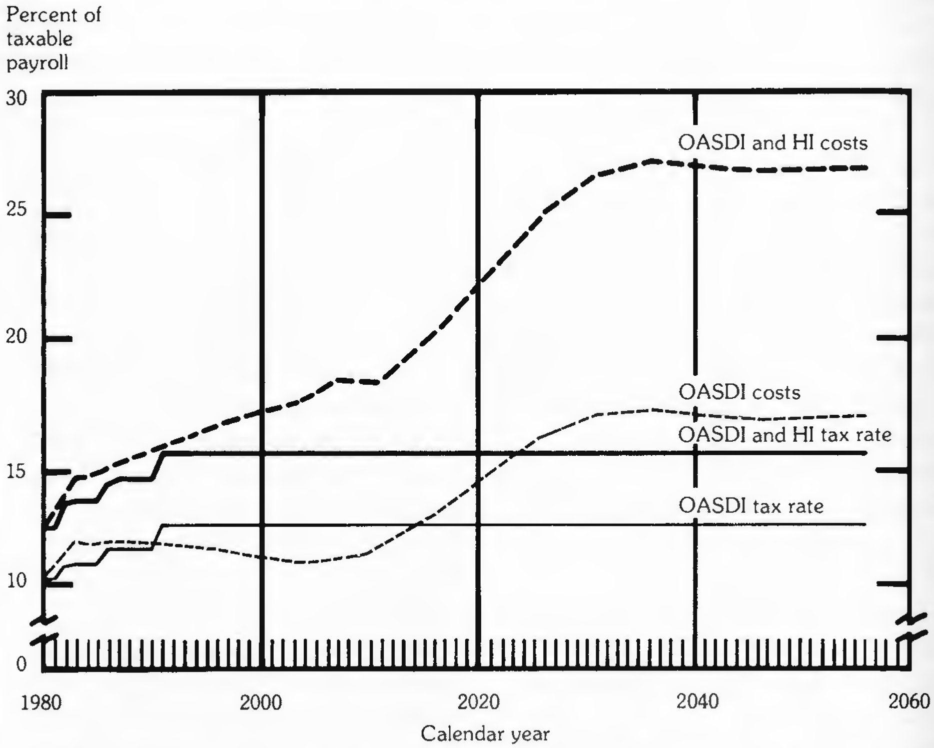
Projections for HI indicate that this trust fund would be insolvent after 1987. The rapid rate of growth in HI outlays can be attributed to escalating medical costs and an increasing number of elderly Americans who require more expensive forms of medical treatment. To cover projected costs, an HI payroll tax of about 9 percent rather than 2.9 percent would be 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 them by federal, state, and local governments.

5. See James R. Capra, Peter D. Skaperdas, and Roger M. Kubarych, "Social Security: An Analysis of Its Problems," *Quarterly Review*, Federal Reserve Bank of New York, vol. 7, no. 3 (Autumn 1982), pp. 1–17, for a detailed discussion of this aspect of the social security funding problem.

6. See Mickey D. Levy, *Achieving Financial Solvency in Social Security*, American Enterprise Institute for Public Policy Research, 1981.

Chart 1 Estimated OASDI and HI Costs

As a percent of payroll and scheduled tax rates, 1980–2055



DATA SOURCES: 1982 Annual Reports, Social Security Board of Trustees; and U.S. Senate Finance Committee (HI projections after 2005).

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 hikes 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 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 the increased tax revenues are paid out as benefits, the tax would transfer income from one segment of the population—wage and salary earners—to another segment of the population—retirees. The tax would reduce consumption for some and increase it for others; the net effect would be fairly neutral. 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 restrictive impact of higher taxes on income growth would dominate the less direct stimulative effects of lower interest rates, especially in the early phases of economic recovery.

The use of general revenues is another alternative to bridge the short-term funding gap. Raising general taxes to finance social security payouts could avoid a crisis, depending, of course, on how much taxes were raised. The impacts on the pace of economic recovery would be the same as those already described for an increase in the payroll tax. Sometimes, however, the proposal to use general revenue funds for social security is offered as if it would avoid a tax increase. This could occur only at the expense of greatly increasing the federal deficit, currently projected to reach $180 billion in fiscal year 1983. In the near term, higher deficits would tend to raise interest rates, which would adversely affect interest-sensitive sectors of the economy such as housing, auto sales, and business fixed investment. In the long term, this option would increase the burden of servicing and retiring the federal debt for future generations of taxpayers.

Other options for improving the social security trust funds in both the short and the long term involve curtailing future benefit increases; these options include freezing benefit payments at current levels for one or two years, altering benefit payout ratios and eligibility rules, taxing a portion of social security benefits, or changing the formulas for COLAs to social security benefits.[7] In general, reducing benefit increases potentially would solve the near-term and long-term funding crisis, depending on the extent to which benefits were reduced. Reducing benefits also would reduce income for a large portion of the population, however, and thus could slow the pace of economic recovery.

A frequently discussed proposal for reducing future social security benefit increases involves changing the COLA formula. Currently, COLAs are tied to the consumer price index. The CPI generally rises faster than wages, so that this formula causes benefit payments to rise faster than receipts. Options for trimming COLAs include permitting only a part of the increase in the CPI to be reflected in social security benefits or tying COLAs to a wage index. The effect of this proposal on improving the sound-

7. Little discussion has focused on the problem of preventing a shortfall in the HI fund in the late 1980s. The Reagan administration is planning to propose medical reforms early in 1983 to reduce health-care expenditures by promoting competition among hospitals. Such competition might be achieved by encouraging greater use of prepaid medical plans or by emphasizing cost-sharing in health-insurance programs. Other alternatives include federal guidelines for increases in hospital expenditures (and revenue controls for hospitals that fail to keep within them) and promotion of state-level rate-setting programs.

ness of the OASDI fund would occur gradually and probably would be of minor significance.

Another proposal for dealing with the OASDI funding shortfall is to extend coverage to workers (primarily state and local government employees) who now are exempt from the program. Although this option would provide a quick influx of revenue, it also would increase the number of eligible benefit recipients in the future. Thus, while easing the near-term shortfall, this option might contribute to the long-term deficit.

One proposal specifically aimed at the long-term deficit would raise the eligible retirement age from 65 to 68. This proposal would help offset the decline in the worker/ beneficiary ratio projected after 2010 and would have the effect of raising tax revenues and reducing benefit payments. 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.

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