

Research Department
Federal Reserve
Bank of
San Francisco

September 3, 1976

Social InSecurity?

Critics of the social-security system—the Old-Age, Survivors and Disability Insurance (OASDI) program—have been pointing with alarm to the growing discrepancy which actuarial studies show developing between the system's projected benefit payments and its anticipated revenues. Already receipts have fallen behind benefits, despite a series of increases in the payroll tax rate from 8.4 percent in 1969 to 9.9 percent in 1975 (excluding Medicare), and despite a constant rise in the maximum earnings subject to tax from \$7,800 in 1969 to \$15,300 this year. The shortfall has reflected the recession's impact on receipts, with unemployment and underemployment cutting into worker earnings, as well as the inflation's impact on benefits, which are now indexed to increase in line with rising prices.

Whatever the reason, worrisome questions have arisen about both the short-term and long-term health of the system. Some observers estimate that heavy demands on the system could bring about a decline of over one-third of the present \$44 billion in trust-fund reserves before the situation can stabilize in the 1980's. Some even claim that reserves will be exhausted within the next decade, forcing stiff tax increases or a call upon Treasury general revenues to balance the books. Looking beyond the turn of the century, all agree that the long-range cost of the program will substantially exceed presently scheduled tax revenues. It is this prospect, rather than the cur-

rent state of the trust funds, which represents the more serious threat to the system's solvency.

What happened?

The system was designed originally to operate on a self-financed, actuarially sound basis. Payroll-tax receipts in excess of benefits were designed to provide a substantial trust fund relative to annual benefit payments, and projected benefits were closely related to each individual's earnings, except for a preferential minimum (base) amount. However, the amendments of 1939 changed this self-sufficient character by stipulating benefits in excess of the actuarial value of taxes paid, in order to provide benefits for those retiring early in the life of the program. Benefits to dependents of retired workers were also extended at that time, without requirement of payment of additional payroll taxes. Amendments in 1950 further diluted the original, fully-funded concept and laid the basis for the present "pay as you go" system.

Much of today's concern over the integrity of the trust funds implies a misunderstanding of the present system. Retirement benefits, on this "pay as you go" basis, are financed essentially from current payroll-tax receipts. The trust funds currently serve to cover temporary excesses of benefits over receipts, and thus represent only a minor fraction of what an actuarially sound private-pension fund would need to meet its obligations. Benefits depend not on invested assets, but rather on future taxable capacity. As it now

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stands, the system is a mechanism for effecting intergenerational transfers from those who are currently active in the nation's workforce to those who are retired, disabled or otherwise dependent. Solvency of the system does not depend on the size of the reserves, but rather on the taxing power of the Federal Government and the willingness of the voting public to support the system.

For many years, Congress periodically increased benefits and taxes on an ad hoc basis, but with its 1972 amendments it shifted to an index basis. Benefit levels were linked to the consumer price index, while maximum taxable earnings were linked to average wages. The increase in nominal benefits was accomplished by raising the entire benefit schedule, both for those who were already retired and those who will retire in the future. But the indexing process, under the spur of inflation, also increased the average monthly earnings—and thereby the future benefits—of the current workforce. This benefit formula thus overcompensated future beneficiaries for the effects of inflation occurring during their working years—and in the process caused a large part of the system's expected future deficit.

A mature system's problems

As it approaches maturity, the "pay as you go" system will require greater tax revenues to provide current benefits for a larger number of beneficiaries. Beyond the turn of the century, the ratio of

workers to beneficiaries will become less favorable. This raises the question of where the funds will come from to meet these new obligations.

For various reasons, the public may not readily accept further significant increases in the payroll tax. This tax, which is now set at 9.9 percent, is split evenly between employer and employee. The employee's share may seem nominal, but economists argue that employees actually bear most if not all of the tax burden, either through higher prices or through smaller wage increases. Moreover, the tax is regressive because it is levied on the first wages earned and not on any wages in excess of the taxable earnings base. In other words, lower-income groups have to pay a larger portion of their income in payroll taxes than do higher-income groups. Still, these drawbacks have to be weighed against the fact that lower-income retirees fare better than higher-income retirees in terms of the proportion of their original earnings received back in the form of benefits.

Two quite distinct factors are involved in the deficit problem: first, the impact of the automatic benefit-increase mechanism, which overcompensates for cost-of-living increases, and second, the changing age structure of the population. Each of these factors is responsible for about one-half of the projected increase in the long-run deficit. The first problem—the inflation-

adjustment problem—can be solved by a policy decision “decoupling” the effect of wage increases and cost-of-living adjustments on benefits. The demographic shift—the declining ratio of workers to nonworkers—is a more serious and difficult problem and cannot be altered in the short run.

Grasping the nettle?

The Congressional Budget Office, in its fiscal 1977 budget analysis, noted that “the basic issue is whether there is an immediate need for remedial action or whether there is time to develop a remedy adequate to solve both the short- and long-term problems.” One possible line of action would be to postpone action for a year or two. Although reserves may be significantly depleted by the end of the 1981 fiscal year, they should still be substantial at that point. Then, if current projections turn out to be too optimistic, tax and benefit adjustments could still be made in a timely fashion without endangering the stability of the funds.

A second possibility, in the C.B.O.’s view, would be for Congress to make limited changes in the tax structure to eliminate the trust funds’ short-term deficit. Public confidence might be improved if reserves were raised above currently projected levels. This action would also provide some protection against unforeseen reserve drains for which no contingency has been made. The C.B.O. notes that an increase of roughly one-quarter percent in the tax rate

would balance the reserves over the near-term period 1976-81.

Another possibility raised by the C.B.O. would be an increase in the wage base subject to social-security taxes. This action could eliminate the short-term deficit if the base were raised above currently scheduled increases. The tax burden would be redistributed toward higher-income workers who could more easily bear this additional burden. At the same time, lower-income workers would not suffer additional deductions from their wages. However, a higher wage base—and the higher future benefits it would generate—would exacerbate the long-term deficit because future costs would be greater than future revenues.

Yet another option is a grant from general revenues. This would avoid changes in the tax rate, in the tax base, and in benefit levels. However, if Congress adopted this solution as a permanent method of financing benefits, it would represent a fundamental change in the heretofore self-financing nature of the social-security system.

The next Congress will have to make some basic decisions about the program, choosing from a long list of alternatives such as those presented here. Much remains to be done to adapt the system to the realities of the late-20th and 21st centuries, but its basic soundness—resting as it does on the taxing power of the Federal Government—seems beyond question.

Ernest Olson

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/18/76	Change from 8/11/76	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	89,062	+ 81	+ 3,724	+ 4.36
Loans (gross, adjusted)—total	67,004	- 294	+ 2,646	+ 4.11
Security loans	1,620	- 512	+ 530	+ 48.62
Commercial and industrial	21,430	+ 2	- 1,306	- 5.74
Real estate	20,469	+ 48	+ 841	+ 4.28
Consumer instalment	11,304	+ 21	+ 1,201	+ 11.89
U.S. Treasury securities	9,646	+ 172	+ 1,564	+ 19.35
Other securities	12,412	+ 203	- 486	- 3.77
Deposits (less cash items)—total*	88,110	- 494	+ 3,142	+ 3.70
Demand deposits (adjusted)	24,918	- 531	+ 1,586	+ 6.80
U.S. Government deposits	462	+ 138	- 3	- 0.65
Time deposits—total*	61,242	- 118	+ 1,524	+ 2.55
States and political subdivisions	5,658	- 105	- 365	- 6.06
Savings deposits	26,685	+ 54	+ 5,867	+ 28.18
Other time deposits‡	26,554	- 62	- 2,744	- 9.37
Large negotiable CD's	10,936	- 147	- 4,263	- 28.05
Weekly Averages of Daily Figures	Week ended 8/18/76	Week ended 8/11/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves	- 6	19		46
Borrowings	17	2		26
Net free(+)/Net borrowed (-)	- 237	+ 17		+ 20
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 156	+ 204		+ 1,795
Transactions of U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 91	+ 444		+ 544

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

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .

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