Woman C.P.A.

Volume 38 | Issue 4 Article 7

10-1976

Legal Developments: Social Security: The Promises, Problems and Possibilities — Part I

Patrica C. Elliott

Legal Developments

SOCIAL SECURITY: The Promises, Problems and Possibilities — Part I

Dr. Patrica C. Elliott, CPA
University of Washington
Seattle, Washington

If Diogenes were around today he would have more difficulty finding a person satisfied with the present Social Security system than he had finding the honest man (sic). Working wives are unhappy because their husbands are not routinely covered as are the wives of working husbands; poor people and liberals are unhappy because the tax is regressive in nature; the conservatives are unhappy because the benefit structure is geared more toward need than based on contributions the way private annuities are; retired people are unhappy because their pensions are not keeping pace with the cost-of-living index; employers and employees are unhappy because the rate is a whopping 5.85% on the first $15,300 of gross salary per year and both the rate and the base are scheduled to rise in the future; economists are unhappy because (unless something is done soon) the current tax rate will have to be tripled in the next 75 years to cover the widening deficit; taxpayers are unhappy because over one-half of them paid more in Social Security taxes than they did in income taxes last year; politicians are unhappy because all of their constituents are unhappy (and unhappy voters tend to vote the old rascals out and the new rascals in); and the Social Security Administration is unhappy because everybody is blaming them and they do not like the situation any better than anybody else. The most tragic fact of all is that all these people are absolutely right — the present Social Security system does do all these things to all these people.

How could a system with such a socially desirable and benevolent purpose be so positively messed up? One way to answer this question is to examine the evolution of the Social Security laws and perhaps sort through how the original goals changed because of changing social and political mores. There may or may not be a way to appease everyone but it might be useful to examine some suggested alternatives.

The Promises

The Social Security Act of 1935 was signed into law by President Roosevelt amidst many misgivings by the population of Depression-era America. The Depression had clearly shown that some type of financial security was desperately needed by older people, yet the majority of the population was afraid that such a system would undermine the Puritan-ethic based ideas of thrift and hard work. The original law was not intended to provide an adequate pension for comfortable living in the worker's old age; it was intended to be a supplement to personal savings and a bare minimum or "floor of protection" for retirees.

Prior to this law it was assumed that the worker would work until death or be supported by family members and savings in cases of illness or disability. The assumption was not too unreasonable for several reasons. First, the population was predominantly rural, where three generations in a family dwelling was not uncommon. In a rural setting, workers were still valuable even if the tasks assumed in old age were different from those performed during one's youth. It simply took all hands to keep a family farm operating. Even in the cities it was more usual for older people to live with grown children than to maintain a separate household[1] and to continue working into their old age.

The life expectancy for all Americans was substantially shorter than it is now. The life expectancy for a man in 1910 was 46.3 years; by 1970 it had risen to 67.1. A female's life expectancy rose during that period from 48.3 years to 74.6 years.[2]

After the passage of the Social Security Act of 1935 (but before any payments to retirees were made), two major changes in emphasis occurred: first, the funding of benefits was put on a pay-as-you-go basis. It was quickly recognized that no meaningful benefits could be paid for several years if benefits were to be based on the retiree's contributions. The second shift was to emphasize the social and financial need of the recipients and the benefits were heavily weighted in favor of low income workers and workers with dependent wives. Thus, before the first payments were made in 1940, the function of Social Security had been split into two (sometimes incompatible) functions: The welfare function and the insurance (annuity) function.

With World War II industrialization and urbanization flowered along with the breaking up of extended families. With the movement of women into the labor force during the war and the subsequent post-war baby boom, it became more attractive to retire older workers in order to make room for younger ones.

Dr. Alicia Munnell, an economist recognized as an expert on Social Security, maintains that Social Security has historically had a dual impact on retirement and savings.[3] First, an employee was less reluctant to require an employee who had a pension (Social Security) to retire than one who did not. Since Social Secuirty coverage is mandatory (with a few exceptions), almost all employees were covered and the trend toward forced retirement at the arbitrary age of 65 (the age at which benefits were originally paid) was begun. Since people then began to expect to retire at 65 and had a longer life expectancy, they began to save more to supplement their modest Social Security benefits. This was in contrast to the opposite impact of having less to save because of the Social Security tax one had to pay. The dual effects tended to negate each other with the tendency being toward more total savings.

Since 1945 the system has been radically expanded. Because increasing the benefits and coverage was a politically "good" thing to do, the coverage and benefits were raised astronomically. The maximum benefits for a retiree and dependent spouse have risen from about $150 per month in 1955 to almost $600 per month in 1976.[4] Benefits for survivors, disability and hospital insurance were added to the original pension. Any time benefits were raised, they were extended to cover not only current retirees but present workers when they did retire in the future. As the benefits expanded, the maximum taxes to support the expenditures have risen from about $200 per year in 1955 to $1,800 per year in 1976. (Half is withheld from the employee and half is paid by the employer.)[5]

With Congress constantly raising benefits (a politically expedient thing to do) and tying benefits to the inflation rate, they are spending nonexistent funds and are promising workers huge benefits for which funding has not yet been arranged.

The Problems

With the rapidly rising benefits workers have begun to view Social Security not as a "floor" to be supplemented by private savings, but as their total retirement savings. As rates of taxation rise, workers expect their future benefits to rise when in actuality the increased taxes are going to pay off present retirees' increased benefits. Still, people cling to the idea that their taxes are funding their future benefits. Some[6] feel the Social Security Administration encourages this belief by talking about the "huge reserves" (which will, in fact, be totally exhausted by 1980) in such a way as to make the public believe that their pensions are, in fact, funded. John A. Brittain, a Brookings Institute economist, does not worry about the "bankruptcy" of the system because Social Security is "backed by the most solid source of funds known, the federal taxing power. The bankruptcy charge is a senseless generator of fear."[7]

If the bankruptcy scare is senseless, certain other facts are not. All predicted taxes are based on population estimates which have been radically altered by the falling birth rate. While life expectancies have risen very little in 20 years, the birth rate has declined dramatically. A major population shift is occurring: One in seven Americans is now receiving Social Security and by 2005 there may be only two workers to support each pensioner.[8]

Since benefits are tied to inflation, the expenditures in the past few years of double-digit inflation have exceeded all projections. Furthermore, there is a built-in double inflation raise. No one objects too much to raising retirees' benefits, but under the 1972 formula (which tied benefits to inflation), an oversight occurred. Not only are retirees' pensions raised for inflation, future retirees' pensions are raised. Those who are not yet retired presumably receive inflation-keyed raises which automatically give them higher scheduled benefits by putting them in higher maximum benefit brackets. This, coupled with the additional inflation raise, gives present workers a double adjustment upwards for inflation. If rapid inflation continued over a long period, it would be possible for today's workers to receive larger pensions than their former salaries!

Another problem is that personal savings for retirement are now declining. Dr. Munnell believes there will be a serious decline in personal savings in the future.[9] If this does happen, it will mean that Social Security benefits will probably rise to fill the need which will result in higher taxes and even less personal savings. This, together with the lower worker-retiree ratio, could have drastic effects on the tax rates.

Another set of serious problems (and of particular interest to women) are centered around the concepts of "fair" and personal "rights." These problems will be covered, along with some possible solutions, in Part II in the next issue.

Notes

[1]Alicia Haydock Munnell, *The Effect of Social Security on Personal Savings,* Cambridge, Mass.: Ballinger Publishing Company, 1974, Chapter 2.

[2]*Statistical Abstract of the United States:* 1972 (93rd Edition) Washington, D. C., 1970, Table 74, p. 55.

[3]*Op. cit.,* Chapter 1.

[4]"Propping up Social Security," *Businessweek,* July 19, 1976, p. 34.

[5]*Ibid.,* p. 37.

[6]Warren Shore, *Social Security: The Fraud in Your Future.* New York: Macmillan Publishing Co., Inc., 1975.

[7]*Businessweek,* op. cit., p. 36.

[8]*Ibid.*

[9]*Op. cit.,* p. 99.

Theory & Practice

(Continued from p. 22)

by the possibility of errors or irregularities in the circumstances, the auditor's judgment concerning the integrity of management, and the relationship between internal control and the potential for errors or irregularities. In the absence of evidence to the contrary, however, the auditor's reliance on the truthfulness of a representation or the validity of a record is reasonable. The auditor cannot be expected to detect unrecorded transactions in the absence of finding evidence of their existence. In determining the extent to which corroboration of management representations is necessary, the auditor should be aware of and consider those circumstances that might predispose management to misstate financial statements, for example, adverse financial developments. However, the auditor is not expected to obtain more than reasonable satisfaction that management has not made material misrepresentations or overridden control procedures. There are inherent limitations on the effectiveness of internal controls which prevent the auditor from placing complete reliance on them. The auditor's examination normally includes procedures to test the existence of errors or irregularities that could have a material effect on the financial statements even in the absence of material weaknesses in the system of internal control. Additional procedures should be performed if the auditor believes errors or irregularities may exist and, depending upon the circumstances, the auditor's opinion should be qualified or disclaimed or the auditor may determine that the only course is to withdraw from the engagement.

The auditor's role in IRS investigations of questionable payments is apparently settled. Now we must wait for the proposed Congressional bill to be enacted, amended or dropped. However, it is highly improbable that legislation will not be forthcoming, even if substantially amended. The proposals of the AICPA in the two exposure drafts need, also, to be finalized and may be changed before issuance as Statements of Auditing Standards. In the meantime, the auditor should maintain an attitude of professional skepticism in planning and conducting examinations of financial statements. Any questionable payments noted or suspected might appropriately be handled at the highest level both in the auditor's firm and in the client's organization complying with the procedures in the exposure draft on illegal acts.