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RESEARCH REPORT

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SOCIAL SECURITY FUNDING: SOME EARLY GUIDELINES

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contents

1. Introduction: The current Social Security funding problem must be related to the performance of the economy in the past decade

The most critical part of Social Security's current financing problem concerns an adjustment to its retirement fund for the period 1983-1989. The need is immediate. The retirement fund must now borrow from Social Security's disability and health insurance funds to meets its commitments. The amount of the adjustment is significant. The projected retirement fund deficit for 1983-1989 is $150–$200 billion.

Whether an adjustment of $150-200 billion is affordable or not depends both on our national priorities and on the performance of our economy. As for the former, a $200 billion adjustment would amount to **one-eighth** of the $1,600 billion military budget authorized for the next five years. As part of this budget, the Pentagon has been authorized to spend between $180 and $220 billion in the next six years for warheads and delivery systems designed to fight a so-called "limited" nuclear war. (See **Labor Center Reporter**, 73.) Also by way of comparison, some projections of the deficit in the federal budget for 1984 are now $200 billion or more.

Extensive adjustments to Social Security funding were made in 1972, 1975, and 1977–totaling far more than the $150-200 billion adjustment currently required. But recurring funding problems have now raised an important question: Is Social Security "going broke," as frequently alleged? Or is the U.S. economy "going broke," and dragging Social Security down with it? The second question raises a more fundamental point: that Social Security funding is linked directly to the performance of the economy.

Unemployment has increased steadily in the 1980s to present double-digit rates. This trend follows the decade of the 1970s in which inflation averaged 10.6% a year (on a cumulative basis, to the end of 1979). During most of this decade, and continuing into the 1980s, price increases measured by the CPI have been greater than average wage increases in the U.S. economy. Most working Americans have therefore been "going broke" with these trends, because their living standards have declined in real terms.

For Social Security beneficiaries, the decline has not been as sharp, because benefit increases have been automatically adjusted to price and wage indexes since 1975. For example, COLA adjustments to Social Security benefits averaged 8.7% a year from 1975 through 1982, giving essential protection to the system's beneficiaries against much of the impact of inflation.

Double-digit unemployment rates in the U.S. are now causing millions of workers to "go broke" much faster than the inflation rates of the 1970s eroded their living standards. Double-digit unemployment rates have the same kind of impact on Social Security, by significantly reducing payroll tax contributions to the system.

Congressional election returns in November clearly indicated widespread concern about the economy–especially about unemployment and Social Security. Key leaders of the new Congress have indicated they will give high priority to both problems. But final Congressional action on Social Security funding is not expected before next June. Until then, the crescendo of rhetoric about our Social Security system will undoubtedly continue to increase.

2. Economic conditions, not long-range population projections, are the cause of the current Social Security funding problem

Mid-range projections of Social Security funding are available for the next 25-30 year period. With respect to the population and the work force, these projections are based primarily on the census count of people now living. In at least five major studies of Social Security funding completed in the past three years, these mid-range projections have called attention to the short-term retirement fund problem (1983-1989), and then have indicated that both OASI and DI are expected to develop surpluses in the 25 year period after 1990–even with mediocre performance of the nation's economy. (See **Labor Center Reporter**, 46). Some of these projections also indicate that without fundamental changes in our health care delivery systems, Social Security will have more problems in funding health care benefits than in funding retirement or disability or survivors' benefits.

Long-term or 75 year projections of Social Security funding are also available, and these depend much more on guesswork–particularly about the birth rate, and therefore also about the population and the work force. Such long-term projections are useful for some purposes, but they have now become a large part of the political rhetoric about Social Security.

Data projected over the next 75 years has been used, particularly by the Reagan Administration, to indicate that a declining number of younger workers will someday have to provide Social Security benefits for an increasing number of older retirees. But the 75-year projections have nothing to do with the current funding problem, which is caused entirely by economic conditions. Further, the longer the long-range projection, the more it is unavoidably based on guesswork. No one can predict what will happen over the next 75 years to birth rates, wage rates, inflation rates, unemployment rates, life expectancy rates, labor force particpation rates (in particular, the number of women in the labor force), and the many other variables that will actually determine future funding patterns.

Long-range birth rate projections are especially hazardous. For example, the Census Bureau recently predicted that the U.S. population is likely to rise by about a third, to 309 million, by the year 2050. But the Bureau also noted that "different developments could radically alter the picture." If women of child-bearing age have only 1.6 babies each, the population in 2050 would be 257 million. On the other hand, if fertility were 2.3 births per woman, population would be 379 million by mid-century. In other words, many know how to use a computer to predict, but no one knows what either the birth rate or the population will be in 2050. And not only these but many other unpredictable variables will also determine the work force and the number of retirees in 2050.

In spite of all the projections, the financing problems of Social Security were met in the last two decades, and will probably continue to be met, with the same kind of actuarial guesswork utilized in all private pension plans. That involves making the best estimates possible about what the future will bring, and then changing this guesswork periodically, by correcting it with the hindsight of actual experience. In this regard, the major differences between Social Security and private pension planning concern (a) the size and importance of Social Security (many zeroes must be added to every comparable estimate and correction); (b) the public spotlight that is always on Social Security but not usually on the private plans; and (c) the political rhetoric that always seems to surround and encumber Social Security.

3. The same funding problems which confront Social Security also confront all private pension plans

The United States has a four-tier approach to retirement income: (a) a nearly universal, wage-related, contributory, compulsory Social Security system; (b) private pension plans covering about half of those currently employed (mostly above-average earners); (c) individual voluntary savings; and (d) underlying the whole, a means-tested program of Supplemental Security Income (which is administered by Social Security, but funded from general revenues). These four tiers are not competing, but complimentary. With some 36 million current beneficiaries, Social Security is by far the most important of the four tiers. All the other tiers are based on the predictability and dependability of the Social Security system.

The funding problems which now confront Social Security have long confronted all private pension plans—even though these problems have not received equivalent attention. Social Security must pay as it goes, but it spreads the risks it covers to a broader population base, and it has a broader financing base than any retirement program in the nation. All private pension plans must earn-as-they-go, from returns on invested savings. They are therefore just as dependent as Social Security on a productive and stable economy.

The nation's private pension plans, covering both private sector employees and state and local public employees, depend heavily on the earnings of invested funds. In private sector plans, earnings from investments are generally expected to pay nearly two-thirds of the final pension benefits of retirees. In state and local public employee plans, earnings from investments are usually expected to pay up to half of the final pension benefits of retirees. (The percentage is lower in the public sector, because the contribution rates of employers and employees are higher.)

During the decade of the 1970s (to the end of 1979), while the cumulative rate of inflation averaged 10.6%, the investment earnings of all private pension plans in the nation averaged only 4.3% (see footnote at end of article). In the same decade, contributions to private plans increased significantly (as did both assets and liabilities). But many private plans were forced to reduce their funding levels. And most private plans significantly reduced the real value of retiree benefits by failing to adjust them for beneficiaries after retirement, in order to keep up with inflation. Their averaged returns on invested assets were not sufficient to protect the real value of post-retirement benefit levels. A few plans beat the dismal average; most fell further and further behind inflation. And the higher levels of unemployment now affect contributions to private plans just as adversely as they affect Social Security.

It is unusual that the public spotlight which glares on Social Security has not illuminated significant comparisons with private plans, especially with respect to COLA protection for beneficiaries. In private sector plans, there is usually no COLA protection for retirees whatever. In public employee plans, a 2% annual adjustment is typical. Here is the difference between a 2% annual adjustment and the actual Social Security adjustments in the eight year period 1974-1982, based on a beginning benefit of $350:

year	Social Security COLA	Benefit Amount adjusted by Social Security COLA	Benefit Amount adjusted at 2% annual rate
1974	—	350.00	350.00
1975	8.0%	378.00	357.00
1976	6.4	402.20	364.14
1977	5.9	426.00	371.42
1978	6.5	453.70	378.85
1979	9.9	498.70	386.43
1980	14.3	570.10	394.16
1981	11.2	634.00	402.04
1982	7.4	680.90	410.08

Not only for retirees, but also for those still working, Social Security automatically adjusts benefit levels upward to legislated maximums, in step with inflation. A comparable automatic indexing feature exists in public employee plans which base the beginning retirement benefit on earnings in the years immediately preceding retirement (a formula which is not as common in private sector plans). As one result, Social Security has been doing a much better job of providing and protecting benefits than the nation's private sector plans. As another result, state and local public employee plans now confront enormous cost pressures in maintaining promised benefit levels. (In public employee plans in California, there is a new proliferation of multiple benefit "tiers," with progressively inferior protection for succeeding waves of new employees.) As a final result, there is a current funding problem in Social Security, which is not as serious as the funding problems that confront all employer-provided plans, in public and private sectors, in the next 25 years.

4. Social Security will continue to be subject to political attacks which are not related to economic adjustments periodically required

Early in 1981, the Reagan Administration proposed benefit cuts far in excess of anything needed to solve Social Security's current short-term deficit problem. These proposals included cutting benefits for the totally disabled by one-third, reducing early retirement benefits by 40%, raising the "normal" retirement age to 68, and reducing the over-all level of the benefit structure by at least 23% (see **American Federationist**, June 1981). The Administration proposed only cuts –no revenue increases–which the AFL-CIO described as "fiscally irresponsible and morally reprehensible."

In Congressional testimony in May 1981, former Social Security Commissioner Robert Ball submitted data showing that Social Security is our most successful anti-poverty program, keeping 14-15 million Americans above the poverty level. When the Administration proposed cutting the Social Security benefit structure by about a fourth, it was also cutting welfare, cutting health and social services, cutting disability programs, and cutting its funding support to the states for all other forms of assistance to those in need (including 31% of aged Americans, who survive at or near the poverty level). The Administration's proposal to dismantle Social Security's benefit structure was also based primarily on the political guesswork of 75-year projections. It can therefore be understood only as a doctrinaire attack on the system itself, and not as a reasonable approach to the urgent problem of the retirement fund's 1983-1989 deficits.

Two reasons why Social Security is subject to purely political attack should be kept in mind. First, Social Security's total budget was made a part of the total U.S. budget in 1969. President Johnson proposed this change, which was implemented under President Nixon. Social Security's extensive reserve funds then made the Vietnam war deficit in the U.S. budget appear less serious. President Reagan uses the total Social Security budget in another political way–by associating the greatest U.S. deficits in history with the costs of social programs, and by dissociating these deficits from the increasing costs of military expenditures, and the even greater costs to our economy of unemployment. The 1983 Congress could do everyone a great favor either by separating the Social Security budget once again from the total U.S. budget, or by financing Social Security's deficits from the general revenues which finance the total budget.

Second, extensive reserve funds are no longer available to Social Security to tide the system over the bust phases of our economy, which still operates at best in boom and bust spurts. Even with the automatic adjustment features added in the 1970s, our pay-as-you-go funding method would not require huge trust fund reserves if our nation's economy were reasonably healthy. With high unemployment now imposed on a decade of high inflation, the lack of a cushion of Social Security reserve funds will make the approach to current funding problems both more nervous and more political.

5. The issue of general revenue funding for Social Security is subject to both economic and political distortion

The chief architects of our Social Security program in 1935 advised that general revenue funding would eventually be required–probably by 1964. Most systems in industrialized nations rely on general revenues (and often on "value added taxes," which the consumer pays like a sales tax, but does not see, because the tax is "added" at manufacturing or assembly or wholesale levels, and is not tacked on to the consumer's bill at the retail purchase point). But the Reagan Administration has made general revenue financing a battleground issue. Arguments for and against are passionate–and also distorted.

Social Security already has extensive general revenue funding, because the private sector employer's mandatory Social Security payroll tax for each employee (currently 6.7% to the maximum taxable wage) is deducted as operating expense from all other obligations of the employer to pay general revenue (corporate) taxes to the U.S. In effect, this part of Social Security funding is now and always has been a general revenue contribution to the system.

The employee's Social Security payroll tax obligation (currently a matching 6.7%) is not a general revenue contribution to the system, because the employee pays general revenue (personal income) taxes on all wages, including the 6.7% Social Security deduction.

Equalizing the general revenue tax treatment of employers and employees would be an equitable source of new funding to meet the greater part of Social Security's 1983-1989 deficits in the retirement program. One way of equalizing would be to allow workers to deduct their Social

Security tax payments from their income for federal tax purposes, as employers are now allowed to deduct their Social Security tax payments. (State and local property tax payments are similarly deductible.) Social Security payroll taxes could then be increased, but the overall tax impact on employees could at the same time be reduced. Of course this would be general revenue funding of Social Security, which we now have in the tax treatment of employers only.

Another way of equalizing the tax treatment of employers and employees would be to eliminate the taxation of the employee's Social Security contribution, and then to tax Social Security benefits. This approach would be more complex, because to maintain equity it would have to incorporate a negative tax schedule (or tax subsidies) for a great many retirees who receive some benefits from Social Security or from SSI, but are still so poor that they have no income tax liability.

6. Preliminary Conclusion

Other funding proposals are now being analyzed by the National Commission on Social Security Reform. In direct contrast to the Reagan Administration's approach, the Commission's staff work is setting forth options to raise the revenues to meet the coming deficits, as well as proposals to limit some benefits. In its public approach to date, the Commission has successfully toned down the Reagan Administration's political distortion of Social Security's current funding problem.

In coming issues, **Labor Center Reporter** will report primarily on the staff work of the Commission and the various Congressional committees (which is usually careful and accurate work), and will seek to distinguish the economic information contained in the staff work from the more blatent political response to it (which can be expected to proliferate in the next six months).

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footnote (refer to p. 4)

The 4.3% annualized investment return for 1970-1979 is from the Becker evaluation service. It was reported by the AFL-CIO Industrial Union Department, in "Pensions: A Study of Benefit Fund Investment Policies," (June 1980), and also by President Carter in his 1980 call for the investment of pension fund assets in a reindustrialization fund. As noted by Roy A. Schotland in his article in **Journal of Labor Research** (Fall 1981), the 4.3% figure becomes 6.3% if computed from 1970 to end 1980 (instead of end 1979). But Schotland also states: "Mediocre investment performance by the private pension system exposes it not only to arguments against traditional prudent investing, but even calls into question the justification for having a private pension system." (p. 73).