Research Department
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Funding the Future

The social-security system has come under a barrage of criticism in the past several years. The tone of the debate occasionally has become rather shrill—"chain-letter scheme" is a favorite epithet—so much so that a group of senior statesmen (including five former HEW secretaries) recently felt compelled to issue a lengthy statement defending the program against its critics at both ends of the political spectrum.

The controversy centers around the financing of a $70-billion program which protects American workers and their families against the loss of income resulting from death, disability or retirement. Controversy has frequently swirled around the hybrid social-insurance system since it was first introduced into this country a generation ago, but attacks may be stepped up in coming months, as Congress turns its attention to recent reports which indicate a sudden worsening of program finances under the double-barreled impact of inflation and recession.

Where money comes from

The Old-Age, Survivors and Disability Insurance program (OASDI) is financed largely by a 9.9-percent payroll tax. (Medicare financing, which is ignored in this analysis, pushes the total tax rate to 11.7 percent.) The rate is split evenly between employers and employees—a minor distinction, since most economists believe that employees bear the entire burden of the tax. This year, the tax is payable on the first $14,100 of earnings. Until 1950, the tax rate was 2 percent on the first $3,000 of earnings, but in the ensuing quarter-century Congress has legislated many social-security tax increases, generally at the same times that it boosted benefits.

In 1972, Congress modified its ad hoc approach and adopted an indexing system for financing the program. Under the new plan, annual benefit increases are based upon changes in the consumer price index, with the first such increase due this midyear. Similarly, the taxable wage base now rises automatically each year in accordance with increases in average wages. But whatever its virtues, the index approach creates difficulties for evaluating the future health of the program, because its financial status now depends not only on current benefit schedules and demographic prospects, but also on far-distant changes in prices and wages.

Another important feature of the plan is a pay-as-you-go ("current cost") method of financing. Under this approach, there is no fund created during a worker's life to serve as a source of his ultimate benefits. The social-security taxes he pays are immediately distributed to persons who are already beneficiaries, while his own benefits will be paid from taxes collected in the future from persons then working. In other words, the benefits paid this year—to the aged, to the disabled, to retirees' dependents, and to the survivors of deceased workers—are derived mostly from this year's contributions by workers and their employers.

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The system has consistently maintained a reserve fund, but nothing comparable to the type maintained by private insurance firms—whence comes the charge that it has unfunded liabilities running into the trillions of dollars. However, any system whose future income is assured by the government's taxing power has no need to build up the huge sums that private insurers would require if they underwrote similar liabilities. The major purpose of the trust fund rather is to serve as a contingency reserve large enough to tide the system over any temporary changes in income and outgo. Thus, during the past decade, trust-fund assets generally have been kept equal to about one year's expenditures. In dollar terms, trust-fund assets have varied over time, rising from $7 billion to $22 billion between 1945 and 1955, declining slightly by 1965, and then rising further to $46 billion in 1974.

Long-term deficit

Current fears about the long-term health of the program center around the wide gap expected to develop between income and outgo after the first decade of the 21st century. These fears first surfaced last year in several Administration and Congressional documents, primarily the annual Trustees Report, and are bound to grow because of the increasing gloominess of more recent official reports.

The assumptions cranked into last year's projections for the 1974-2048 period include a 5.0-percent average annual rate of increase in wages, a 3.0-percent rate of increase in consumer prices, and a 2.1 total fertility rate after 1985. (The latter is the average number of babies borne by each woman during her lifetime.) Given these assumptions, the cost of scheduled benefits would average 13.9 percent of the total taxable payroll over the 75-year period, but the tax rate would average only 10.9 percent over the same time-span. The difference between the average cost of the program and the average tax rate represents a financing deficit equivalent to 3.0 percent of total payroll—even greater when allowance is made for the benefit increase scheduled this year.

Different values for the wage and price variables of course would provide different results. Still, the bulk of the expected deficit arises from increasingly conservative demographic assumptions, which indicate that the number of beneficiaries per 100 workers will rise from 30 to 45 between now and the year 2030. This reflects the expectation that, with low birth rates, relatively few workers will be available to support the very large number of people who were born soon after World War II and who will retire in the 21st century.

Short-term deficit

Despite the importance of the debate over the long-run health of the social-security program, the system's short-run financing problems

will undoubtedly dominate the headlines in coming months. Last year, the Trustees' worst-case projection showed a near-balance in the program over the next several years, leaving $44 billion in trust-fund assets at the end of 1978. In contrast, the Trustees' forthcoming report—reflecting the gloomy economic projections of the President's Council of Economic Advisers—may show a severe drain capable of wiping out trust-fund assets by the end of the decade.

The sudden worsening of the program's short-term financial outlook reflects the same combination of factors that has created such havoc in the nation's overall economy. Unemployment has eroded payroll-tax revenues, and has also speeded the drain on the trust fund because of more workers seeking retirement or disability benefits. Inflation meanwhile has increased social-security outlays under the automatic benefit formula; this is expected to lead to an 8.7-percent benefit increase this June and a further 9.2-percent increase in June 1976. To be sure, the sluggish economy will get a boost from this year's $2.5-billion social-security deficit, but we can't assume that a projected $6.1-billion deficit in 1976 (or a $9.6-billion deficit in 1980) will be equally appropriate.

Congressional hearings are likely soon, at which point a number of proposals will be advanced to deal with the suddenly increased OASDI deficit. The administration has already rejected a proposal contained in a recent Advisory Council report, which would have shifted $7 billion of Medicare financing from the OASDI program to the shoulders of the general taxpayer, and it certainly would reject the AFL-CIO view that at least one-third of OASDI program costs should eventually be met from general tax revenues.

One financing possibility, advanced by the Advisory Council, would be an immediate increase in the social-security tax rate from 9.9 percent to 10.9 percent (exclusive of Medicare), and further increases rising to 16.1 percent in the year 2025. Another possibility would be a further expansion in the taxable wage base, which under the automatic formula has reached $14,100 this year and might reach $15,300 next year. The AFL-CIO argues that Congress should raise the base to roughly $28,000, at which point 97 percent of all workers would have their full wages taxed—the same situation prevailing at the outset of the program in the 1930's. (Insurance-industry spokesmen have consistently attacked proposals of this kind, on the grounds that the program would then usurp private savings and leave room for no other type of individual financial planning.) But whatever proposal is chosen, the latest financial estimates indicate that the total cost of the OASDI program will double between 1974 and 1980, to $120 billion, so that steps must be taken soon to find more money.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/12/75	Change from 3/5/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	85,824	+ 99	+6,242	+ 7.84
Loans (gross, adjusted)—total	66,274	− 743	+5,945	+ 9.85
Security loans	2,272	− 330	+1,144	+101.42
Commercial and industrial	23,590	− 214	+2,262	+ 10.61
Real estate	19,780	− 25	+1,157	+ 6.21
Consumer instalment	9,831	− 13	+ 676	+ 7.38
U.S. Treasury securities	6,860	+ 758	+ 710	+ 11.54
Other securities	12,690	+ 84	− 413	− 3.15
Deposits (less cash items)—total*	84,394	+ 533	+9,652	+ 12.91
Demand deposits (adjusted)	23,015	+ 496	+1,039	+ 4.73
U.S. Government deposits	438	− 12	+ 91	+ 26.22
Time deposits—total*	59,618	+ 509	+8,352	+ 16.29
States and political subdivisions	6,723	− 52	+ 294	+ 4.57
Savings deposits	18,986	+ 172	+1,084	+ 6.06
Other time deposits‡	30,591	+ 207	+6,119	+ 25.00
Large negotiable CD's	17,010	+ 403	+5,690	+ 50.26

Weekly Averages of Daily Figures	Week ended 3/12/75	Week ended 3/5/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	41	66	29
Borrowings	0	4	243
Net free (+) / Net borrowed (−)	+ 41	+ 62	− 214
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions Net purchases (+) / Net sales (−)	+2,004	+1,677	+1,582
Transactions of U.S. security dealers Net loans (+) / Net borrowings (−)	+1,573	+ 912	− 21

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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