FRBSF Weekly Letter

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# Reconsidering Social Security

Many consider Social Security "off limits" in discussions of federal budget reform. This view — embodied formally in the Gramm-Rudman Amendment — limits considerably the options open to those who would balance the federal budget. In 1985, spending on the Old Age, Survivor's and Disability Income Program (OASDI), along with Medicare, represented about 27 percent of all federal spending. To eliminate the $200 billion budget deficit entirely through spending cuts would require a 29 percent across-the-board cut in other spending programs if Social Security and Medicare were untouched. If current levels of defense spending also were preserved, remaining domestic programs would have to be cut by almost 45 percent.

Social Security programs limit the practicality of resolving the budget imbalance through increases in taxes as well, since the large size of the Social Security tax levies already are a growing burden on wage income. Not only have Social Security tax rates risen sharply over time (the current combined employee and employer tax is about 14 percent), but the level of earnings subject to tax also has increased significantly. The maximum Social Security tax has risen 100-fold since 1939 and 16-fold just since 1968.

Although efforts to balance the federal budget clearly would be made easier if current spending on Social Security programs could be considered in budget reform, previous attempts to cut current Social Security benefits have floundered in Congress. Now that the depth of cuts required in other programs is more apparent, budget analysts are once again scrutinizing Social Security spending, particularly in light of the questionable Constitutional status of Gramm-Rudman. In this *Weekly Letter,* we review the case for subjecting the Social Security program to the same budgetary scrutiny as other income transfer programs.

**Social Security as an entitlement**

A major argument against cutting current Social Security benefits is essentially an ethical one since receiving Social Security retirement benefits is conditioned, at least partly, on the participation of workers in the system in their pre-retirement years. Indeed, some workers believe their retirement benefits approximate the current economic value of their accumulated contributions to the retirement system.

In fact, the relationship between retirement benefits and previous payment of Social Security taxes is exceedingly weak. The retirement benefits structure is very complex, involving a progressive benefit structure, dependency benefits and allowances for survivors and the disabled. As a result, a large portion of Social Security benefits are paid to individuals on bases other than their contributions.

Moreover, the benefits paid to individuals with identical pre-retirement contribution histories can be radically different. For example, a household consisting of a single, 55-year old male can, under current law, expect to receive at retirement upon age 65 less than half the retirement benefits of a similar household with a non-working wife, despite identical Social Security contribution histories.

More importantly, Social Security benefit levels, even in the aggregate, bear no economic relationship to prior contribution levels. The system is funded on a pay-as-you go basis whereby current benefits are paid out of current tax revenues with the Social Security "trust funds" serving only to buffer transient discrepancies between current outlays and current Social Security revenues. As a result, Social Security benefits cannot be viewed as an annuity flowing from accumulated prior contributions. Indeed, the current population of retirees is receiving benefits three to four times greater in value than the fair invested value of its contributions. Such features make the Social Security retirement program primarily an income transfer program and it could be argued, therefore, that Social Security expenditures should be subject to the same annual budget scrutiny as other income transfer programs such as Aid to Families with Dependent Children (ADFC).

**Altered expectations**

An argument against including Social Security spending in the annual budget process is that retirees have conditioned their retirement on the expectation of certain benefits. Altering those benefits presumably would unfairly disrupt their economic lifestyles at a time when they can do little to adjust. Such an argument is based in part on the presumption that today's generous benefit levels were anticipated fully by the retired during their working years and, thereby, induced irreversible changes in working and saving patterns.

On the contrary, Social Security benefit levels rose most sharply during the 1970s as a result of (presumably unanticipated) Congressional actions and the interaction of Social Security benefits formulae with inflationary shocks that occurred at that time. (For example, benefits were doubly boosted in the 1970s because both the wage base and benefit levels were indexed to inflation.) This contributed to an increase in the incomes of the elderly of over 45 percent, in real terms, in contrast to a decrease of 7 percent in real wages of workers between 1970 and 1984.

There also appears to be more room than often thought for adjusting post-retirement lifestyles to changes in Social Security benefits. Since the advent of Social Security, many more individuals over 65 do not work at all or work only part-time. According to the Economic Report of the President, whereas only about 14 percent of persons 65 years or older work today, over ⅔ of persons in the over-65 age group worked prior to the advent of Social Security. Although any change in Social Security benefits that might force additional elderly persons to work is undesirable in and of itself, this disadvantage must be weighed against the alternative of an increasing burden on the working generations. (According to a recent household survey, leisure time of young, working households has fallen nearly 30 percent in just ten years.)

**Retirement incomes**

Proposals to cut current Social Security spending raised the spectre of impoverishing a segment of our population that seemingly already is poor and in ill health. In fact, Social Security benefits at the present time represent only about 29 percent of the income of the elderly when income is imputed from all sources. The clustering of retirement ages around the ages of 62 and 65 (the ages of qualification for partial or total Social Security benefits) suggests that most retirement is not stimulated by health considerations but rather by the Social Security system itself.

There is evidence that the economic status of the elderly is no longer low relative to other age groups. According to data from the Department of Commerce and the Department of Health and Human Services, the median per capita income of individuals 65 and over in 1983 was actually greater than that of those between 25 and 65 years of age by about 10 percent. And whereas the poverty rate of the general population has risen since 1966, the poverty rate of the elderly has fallen 60 percent in the same period. It is now only about half the rate of working households when the value of medical services and other non-retirement benefits are included in income measures.

The current retired generation also has benefitted significantly from the rapid appreciation in the value of real assets — such as housing — that occurred in the 1970s. According to Federal Reserve data, about 70 percent of all retired households in 1983 owned a home with an average net equity of $70,000. In addition, 86 percent of retired households held financial assets with an average value of over $50,000.

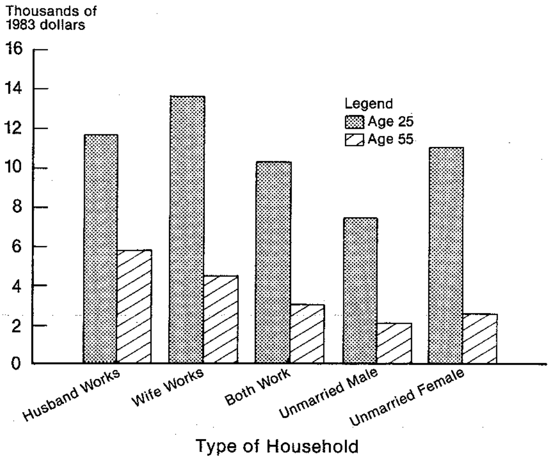
**Demographic changes**

When debating the impact of reductions in Social Security income on the retired, it also is important to consider the burden of current Social Security spending levels on the current working population. Because the Social Security system is funded on a pay-as-you-go basis, the income redistribution caused by any given benefit policy depends critically upon the overall demographics of taxpaying and recipient populations and on the rate of growth of the economy.

Over the past decades, there have been increases in life expectancy, and, more recently, sharp downturns in the birthrate. As a result, whereas only 1 person in 18 was over 65 at the time that Social Security was passed, by 2030 the figure will be 1 in 5. When coupled with secular declines in the rate of economic growth, it is not possible to improve or even maintain the relative economic status of the retired generation without a dramatic acceleration in the size of the burden on the youngest workers.

In response to a looming Social Security deficit, amendments were made to the Social Security Act in 1983. Although current benefit levels were left largely untouched by the amendments, future beneficiaries will be affected by a phased-

Loss of Social Security Wealth
from 1983 Amendments*
(Households earning $25,000)




* From Pellechio and Goodfellow.

in increase in retirement age, taxation of Social Security benefits, and other provisions that have the effect of reducing future benefit levels. In addition, the scheduled increases in Social Security tax rates were put into place immediately.

Pellechio and Goodfellow have modeled the effects of the 1983 amendments on the net benefits from Social Security that can be expected by various types of working households. They found that the amendments represented a net loss (relative to the prior provisions) of net Social Security benefits to virtually all income classes, age groups and household types, but particularly to the youngest households. For a married couple of median income headed by a 25-year old, for example, the amendments were tantamount — in terms of wealth — to a one-time $10,000 to $13,000 tax (see chart). In contrast, a similarly situated 55 year old couple faced losses ½ to ⅓ that of the young couple. Overall, for many young households, the Social Security retirement program can be expected to return less in benefits than they will pay out in taxes over their working lifetime — the opposite of the circumstances enjoyed by the current generation of retirees.

**Consequences for the economy**

Some economists argue that the very existence of a pay-as-you-go retirement system retards economic growth. Economist Martin Feldstein argues that this occurs because Social Security depresses private saving. The prospect of Social Security benefits therefore increases lifetime consumption. At the same time, the Social Security tax diverts funds away from productive investment. Recent work by Boskin and others supports the contention that Social Security depresses saving and investment and, thereby, presumably retards economic growth.

A second effect on the economy may flow from the way in which Social Security has been altered in recent years. As mentioned earlier, imbalances in the Social Security budget have been resolved largely by implementing immediate increases in taxes while scheduling any reductions in benefits far into the future. As Burkhauser and Warlick have argued, the postponement and ambiguity of benefit cuts may cause current workers to overestimate their future Social Security incomes. This, coupled with the immediate increase in Social Security taxes may cause them to avoid making the offsetting increases in private saving that would be expected to result from reforms such as those embodied in the 1983 amendments.

**Can benefits be cut?**

Any proposal to cut Social Security spending raises basic issues dealing with income distribution and economic growth. What constitutes a "fair" or equitable distribution of income in our society is not possible to specify objectively. It is clear, however, that the once relatively low economic status of the elderly is not as compelling an argument today against cuts in Social Security benefits. It also seems clear that the growing burden on young workers may have serious implications for the economic well-being of all members of the society, both working and retired, if it results in reduced economic growth and an excessive tax on the younger generation.

It also must be recognized that many retired households do not enjoy the "average" economic and health conditions these statistics imply. Any reform of Social Security spending, therefore, must recognize the program for what it is — an income transfer program that should employ, at least partly, means and needs tests.

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**Editorial comments may be addressed to the editor (Gregory Tong) or to the author. . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.**

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## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 2/5/86 | Change from 1/29/86 | Change from 2/6/85 Dollar | Change from 2/6/85 Percent[7] |
|---|---|---|---|---|
| Loans, Leases and Investments[1 2] | 201,382 | 720 | 12,822 | 6.7 |
| Loans and Leases[1 6] | 182,146 | 801 | 11,633 | 6.8 |
| Commercial and Industrial | 52,574 | 507 | 211 | 0.4 |
| Real estate | 66,083 | 64 | 3,886 | 6.2 |
| Loans to Individuals | 38,671 | − 84 | 6,149 | 18.9 |
| Leases | 5,627 | − 73 | 337 | 6.3 |
| U.S. Treasury and Agency Securities[2] | 10,921 | 117 | − 160 | − 1.4 |
| Other Securities[2] | 8,315 | − 198 | 1,347 | 19.3 |
| Total Deposits | 201,193 | 3,999 | 7,170 | 3.6 |
| Demand Deposits | 48,129 | 2,708 | 3,113 | 6.9 |
| Demand Deposits Adjusted[3] | 32,061 | 495 | 3,102 | 10.7 |
| Other Transaction Balances[4] | 15,227 | 769 | 1,995 | 15.0 |
| Total Non-Transaction Balances[6] | 137,837 | 522 | 2,064 | 1.5 |
| Money Market Deposit Accounts—Total | 45,705 | 86 | 2,272 | 5.2 |
| Time Deposits in Amounts of $100,000 or more | 38,401 | 354 | − 780 | − 1.9 |
| Other Liabilities for Borrowed Money[5] | 25,012 | − 804 | 6,182 | 32.8 |

| Two Week Averages of Daily Figures | Period ended 1/27/86 | Period ended 1/13/86 |
|---|---|---|
| **Reserve Position, All Reporting Banks** | | |
| Excess Reserves (+)/Deficiency (−) | 15 | 107 |
| Borrowings | 64 | 3 |
| Net free reserves (+)/Net borrowed(−) | − 48 | 104 |

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change