Staff Papers Series

Staff Paper P84-9

March 1984

Social Security Reform:

How to Make It Secure

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Staff papers are published without formal review
by the Department of Agricultural and Applied Economics.

Social Security Reform: How to Make it Secure [1/]

The federal government established the Social Security System in 1936. For decades most people believed the system to be secure. For years sophisticated students of the system knew that trouble was ahead. The general public became aware of problems only since about 1977. What happened?

Simply put, people believed that they had been "contributing" to the social security trust fund to get back the principal plus compound interest in the form of retirement benefits. They believed that they were buying a sort of annuity. They were encouraged to believe this fiction by the social security administration and by politicians. It is high time that the system be recognized for what it really is, a massive intergenerational transfer of funds from the working generation to the retired generation and/or their survivors and to the disabled. Except those who died an untimely death (unless they left several survivors), most recipients of social security benefits received benefits far greater than their "contributions".

Social security contributions is a misnomer. They are not contributions. They are taxes. The taxpayers are not paying for their own future benefits but the benefits of current recipients. This generation of social security taxpayers will receive their benefits from the next generation of workers.

1/ For those interested in detailed changes made by the 1983 law see "Social Security Rescue Plan Wins Final Approval", *Congressional Quarterly*, May 26, 1983.

It is important, indeed essential, that the public understand this. The future success of the system hinges on the ability and willingness of the "next generation" to foot the bill. When the post-World War II baby boom people retire early in the next century the ranks of social security recipients will boom but the then working taxpayers will be the current baby bust; the ratio of covered workers to beneficiaries is sure to fall substantially. Indeed it already has. The ratio was 16.5 to 1 in 1950, 5.1 in 1960, 3.7 in 1970, 3.3 in 1980. The ratio is projected to fall to 2.5, 2.1, or 1.7 by the year 2030 depending on whether we actually experience the optimistic, intermediate, or pessimistic projections. [2/]

Over the years, the social security system was greatly expanded. Initially only the employees of fairly large employers (eight or more employees) were covered by the system, and no one was drawing benefits for the first few years because no one had established eligibility. Initially the tax was 1% of the first $3000 of annual earnings from work. The maximum tax was thus $30 on the employee and this was matched by the employer. The tax did not (and still does not) apply to property income, such as dividends, interest, and rent. The law provided for benefits to cover retired workers only - not to survivors nor to the disabled, nor to self-employed, nor to employees of small employers. As the system matured, benefits were added for survivors of covered workers, then for nearly all employees, and then for self-employed, many of whom were brought into the system after as little as one and a half years as social security taxpayers (1950) and for the disabled (1956).

2/ Lawrence H. Thompson, "The Social Security Reform Debate", Journal of Economic Literature, December 1983, p. 1432.

Also medical care benefits were added (1966). For years benefits were greatly increased without the necessity of increasing taxes at all or, at least, not increasing them very much. This was possible because, as each expansion in the coverage of the system to new groups added many taxpayers, the retired members of these new groups were not eligible for benefits since they were not covered by the system during their working years. The system benefited from a windfall. So Congress could and did greatly increase benefits (almost always in election years) which the public liked without increasing social security taxes which the public did not like.

Now the system covers nearly all workers whether employees of others or self-employed. More than 90% of workers are now covered. Most of those not covered by social security are covered by retirement systems for government employees and railroad workers. New federal workers (as of January 1, 1984) have been brought into the system but state and local government employees, unless already covered, have an option to enter or stay out. Also employees of non-profit institutions are covered. No doubt the rest of these workers will eventually be brought into the system (and, in my view, should be). No longer can we increase benefits without increasing taxes though we might finance a part of the benefits by use of general revenues, that is by increasing other taxes instead of social security taxes. The latest legislation opened this door by subjecting part of social security benefits to income taxes with the revenue being transferred to the social security fund. Beginning in 1984 up to half of social security benefits are subject to income taxes. Social security benefits are subject to the federal income tax depending on income, including interest income exempted from federal income tax and half of social security benefits. Benefits of single persons are taxable up to 50% of the excess of income (calculated as above) over $25,000 per year ($32,000 for couple) or half of social security benefits, whichever is less.

The growth in the number of social security beneficiaries and the growth in benefits (excluding medicare) is shown in Table I (p. 14) for the years 1960, 1970 and 1980. From 1960-1980 the number of beneficiaries grew from 14,845,000 to 35,620,000 or 140%. Benefits grew from $11,081 million to $120,118 million from 1960-1980 or 984%.

The social security benefits including medicare are rising much faster than are the cash benefits. Between 1975 and 1983, cash benefits have increased from $65 billion to $171 billion or 164% while medicare benefits increased from $13 billion to $53 billion or 308%. Medicare costs increased nearly twice as fast as cash benefits. Perhaps the biggest problem of the social security system is now containment of medicare costs. The problem is getting worse. The projected cash benefits for 1985 are 11.7% larger than in 1983 while medicare costs are 32.5% larger-nearly three times the rate of increase in cash benefits. It appears that we have no choice other than sharply cutting the proportion of medical costs paid by medicare or controlling the charges made by hospitals and doctors. (See Table on page 5.)

Social Security Benefits 1975-1983 with Projections for 1984 and 1985. (millions of dollars)

Year	Social Security Benefits	Medicare	Benefits Including Medicare
1975	$64,658	$12,874	$77,532
1976	$73,903	$15,834	$89,736
1977	$85,068	$19,345	$104,414
1978	$93,861	$22,768	$116,629
1979	$104,073	$26,495	$130,567
1980	$118,559	$32,089	$150,648
1981	$139,584	$39,149	$178,733
1982	$155,964	$46,567	$202,531
1983	$170,724	$52,588	$223,311
1984	$179,161	$61,064	$240,225
1985	$190,639	$69,683	$260,321
Percent increase 1975-1983	164%	308%	188%
Percent increase projected 1983-1985	11.7%	32.5%	16.6%

SOURCE: Economic Report of the President, February 1984.

The size of social security benefits paid to a covered retired worker is related to the worker's social security taxes but the relation is a very loose one. Among retired covered workers who paid the same amount of social security taxes, the benefits vary greatly depending on whether the taxpayer is single, married without dependent children, married with dependent children, or self-employed, whether or not the spouse worked on a covered job, what formula is used to determine benefits and when the worker was born.

Social security taxes paid are roughly proportionate to income up to the level of maximum covered income (MCI), \$3,000 in 1937, \$25,900 in 1980, and \$37,800 in 1984. The tax is regressive for all taxpayers with income in excess of MCI. As the social security tax rates and MCI were increased since 1949, the tax as a whole became increasingly regressive until 1971 because the rates increased faster than the MCI. Since then the MCI has increased faster than the rates so the tax is becoming less regressive. However, the tax is still regressive for a substantial part of the population - the richest part. (See Table II). The percentage of the total income taxed away in 1983 for a worker who earned \$35,700 was 6.70%. For a worker who earned \$71,400 the rate was 3.35%. One who earned \$357,000 paid 0.67%. If one's income were \$357,000 or \$357,000,000 but all of it was property income, such as interest, rent, dividends, and capital gains, the social security taxes were zero.

For those who have consistently earned the MCI or more, the taxes paid are the same and the benefits received are the same for the retired workers, provided they retire at the same age and live the same length of time after retirement. However, they do not retire at the same age, some live longer after retirement and some have no survivors or a different number of survivors who draw benefits. The relation between taxes paid and benefits received is clearly not a close one even for those who consistently earned the MCI or more. However, over time about half of the covered workers earned less than the MCI and therefore paid less taxes than those who earned more income. They also are entitled to less benefits but not proportionately less. The system is designed to shift benefits from those with middle (earned) income or higher to those with lower earned income.

For those reaching 62 years of age in 1983 or later the formula for determining benefits is as follows, based on his (her) average indexed monthly wage history.

90% of the first $254 of the average wage plus

32% of the next $1274 plus

15% of excess over $1528.

Benefits are subject to a maximum and a minimum. $254 and $1528 are called "bendpoints". These are indexed so that they will rise over time, assuming average wage rates rise.

Those who reach age 62 before 1983, receive benefits based on their average covered wage rather than average indexed wage. Their benefits are also weighted in favor of low wage earners.

Thus those covered workers who earned low incomes receive much larger benefits in proportion to the taxes they paid than those with income near the maximum covered income (MCI) or more while working; the social security benefits structure contains a large element of welfare. For example, one whose average indexed covered earnings is $1,620 ($135 a month) paid roughly one-third as much social security taxes as one whose average covered income was $4,800 ($400 a month). He (she) receives benefits about 50% as large. See Table III (p. 17). If a worker with average indexed monthly earnings (AIME) of $135 has a spouse age 65 and the worker with AIME of $400 is single, the former's benefits are 76% as large as that of the latter. See Table III, for the falling ratio of benefits received to AIME as income rises. One with an AIME of $135 receives monthly benefits 123% of his (her) wages while working. One, with an AIME of $400 receives benefits 82% of his (her) wages while working. One with an AIME of $1387 receives benefits 51% of his (her) wages. So all those who have close to or more than the maximum covered income subsidize the poor - but those with the maximum average covered income now subsidize the aged poor and/or the survivors as much as the richest person in the country. Furthermore, those rich whose income comes from property (no "earned" income) and persons not covered by social security, mostly public employees, pay none of the subsidy to poor social security beneficiaries.

With rapidly rising costs of paying social security benefits and rapidly rising social security taxes, it will become vital to reform the system. If we do not do it before the post-World War II baby boom starts to retire about the year 2010 to be supported by social security taxes paid by the workers' from the current baby bust, the system will be in very serious trouble. What can be done? We need to reform both the benefits and the taxes and the quicker we do it, the better.

Reforming Benefits

Some suggested reforms follow:

1. Gradually increase the age of retirement from 62 to 65 to 66 or higher - paying benefits earlier to those who are not able to work (at whatever age) as we do now. We might well "index" the retirement age to longevity. We are probably well advised to defer beginning to do this until we near full employment. Life expectancy for males at age 65 rose from 11.9 years in 1940 to 12.9 years in 1960 to 14.0 years in 1980 and for females from 13.4 years, 15.9 years, and 18.3 years respectively.

The new law (1983) provides for gradually increasing the retirement age (for full benefits) to 67 starting in 1990. This appears to be a step in the right direction, however, it appears to be advisable to start it when we have returned to full employment rather than arbitrarily selecting a year to begin. The law also calls for reducing benefits to those who retire early. Currently one who retires at 62 receives about 80% of the age 65 benefits. This rate is to be cut to 75% by 2009 and 70% by 2027. This may be too little cut and too late.

2. We could encourage older people who are able to work beyond the age of 65 to do so by increasing their benefits when they do retire. Those who reached 65 years of age before or during 1981 now receive 1% extra benefits for each year they worked or work beyond age 65. This is not enough incentive. Congress has at last recognized this. Those who reached 65 after 1981, will receive 3% extra benefits for each year they worked or work beyond age 65. This is better but not enough incentive. The new law provides for increasing the incentive to 8% per year worked beyond age 65 (up to age 70) to be phased in between 1990 and 2008.

3. Currently social security benefits are fully indexed to the cost of living. But the CPI we have been using for increasing social security benefits was not appropriate. The index was heavily influenced by rising interest rates and the rising price of houses but the aged for the most part were not paying the interest and were not buying houses. Many of them collected interest instead of paying it; so we have had in recent years many retired people whose interest income has increased because of higher interest rates and whose social security benefits were increased also for the same reason. We have modified the CPI to de-emphasize interest rates and home prices which improves the use of the index for social security purposes. The new law also provides for indexing benefits by

the lesser of CPI or the average wage increase which ever is smaller when the fund's reserves dip to 15% of a year's expected pay out for years 1985 to 1988 (20% for years after 1988). The law also provides for recouping if the fund rises to 32% of a year's payout in later years. We should probably prepare a separate CPI for the retired or partially index the benefits say at 75% of the change in CPI (preferably the former), and index social security benefits to this new index or the average wage increase whichever is less.

4. We currently reduce social security benefits for those who continue to work part time earning over a certain amount ($6,600 in 1983 for those 65 or older - $4,920 for those age 62). At age 70 there is no reduction for earnings of any amount. The amount that can be earned without reducing benefits is indexed by the increase in average wages. We could increase the amount of income one can have before social security benefits are reduced but make the criteria income from all sources - not just earned income.

Reform of Social Security Taxes

Some suggested reforms follow: (In some cases the suggestions are alternatives).

1. Apply the tax to all earned income which would make the tax roughly proportionate for the vast majority of taxpayers - instead of regressive as it is now. If we did this, the base would be enlarged enough to reduce the rate and therefore the tax on low income persons or families and increase the tax take at the same time.

2. Apply the tax to all income from whatever source. This would enlarge the tax base even more and permit a larger reduction in the rate and convert the tax to a strictly proportionate (income) tax.

3. Couple either one or two above (preferably 2) with allowing a personal exemption from income for social security tax purposes. For example, a worker with an income of $4000 and three dependents would get a refund of all his (her) social security taxes assuming a personal exemption of $1000. We might well consider indexing the size of this exemption also. If we allow personal exemptions, we would make the social security tax slightly progressive, and eliminate an onerous burden on those with less than the poverty level income.

4. Since the social security taxes paid by employers is shifted to employees, the total burden on employees is really double what employees think it is. (See Column 5, Table II, pp. 15-16). The social security tax on the self-employed has been about 40% larger than that nominally placed on employees. The new legislation has increased the rate of the self-employed to double the rate on employees, i.e., equal to the tax paid by employees plus the tax paid by employers. Since employees do not pay personal income taxes on social security taxes paid by employers, we would be unfair to the self-employed unless we either: (1) include the employer's social security taxes in employees taxable income or (2) permit self-employed persons to deduct half their social security taxes from taxable income. The new legislation opts for alternative (2). Of course, if we applied the tax on income from all sources, all rates could be reduced.

5. Social security benefits could be included with other income for income tax purposes. This would increase the tax base. Exempting social security benefits from taxation does not aid the poor aged - they do not pay income taxes anyway. Exempting benefits from income taxes helps the aged who are not poor. The new legislation provides for taxing part of social security benefits (see p. 4, above)

6. The best alternative might be to permit all social security taxes to be deductible and tax all benefits.

Taking the Welfare Out of the Social Security System

An alternative reform of social security suggested by Alicia Munnell of the Brooking Institution (See Tax Review, Tax Foundation, April 1979) is that we take the welfare out of the system by making each covered worker's benefits strictly proportionate to social security taxes paid. This would make the system what perhaps most people believed it to be all along. If this is all we did, those who spent a life time earning low incomes would have a below poverty level of income to retire on. For these, we could supply supplementary social security income (SSI) but finance it from general revenues (mostly personal income taxes) instead of social security taxes. Munnell is suggesting that the welfare part of social security should be financed out of general revenues. Her suggestion deserves serious consideration. If we were to follow Munnell's suggestion, we might well be advised to partially fund the future payments instead of adhering strictly to pay-as-you-go as we do now.

TABLE I

Cash Benefits Paid (excludes Medicare)
Number of Beneficiaries and Amount of Benefits Paid

		Number of Beneficiaries (Thousands)	Amount of Benefits (Millions of $)
1960	Retired Workers	8,061	7,053
	Disabled Workers	455	489
	Spouses	2,346	1,083
	Children	2,000	1,085
	Widowed Mothers	401	286
	Surviving Spouses	1,544	1,057
	Parents	36	28
	Total	14,845	11,081
1970	Retired Workers	13,349	18,437
	Disable Workers	1,493	2,448
	Spouses	2,952	2,194
	Children	4,122	3,517
	Widowed Mothers	523	574
	Surviving Spouses	3,227	4,055
	Parents	29	39
	Total	26,229	31,570
1980	Retired Workers	19,583	70,359
	Disabled Workers	2,861	12,817
	Spouses	3,480	7,043
	Children	4,610	10,514
	Widowed Mothers	563	1,572
	Surviving Spouses	4,415	17,638
	Parents	15	55
	Total	35,620	120,118

Source: Statistical Abstract of the U.S., 1981, p. 329.

TABLE II

Social Security Tax Rates and Bases
Median Family Income, and Percent of Families with
Incomes Below the Maximum Covered Income, Selected Years, 1937-83

Col. 1	Col. 2	Col. 3*	Col. 4	Col. 5**	Col. 6 1/	Col. 7*** 1/	Col. 8
Year	Maximum Covered Income	Social Security Tax Rate	Maximum Tax On Employee	Total Social Security Tax	Median Family Income	Percent of Families With Income Below Maximum Covered Income	Rates for Self Employed
1937	$3,000	1.000%	$30.00	$60.00			
1950	$3,000	1.500%	$45.00	$90.00	$3,319	42.50%	
1951	$3,600	1.500%	$54.00	$108.00	$3,709	47.82%	2.25%
1953	$3,600	1.500%	$54.00	$108.00	$4,233	39.68%	2.25%
1954	$3,600	2.000%	$72.00	$144.00	$4,173	41.00%	3.00%
1955	$4,200	2.000%	$84.00	$168.00	$4,418	46.30%	3.00%
1956	$4,200	2.000%	$84.00	$168.00	$4,783	41.06%	3.00%
1957	$4,200	2.250%	$94.50	$189.00	$4.971	39.02%	3.375%
1959	$4,800	2.500%	$120.00	$240.00	$5,417	42.16%	3.750%
1960	$4,800	3.000%	$144.00	$288.00	$5,620	39.90%	4.500%
1962	$4,800	3.125%	$150.00	$300.00	$5,956	37.10%	4.700%
1963	$4,800	3.625%	$174.00	$348.00	$6,249	34.40%	5.400%
1965	$4,800	3.625%	$174.00	$348.00	$6,957	30.12%	5.400%
1966	$6,600	4.200%	$277.20	$554.40	$7,500	42.24%	6.150%
1967	$6,600	4.400%	$290.40	$580.80	$7,933	38.08%	6.400%
1968	$7,800	4.400%	$343.20	$686.40	$8,632	43.14%	6.400%
1969	$7,800	4.800%	$374.40	$748.80	$9,433	38.09%	6.900%
1971	$7,800	5.200%	$405.60	$811.20	$10,285	34.63%	7.500%
1972	$9,000	5.200%	$468.00	$936.00	$11,116	38.00%	7.500%
1973	$10,800	5.850%	$631.80	$1,263.60	$12,051	42.98%	8.00%
1974	$13,200	5.850%	$772.20	$1,544.40	$12,902	50.79%	7.90%
1975	$14,100	5.850%	$824.85	$1,649.70	$13,719	51.39%	7.90%

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Incomes Below the Maximum Covered Income, Selected Years 1937-83

Col. 1	Col. 2	Col 3*	Col. 4	Col. 5**	Col. 6	Col. 7***	Col. 8
Year	Maximum Covered Income	Social Security Tax Rate	Maximum Tax On Employee	Total Social Security Tax	Median Family Income	Percent of Families With Income Below Maximum Covered Income	Rates for Self Employed
1976	$15,300	5.850%	$895.05	$1,790.10	$14,958	50.03%	7.90%
1977	$16,500	5.850%	$965.25	$1,930.50	$16,009	49.49%	7.90%
1978	$17,700	6.050%	$1,070.85	$2,141.70	$17,648	48.89%	8.100%
1979	$22,900	6.130%	$1,403.77	$2,807.54	$19,661	59.35%	8.100%
1980	$25,900	6.130%	$1,587.67	$3,175.34			8.100%
1981 1/	$29,700	6.650%	$1,975.05	$3,950.10			9.300%
1982	$32,400	6.70%	$2,170.80	$4,341.60			9.350%
1983	$35,700	6.70%	$2,391.90	$4,783.80			9.350%
1984	$37,800	7.00% 2/	$2,646.00	$5,292.00			14.00%

* This is the rate applied to the employees. Employers match this.
** Combined SST, employee's plus employer's.
*** The social security tax is roughly proportionate to income for this percent of families, regressive for the rest of them.

1 After 1981 the maximum covered income (=MCI) will be adjusted upward at the rate of increase of average wages.

2 For 1984 only the increase in rate from 6.7 to 7% is offset by an income tax credit for the employee-but not for the employer.

For Median Family Income and percentage below maximum covered income see Statistical Abstract of the U.S.

Table III. Samal Benefits for Workers Reaching Age 65 in 1983.

Average Indexed Monthly Wage	Primary Insurance Amount (PIA) Retired at 65 Worker	PIA as % of Wage	Retired Couples, Spouse 65*	Couples' Benefits as % of Wage	Child Benefits	Maximum Family Benefits**	Maximum Benefits as % of Wage
$135 or less	$166	123% or more	$249	184% or more	$124	$249	184% or more
$200	$241	121%	$361	181%	$180	$361	181%
$400	$328	82%	$492	123%	$246	$492	123%
$600	$415	69%	$622	103%	$311	$718	120%
$800	$503	63%	$754	94%	$377	$935	117%
$1000	$590	59%	$885	89%	$442	$1052	105%
$1200	$671	56%	$1006	84%	$503	$1174	98%
$1387***	$709	51%	$1063	77%	$532	$1241	89%

* Spouse didnot work at covered employment or, if so, earn enough to receive PIA in her (his) own right larger than half spouse's PIA. Note figure in column 4 is 150% of that in column 2.

** Note that a couple both 65 and with a child do not receive the sum of couple's benefits and child's benefits because they bump in to the maximum.

*** $1387 is the maximum average indexed monthly earnings for most workers.

SOURCE: <u>Commerce Clearing House</u>, 1983, p. 3444.