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Social Security Reform: How to Make it Secure

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

Simply put people believed that they have 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, namely a massive intergenerational transfer of funds - from the working generation to the retired generation and/or their survivors and to the disabled. Except for those who died an untimely death (unless they left several survivors), most persons have received far more benefits than they "contributed". Social security contributions is a misnomer. They are not contributions at all. 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. It is important, indeed essential, that the public understand this. 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-drought; the ratio of beneficiaries to taxpayers is sure to rise substantially.

Over the years, the social security system was greatly expanded. Initially only the employees of fairly large employers (8 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 employers. The tax did not (and still does not) apply to property income - dividends, interest, rent, etc. The law provided for benefits to covered, 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 blanketed in after as little as one and a half years as social security taxpayers) (1950) and for the disabled (1956). 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 very much. This was made 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 benefitted from a windfall. So Congress could and did greatly increase benefits (almost always in even numbered years) which the public likes without increasing social security taxes which the public did not like - or, at least, without increasing taxes very much.

Now the system covers nearly all workers whether employees of others or the 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 who have their own systems. No doubt these workers will eventually be blanketed into the system (and, in my view, should be) but this will not give the system a windfall since the obligation to the retired members of these groups will have to be blanketed into the system also. No longer can we increase benefits without increasing taxes though we might finance a part of the benefits by use of general revenues, i.e. by increasing other taxes instead of social security taxes.

The growth in the number of social security beneficiaries and the growth in benefits (excluding medicare) is shown in Table II 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 benefits are now well over the 1980 benefits; the 1981 benefits including medicare amounted to $180.3 billion.

The size of social security benefits paid to a covered retired worker is related to the workers 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 but no dependent children, married with dependent children, or self-employed and whether or not the spouse worked on a covered job. (See Table III).

Social security taxes paid are roughly proportionate to income up to the level of maximum covered income (MCI), $3000 in 1937 and $25,900 in 1980, $35,700 in 1983. (Roughly because the tax does not apply to property income.) 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. The tax has been regressive for about half or more of the taxpayers for most of the post war (II) period. Since 1971 the MCI has increased faster than the rates so the tax is becoming less regressive. However, the tax is still (1983) regressive for a substantial part of the population - the richest part. (See Table I). The percentage of the total income taxed away in 1980 for a worker who earned $25,900 was 6.13%. For a worker who earned $51,800 the rate was 3.065%. One who earned $259,000 paid 0.613%. If one's income were $259,000 or $259,000,000 but all of it was property income - interest, rent, dividends, capital gains, etc., 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 example, one whose average covered income is $10,000 pays twice as much social security taxes as one whose average covered income is $5,000. He (she) receives only 51% more benefits in retirement. If the worker with $10,000 has no spouse or dependents and the worker with $5,000 has an aged spouse and children under 18 (or under 22 and in college until 1982), or a young spouse with two dependent children, then the total benefits of the worker with $10,000 average covered income is 18% less than the worker with $5,000 average covered income. So all those who have close to or more than the average 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 worker from the current baby drought, 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 as we do now. We might well "index" the retirement age to longevity; (we probably ought to delay doing this until we approach full employment).

2. We could encourage older people who are able to work beyond the age 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 beyond age 65. This is not enough incentive. Congress has at last recognized this. Those who reach 65 after 1981, will receive 3% extra benefits for each year they work beyond age 65. This is better but not enough incentive; (this also could wait until we approach full employment).

3. Currently social security benefits are fully indexed to the cost of living. But the CPI we use for increasing social security benefits is not appropriate. The index is heavily influenced by rising interest rates and the rising price of houses but the aged for the most part are not paying the interest and are not buying houses. Many of them collect 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 should clearly prepare a separate CPI for the retired or partially index the benefits say at 75% of the change in CPI - preferably the former; or we could index benefits by the change in CPI or the average wage rate, whichever is lower.

4. We currently reduce social security benefits for those who continue to work part time earning over a certain amount ($5,000 in 1980 for those 65 or older.) The amount is indexed so that it rises over time. 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.

<u>Reform of Social Security Taxes</u>

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; (We are approaching applying the tax to all "earned" income now - see Table I for the rapid increase in MCI in recent years.)

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 did this, we would make the social security tax slightly progressive, and eliminate an onerous burden on those with less than the poverty level income; (If this alternative is used the exemption ought not be allowed to teenagers who live at home and are claimed as exemptions by parents.)

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 I). The social security tax on the self employed is about 40% larger than that nominally placed on employees. Suggestion - the rate of the self employed should be about 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. Of course, if we applied the tax on income from all sources, all rates could be reduced;[1/]

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, benefits the aged who are not poor.[2/]

6. Actually it might be better to permit all social security taxes to be deductible and tax all benefits.

1/ The social security Commission (chaired by Greenspan) just recommended this reform with exempting half the social security taxes from income taxes for the self employed.

2/ The commission recommended that half the social security benefits be subject to income taxes for singles with income over $20,000 and couples with incomes over $25,000.

Taking the Welfare out of the Social Security System

An alternative reform of social security suggested by Alicia Munnell of the Brookings 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 all the welfare part of social security should be financed out of general revenues. Her suggestion deserves serious consideration.

TABLE I
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%

TABLE I CONTINUED
Social Security T x 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
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%

* 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.

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

TABLE II

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

II a		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

II b Old age, survivors, disability, health insurance benefits. Selected years.

Year	Benefits in billions of dollars
1941	0.1
1950	1.0
1960	11.1
1970	38.5
1975	81.4
1980	153.8
1981	180.3
1981 IV Quarter	191.1 (annual rate)

Source for II a: Statistical Abstract of the U.S., 1981, p. 329
Source for II b: Economic Report of the President, February, 1982, p. 259.

TABLE III

Relation Between Taxes Paid and Monthly Benefits Received: Selected Comparisons[1]
(This data reflects what the law was in 1980.
The figures are not accurate in 1983 but still indicative of the
loose relationship between taxes paid and benefits received).

Category, ACI=average covered income.[2]	B's Taxes Compared to A's.	B's Benefits Compared to A's.
1. Single retired workers, age 65 A's ACI = $5,000 B's ACI = $10,000	Twice as much	51% more
2. Retired workers, age 65 ACI = $8,000 A, single B, married, spouse had not worked under social security and 65 or more at retirement	Same	50% more
3. Retired workers, age 65 ACI = $8,000 A, single B, married, spouse had not worked under social security and 65 or over at retirement; also one child under 18 or under 22 and in college*	Same	75% more
4. Married retired workers, age 65, A, ACI of $8,000, spouse did not work under social security B, ACI of $4,000 for husband and ACI for wife of $4,000	Same	23% more
5. Married retired worker, age 65 A, ACI of $8,000 and average income of $16,000, wife did not work under social security. B, Both worked, each with average income of $8,000 and ACI of $8,000	Twice as much	33% more
6. Single retired workers, age 65, no dependents A's ACI = $5,000 B's ACI = $10,000 B died first month of retirement	Twice as much	B gets no benefits A's benefits are $377.60 per month.

1 The figures are based on the assumption that one pays social security taxes only on the years which are included in the average covered income. For a few this is accurate, but for most the taxes are paid for many years that are not included. One covered worker may work from age 18 to 65, paying social security taxes for 47 years while another may have been covered and paid social security taxes only from age 45 to 65. If their average covered income for the last 20 years is the same, their benefits are the same though the first worker paid much more in social security taxes. The relation between taxes paid and benefits received is a very loose one.

2 In calculating average covered income, earned income only is counted and that is only counted up to a certain amount called the covered income which has been increasing rapidly. The later one retires, the greater the average covered income so long as one's earned income is close to, equal to, or greater than the maximum covered income.

Source of data: Your Social Security, SSA Publication Number 05-10035. February, 1980, p. 19.

* Since this was prepared, the law deleted SS Benefits for those over 18 whether or not in college.

TABLE IV

Public Income Maintenance Programs
Benefits in Billions of Dollars

	1960	1970	1976	1979	1976-79 % Change
Total	$25.9	$64.5	152.7	193.2	26.5%
1. OASDHI	$11.1	$31.6	75.3	104.0	38.1%
2. Public Employees Retirement	$2.6	$9.2	24.5	34.3	40%
3. Unemployment Benefits	$3.0	$4.2	16.7	9.9	-40.7% *
4. Public Assistance	$3.3	$8.9	11.4	12.4	8.8%
5. Veterans Pensions	$3.4	$5.5	8.4	10.6	26.2%
6. SSI	----	----	6.1	7.2	18.0%
7. Workers Compensation	$.9	$2.0	5.2	8.5	63.5%
8. Railroad Retirement	$.9	$1.8	3.6	4.4	22.2%
9. Temporary Disability	$.4	$.7	1.0	1.1	10.0%
10. Social Security = OASDHI as % of Income Maintenance	42.9%	49.0%	49.3%	53.8%	25.4%

Source: Statistical Abstract of the U.S., 1981 p. 323

* Unemployment compensation varies greatly over the business cycle, of course. The unemployment rate was 5.8% in 1979, 10.8% in November, 1982.