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FOR $168 *BILLION, ONLY A BAND-AID FOR SOCIAL SECURITY*

INTRODUCTION

The Social Security system is in serious trouble. It is losing $20,000 a minute and, without corrective action, will be unable to meet its benefit obligations by July 1983. But instead of offering a way to revitalize the ailing program, the National Commission on Social Security Reform has prescribed a bigger dose of the same medicine that has weakened the system for decades.

The Commission's "cure" is a $168 billion package that raises taxes, reduces benefits, and diverts money from general revenues and other pension plans. Congress tried a similar approach in 1977 with a program then, as now, described as a "permanent" solution.

The Commission's solution is political in nature, not practical. Not until after the November election would the seven Democrats on the panel even concede that the system was facing serious financial problems. The Commission members then agreed that Social Security was facing a shortfall of between $150 billion and $200 billion for the years 1983-1989. The Commission also estimated the long-term deficit to be 1.8 percent of taxable payroll, which is another way of saying the system has an unfunded liability of $1.6 trillion over the next seventy-five years. This shortfall represents the difference between promised benefits and tax revenue under current law. Ultimately, it must be bridged by cutting benefits and/or increasing taxes--neither of which is popular.

Many groups have already announced their opposition to the plan. Organizations representing business and labor are opposed to tax increases, which they feel are inappropriate at a time of high unemployment and slow economic growth. Senior citizen groups are resisting the slowdown of benefit growth. Federal

employee unions object to the inclusion of government workers in the Social Security system. And in Congress, many Republicans feel the package should have more benefit reductions while many Democrats favor bigger tax hikes or general revenue financing.

The fundamental flaw of the report is that its recommendations fail to address the system's underlying structural problem--its attempt to fulfill the conflicting objectives of insurance and welfare. As Commission member, Congressman Bill Archer (R-Tex.), argued when he voted against the report, "The proposals treat symptoms, not causes." The Commission turned a blind eye to these causes when it declared that it "should not alter the fundamental structure of the Social Security program...." Yet it is precisely the system's flawed structure that has led it to the edge of bankruptcy. According to Archer: "We have postponed once again the day of reckoning by transferring the burden of supporting the system's shortcomings to future generations."

The first step in reforming Social Security is to acknowledge that a mistake was made at the design stage. And while the government is honor-bound to fulfill the promises made to those already retired or nearing retirement, it is not too late to begin changing the program for the nation's young people, who face a constantly rising tax burden and the shadow of bankruptcy over their retirement security. Congress must begin the process of splitting Social Security into its welfare and insurance elements, funding the welfare segment out of general taxation, and allowing workers the option of either contributing to a restructured Social Security pension plan or contributing the same money to a private plan.

BACKGROUND

About 116 million workers pay Social Security payroll taxes to support 36 million people receiving benefits. The system consists of three distinct programs: (1) The Old-Age and Survivors Insurance (OASI) program, which pays cash benefits to a retiree and his dependents, or to the survivors of a deceased worker; (2) The Disability Insurance (DI) program, which pays cash benefits to a worker and his family if he becomes disabled; (3) The Medicare (HI) program, which provides health insurance for those over 65 who are eligible for Social Security. In 1982, spending on Social Security accounted for 28 percent of all federal spending, with $156 billion in OASDI benefits and another $50 billion for Medicare.

Social Security's financial problems are both short and long term in nature. The primary reason for these difficulties is that the system operates on a pay-as-you-go basis. Contrary to common perceptions, contributions to the program are not saved and invested, but paid out almost immediately to beneficiaries. This makes the program very sensitive to economic and demographic shifts.

The short-term problem stems from the poor performance of the economy in recent years. High rates of inflation, combined with the automatic indexing of benefits, have raised the system's outlays, while high unemployment has led to a shortfall in anticipated revenues from the payroll tax. Moreover, when prices rise faster than wages, as they have in recent years, the gap widens because cost-of-living increases are based on prices, but revenues are based on wages. When Congress in 1977 last enacted a major change in the system, it wrongly assumed that the economy would be characterized by low inflation and unemployment and improving productivity. That error has pushed the system to the point of bankruptcy.

The long-term problem arises from changing demographics. In the early years of the system, many workers supported a relatively small recipient group, allowing Congress to legislate benefit increases without worrying about tax increases. In 1945, for example, there were 42 workers paying taxes for each beneficiary. This ratio changed dramatically in subsequent years: it fell to 16.5:1 in 1950; 4:1 in 1965; and it is only 3.2:1 today. By 2030, it is expected to be 2:1 or lower. One key reason for the changed ratio is the increase in longevity. This could throw the system out of balance completely should a medical breakthrough slow down the aging process significantly.

Social Security's long-range projections are commonly measured in terms of "cost rates." The cost rate is the annual outlays as a percentage of taxable payroll--in other words, the tax rate needed to avoid a deficit. Under the Social Security Administration's intermediate assumptions, the tax rate needed to meet benefit payments for the OASDI program would reach 17 percent by the year 2035 (compared with an OASDI tax rate of 10.8 percent in 1983). Under its pessimistic assumptions, which have proved to be more realistic in the past, the tax rate would reach 24 percent in 2035 and 28 percent in 2055.

Worse than the future costs of financing the OASDI program are the projections for the Hospital Insurance (HI) program. Even under the intermediate assumptions, the total Social Security payroll tax rate would have to rise to over 28 percent by the year 2035, and might well exceed 40 or 50 percent if the thus far more trustworthy pessimistic assumptions once again prove to be correct. As the burden on future generations of workers increases, already declining public support for the program can only be undermined further.

RECOMMENDATIONS OF THE NATIONAL COMMISSION ON SOCIAL SECURITY REFORM

On January 15, 1983, by a vote of 12 to 3, the National Commission on Social Security Reform approved a plan designed to bail out the Social Security system for the next seven years and reduce the long-term deficit by about two-thirds. Senator Robert

Dole (R-Kan.) has introduced a bill (S.1) entitled "Social Security Amendments of 1983," which incorporates the recommendations.

The Commission's proposals would affect nearly every worker in the labor force, every business, all levels of government, and 36 million beneficiaries. Table 1 outlines the specific proposals along with the short-term savings (in billions of dollars), as calculated by the Commission.

Speaking for the Commissioners opposing the plan, Senator William Armstrong (R-Colo.) complained that the package covers the shortfall mainly by increasing taxes. "Including revenues from expanded coverage," he noted in his dissenting statement, "higher taxes account for 75 percent of the proposed deficit reduction between now and 1990--$126 billion of the $169 billion total. In the long run, the balance is even more lopsided. Tax increases constitute 91 percent of the Commission's recommendations." Like Congressman Archer, another Commission member who voted against the package, Armstrong is concerned that much of the tax revenue raised will simply come from scarce general revenues, either through tax credits and deductions or from direct transfers into the trust funds.

The following are the principal recommendations of the Commission as contained in S.1.

1) Increased Payroll Taxes

Proposal: The payroll tax, now 6.7 percent on both employees and employers, already is scheduled to rise in stages under the 1977 Carter legislation, to 7.65 percent by 1990. The Commission recommended an acceleration of the tax hike (see Table 2).

Table 2

	Employer and Employee OASDHI Rate (combined)	
Year	Present Law	Proposal
1983	13.4%	13.4%
1984	13.4	14.0
1985	14.1	14.1
1986	14.3	14.3
1987	14.3	14.3
1988-1989	14.3	15.02
1990 and after	15.3	15.3

The maximum taxable level of income would remain unchanged. This currently is $35,700 and will grow each year to reflect the rise in average wages.

Analysis: Raising payroll taxes has been a favorite method of "dealing" with Social Security's financial problems. Between 1950 and 1980, Social Security taxes soared by over 2,000 percent,

Table 1
YEAR-BY-YEAR COST ANALYSIS OF OASDI PROPOSALS

Proposal	Short-Range Savings (in billions of $)							
	1983	1984	1985	1986	1987	1988	1989	1983-89
Cover nonprofit and new federal workers[a/]	--	+$1	+$2	+$3	+$4	+$4	+$5	+$20
Prohibit withdrawal of state/local workers	--	*	*	*	+1	+1	+1	+3
Taxation of benefits for higher-income persons	--	+1	+4	+5	+6	+7	+8	+30
Shift COLAs to calendar-year basis	+$5	+5	+5	+6	+6	+6	+7	+40
Eliminate windfall benefits	--	*	*	*	*	*	*	+.2
Benefits for remarried widow(er)s	--	*	*	*	*	*	*	-.1
Index deferred widow(er)'s benefits by wages	--	*	*	*	*	*	*	-.2
Divorced spouse's benefits when husband eligible	--	*	*	*	*	*	*	-.1
Higher benefit rate for disabled widow(er)s	--	*	*	*	*	*	*	-1
Revised tax schedule	--	+9	*	--	--	+15	+16	+40
Revised tax basis for self-employed	--	+1	+3	+3	+3	+4	+5	+18
Credit trust funds for military wage credits	+20	-1	-1	*	*	*	*	+18
Total Effect	+25	+16	+13	+17	+20	+37	+41	+168

* Less than $500 million.

a/ Includes effect of revised tax schedule.

NOTE: See text for complete description of the proposals. Those having no short-range cost effect are not shown here. Totals do not always equal the sum of the individual items, due to rounding.

Source: Report of the National Commission on Social Security Reform.

while wages only went up by 490 percent. Increasing such a tax raises employment costs to businesses. The result: longer unemployment lines, lower capital investment, and slower economic recovery. The Congressional Budget Office estimated that the 1977 payroll tax increases have reduced employment by 500,000.[1] Rather than easing Social Security's financial problems, the Commission's proposal could cause the economy to slow down--thereby weakening Social Security revenues and forcing more extreme corrective action in the future.

Raising payroll taxes was supposed to solve Social Security's problems in 1977. President Carter claimed that legislation was "the guarantee that from 1980 to 2030 Social Security funds will be sound." It did not work then, and there is no reason to believe it will work now.

To alleviate the hardship associated with a payroll tax increase, the Commission suggested altering the tax treatment of employee paid Social Security contributions by allowing individuals to offset the 1984 payroll tax increase with a refundable federal income tax credit. This is little more than a backdoor method of financing Social Security from general revenues. The tax expenditure it entails would merely redistribute the tax burden, not reduce it, and add to the burgeoning non-Social Security budget deficit.

The total tax requirement of Social Security is the total dollar value of benefits. Slowing the growth of benefits or, better still, allowing workers to opt out of the system are the only means of lowering outlays, and thus, the tax burden.

2) Extra Taxes on the Self-Employed

Proposal: An additional $18 billion would be raised by increasing the tax rate on self-employed persons from three-fourths of the combined employer-employee rate to the full employer-employee rate. Half of the OASDHI tax could then be deducted from taxable income. This latter provision would reduce income tax revenues by about $12 billion.

Analysis: Under this proposal, many of the self-employed would end up paying more in total taxes, and those at the lower end of the income distribution (with lower marginal income tax rates) would find the deduction largely valueless and the increase in the payroll tax devastating.

3) Expanded Coverage

Proposal: Coverage under the OASDI program would be extended to federal employees hired as of January 1, 1984, and all nonprofit

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[1] Congressional Budget Office, Aggregate Economic Effects of Changes In Social Security Taxes (August 1978).

groups now outside the system would be covered.[2] In addition, no longer would state and local governments have the right to withdraw from Social Security.

Analysis: Forcing new participants into the system, however, only postpones the day of reckoning, since the additional revenue will be offset eventually by the liabilities imposed by a larger pool of beneficiaries.[3]

This element of the plan would also undermine sound private pension plans and torpedo the Civil Service Retirement System (CSRS). The CSRS, like Social Security, is largely a pay-as-you-go system. Federal workers now contribute 7 percent of their salaries to the CSRS trust fund to finance the pensions of current federal retirees. Without new employees contributing to the system, the CSRS trust fund would eventually be depleted and the general revenue subsidy (already 80 percent) would need to be increased. In addition, the taxpayer would have to foot the bill for the employer's share of the Social Security payroll tax paid for new federal employees, along with any supplementary plan set up for new federal hires. The money obtained by drawing new federal workers into the system would merely mean an increase in the non-Social Security deficit.

Many Americans obviously want to withdraw from the Social Security system. In 1982, for example, 172,000 employees from more than 100 organizations withdrew. Another 387 local government entities representing 167,000 employees have made plans to drop out in the next two years. If people believe Social Security is not a good insurance program, they should not be compelled to join it. Instead, the government should allow them to select private sector alternatives for Social Security's insurance functions.

The Yuma Regional Medical Center in Yuma, Arizona, for example, withdrew from Social Security three years ago and employees there now contribute the same proportion of their wages formerly put into Social Security to a fund that purchases tax-sheltered annuities, disability and life insurance and long-term survivors' benefits. After three years, the medical center contributes 4.39 percent of each employee's wage to his benefit

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2 Federal employees have been covered under the HI program since January 1, 1983.

3 Including additional groups of workers would, simultaneously, have a positive effect on Social Security financing in the long run because, as the Commission report points out, "additional OASDI taxes paid on behalf of the newly covered workers over the long run will exceed, on average, the additional benefits which result from such employment." But the system will benefit largely because many workers will receive a poor return on their tax "contributions" (or have at least a return lower than they otherwise would have received).

package, in addition to payments to a conventional retirement plan. According to Dwight King, the personnel administrator: "Our employees are a lot better off than they were under Social Security."

That statement would be true for most of today's younger workers, who stand little chance of receiving a return from Social Security comparable with that of a private plan. Forcing more people into this system will merely result in a transfer of money from sound private funds to the unsound Social Security system.

4) Elimination of the "Windfall" Benefit

Proposal: The Commission would eliminate the so-called windfall benefit received by workers who are covered by Social Security for only a short period. This change would only apply to those becoming eligible for benefits after 1983.

Analysis: These "windfalls" arise because Social Security's weighted benefit structure treats individuals with short periods of employment under Social Security as though they were "long-service, low-earnings workers." Because many of these workers have qualified for benefits under other retirement programs, the Commission felt that they should receive benefits that "are more nearly of a proportionate basis than the heavily-weighted benefits now provided."

Though the short-term savings from this measure would be small, the proposal illustrates the flaws in the Commission's report. Virtually all retirees, rich and poor, currently receive sizeable windfalls from the system. If the Commission were truly concerned about windfalls, it should have suggested restructuring the benefit formula to make it completely proportional, i.e., benefits based solely upon contributions, plus interest.

5) Taxing Benefits

Proposal: Beginning in 1984, half of Social Security benefits would be taxed. This would apply to single persons with an adjusted gross income over $20,000 (from all sources, excluding Social Security), and over $25,000 in the case of married couples filing jointly. Proceeds from the tax would be credited to the Social Security trust funds.

Analysis: The rationale behind this change is that employees have already paid income taxes on the part of their earnings also subject to the Social Security payroll tax, but that the employer's share has escaped taxation because it is considered a business expense. Including half of all benefits in taxable income, it is argued, would approximate the current tax treatment of private pensions and benefits from other government programs. It is also argued that taxing a portion of benefits would recapture some of the excessive growth in benefits. Since the average retiree

today receives about five times more in benefits than he paid in taxes (even after adjusting for interest), such a tax would supposedly limit the "welfare" that goes to the non-needy.[4]

Taxing benefits would reduce benefits for about 10 percent of OASDI beneficiaries. Moreover, the number of people affected would grow as inflation eroded these thresholds. Even if inflation is low, Congress may well decide to lower the thresholds--as it has with unemployment compensation.

The Commission also admitted that a "notch" is present in this proposal, which may distribute the tax burden unfairly. The difference of a few pennies in income could mean a difference of hundreds of dollars in taxes paid, depending on whether one is below or above the thresholds. This not only penalizes those who have saved for retirement, but provides a clear incentive to reduce one's income to get under the notch, either by working less or by investing in tax-exempt bonds or some other tax avoidance scheme.

The taxation of benefits should not be adopted unless it is accompanied by the elimination of the earnings test which limits benefit payments to otherwise eligible Social Security recipients who earn more than a specified amount. In 1983, beneficiaries between 65 and 69 will lose $1 for every $2 earned in excess of $6,600 (the exempt amount for those under 65 is $4,920). This benefit reduction effectively raises marginal tax rates for older workers. When combined with the income and Social Security payroll taxes they also pay, these workers become one of the nation's most heavily taxed groups. As a result, many of the elderly who otherwise would have continued working are forced into complete retirement.

6) A COLA Delay

Proposal: The annual cost-of-living adjustment (COLA) now paid in July would be delayed for six months until January, and then continued on a calendar year basis.

Analysis: Proponents of this change point out that few private plans offer complete protection from inflation. They add that an adjustment now could allow the government to recoup some of the excessive growth in benefits that has occurred in recent years. From 1970 to 1981, for instance, the average Social Security benefit rose 221 percent, far outpacing inflation and the average weekly wage, which rose only 134 percent (as measured by the CPI) and 113 percent, respectively.

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[4] Despite the tilt in the benefit formula, the windfalls in absolute dollar terms have thus far favored the high wage earner. See, for example, Martha N. Ozawa, Social Security: Toward a More Equitable and Rational System (Center for the Study of American Business, St. Louis, Missouri), Formal Publication Number 52, October 1982.

It may have been highly irresponsible for the government to promise benefits that are becoming increasingly difficult to provide, but these are obligations that should be honored for those now retired or nearing retirement. Millions of retirees have based their plans on the expectation of receiving inflation-adjusted benefits. The net effect of this proposal would be to reduce benefits by $40 billion. But part of the savings are illusory, since they would be offset by increased spending on poverty programs financed by general revenues, such as SSI, and therefore only shift the strain to other budgetary sectors.[5]

7) <u>Treasury Reimbursement</u>

<u>Proposal</u>: The OASDI trust funds would be credited next year with $18 billion from the Treasury for benefits received by military personnel, for which no contributions were made to the funds. In addition, the funds would be credited for certain uncashed Social Security checks that were paid into the Treasury.

<u>Analysis</u>: This again is just a way of rearranging the budget deficit, shifting it from the Social Security to the non-Social Security budget.

8) <u>Other Changes</u>

The Commission proposed several other changes, such as altering the manner in which benefits are determined for widows, gradually increasing the delayed retirement credit from 3 percent a year beginning in 1990 to 8 percent by 2010, and putting in a "stabilizer" that would base annual COLAs on the lesser of wages or prices whenever the reserves in the trust funds fell to dangerously low levels.

CONCLUSION

Although most of the proposals made by the National Commission on Social Security Reform address the program's immediate insolvency, they fail to get at the root of the problem--namely, the inability of the system as now designed to fulfill adequately both its insurance and its welfare objectives. By explicitly ignoring this issue, they overlook two other, equally serious, problems: the unfair treatment of certain groups and the adverse economic effects of the system. Until these issues as well are dealt with, public confidence will not be restored and the system will remain vulnerable to changing economic, social, and demographic conditions. The Commmission's report provides Congress with a Band-Aid, but the system needs major corrective surgery.

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[5] The Commission did recommend that the level of OASDI benefits which is disregarded for purposes of determing SSI payment levels be increased from $20 a month to $50.

True reform of Social Security cannot begin until it is recognized for what it is: a mixture of insurance and welfare. A successful plan to rebuild Social Security must meet certain standards of fairness and efficiency.[6] Foremost among these principles must be that full benefits should be guaranteed to those retired or nearing retirement. Rather than threatening the security of America's elderly, reformers must acknowledge these liabilities as a total write-off and move to reform the system in such a way that the young people are also assured security in their old age.

Equally important is the need to educate the public on how the system works, the relationship between contributions and benefits, the economic and demographic realities confronting the system, and the host of other factors affecting it. One step in this direction would be to require the Social Security Administration (SSA) to establish an individual account for everyone participating in the program and to provide them with an annual statement showing how much they have paid into the system and an estimate of the benefits they can expect to receive.

Then, Social Security's conflicting insurance and welfare functions should be separated.

At the same time, the government should begin to allow workers to invest part, and eventually all the money now paid into Social Security, in expanded Individual Retirement Accounts, in return for a corresponding reduction in their future Social Security benefits. The evidence suggests that IRA benefits would more than compensate for the lost Social Security benefits and private pension plans constitute genuine savings, leading to more investment funds and more jobs in the economy. The government would continue to pay Social Security benefits exactly as promised to those who remain in the system, making up the loss in payroll taxes from general revenues.[7]

Such reform would have the effect of expanding Social Security, generically understood as providing for retirement, by incorporating a private element, thereby strengthening the overall system. It would offer a superior alternative for the younger worker, and it would assure full payment of expected benefits for the elderly.

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[6] Peter J. Ferrara, Social Security Reform: The Family Plan (Washington, D.C.: The Heritage Foundation, 1982); and Rebuilding Social Security, Heritage Lectures 18 (Washington, D.C.: The Heritage Foundation, 1982).

[7] Peter Ferrara has developed a specific plan for achieving such a reform which would be phased in between 1986 and 2016. He estimates that the average annual general revenue subsidy under his proposal would be about $20 billion (in constant 1982 dollars). See Ferrara, op. cit.