REPORT OF THE CONSULTANT PANEL ON SOCIAL SECURITY

Chapter 1.-Summary and Recommendations

PREAMBLE

Three independent reports*[1] submitted to the U.S. Congress have disclosed the insufficiency of scheduled taxes to cover expected outlays of the social security cash program (OASDI). In addition, and of equal importance, these reports found that the program's benefit structure suffers from a serious technical flaw which produces benefits that respond erratically to fluctuations in economic conditions. This flaw endangers not only the financial security promised to future beneficiaries, but also the financial soundness of the entire social security system. In response to these findings, Congressman Al Ullman, Chairman of the House Committee on Ways and Means, and Senator Russell B. Long, Chairman of the Senate Committee on Finance, requested the U.S. Congressional Research Service:

> to engage a group of outside consultants to examine the various ways in which the benefit structure could be revised to correct the problem of any overreaction to changes in price levels. Such an examination should include an analysis of the impact which such revisions of the benefit structure would have on the financing of the program and on the benefits actually payable to various categories of beneficiaries.

These requests were complied with in April, 1975, by the appointment of a panel of actuaries and economists. The Panel's membership now is:

Peter A. Diamond, Ph.D., Professor of Economics, Massachusetts Institute of Technology;

James C. Hickman, F.S.A., M.A.A.A., Ph.D., Professor of Business and Statistics, University of Wisconsin;

Ernest J. Moorhead, F.S.A., M.A.A.A., retired actuary, Winston-Salem, North Carolina; and

William C. Hsiao, F.S.A., M.A.A.A., Ph.D., Associate Professor of Economics, Harvard University (Project Director).

The Panel's tasks were (1) to develop and study alternative benefit formulas designed to solve the system's problems, thus re-establishing justifiable public confidence in OASDI, and (2) to estimate the costs and evaluate methods of financing the program.

MAJOR ISSUES

1. Erratic benefits-The present social security benefit formula, legislated in 1972, adjusts benefits automatically to reflect changes in the Consumer Price Index. These automatic provisions cause both benefits and taxable earnings base to rise as average wages under covered employment increase. The Panel approves the concept of automatic adjustments. However, the method now employed suffers from a flaw of overindexing whose probable effect will be disproportionate benefit increases for future beneficiaries in relation to price and wage increases. The outlook is for benefits that will be erratic and even capricious in terms of historical precedents. These tendencies are accentuated during periods of high inflation.

[1] These three reports are:

1974 Annual Report of The Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (May, 1974);

Report of the Panel on Social Security Financing to the Committee on Finance, United States Senate (Feb., 1975); and

Reports of The Quadrennial Advisory Council on Social Security (March, 1975).

2. Serious financial deficit-The OASDI program faces large financial deficits over both the short- and long-range.

Recent heavy inflation and increase in unemployment have created the short-range difficulties. Payroll tax revenues had not kept pace with benefit payments. These payments have increased because of (1) more claimants, and (2) operation of the automatic adjustments.

The size of the long-range deficit is attributable also to expected increase in the ratio of OASDI beneficiaries to working contributors, and to the flaw in the automatic provisions.

Perhaps the most important lesson learned from the financial difficulties now facing the OASDI program is that an element of flexibility must be built into its design. Abrupt changes in benefits and supporting taxes must be avoided. In our constantly changing society and economy, public interest can best be served by a system with built-in margins that will permit measured response to the needs of an uncertain future.

It has been pointed out that on reasonable economic and demographic assumptions the payroll tax rates needed to finance benefits payable in the first half of the next century will rise to more than double present rates. An issue that should not be overlooked is what future tax rates will be needed to finance any proposal offered as an improved benefit structure. The Panel believes that future generations of workers should not be committed in advance to materially rising tax rates.

3. Appropriate type of benefit formula-There are several quite different types of benefit formula that warrant consideration for a social insurance program; among these are: a flat benefit; a money-purchase plan; a final-average, or related High-5, etc., type; a wage-indexed formula; and a price-indexed formula. The Panel considered all these possibilities in the light of the general criteria that are listed in Chapter 2. The flat benefit and money-purchase types are too far removed from the existing type to be feasible. Comparative analyses of the other types are set forth in Chapter 3.

4. Spouse's benefit-The benefit awarded at retirement to a worker with a spouse who has no earnings record when both are over age 65 is 150 percent of the benefit paid to an unmarried worker who has made identical contributions. Furthermore, moderate past earnings by the spouse create no additional benefits. This benefit design, doubtless appropriate during the early years of the OASDI program when fewer than 15 percent of married women were in the labor force, becomes less and less so as more and more married couples have both spouses earning OASDI benefits. This issue goes beyond simply providing more equitable treatment between one- and two-worker families. The spouse benefit also magnifies the irrationality of the benefit structure. Inevitably, a significant number of families will receive tax-free retirement benefits greater than their pre-retirement earnings net after taxes and the costs of generating those earnings.

5. Effects of other government programs-Two recent pieces of Federal legislation have had significant impacts on the OASDI program and its financing: the Supplemental Security Income Program and the Earned Income Tax Credit provision.

A. Supplemental Security Income Program (SSI)-The original Social Security Act of 1935 offered economic security to the aged through two programs: an earnings-related old-age income program and a system of Federal matching grants to State old-age assistance programs. The assistance was meant to provide subsistence to all recipients. The earnings-related program (OASI) was designed to be a second tier of coverage to meet basic needs above subsistence. But a serious problem with the States' old-age assistance programs was the variety in eligibility standards and payment levels. The SSI program was enacted in 1972 to provide uniform Federal means-tested benefits, thus assuring a basic subsistence income to all the aged. Appropriately, this program is financed from general revenues; the outlay for fiscal year 1976 is estimated at $5.2 billion.

Future OASDI benefit levels must take the SSI program into consideration if duplications of efforts and expenditures are to be avoided.

B. Earned Income Tax Credit-Criticism has been directed at the allegedly regressive nature of the OASDI payroll tax. If the tax is appraised in isolation, then it is indeed regressive, but this is taking an excessively narrow view. The nature of the benefit formula causes low-income workers to receive benefits that are proportionately higher than those of high-income workers.[1] If the taxes and benefits are examined together, then the whole system is seen to be progressive. Even when attention is confined to the tax levy upon low-income workers, it seems that the more appropriate frame of reference is the sum of all taxes rather than each tax considered by itself.

Enactment of the Earned Income Tax Credit provision constitutes a useful new tool for modifying the taxes and resulting income of the poor. The total expenditure in fiscal year 1976 for this provision is estimated at $1.5 billion. The financing of the OASDI system should be coordinated with this and other tax decisions affecting low-income workers.

MAJOR RECOMMENDATIONS

In arriving at its recommendations, the Panel has been acutely aware of the financial needs of retired persons, both now and in the future. But we recognize that every increase in benefits must be financed by an increase in taxes-whether from payroll or from general government revenue. We have tried, therefore, to strike a reasonable balance between benefits and the costs of providing them.

The Panel was guided also by the long-established principles that Congress has set for the earnings-related OASDI: namely, the principles of social adequacy and individual equity applying to both benefits and the supporting taxes. Furthermore, we recognize that the social security system has created strong expectations among its participants that they will receive retirement benefits that are reasonably related to their lifetime earnings. The OASDI must seek to fulfill these expectations.

A worker's willingness to pay the required taxes depends largely on his belief that his expectations will be realized. Yet, if these benefit expectations are unreasonably high, then the program will encounter financial difficulty. To operate the system successfully in the face of unpredictable social, demographic, and economic changes, requires flexibility that the system now lacks.

1. *Benefit formula*-The Panel recommends that:

(a) as under present law, retirement benefits continue to be increased automatically after retirement in proportion to the Consumer Price Index;

(b) benefits for future retirees be computed using earnings that have been indexed in proportion to the change in price levels during the earnings-averaging period;

(c) the progressively lengthening averaging period of present law be retained;

(d) the minimum benefit provision under OASDI be eliminated; and

(e) future Congresses determine the extent to which benefits can be increased beyond the levels reached automatically, in the light of needs of the beneficiaries and willingness of the workers to pay the necessary taxes.

The effect of these recommendations would be:

- -Benefits to workers already retired would be protected against erosion from inflation.
- -The purchasing power of benefits for future retirees would tend to increase even without future congressional action and can be further increased by congressional action. However, in the absence of such action, the benefit

[1] For example, contrast the monthly benefits upon retirement at age 65 in early 1976 of three workers whose average monthly earnings were $600, $300 and $150, respectively. For the $600 case, the benefit is $371.50; for the $300, it is $231.60; for the $150, $161.10.

measured in relation to worker's pre-retirement earnings would decline .[2] The benefit patterns, in the absence of legislated increases, under the recommended formula are illustrated below.

-Workers would receive more equitable benefits in relation to their contributions

-It would be left to future generations to decide what benefit increases are appropriate and what tax rates to finance them are acceptable, and to implement those decisions through congressional actions

-Windfall benefits to people with short earnings records under the social security system; (e.g., government employees who develop a period of covered employment under OASDI) would be progressively reduced.

Illustration of the retirement benefit for a worker who retired in 1976. Benefit measured in constant 1976 dollars.

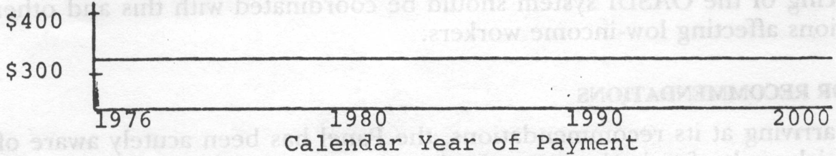
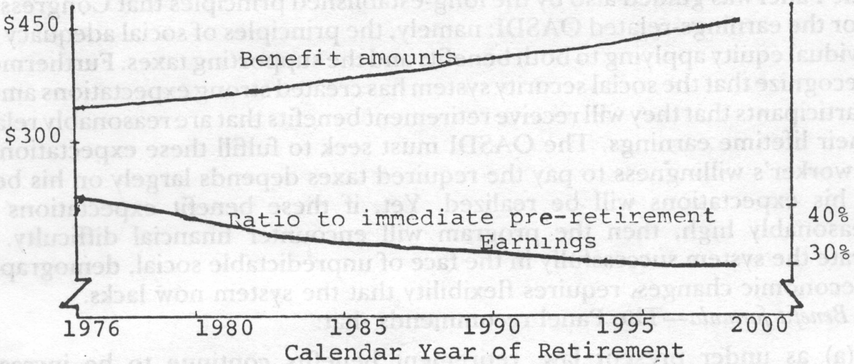


Illustration of Initial Benefits for Median Income Male Workers who Retire in Different Future Years (excluding legislated increases)

Benefits measured in constant 1976 dollars.



(It should be noted that the first of these two charts portrays the situation according to calendar year of benefit payment, the second according to calendar year of retirement.)

2. Financing-The Panel recommends that:

(a) the system continue to be financed by payroll taxes, not from general government revenues;

(b) the ceiling on wages subject to payroll tax be moderately increased, and then maintained at a point at which the entire earnings of approximately 90 percent of all workers are covered. In 1977, the estimated maximum would be $18,900 instead of the $16,500 expected under present law. This maximum would continue to increase automatically in proportion to increases in covered wages, subject to revisions from time to time to maintain the 90 percent benchmark;

(c) the combined employer and employee payroll tax rate be increased by 0.4 percent (i.e. 0.2 percent each); and

(d) the tax rate for the self-employed, for both OASDI and HI, be increased to 75 percent of the combined rate for employees and employers.

[2] Note that this is not a benefit reduction for those already retired. Nor is it a reduction in the purchasing power of benefits for any generation of retired people compared with corresponding people of previous generations.

The effect of these financing recommendations, in conjunction with the benefit structure recommendations, would be:

- Under economic and demographic assumptions that appear to be within a reasonable range, the tax rates needed to finance promised benefits would remain close to those initially recommended by this Panel. (Tables at the end of this chapter illustrate these rates.)
- Congress would have leeway to finance additional benefits out of acceptable tax increases.
- The tax rate for the self-employed would return to the level relative to the combined employer-employee tax rate that existed in the past.

The emphasis of this Panel's proposal is upon congressional control rather than upon maintenance of approximately today's tax rate. Even if Congress' believes that workers at the turn of the century will be willing to pay a combined payroll tax rate substantially higher than the current tax rate, we consider it undesirable to incorporate that belief into the system at the present time, thereby causing rigidity. As time passes Congress can raise benefit levels and the corresponding taxes at its discretion.

The Panel has concluded that the use of general government revenue to finance the OASDI program is inappropriate. Our reasons are:

- General revenues are more properly used to support needs-related old-age income programs and general tax relief to low-income workers.
- Needs of elderly persons other than for income maintenance-such as housing, long-term care, and social services-appear to have more urgent claims on general revenues.
- General-revenue financing of the OASDI program would weaken the earnings-related nature of the program. It could even jeopardize the long-range stability of the entire social security system, thwarting citizen expectations of retirement income protection.

3. *Spouse's benefit-The* Panel recommends abandonment of the present schedule of spouse benefits for future retired workers. We recommend instead averaging the earnings of the husband and wife for determining benefits to members of both one-worker and two-worker families. This procedure would result in more equitable treatment in relating benefits to contributions.

OTHER RECOMMENDATIONS

1. *Retirement test*-Effects created by the retirement test are largely unknown; so are the forces responsible for the present large number of early retirements. The Panel recommends that Congress use OASDI Trust Funds to finance a study of the economic impact of the retirement test. The study would apply different retirement tests to different samples of workers. Resulting increased knowledge of the factors affecting retirement decisions could aid Congress in making sound changes.

This Panel supports in the interim the removal of the monthly earnings test as part of the retirement test.

2. *Universal coverage-The* Panel recommends that social security coverage be made universal. In particular, we find no reason for the exclusion of federal government employees. The present system produces many windfall benefits to those who are covered by other systems, but who nevertheless qualify for social security benefits by reason of limited periods of covered employment.

FUTURE TAX RATES

It is important to distinguish between the tax implications of this Panel's recommendation and the tax implication of other proposals currently presented to Congress. It is also essential that comparisons among proposals all be based upon the same or similar economic and demographic assumptions. A third essential is that each proposal be tested to determine its sensitivity to variations in assumed future conditions. The major causes of such sensitivity are the rate of price increase and the relation of the rate of price increase to the concurrent rate of wage increase.

There follow three tables. The first table illustrates future tax rates on the assumption that wage growth will be 5 3/4 percent per year and prices will increase 4 percent per year, both compounded annually. These are the intermediate assumptions employed in illustrating other proposals made to Congress, including the "Social Security Benefit Indexing Act" proposed by President Ford on June 17, 1976. The President's proposal, however, provides no remedy from the long-range financial deficits of the program. It leaves a significant actuarial deficit in the financing of the OASDI system.

The second table shows the stability of the tax rates needed to finance promised benefits under this Panel's recommendation-a stability not enjoyed by other major recommendations that Congress is considering.

The third table illustrates the steadily increasing purchasing power of benefits promised to different generations of retired people under this Panel's recommendation.

TABLE 1. ESTIMATED EXPENDITURES UNDER THE SET OF INTERMEDIATE ASSUMPTIONS ADOPTED BY THE 1976 BOARD OF TRUSTEES FOR THE OASDI PROGRAM[1]

[In percent]

		This panel's recommendation[2]		President Ford's proposal[3]	
Calendar year	Tax rate scheduled under present law	Expenditures as a percent of taxable payroll	Tax rqtes recommended	Expenditures as a percent of taxable payroll	Tax rates recommended
1980	9.9	10.6	10.3	10.7	10.5
1990	9.9	10.5	10.3	11.8	10.5
2000	9.9	10.0	10.3	12.4	10.5
2010	9.9	10.0	10.3	13.4	10.5
2020	11.9	11.5	10.3	16.5	12.5
2030	11.9	12.5	10.3	18.9	12.5
2040	11.9	11.9	10.3	18.9	12.5
2050	11.9	11.3	10.3	18.8	12.5

Average over next 75-year period	Panel's recommendation	President Ford's proposal
(1) Expenditures	11.0	15.0
(2) Tax rate	10.3	11.6
Excess of (1) over (2), often called "actuarial balance"	[4]—0.7	—3.4

[1] Each 1 percent of taxable payroll equals $8 billion in 1977. This set of intermediate assumptions is explained in the 1976 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds, May 1976; it is labelled "Alternative II" in that report.

[2] The estimated expenditures assume adoption of the maximum taxable earnings base recommended by the Panel. In 1977, this maximum would be $18,900 instead of the $16,500 expected under present law.

[3] These figures are applicable to the wage-indexing formula proposed by President Ford in June, 1976. The formula for 1978 retirement at age 65 is: 91% of the first $175 of average indexed monthly earnings, plus 33% of the next $875, plus 17% of the excess over $1,050. For retirements after 1978 the dollar figures in the formula are wage-indexed upwards. President Ford's proposal recognizes that it does not provide adequate financing for the program beyond the next several years. It proposes to make further studies and then recommend corrective actions.

[4] Under these particular assumptions, the tax rate recommended by this Panel is shown to be insufficient, by an average of 0.7% per year, to cover expenditures over the next 75-year period. These estimates, however, are based on the intermediate assumptions employed in the 1976 OASDI Trustees Report. The Panel considers those assumptions overly pessimistic in two elements, viz., wage increase rates and fertility rates. If the assumptions preferred by this Panel—a 6% annual increase in wage rates, and ultimately a 2.1% fertility rate—are used, the insufficiency is erased.

TABLE 2. TAX RATE NEEDED TO SUPPORT THIS PANEL'S BENEFIT RECOMMENDATIONS UNDER SEVERAL WAGE & PRICE INCREASE ASSUMPTIONS

	If excess of wage over price growth is 2 percent		If excess of wage over growth is 1 percent	
Calendar year:	5–3	7–5	5–4	6–5
1980	10.6	10.6	10.7	10.7
1990	10.4	10.3	11.4	11.3
2000	9.6	9.6	11.4	11.3
2010	9.5	9.5	12.0	11.9
2020	10.8	10.8	14.2	14.2
2030	11.7	11.7	15.8	15.8
2040	11.0	11.0	15.3	15.2
2050	10.4	10.4	14.8	14.7
Average pay-as-you-go	10.5	10.5	13.1	13.1

Note.—Assumptions other than for wage and price increase rates used in deriving figures for table 2 are the intermediate assumptions in the 1976 OASDI Trustees' Report.

TABLE 3. PURCHASING POWER (I.E., VALUE IN 1976 DOLLARS) OF BENEFITS PROMISED TO WORKERS WHO RETIRE AT AGE 65 AT DIFFERENT TIMES—THIS PANEL'S BENEFIT RECOMMENDATION (SEE CHAPTER 3 FOR PARTICULARS)

	Calendar Year of Retirement				
Earnings during averaging period	1976	1983	1990	1997	2003
Median of year-round full-time workers:					
Men	$341	$375	$408	$450	$511
Women	281	293	312	327	357
Workers earning taxable maximums in all years	352	399	438	489	563

A COMPARISON OF THE PANEL'S RECOMMENDED PRICE-INDEXING METHOD AND WAGE-INDEXING METHOD PROPOSED BY PRESIDENT FORD IN JUNE 1976.

There is widespread agreement that the present overindexing of benefits must be corrected. Two major alternatives have been proposed: the price-indexing method recommended by the Panel and the wage-indexing method proposed by President Ford. These grant identical treatment to those already receiving benefits, both guarantee that benefits will keep pace with increases in the Consumer Price Index.

However these two approaches differ in the computation of initial benefits for workers who retire in the future. The Panel's price-indexing method would protect future retirees against inflation through automatic adjustments in the benefit formula used to compute initial retirement benefits. In other words, the benefits for workers retiring in the future years would be automatically increased to keep pace with inflation. In addition, their initial benefits would tend to increase even further when real wages increase. However, the initial benefits, measured as a percent of immediate pre-retirement earnings would decline in the absence of legislated increases.

On the other hand, the wage-indexing method proposed by President Ford would provide an initial retirement benefit that replaces approximately the same ratio of each worker's pre-retirement wages as applies for a worker who retires in 1976.

The two different approaches of correcting the overindexing produce very different outcomes in:

1. *Flexibility and congressional control-These* two methods produce different promises of benefits to workers retiring in the future. The price-indexing method guarantees a moderate benefit that compares favorably with that for a worker who

has previously retired and preserves a greater degree of control and flexibility for Congress to increase the benefit in the future. The price-indexing method would guarantee a benefit amount that is protected against inflation. Moreover, the benefits for future retirees would tend to increase even without future congressional action because of the rise in workers' productivity. Congress can further raise the benefits in light of the needs of retired people and the economic, social, and demographic conditions prevailing at that time.

The wage-indexing method, on the other hand, would make benefit levels fully automatic. These automatic adjustment provisions establish benefits at a higher level and thus leave less financial flexibility for congressional control. Belief in the achievability of these promised higher levels of benefits without large tax increases requires a strong faith in the reliability of forecasts about future economic and demographic conditions.

2. Benefits promised and incidence of their costs-Under the pay-as-you-go method of financing social security, taxes paid by each generation of workers are immediately paid out to people already retired. The retirement benefits of current workers will when the time comes, be financed by the payroll tax contributions collected from the next generation of workers. Therefore whether the expectations of current workers can be realized depends upon whether the next generation of workers is willing to pay the required taxes. If the promised benefits are unreasonably high, the program will encounter financial difficulties.

The two alternatives proposed to correct overindexing promise different benefits. Correspondingly, their respective costs are very different. The wage-indexing method proposed by President Ford may require a future generation of workers to pay a payroll tax that is 70 percent higher than the present level. This Panel gravely doubts the fairness and wisdom of now promising benefits at such a level that we must commit our sons and daughters to a higher tax rate than we ourselves are willing to pay.

Social security is a long-term program. Its stability and financial soundness depend on the Congress taking a long-term view. Long-range projections are inherently quite complicated and based on assumptions. Some important elements that determine the costs are more predictable than others, some of the factors are close to being unpredictable. Nevertheless, the projections provide valuable indications and ranges of future costs and financing requirements.

In the next table are shown cost comparisons using the intermediate assumptions of the 1976 Trustees Report. The price-indexing method produces expenditures that are relatively level as a percentage of taxable payroll. But the wage-indexing method produces expenditures that require substantially greater tax payments from future generations of workers.

TABLE 4.-COMPARISON OF OASDI LONG-RANGE COST

[In percent]

	Expenditures as percent of taxable payroll[1]	
	Price-indexing method using the Panel's formula	Wage-indexing method using President Ford's formula
1976	10.8	10.8
1980	10.6	10.7
1990	10.5	11.8
2000	10.0	12.4
2010	10.0	13.4
2020	11.5	16.5
2030	12.5	18.9
2040	11.9	18.9
2050	11.3	18.8

[1] 1 percent of taxable payroll equals $8 billion in 1977.

3. Unequal treatment ofpeople retiring at different times-The price-indexing formula provides that retirement benefits will be protected against inflation. It leaves financial flexibility for Congress to give whatever periodic general benefit increases that appear reasonable from time to time for everyone: currently retired people and workers retiring in the future.

In contrast to this, the wage-indexing method provides a sharp tilt in favor of workers retiring in the future. The increases in benefits for workers already retired are limited to increases in the rise in the Consumer Price Index. Yet workers who retire five years later will receive increments due to both price changes and increases in real wages. This difference in retirement benefits can be substantial. For example, consider three workers whose life-time earnings are in the same relative position, i.e., at the median for the total economy. Assume, one man was born in 1911 and retired in 1976; the second was born five years later, 1916, and retires in 1981; the third was born in 1926 and retires in 1991 under the assumptions stated in Chapter 3 of this report, the wage-indexing method would produce the following benefits if they are expressed in 1976 dollars.

MONTHLY RETIREMENT BENEFIT (EXCLUDING SPOUSE BENEFIT) FOR THREE MEDIAN EARNERS

		President Ford's proposal: wage-indexing method		Panel's recommendation: price-indexing method	
Year of birth	Year of retirement	Benefit amount in constant 1976 dollars	Ratio of initial benefit awards to 1976 retiree's benefit	Benefit amount in constant 1976 dollars	Ratio of initial benefit awards to 1976 retiree's benefit
1911	1976	$347	1.00	$341	1.00
1916	1981	413	1.19	366	1.07
1926	1991	521	1.50	414	1.21

Measured in constant purchasing power, the man retiring in 1981 will receive 19 percent more in purchasing power (real monthly retirement benefits) than the man who retired in 1976. The man who retires in 1991 will receive 50 percent more in purchasing power than the first person.

The Panel's belief is that each of the features outlined here, the price-indexing approach proves itself more suitable than the wage-indexing approach.