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The policy implications of Social Security financing are significant because of heightened concern about the long-term stability of the program and its possible role in increasing national saving.



Financing Social Security Retirement into the 21st Century

- ◆ Social Security covers nearly all U.S. workers and provides earnings-related indexed benefits to the vast majority of elderly families. It is the foundation of a four-tier retirement system that includes private pensions, individual savings, and Supplemental Security Income.
- ◆ The proportion of the U.S. population aged 65 and over is projected to grow from approximately 12 percent today to more than 22 percent after the year 2030. This means that the relative number of active workers paying Social Security taxes to support beneficiaries will be reduced in the future.
- ◆ An imminent financial crisis in the early 1980s prompted Congress to move the system to partial reserve financing from pay-as-you-go. This financing change is creating a build-up of reserves in the Old-Age, Survivors and Disability Insurance (OASDI) trust funds.
- ◆ Some believe the accumulating reserves in the OASDI trust funds are a potential pool of investment funds that could be used to prefund the baby boom's retirement by increasing capital formation and the productivity of future workers.
- ◆ In the 1991 budget agreement (OBRA '90) Congress enacted a provision that removes the OASDI trust funds from deficit reduction calculations, a move that essentially prevents the federal government from using surpluses in the funds to mask deficits in the rest of the federal budget.

◆ Introduction

Financing the Old-Age, Survivors and Disability Insurance (OASDI) program,¹ also known as Social Security, has consistently been a major public policy issue. It is especially important today because of heightened concern about the program's long-term stability and its possible role in increasing national saving.

Social Security pays monthly benefits to retired and disabled workers and their dependents and survivors. The program taxes the earnings of current workers to finance the benefits of current beneficiaries. The taxes paid by covered workers are based on current earnings, while beneficiaries' benefits are based on their past earnings.

In 1989, approximately 132 million covered wage and salary and self-employed workers and their employers contributed \$274 billion in payroll taxes to the OASDI trust funds.² The Social Security program paid monthly benefits to nearly 39 million beneficiaries, totaling an average of \$19 billion per month, or 20 percent of federal expenditures.

The 1977 and 1983 Social Security amendments moved the Social Security program from pay-as-you-go financing (in which annual income to the OASDI trust funds approximates annual outgo) to partial reserve financing (or prefunding). With this financing change, today's payroll tax revenues are exceeding current costs, and sizable reserves are accumulating. These reserves are a potential pool of investment funds that some believe could be used to prefund, in a sense, the baby boom's retirement by increasing capital

¹The Social Security program also includes the Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) trust funds, which finance Medicare, the health insurance program for the elderly and long-term disabled. This *Issue Brief* is devoted solely to the discussion of the retirement income portion of the Social Security program. It does not attempt to examine issues relating to the Medicare trust funds.

²Beginning in 1983, these taxes include government contributions on noncontributory wage credits for military service in 1957 and later.

formation and future workers' productivity (Aaron et al., 1989). On November 5, 1990, President Bush approved the 1991 budget agreement, the Omnibus Budget Reconciliation Act of 1990 (OBRA '90), which removed the OASDI trust funds from Gramm-Rudman-Hollings deficit reduction calculations. This action will prevent the reserves from masking deficits in the rest of the federal budget.

The funds for the baby boom generation's retirement must come from the pool of resources generated by the economy of that time. Providing these funds will not be a major burden on the U.S. economy if the economy is larger (capable of producing greater economic output) than it is today. One method of ensuring that the economy will be larger is to increase the funds available for investment by increasing the savings rate. Recently, the U.S. savings rate has declined. For example, although personal savings rates have recently risen, they declined from an average of 8.0 percent of disposable income in the 1970s to 3.2 percent in 1987 (Davis, 1989). In addition, the federal deficit peaked at more than \$200 billion in fiscal year 1990. Some believe the growing reserves in the OASDI trust funds are a potential pool of investment funds that can compensate for reduced U.S. savings and thus contribute to making the economy of the future larger than it is now.

This *Issue Brief* explains the basic structure of the Social Security program and its role in retirement income and examines the potential impact of the U.S. population's changing demographic composition and the build-up of reserves in the OASDI trust funds. It also describes the possible effects that alternative OASDI financing options may have on national saving. Finally, this *Issue Brief* explores recent policy proposals and legislation relating to the removal of the OASDI trust funds from deficit reduction calculations.

◆ Overview of the Social Security Program

Social Security is a federally sponsored program which, since its inception in 1935, has grown to cover nearly

all U.S. workers and provide earnings-related indexed benefits to the vast majority of elderly families.



Between 1936 and the present, the proportion of workers covered by Social Security has increased from approximately 60 percent to nearly 92 percent of the work force.



Coverage

When Congress passed the Social Security Act in 1935, it limited coverage to workers in commerce and industry (excluding the railroad industry). Legislation in the 1950s extended coverage to additional groups, including regularly employed farm and domestic workers, the nonfarm self-employed, newly hired railroad workers, and active duty members of the uniformed services. The 1983 amendments extended coverage to all newly hired federal employees. Furthermore, OBRA '90 will extend OASDI coverage to all state and local government employees who are not participating in a state or local public employee retirement system, beginning July 1, 1991. **Between 1936 and the present, the proportion of workers covered by Social Security has increased from approximately 60 percent to nearly 92 percent of the work force.** Mandatory universal OASDI coverage has been recommended by several advisory groups, including the 1975 and 1979 Advisory Councils on Social Security and the 1981 National Commission on Social Security.

Beneficiaries

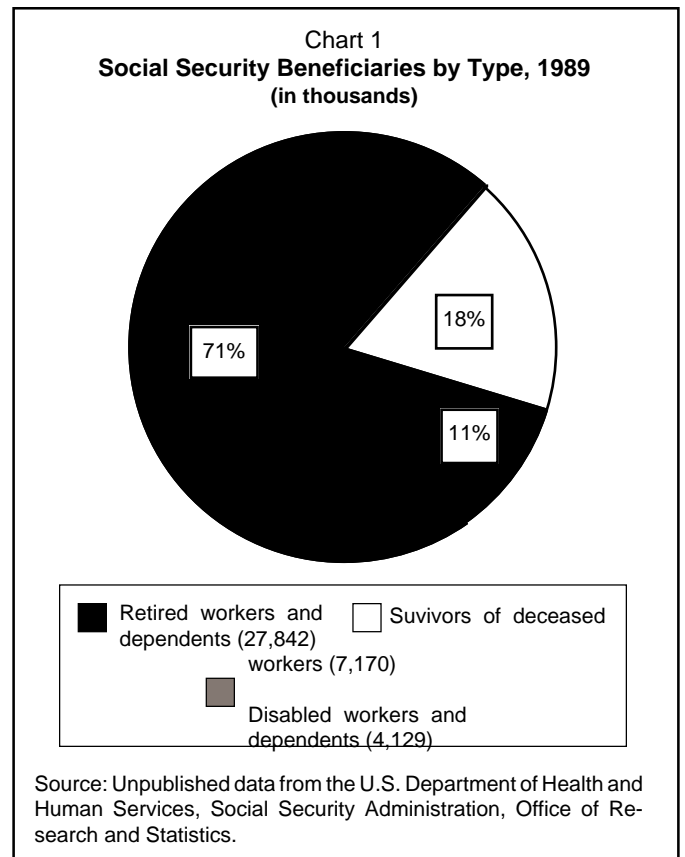
In 1989, approximately 39 million people received monthly Social Security benefit checks—roughly one in seven people in the United States. Retired workers and their dependents represented the largest group of beneficiaries, followed by the survivors of deceased

workers. Disabled workers and their dependents were the smallest group (chart 1). The 1935 Social Security Act guaranteed benefits only for retired workers covered by the program. The 1939 amendments added the dependents and survivors of covered workers to the beneficiary rolls. The 1956 amendments authorized benefits for disabled workers, while the 1958 amendments guaranteed benefits to their dependents.

Funding

Employees in Social Security covered jobs, their employers, and the self-employed make contributions based on wages and earnings up to the annual maximum taxable wage base (\$53,400 in 1991) under the

³Self-employed persons make contributions under the Self-Employment Contributions Act (SECA).



Federal Insurance Contributions Act (FICA).³

Employee contributions are automatically withheld from wage and earnings payments, and employers make a matching contribution. Self-employed workers contribute at the same rate as covered workers and employers combined.

In 1989, 95 percent of Social Security revenue came from payroll taxes paid by employees, employers, and the self-employed. At present, employees and employers each pay 6.2 percent of payroll.⁴ The employer portion is not included in employees' taxable income. The self-employed pay both the employee and employer share of payroll taxes;⁵ however, they can deduct one-half of their payroll tax contribution from taxable income. In 1989, 5 percent of the OASDI trust funds' income came from taxation of benefits (1 percent) and earned interest (4 percent). Maximum annual taxable earnings will rise to \$53,400 in 1991 from \$51,300 in 1990.

Qualifying for Benefits

Retired or disabled workers and their dependents or survivors are eligible to receive benefits only if the workers have accumulated enough quarters of covered employment to become insured for these benefits.

Each calendar year consists of four quarters of coverage. Before 1978, workers earned one quarter of coverage for every \$50 of covered earnings (earnings up to the maximum annual taxable amount) during a calendar quarter. Currently, quarters of coverage are credited to a worker's account annually. In 1990, workers earned one quarter of coverage for every \$520 of covered earnings for the year, up to a maximum of four quarters for earnings of \$2,080. The amount of covered earnings needed to earn one quarter of coverage changes annually because it is indexed to rise with average wages.

⁴The OASI portion is 5.6 percent and the DI portion is 0.6 percent.

⁵The OASI portion is 11.2 percent and the DI portion is 1.2 percent.

Insured status, also known as benefit eligibility, varies with the number of earned quarters. For instance, workers are *currently insured* if they have earned six quarters of coverage (whenever acquired) during the 13-quarter period ending with the quarter in which they retired, became disabled, or died. *Currently insured* status qualifies a worker's survivors, excluding dependent parents and widow(er)s, for benefits. Workers become *fully insured* if they earn one quarter of coverage (whenever acquired) for every year (or four quarters) after 1950 or during the year in which they reach age

Table 1
Comparison of Social Security Replacement Rates^a for Workers Retiring at Age 65

Year	Earnings Level ^b		
	Low	Average	Maximum
1945	30.2	17.9	17.3
1950	33.4	20.0	21.2
1955	52.5	34.6	32.8
1960	49.1	33.3	29.8
1965	45.6	31.4	32.9
1970	48.5	34.3	29.2
1975	59.9	42.3	30.1
1980	68.1	51.1	32.5
1981	72.5	54.4	33.4
1982	65.8	48.7	28.6
1983	63.5	45.8	26.4
1984	62.7	42.9	23.7
1985	61.2	40.9	22.8
1986	60.4	41.2	23.1
1987	59.6	41.3	22.6
1988	58.4	40.9	23.1
1989	57.9	41.7	24.1
1990	57.2	42.4	24.5

Source: Unpublished data from the U.S. Department of Health and Human Services, Social Security Administration.

^aThis replacement rate refers solely to the replacement of a worker's past earnings. It does not include benefits received by dependents and/or survivors of deceased workers.

^bThe earnings levels of workers are divided into three categories: low, average, and maximum. Beginning in 1989, replacement rates for *low* earners, as computed by the Social Security Administration, reflect rates for workers earning 45 percent of average earnings in a specified year rather than rates for workers earning the current minimum wage; *maximum* earnings are the maximum earnings subject to Social Security taxation (\$53,400 in 1991) in a specified year; and *average* earnings refers to the average earnings of wage and salary workers in the economy in a specified year (\$20,099.55 in 1989).

21 (whichever is later) and prior to the time they reach age 62, become disabled, or die. The number of required quarters of coverage is between 6 and 40, depending on the age at which benefit receipt begins. *Fully insured* status means that a retired or disabled worker, as well as his or her dependents or survivors, is eligible to receive benefits.

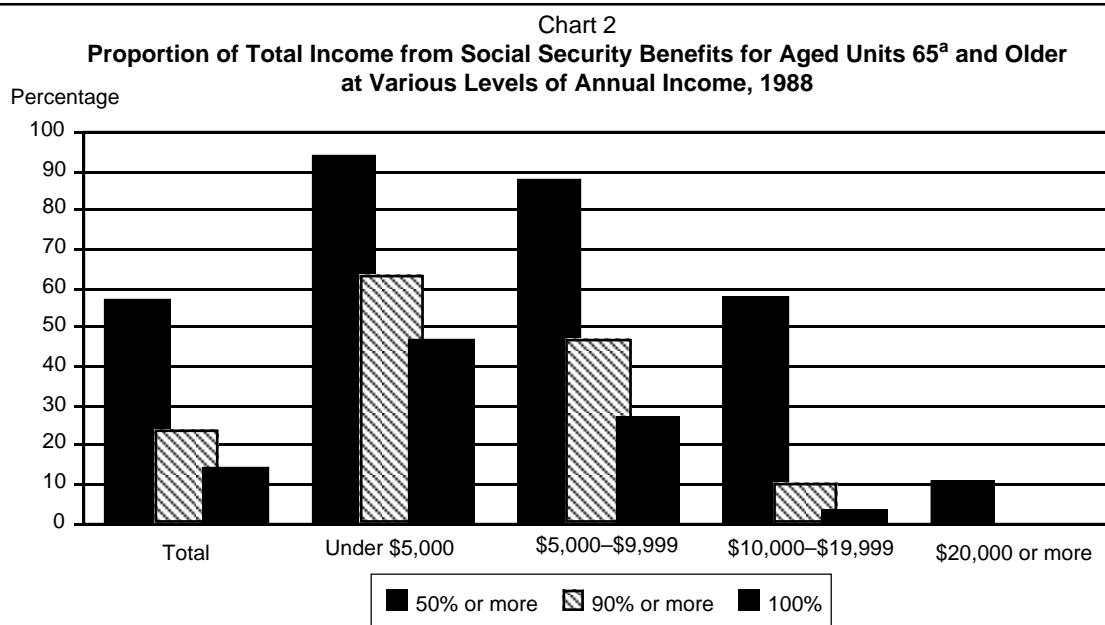
To qualify for disability benefits, an insured worker must demonstrate his or her inability to engage in substantial gainful activity (earning \$500 or more per month) because of a medically determinable, permanent physical or mental impairment.

Determining the Amount of Benefits

The framers of the Social Security Act designed a system that replaces a greater proportion of past earnings for low earners than for high earners (table 1). The rationale for this is that persons with high lifetime earnings generally have greater access to

additional sources of retirement income to supplement OASDI benefits (chart 2). The Social Security program is the foundation of a four-tier system, which includes private pensions, individual savings, and a federal means-tested program—Supplemental Security Income (SSI)—for the poorest elderly (Ball, 1985). On average, Social Security benefits account for about 38 percent of retirement income (chart 3).

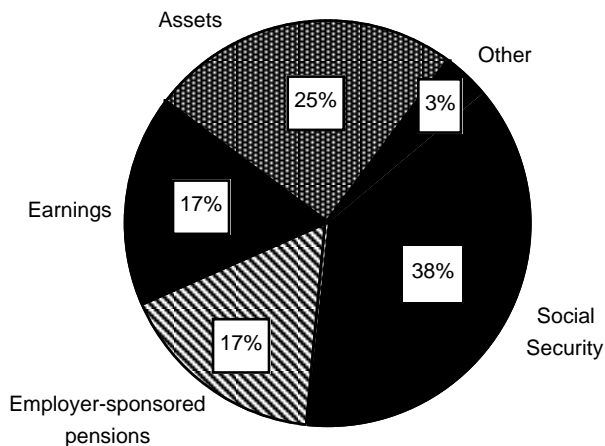
The 1972 amendments authorized automatic adjustment provisions in benefits, which linked the financial status of the Social Security program to increases in inflation. Indexing enables beneficiaries to keep pace with rising prices (Ball, 1985). First instituted in fiscal year 1975, cost-of-living adjustments (COLAs) are calculated to rise in relation to increases in the consumer price index for urban wage earners and clerical workers (CPI-W, more generally referred to as the CPI). The COLA is computed by comparing the arithmetical mean of the CPI from a designated three-month period during the last fiscal year in which there



Source: Susan Grad, *Income of the Population 55 or Older, 1988*, U.S. Department of Health and Human Services, Social Security Administration, pub. no. 12-11871 (Washington, DC: U.S. Government Printing Office, 1990).

^aAged units 65 and older are married couples living together—at least one of whom is aged 65 or older—and nonmarried persons aged 65 or older.

Chart 3
**Percentage Distribution of Income from All Sources
 for Aged Units 65 and Older, 1988**



Source: Susan Grad, *Income of the Population 55 or Older, 1988*, U.S. Department of Health and Human Services, Social Security Administration, pub. no. 12-11871 (Washington, DC: U.S. Government Printing Office, 1990).

was a COLA with the arithmetical mean of the CPI for the three-month period of the current fiscal year. Current law states that there will be a COLA if consumer prices rise by more than 0.1 percent.⁶

The 1977 amendments provided for additional indexation and automatic increases. Average wages provide the basis for the indexation of several key features of the Social Security program, including the benefit formula, the contribution and benefit base, the amount of earnings required for a quarter of coverage, and the amounts exempt under the retirement earnings test.

The size of monthly benefits for qualified beneficiaries varies in relation to the amount they contributed during their years of covered employment. Prior to the 1977 amendments, the benefit formula relied on the

⁶Prior to the Omnibus Budget Reconciliation Act of 1986, consumer prices would have to rise by more than 3 percent to initiate a COLA.

average monthly wage (AMW) of an insured worker. Generally, the AMW was calculated by adding nonindexed earnings between 1950 and the year before retirement or death and dividing the sum by the number of months during that period. The 1977 amendments provided for the indexing of earnings in the numerator by multiplying actual earnings by the average wage in the economy two years before a worker reaches age 62, becomes disabled, or dies. This is known as a worker's average indexed monthly earnings (AIME). The AIME is the basic unit in the benefit formula used to calculate a worker's monthly benefit or primary insurance amount (PIA). The PIA is the monthly benefit of an insured worker who begins to receive benefits at the normal retirement age, which is currently 65.

The benefit formula contains specific dollar amounts, or bend points, which are used in each of the AIME brackets. The bend points are indexed according to the growth in average wages. The formula for monthly benefits in 1991 is the sum of 90 percent of the first \$370 of AIME, 32 percent of AIME between \$370 and \$2,230, and 15 percent of any earnings over \$2,230.

Benefits paid to the families of retired, deceased, or disabled workers are computed using a similar formula based on the worker's average earnings. This formula is used to determine the maximum family benefit for insured workers' dependents and survivors. In 1991, for example, the maximum family benefit is computed by adding 150 percent of the first \$473 of the PIA, adding 272 percent of the PIA from \$473 through \$682, adding 134 percent of the PIA from \$682 through \$890, and adding 175 percent of the PIA over \$890.⁷

The age at which a person retires affects the size of his or her benefit because the PIA is linked to the normal retirement age. Specifically, persons who retire at the normal retirement age receive 100 percent of their PIA. Persons who retire before the normal retire-

⁷The benefit cannot be increased once the maximum benefit limit is reached, even if the number of entitled beneficiaries increases.

ment age receive benefits that are actuarially reduced by 5/9 percent for every month prior to age 65, reaching 80 percent of PIA at age 62.⁸ Persons who delay retirement until after the normal retirement age can earn delayed retirement credits (DRCs) amounting to an annual 3 percent benefit increase through age 70⁹ (table 2). For example, in 1990, a retired fully insured worker whose PIA was \$600 will receive \$600 per month at age 65, \$480 per month at age 62, and \$636 per month at age 67. Between the years 2000 and 2005, the normal retirement age will gradually rise to age 66 for persons who reach age 62 during that time. It will remain at age 66 until the year 2017, when the normal retirement age will begin rising again through the year 2022 to age 67 (table 3). In 1989 the average monthly benefit for a retired worker was \$540: \$610 for men and \$465 for women. The average monthly benefit for aged widow(er)s that year was \$500, and the average for disabled workers was \$530.

⁸The actuarially reduced benefit at age 62 will decline to 70 percent when the normal retirement age reaches 67 in the year 2022.

⁹A provision of the 1983 amendments provided for DRCs to rise incrementally to 8 percent after the year 2007.

Table 2
Changes in Delayed Retirement Credits Prior to 1982 through the Year 2008 and Later

Attain Age 65	Monthly Percentage Increase	Yearly Percentage Increase
Prior to 1982	1/12 of 1%	1%
1982–1989	1/4 of 1%	3%
1990–1991	7/24 of 1%	3.5%
1992–1993	1/3 of 1%	4%
1994–1995	3/8 of 1%	4.5%
1996–1997	5/12 of 1%	5%
1998–1999	11/24 of 1%	5.5%
2000–2001	1/2 of 1%	6%
2002–2003	13/24 of 1%	6.5%
2004–2005	7/12 of 1%	7%
2006–2007	5/8 of 1%	7.5%
2008 or later	2/3 of 1%	8%

Source: U.S. Department of Health and Human Services, Social Security Administration, *Social Security Handbook, 1988* (Washington, DC: U.S. Government Printing Office, 1988).

Table 3
Increases in Normal Retirement Age for Persons Reaching Age 62 in Each Year, Prior to 1999 and Later

Year of Birth	Year Reaching Age 62	Normal Retirement Age
1937 and before	1999 and before	65
1938	2000	65 + 2 months
1939	2001	65 + 4 months
1940	2002	65 + 6 months
1941	2003	65 + 8 months
1942	2004	65 + 10 months
1943–54	2005–16	66
1955	2017	66 + 2 months
1956	2018	66 + 4 months
1957	2019	66 + 6 months
1958	2020	66 + 8 months
1959	2121	66 + 10 months
1960 and later	2022 and later	67

Source: U.S. Congress, House, Committee on Ways and Means, *Overview of Entitlement Programs: 1990 Green Book* (Washington, DC: U.S. Government Printing Office, 1990).

Two additional components of the Social Security program influence the level of retirement income provided by Social Security: the earnings test and taxation of Social Security benefits.

Earnings Test—Social Security benefits are reduced if a beneficiary under age 70 works after retiring and earns income that exceeds specified amounts in any given year. In 1991, the earnings test requires benefit reductions of \$1 for every \$2 of earnings over \$7,080 for beneficiaries under age 65, and \$1 for every \$3 of earnings above \$9,360 for beneficiaries aged 65–70. These amounts are indexed annually. There is no limit on the amount individuals aged 70 and over may earn and still receive unreduced Social Security benefits.

Taxation of Benefits—Social Security benefits were not subject to federal, state, or local income taxes prior to the passage of the 1983 amendments. Beginning in 1984, up to one-half of Social Security benefits are included in taxable income above an unindexed threshold. For a single person, the threshold is \$25,000 per year (adjusted gross income). A \$32,000 threshold applies to married couples filing a joint return and to all

married taxpayers who live with their spouses any time during the tax year and file separately. If the income of the elderly population increases, the number of beneficiaries subject to such taxation would increase.

◆ Demographic Factors Affecting OASDI Financing

Demographic shifts affecting Social Security financing began after World War II. Fertility rates¹⁰ rose sharply (a period known as the baby boom), peaking at 3.6 in 1960, then sharply declined to 1.74 in 1976. At the same time, life expectancy increased. While in 1950 a 65-year-old man could expect to live an additional 12.8 years, in 1990 a 65-year-old man could expect to live an additional 15 years. For women, life expectancy at age 65 rose from 15.1 years to 18.9 in the corresponding years. As a result of these trends, the elderly dependency ratio (the ratio of persons aged 65 and over to those aged 18–64) is rising, indicating that there will be fewer active workers per beneficiary in the future. **By the time the entire baby boom generation (those born between 1945 and 1964) has reached at least age 65 (in the year 2030), the elderly dependency ratio in the Social Security system will have increased from the current ratio of one elder per 3.4 working age persons to a projected one elder per 1.9 working age persons.** This ratio may not significantly decline after the retirement of the youngest baby boomers because of increased life expectancy.

The baby boom generation is a disproportionately large cohort that is transforming the demographic composition of the U.S. population as it ages. In 1950, the median age of the population was 30.2; it fell to 27.9 in 1970 because of the large bulge of baby boomers, rising again to 30.6 in 1982 and to 33 in 1990. It is projected to increase to 36.3 in the year 2000 and to 40.8 in the year 2030 (Espenshade and Goodis, 1987). As the baby

¹⁰According to the Social Security Administration, the total fertility rate is defined as the average number of children that would be born to a woman during her lifetime if she were to experience the birth rate by age observed in, or assumed for, the selected year and if she were to survive the entire childbearing period.

boom generation passed through childhood, the percentage of children in the population rose from 34.4 percent in 1940 to 38.5 percent in 1960. Currently, the baby boom generation is aged 26–45 and constitutes a sizable proportion of the work force. The proportion of the population aged 65 and over is leveling out at around 12 percent and will begin to rise sharply again between the years 2010 and 2030 with the retirement of the baby boom generation.

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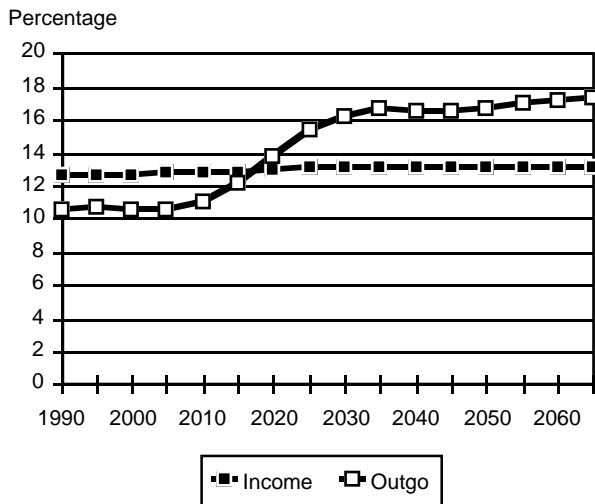
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The aging of the baby boom generation also influences the allocation of national resources. While baby boomers were children, the funds used to finance education rose from 3.2 percent of Gross National Product (GNP) in 1940 to 7.6 percent of GNP in 1975 (U.S. Department of Commerce, 1978). The United States is expected to devote an increasing share of resources to the population aged 65 and over in the next century because of the large bulge of baby boomers. **Thus, the Social Security program as a share of GNP is projected to grow from under 5 percent today to around 7 percent in the year 2030 (U.S. Department of Commerce, 1990). In addition, according to the II-B intermediate assumptions,¹¹ OASDI expenditures—currently approximately 10 percent of payroll—are projected to rise above 16 percent of payroll beginning in the year 2030 (chart 4).**

¹¹The trustees of the OASDI trust funds make projections concerning the trust funds using four alternative measures based on different sets of assumptions of economic and demographic conditions: the optimistic assumptions (I), the intermediate assumptions (II-A and the II-B), and the pessimistic assumptions (III). The II-B assumptions are most commonly used and are used in this discussion.

Chart 4
**Projected OASDI Trust Fund Income and Outgo
 as a Percentage of Payroll, 1990–2065,
 II-B Intermediate Assumptions**



Source: U.S. Department of Health and Human Services, Social Security Administration, *1990 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, DC: U.S. Social Security Administration, 1990).

It is significant that at the time when Social Security will consume a greater portion of resources generated by the economy of the time, the ratio of workers to beneficiaries will be the lowest in the history of the program.

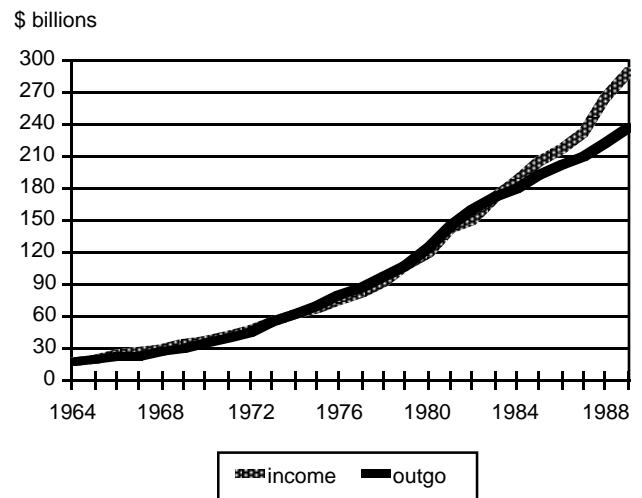
◆ Financing Social Security in the Future

In the late 1970s and early 1980s, outgo from the OASDI trust funds began to exceed income (chart 5). High inflation during the period triggered sharp increases in program expenditures because the benefit formula links the bend points to a rise in average wages in the economy. In addition, the size of annual COLAs is linked to increases in the CPI. As a result, Social Security beneficiaries received an unprecedented 14.3 percent increase in benefits in June 1980. High unemployment decreased the tax base and thereby reduced growth in payroll tax income. The 1977 amendments

moved up scheduled payroll tax increases, but the most significant of these were not scheduled to take effect until 1981 and later. In the meantime, economic performance steadily worsened.

In May 1981 the Reagan administration issued a proposal that called for the reduction of Social Security benefits to compensate for projected OASDI shortfalls. Congressional and public disapproval of this proposal prompted the president to appoint the National Commission on Social Security Reform in December 1981 to study the program's financing problems and provide solutions. The commission's report later became the blueprint for the 1983 amendments. The amendments' provisions included raising the normal retirement age, delaying the annual COLA by six months, accelerating payroll tax increases, increasing the contribution rate of the self-employed, and taxing 50 percent of the benefits of recipients with incomes above a specified unindexed threshold (Burtless, 1988).

Chart 5
OASDI Income and Outgo, 1964–1989^a



Source: U.S. Department of Health and Human Services, Social Security Administration, *Social Security Bulletin: Annual Statistical Supplement, 1989* (Washington, DC: U.S. Government Printing Office, 1989).

^aUnpublished 1989 data from the Office of the Actuary, Social Security Administration.

The most important outcome for OASDI financing from the 1977 and 1983 amendments is that the pay-as-you-go financing schedule was replaced with partial reserve financing, which is generating the build-up of reserves in the OASDI trust funds.

Growth in the OASDI Trust Funds

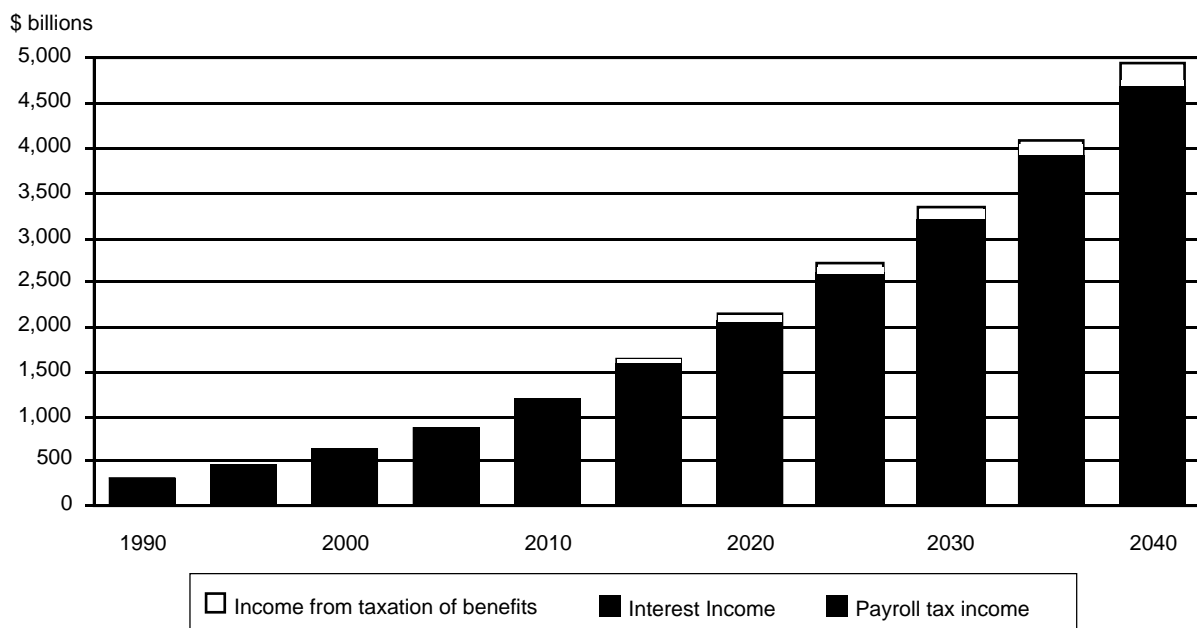
Although under current law OASDI payroll taxes will remain at the combined employee-employer rate of 12.4 percent, income to the trust funds is projected to rise. One reason is that the proportion of workers in Social Security covered jobs in relation to the current beneficiary population is disproportionately large and is thus generating surplus payroll tax revenue. At the same time, sizable interest earnings are projected. In addition, the taxation of benefits above an unindexed threshold is projected to contribute to a build-up.

Current law stipulates that reserves in the OASDI trust funds are to be invested solely in special issue U.S. Treasury securities. According to intermediate assumptions, income to the funds from interest earnings will account for 22 percent of income in the year 2020, compared with 5 percent today (chart 6).

In fact, income to the OASDI trust funds including interest earnings is projected to be more than 16 percent of taxable payroll between the years 2015–2025. Income excluding interest earnings is projected to remain at around 12 percent of taxable payroll (chart 7). **In addition, it is estimated that interest earnings will delay the projected date by which the trust funds will begin experiencing negative annual balances.**

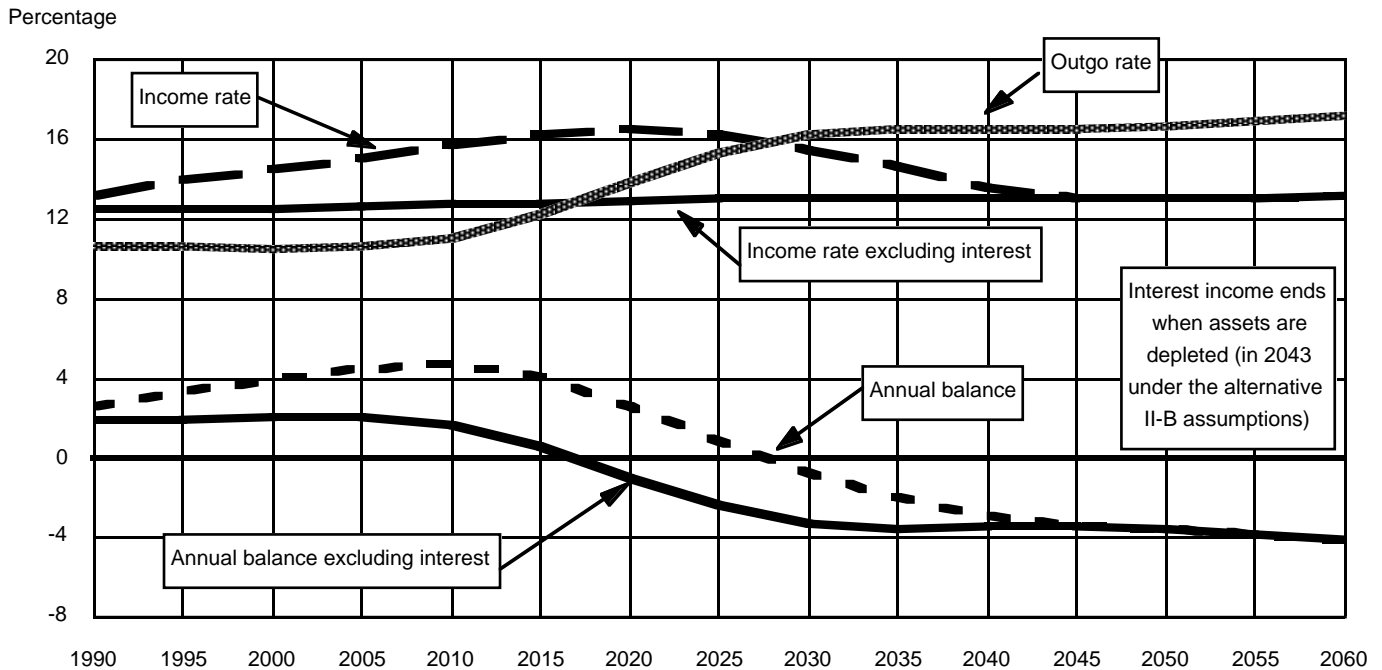
The taxation of benefits is also projected to increase income to the OASDI trust funds. Benefits are taxed through the general income tax, and proceeds are

Chart 6
Projected Income to the OASDI Trust Funds in Current Dollars, 1990–2040, II-B Intermediate Assumptions



Source: U.S. Department of Health and Human Services, Social Security Administration, *1990 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, DC: U.S. Social Security Administration, 1990).

Chart 7
**Long-Range Income and Outgo and Annual Balance of the OASDI Trust Funds
as a Percentage of Taxable Payroll, Alternative II-B Assumptions**



Source: U.S. Department of Health and Human Services, Social Security Administration, *1990 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, DC: U.S. Social Security Administration, 1990).

delivered to the OASDI trust funds. In 1990, the taxation of benefits represented 2.1 percent of total income; this proportion is projected to rise to nearly 5.5 percent by the year 2040 because more beneficiaries will have annual incomes above the unindexed threshold (chart 6).

The trustees for the OASDI trust funds issue an annual report indicating the trust funds' future financial security in the near term (5 years) and the long term (75 years). In 1989, according to the report, the OASDI trust funds accumulated an additional \$52.4 billion, resulting in a total of \$156.7 billion. **The funds are projected to continue to grow into the next century and then decline during the baby boom generation's retirement.** The contingency fund ratio,

which is large enough to pay benefits in the event of unexpected adverse economic conditions that jeopardize the rate of income and outgo, is also projected to rise and later to decline during the baby boom's retirement (according to all except the optimistic alternative I assumptions) (chart 8).

OASDI Financing Alternatives

Policy interest in OASDI financing arises from concern about the long-term viability of the Social Security program and its effect on national saving. Financing debates often relate program viability to national saving on the assumption that the investment and productivity growth associated with savings are essential to the maintenance of living standards for an

aging population. Alternative approaches to OASDI financing include pay-as-you-go, full funding, and some combination of the two.

Pay-as-you-go financing was generally used before the 1977 amendments were enacted. Under this plan, annual income to the OASDI trust funds is projected to approximate annual outgo, making the trust funds vulnerable to income and outgo fluctuations. Therefore, there is usually a provision requiring an adequate contingency reserve fund. Opinion differs as to what constitutes an adequate reserve, with debate centering on whether a reserve sufficient to pay 12 months or 18 months of benefit obligations is ideal.

Full funding is generally the financing mechanism used by private pension funds. It calls for the accumulation of reserves equivalent to current liabilities. In other words, a plan that is fully funded has enough reserves to

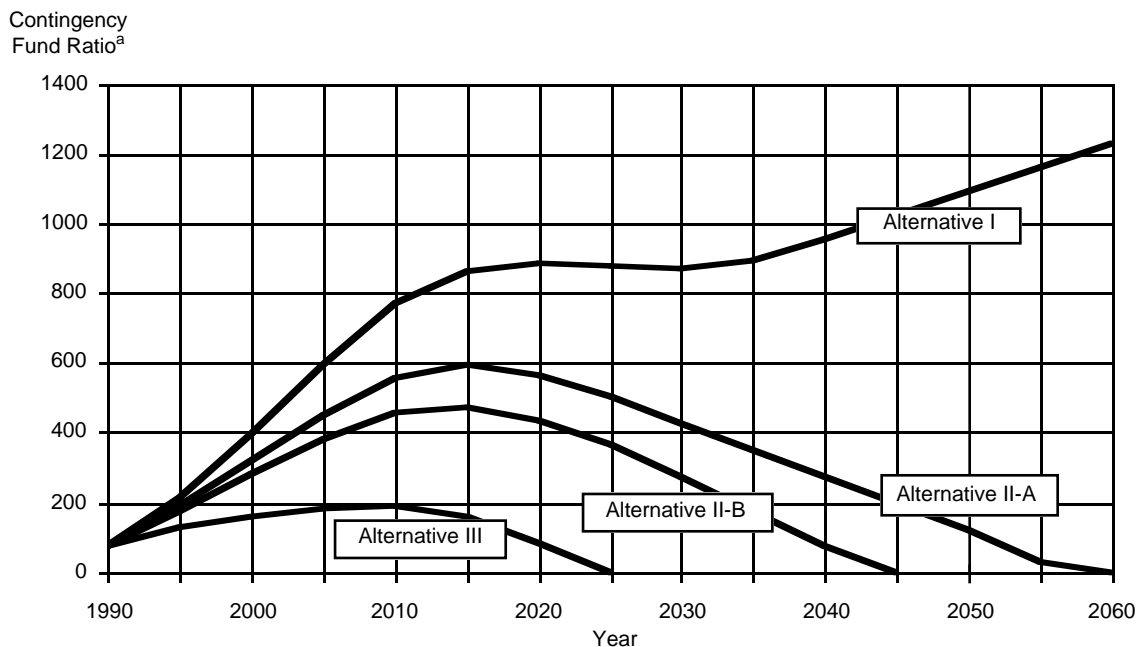
pay all earned benefits and does not require the transfer of funds from one generation to the next.

The partial reserve approach embodied in current law is a combination of pay-as-you-go and full funding. Under this approach, the baby boom cohort's retirement benefits will be financed in part by the accumulated reserve attributable to the cohort's own OASDI contributions and, in part, by the contributions of future workers.

Financing strategies falling at different points along the continuum from pure pay-as-you-go financing to full funding may have different implications for national saving and program viability.

OASDI and Saving—National saving includes personal saving, business saving, and the surpluses or deficits of

Chart 8
Ratio of Assets to Disbursements in the OASDI Trust Funds, Alternative Actuarial Assumptions, 1990–2060



Source: U.S. Department of Health and Human Services, Social Security Administration, *1990 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, DC: U.S. Social Security Administration, 1990).
^aRepresents assets at the beginning of the year, plus advance tax transfers, as a percentage of disbursements during the year.

state and local governments and the federal government. **The national savings rate was generally lower during the 1980s than it was during the two preceding decades, largely as a result of persistent, large federal deficits.** Some economists argue that national saving should be increased. Productivity decreased in the early 1970s, while government dissaving dramatically reduced national saving during the 1980s. Some argue that a strong and growing economy would lessen the economic burden of supporting the large retiree population by increasing earnings and productivity (Burtless, 1989).



Under OBRA '90 Congress removed the OASDI trust fund operations from deficit calculations for purposes of meeting Gramm-Rudman-Hollings targets.



The Social Security program affects national saving. Because the program promises retirement income payments, individuals may elect to save less than they would in the absence of the program; thus, OASDI may reduce personal saving. Under pay-as-you-go financing, in which income equals outgo, this reduction in personal saving would not be offset by an increase in net federal saving. Under the current partial reserve financing approach, in which income exceeds outgo, reductions in personal saving may be offset—if the accumulation of OASDI reserves in fact represents net federal saving.

Because OASDI surpluses are invested exclusively in Treasury securities and the non-OASDI budget remains in deficit, the Treasury is effectively borrowing from the trust funds to finance current spending.

Prior to the enactment of OBRA '90, deficit targets under Gramm-Rudman-Hollings were specified in

terms of the unified federal budget. That is, the non-OASDI federal budget and the operation of the OASDI trust funds were combined for purposes of computing the deficit. Critics contended that OASDI surpluses did not reduce the deficit, and therefore did not contribute to national saving. In the absence of these surpluses, other government spending might have been cut or other taxes raised. In other words, OASDI surpluses were not dedicated to deficit reduction, but instead were used to finance current spending and/or cuts in non-OASDI taxes, according to critics.

Partly to address this concern, under OBRA '90 Congress removed the OASDI trust fund operations from deficit calculations for purposes of meeting Gramm-Rudman-Hollings targets. Advocates of this approach contend that focusing separately on the non-OASDI budget deficit will preclude or discourage policymakers from considering OASDI surpluses when evaluating the level of resources available for non-OASDI federal programs. In this scenario, OASDI surpluses will reduce overall federal dissaving, and therefore contribute directly to national saving.

Long-Term Viability of OASDI—According to intermediate projections, under current law the OASDI trust funds will begin to run a deficit just prior to the year 2020. At that time, benefit payments will be financed in part by drawing down the accumulated reserve. Because the reserve will consist entirely of Treasury securities, this money will be drawn from the non-OASDI budget. Critics emphasize the substantial challenge this will pose for the Treasury's general fund. Treasury must raise this money either through non-OASDI taxes, new borrowing, or non-OASDI spending cuts.

To meet this challenge, some recommend the reduction or elimination of the non-OASDI budget deficit, which would raise national saving and thus foster productive investment and long-term economic growth. **A larger economy would provide a broader tax base from which Treasury could raise non-OASDI tax revenues and would also increase payroll tax revenue to the**

OASDI trust funds. In addition, a balanced non-OASDI budget combined with OASDI surpluses could facilitate the retirement of some unified federal debt, possibly clearing the way for future Treasury borrowing.

In the absence of such fiscal restraint, the OASDI program's long-term viability may be called into question. Slower growth of the tax base and additional growth in the federal debt burden could point to an eventual need for benefit cuts. If surplus OASDI taxes loaned to the Treasury to finance current non-OASDI spending are not subsequently repaid in the form of nonreduced benefits for future retirees, the traditional political balance between regressive taxes and progressive benefits in the OASDI program might be upset. The prospect of such an outcome has prompted questions about the appropriateness of loaning OASDI tax surpluses to the Treasury while non-OASDI deficits persist.



Moynihan's proposal garnered considerable attention and forced Congress to reexamine Social Security funding and the use of the OASDI trust funds to reduce the size of the federal budget deficit.



At present, experts differ as to what is the most appropriate financing approach for OASDI. Some support cutting payroll taxes and returning to a pay-as-you-go financing schedule. They argue that advance funding would have several negative consequences. First, large reserves in the trust funds would be available to fund excessive general fund spending. Second, Congress might be tempted to liberalize benefits, raising the program's long-term costs. Third, the reserves in the trust funds could absorb the entire national debt, thereby limiting the amount of funds available to general investment markets (Myers, 1989).

Others contend that there is no best method of financing Social Security over the next 75 years. They maintain that the program can operate equally well as a prefunded or as a pay-as-you-go system. However, they suggest that a prefunded system may be more beneficial for the economy because the trust fund reserves may lessen the burden of supporting future generations of retirees (Munnell, 1989).

The 1991 Advisory Council on Social Security, a quadrennial council established, in part, to review the status of the Social Security program, released its *Interim Report on Social Security and the Federal Budget* in July 1990. The council rejected a reduction of the contribution rate and a return to pay-as-you-go financing. It supported the continuation of partial reserve financing and recommended a major reduction in the size of the non-Social Security portion of the federal budget.

◆ Policy Proposals

Recent public policy attention has focused on the inclusion of the OASDI trust funds in the federal budget. According to the director of the Congressional Budget Office (CBO), the inclusion or exclusion of these funds in the federal budget has no effect economically, the important factor being the true size of the federal deficit (Reischauer, 1989). Another view holds that the entire unified budget, including the OASDI surplus, must be examined when debating fiscal policy (Rivlin, 1989). On the other hand, some believe that it may be politically easier to reduce the deficit if the public is made aware of its true magnitude, excluding the OASDI reserves. **It is for this reason that the 1991 Advisory Council on Social Security recommended that Social Security be removed from deficit reduction calculations. OBRA '90, approved by Congress on October 27, 1990, and signed by the president on November 5, accomplished this.**

Prior to OBRA '90, the trust funds were included in the unified budget and were figured into budget deficit calculations. Essentially, this made the federal deficit

appear smaller than it really was because the building surplus in the OASDI trust funds progressively offset the non-OASDI budget deficit. In fact, the unified budget deficit in fiscal year 1990 was \$161.8 billion; excluding the OASDI trust funds, however, the deficit amounted to \$220.4 billion (Uchitelle, 1990).

In addition, OBRA '90 established a five-year, pay-as-you-go system for taxes and entitlement programs. This means that any legislation that expands an entitlement program by increasing federal spending or reducing federal revenue must either increase taxes to compensate for the lost revenue or reduce spending in another entitlement program by a corresponding amount. Any cuts in Social Security taxes must therefore be accompanied by an equal cut in Social Security benefits, cuts in another entitlement program, or increases in taxes.

OBRA '90 also increased the maximum earnings subject to the 1.45 percent Medicare Hospital Insurance tax to \$125,000 in 1991 (up from \$51,300 in 1990). **Some observers anticipate that policymakers will suggest that the maximum taxable earnings for the OASDI program be increased as well.**

In addition to the provision enacted in OBRA '90, several proposals dealing with the removal of the OASDI trust funds from Gramm-Rudman-Hollings budget deficit calculations and the reduction of payroll taxes were introduced during the last session of Congress.

Moynihan Proposals—In January 1990, Sen. Daniel Patrick Moynihan (D-NY) introduced a proposal (S. 2016) to cut back Social Security payroll taxes and return to a pay-as-you-go financing schedule. **His proposal garnered considerable attention and forced Congress to reexamine Social Security funding and the use of the OASDI trust funds to reduce the size of the federal budget deficit.** His proposal would rescind the 0.14 percent tax increase of January 1990, reduce the tax rate on covered workers and their employers by an additional 0.96 percent in 1991, and

legislate a pay-as-you-go financing schedule after 1991. The rate would gradually rise to 6.2 percent during the period 2015–2019, to 7.0 percent during 2020–2024, to 7.7 percent during 2025–2044, and to 8.1 percent in the year 2045 and beyond. According to the Social Security Administration, Moynihan's proposal would cut OASDI revenue by \$568 billion between 1990 and 1998 (U.S. Department of Health and Human Services, 1990a).

Moynihan has suggested that using the surpluses in the trust funds to finance general operations of the federal government is a misuse of the funds and particularly unfair to lower earning workers because of the regressive nature of payroll taxes. Furthermore, he criticized the marked rise in the regressivity of the U.S. tax structure over the past 10 years, stating, "The United States almost certainly now has the most regressive tax structure of any Western nation" (Moynihan, 1989).

One economist has agreed with Moynihan that it is inappropriate to use regressive payroll taxes to finance non-Social Security programs because it violates the agreement among payroll tax payers who believe they are making contributions to their generation's retirement benefits. However, the economist has maintained that cutting payroll taxes would increase the federal budget deficit and ultimately discourage investment (Rivlin, 1990).

Moynihan released a revised proposal (S. 3167) in August 1990 in which he advocated spreading Social Security tax cuts over a five-year period. Specifically, the proposal calls for reducing the current OASDI payroll tax rate from 6.2 percent to 6.0 percent in 1991, to 5.8 percent in 1992, to 5.6 percent in 1993, to 5.4 percent in 1994, and to 5.2 percent between 1995 and the year 2009.

The Senate effectively prevented passage of Moynihan's revised proposal on October 10, 1990, failing to give it the three-fifths majority vote required to waive a procedural block against voting on legislation that would result in lost federal revenue once the Senate has passed a budget resolution.

Hollings Plan—Sen. Ernest F. Hollings (D-SC) issued a proposal (S. 2084) in January 1990 to repeal the 1990 payroll tax increase and to cut the tax rate thereafter. Unlike Moynihan, Hollings called for a value-added tax to compensate for the reduction in general revenue. His proposal includes cutting payroll taxes from 6.2 percent to 5.1 percent, reducing the capital gains rate to 15 percent for stocks and bonds, restoring the tax deduction for individual retirement accounts, adding tax credits for research and investment, reintroducing revenue sharing earmarked for education, and enacting a 5 percent value-added tax.

Kasten Plan—Sen. Robert Kasten (R-WI) also has supported reducing the Social Security payroll tax. Under his proposal (S. 2052), the rate would be retroactively reduced from 6.2 percent to 5.9 percent. It would be further reduced to 5.6 percent in 1991 and to 5.3 percent in 1992.

◆ Conclusion

The Social Security program is widely credited with reducing the percentage of the elderly with incomes below the poverty line and for providing the foundation of income support for the majority of retired and disabled workers as well as for their dependents and survivors.

Historically, public support for Social Security has been strong. However, the results of two recent EBRI/Gallup polls suggest that Americans are divided about the program's future. On the one hand, a majority of Americans support the Social Security program. In fact, nearly three out of five respondents indicated that the Social Security program is "very important" or "one of the most important programs" to themselves personally, and a majority (57 percent) indicated that they are opposed to cutting Social Security payroll taxes. An even greater percentage (69 percent) of respondents opposed a reduction in Social Security payroll taxes if it required an increase in other taxes in the next year. Yet the majority of nonretired respondents said they did not expect Social Security benefits to be their major source

of retirement income. Specifically, 50 percent said they thought Social Security benefits would only provide about one-third or less of their retirement income, while 75 percent thought it would provide 50 percent or less.

The EBRI/Gallup poll also indicated that the American public may be receptive to structural changes in the program's administration. For example, nearly one-half (49 percent) of respondents favored applying either all or a portion of Social Security taxes to individual retirement accounts in their name.

Moreover, in another EBRI/Gallup poll, nearly one-half (47 percent) of all respondents stated that they did not think that the Social Security system will be able to pay them a benefit when they retire. Confidence in the Social Security system was greater among older respondents. Forty-six percent of 18–34-year-olds and 47 percent of 35–54-year-olds said that they expect to be paid a benefit, while among those close to retirement age (aged 55 and older) 76 percent expected payment.

Current public concern about the Social Security program, at a time of accumulating reserves and a strong ratio of workers to beneficiaries, suggests that public support for the program may decline in the next century, when the cost of the program is projected to be greater. Maximum taxable earnings in the OASDI program may rise, and an increasing proportion of beneficiaries may face income taxation of benefits as their incomes rise above the unindexed threshold.

As the U.S. population ages, the Social Security program must evolve in order to accommodate changing needs and circumstances. At issue is whether the public will continue to support the transfer of resources to the elderly as this population grows from approximately 12 percent to a projected 22 percent of the total population and workers are required to contribute more resources to the program but receive less in return. Another question is whether the American public will accept 67 as the normal retirement age.

Taken together, today's issues suggest that the formulation of a national retirement income policy that incorporates Social Security benefits, private pensions, and individual savings will become an important national policy issue.

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