

## The Future of Social Security

By WILLIAM C. BIRDSALL and JOHN L. HANKINS

**ABSTRACT:** Social security has been the most, perhaps the only, popular social welfare program in the United States. Until recently it has steadily expanded in coverage, beneficiaries, and costs with little fanfare or notice. Since the mid-1970s that expansion has begun to threaten its financial soundness. Literal bankruptcy has become a short-run possibility as expenditures continually outrun receipts. Worse, in some respect, is the realistic possibility that the retirement costs of the baby-boom generation in the twenty-first century may be too great a burden for future workers to bear. How well social security has done, is doing, and is projected to do are analyzed in terms of the system's twin goals of adequacy and individual equity. Options for change are severely limited by our stumbling economy and the high costs of a mature pension system. It is not likely that the traditional groups and alliances that played important roles in the expansion of social security will play predictable roles in its retrenchment.

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**S**Ocial security had its origins with the Committee on Economic Security, mandated by President Roosevelt during the Great Depression to find a permanent solution to the problems that were being addressed by the National Recovery Act. The committee reported to the president in January 1935 and stated its primary long-run goal in eloquent words:

A program of economic security, as we envision it, must have as its primary aim the assurance of an adequate income to each human being in childhood, youth, middle age, or old age—in sickness or in health. It must provide safeguards against all the hazards leading to destitution and dependency.<sup>1</sup>

The Social Security Act was the direct product of that report. What is today known as social security was only one part of a larger piece of social welfare legislation that also included aid for children in indigent families and unemployment insurance. The social security section of the act addressed the problem of inadequate savings and the lack of financial security in retirement. By 1935 one-half of the banks in America had failed; stock values had plummeted. Savings were lost. To cope with this problem the act set up, over 20 years, an earnings insurance system so that the cessation of earnings would not result in a cessation of income, whether due to retirement, death, or disability. This program—Old Age, Survivors, and Disability Insurance (OASDI)—was consciously intended to be in contrast to the welfare programs in three respects. First, the amount of the benefit depended on past earnings. Second, it was financed by the employees and employ-

ers themselves via an earmarked tax and thus was, in some sense, an earned benefit. Third, the benefits were not subject to the nefarious means test.

Two notes on the ideological flavor of Old Age Insurance (OAI). First, contrary to what some analysts assert and assume, it was not, even in its first version, purely oriented to individual equity wherein each worker would get back the actuarial value of his or her contribution. It was a combination of a tax—a slightly regressive but roughly proportional one—and a progressive benefit formula, sharply favoring the low earner and slightly favoring the median earner.

Furthermore, there is every reason to think that its framers were only waiting for the Supreme Court's approval to initiate benefits for the retired worker's wife—later, spouse—children, and parents. This extension of coverage occurred in 1939 and was clearly motivated by the goal of social adequacy; that is, establishing a system that provided a benefit commensurate to need. Adequacy was not allowed to run rampant; a maximum family benefit was also inaugurated to keep the family benefit below previous earning. The hazard of the worker's death was also covered in 1939 with the inauguration of Survivors Insurance (SI). The 1939 amendments also altered the formula by which benefits were calculated in a way that resulted in a benefit increase. All this was possible without raising taxes because revenues from the earmarked tax proved higher than were originally predicted in 1935.

The ten years from 1940 to 1950 were characterized by very high employment and low retirement rates. By 1950, due to tight labor markets and growing wages, the system was bringing in more

1. Committee on Economic Security, *Report to the President* (Washington, DC: Government Printing Office, 1935).

revenues than expected. The benefit formula was outdated by the accompanying inflation; if left unchanged the formula would have provided very low benefits in terms of real purchasing power. In 1950 this was adjusted for by giving retirees a new start in 1951, letting their benefits be based on post-1950 earnings. Then, as inflation continued, beginning in 1955 retirees were able to drop their lowest five years of earnings in calculating their average monthly wage, which was an indirect method of increasing benefits. Periodically for the next 17 years, usually in an election year, benefits were improved in dollar terms, roughly keeping pace with inflation.

#### SOCIAL SECURITY'S FINANCIAL STRUCTURE

Social security is financed by a proportional tax on earnings up to a maximum annual amount. This began as a 1 percent tax levied on both the employer and employee on earnings up to \$3000; this tax financed OAI and SI. Tax rates for Disability Insurance (DI) and Medicare (HI) were added. The base grew in amount irregularly and, from 1937 to 1965, very slowly. The self-employed were taxed beginning in 1951, at three-fourths the combined employer/employee rates. By 1983, the separate employer/employee rate reached 6.7 percent—4.775 percent for OASI; 0.625 percent for DI; 1.3 percent for HI—levied on the first \$37,200 of earnings. The revenues from this tax are deposited by the U.S. Treasury into trust fund accounts, one for each type of insurance, OASI, DI, and HI. Congress displayed a legislative ambivalence about the function of these trust funds concerning whether they were intended to build large reserves or to be temporary buffers. De facto they

became buffer funds as the ratio of funds to outgo steadily declined over the period since 1950. By 1981 the funds ratio of assets to annual outgo had declined to 18 percent for OASI, 21 percent for DI, 45 percent for HI, and to 29 percent for the three funds combined.

There were two very important changes in the Social Security Act in 1972. The act was amended to change welfare for the aged, the blind, and the disabled from a federal-state partnership to a federal program with states supplementing the benefit. This program is called Supplemental Security Income (SSI). Among means-tested programs it was and is unprecedented in its generosity. The maximum transfer one could receive was set at 80 percent of the poverty threshold for couples and 70 percent for single persons. SSI disregards the first \$20 per month of unearned income, but is lowered dollar-for-dollar for any income above that, including income from social security. This program now supports a little over 2 million aged persons, 75 percent of whom also receive social security.

The second important change in social security in 1972 was the enactment of an automatic cost-of-living adjustment (COLA) by which benefits were to rise each year by the percentage change in the consumer price index. To finance the COLA, the tax base was scheduled to rise each 1 January by the percentage increase in average wages. Since wages had historically grown by about 2 percent more than prices, this should have been more than adequate financing for the COLA.

#### *The short-run problem: stagflation*

The first year of the automatic COLA, 1974, set the theme for the

decade. The inflation rate, 10 percent, was double digit for the first time since 1947. Wages, instead of growing by two percentage points more than prices, grew by two points less than prices. This is the now familiar phenomenon of stagflation, which is the combination of rising prices—inflation—accompanied by stagnation, manifested in high unemployment and low or no real wage growth. Stagflation is perverse for a payroll-tax-financed pension system with benefits tied to the growth of prices and with revenues tied to the growth of wages. The inflation side of it fuels large benefit increases. But this takes place in the absence of high employment and growing wages. The worse the stagflation the greater the gulf between the automatic benefit increase and lagging revenue growth. This imbalance then threatens to break the trust funds. This is the short-range problem.

The 1977 amendments were designed to remedy this imbalance. The main element in restoring short-term soundness was large jumps in the taxable maximum, much more than would have occurred automatically. These provisions failed because they assumed that stagflation was temporary and would abate, when in fact it worsened. The COLA rose above 14 percent, real wages grew little or sporadically, and unemployment became double digit and stubborn.

As early as 1979 it became clear that the OASI Trust Fund would run out in 1983 or 1984.<sup>2</sup> By 1981, it was clear that unless at least interfund borrowing was allowed in 1982, technical bankruptcy of the OASI fund could occur in 1982 or

1983. This borrowing was provided in the Omnibus Budget Reconciliation Act of 1981.<sup>3</sup> However, this was only a stopgap measure.

*The long-run problem:  
demographic shifts*

The social security system also faces a very serious long-run problem. Table I presents a series of alternative futures based on a number of key economic and demographic assumptions drawn up by the social security staff. The upper part of Table I contains four of the most important assumptions affecting social security performance. These assumptions are given for four alternative futures. The last column contains the actual figures for these factors in 1980.

Alternative I presents the most optimistic future, alternatives II-A and II-B share the same demographic assumptions—slightly more pessimistic than alternative I—but II-A uses more robust economic performance assumptions than II-B. Alternative III uses what might be considered a very pessimistic set of factors.

The long-run problem can be seen in the last two rows in Table I. In all but the most optimistic of assumptions, alternative I, the system begins to show an imbalance between revenues and expenditures that results in system bankruptcy. The most pessimistic assumption, alternative III, predicts system bankruptcy by 1985. The second row from the bottom in Table I describes the

2. Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, *1979 Annual Report* (Washington, DC: Government Printing Office, 1979).

3. This act reduced costs somewhat by such steps as revoking the minimum benefit for future retirees and revoking college students' survivors benefits, but these changes do not account for much saving. See "History and Provision to the Old Age, Survivors, Disability, and Health Insurance Program," *Social Security Bulletin Annual Statistical Supplement* (1981).

cost of OASDI as a percentage of taxable payroll. Excluding alternative I, OASDI is predicted to cost anywhere from 15 to 28 percent of taxable payroll by the year 2060. Taken together, these projections suggest that within 75 years the social security system, as it is currently structured, will face almost certain bankruptcy even with a social security—OASDI—payroll tax rate of 12.40 percent.

The cause of the long-run problem is found primarily in the changing demographics of the next 50 years. The best

measure of the demographic effects is the dependency ratio, the ratio of retired workers—those drawing benefits—to active workers—those making contributions. This ratio is of importance due to the fact that the social security system is dependent on pay-as-you-go financing. That is, the active worker's contribution is used to finance the retired worker's benefit. This is in contrast to a deposit-type system in which the worker's contribution builds up a fund with interest to be withdrawn years later as a retirement benefit by that same worker.

TABLE 1  
THE LONG-RUN IMPACT ON SOCIAL SECURITY OF ALTERNATIVE  
ASSUMPTIONS OF ECONOMIC AND DEMOGRAPHIC VARIABLES (Percentage)

	Alternative I	Alternative II-A	Alternative II-B	Alternative III	1980 (actual)
Assumptions for the Year 2000 and Beyond					
Real gross national product increase	3.5	3.1	2.6	2.1	-0.2
Consumer price index increase	2.0	3.0	4.0	5.0	13.5
Unemployment rate	4.0	5.0	5.0	6.0	7.1
Fertility rate	2.40	2.10	2.10	1.70	1.84
Measures of Impact in the Year 2060					
Beneficiaries as percentage of covered workers	38	50	50	80	31
Cost of OASDI as percentage of taxable payroll	11.1	15.63	16.81	28.49	10.72
OASDI trust fund ratio*	8.60	Trust funds depleted in 2040	Trust funds depleted in 2030	Trust funds depleted in 1985	.21

SOURCE: Compiled from Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, *1982 Annual Report* (Washington, DC: Government Printing Office, 1982), tabs. 10, 11, 28, 29, and 32.

\*Assumes a legislated tax rate of 12.4 percent from 1990 through 2060.

Under both low-fertility—unfavorable—and high-fertility—favorable—projections, the dependency ratio increases until about 1990. The active workers during this period are made up primarily of the post-World War II baby-boom generation. The retirees during this time are their parents.

Beginning about 1990 and continuing until 2010 the ratio decreases rather sharply. Due to the very large size of the baby-boom generation that will then be the workers, the system is able to enjoy large contributions to a decreasing number of beneficiaries during this period. The average baby boomer—born in 1950, for instance—will not begin to consider retirement until at least 2010, age 60.

Unfortunately, major problems beset the system when this generation does begin to retire in 2010. The ratio begins to rise very steeply. This is due to the large size of the baby-boom generation coupled with the relative scarcity of workers due to the low fertility rate of this group.

The importance of the fertility rate is clear in Table 1. Compare row 4, the fertility rate assumptions, with row 5, beneficiaries as a percentage of covered workers. This shows the great sensitivity of the dependency ratio with respect to our fertility rates. The relationship is ominous in its implications. If the fertility rate should fall slightly from the present rate of 1.84 to 1.7, the dependency ratio will be 4 beneficiaries for every 5 workers, or 80 percent, an impossible burden for the social security system. In order to attain 1 beneficiary to 2 workers—a 50 percent dependency ratio—the fertility rate must rise to the zero-population-growth rate of 2.1.

Understand that the alternatives shown here simply predict system performance given a certain combination of demographic and economic factors. In the real world these factors are interrelated and would vary in systematic ways. For instance, declining fertility would also result in a declining unemployment rate since progressively fewer new workers would be entering the labor force. The alternatives displayed in Table 1 do not reflect these relationships; and while it is possible that the outcomes shown here might, in fact, emerge, it is highly unlikely that they would do so as a result of the specific values presented here. However, while Table 1 is not entirely realistic in its representation of the future, it is extremely useful in that it provides some idea of social security's performance within the context of a variety of economic and demographic conditions.

Two other factors should be considered when discussing the long-range problems of the social security system. The first of these is a steady increase in life expectancy. Over the next 80 years the life expectancy for women is likely to increase 6.1 years, from 78.0 to 84.1 years of age. The life expectancy for men will increase 5.3 years, from 70.1 to 75.4, over the same time period. This phenomenon can only raise costs as the system is presently structured.

The second problem concerns long-term economic growth. The benefits that the system provides today are due primarily to system changes that were instituted as a result of economic expansion in the 1960s. Unless the economy resumes its former high levels of growth, the social security system simply cannot, over the long run, continue

to maintain the level of benefits available today.<sup>4</sup>

SOCIAL SECURITY SYSTEM  
PERFORMANCE: ADEQUACY  
AND EQUITY ISSUES

Traditionally the goals of social security have been described as social adequacy, the provision of a benefit commensurate with need, and individual equity, the provision of a benefit commensurate with contributions. It is important to give particular attention to adequacy because we are apt to assume that the rise in social security benefits over the last decade has resulted in a system that is overly generous.

*Social adequacy*

There are myriad ways in which adequacy can be measured.<sup>5</sup> With appropriate caveats the official U.S. poverty statistics are the best source for providing both a recent view and a historical perspective.

Table 2 displays the rates of incidence of poverty and other measures of affluence for the nonaged, the aged, and subgroups of the aged. The data are for 1981. The official poverty thresholds underlie all these numbers.

4. For a detailed discussion of this issue, see Peter G. Peterson, "Social Security: The Coming Crash," *New York Review of Books*, no. 19, pp. 24-39 (2 Dec. 1982).

5. Moon, for example, studies the effect on poverty and the income distribution of the aged of adjusting their incomes for the annuity value of their assets, for in-kind benefits, and for intra-household transfers. See Marilyn Moon, *The Measurement of Economic Welfare* (New York: Academic Press, 1977). See also Sheldon Danziger et al., "Income Transfers and the Economic Status of the Aged" (Paper delivered at NBER Conference on Research in Income and Wealth, Madison, WI, May, 1982).

The second column of figures, labeled "Poor (under 1.0)," gives the percentage of the demographic groups that are poor, that is, whose ratio of gross money income to the respective poverty threshold is less than 1. We see that the 13.9 percent poverty rate of the nonaged is less than the 15.3 percent rate of the aged. These are two reasons for being very cautious about concluding from this that the aged are worse off than the nonaged. First, there are analysts who reasonably argue that the measure of need is somewhat more generous for the aged and that their income is underestimated. Second, the first column shows us that extreme poverty is rarer among the aged, at 6.3 percent, than among the nonaged, at 9.4 percent.<sup>6</sup>

More significant than any comparison of overall poverty rates for aged versus nonaged is the contrast in rates for subgroups of the aged. Families headed by an aged person tend to do better than families with a nonaged head, while people living alone—usually widowed or divorced, usually female, usually somewhat older—have much higher rates of being very poor—12.1 percent—or poor—29.8 percent—than either aged families—4.0 percent very poor and 9.1 percent poor—or nonaged individuals—9.4 percent very poor and 13.9 percent poor.

If aged families are less likely to be poor than the nonaged, largely they are still close to poverty. This can be seen from the fact that 23 percent of aged families and of the nonaged are near poor or worse off; that is, they have incomes below 150 percent of their

6. The term "extreme poverty" refers to 75 percent of the official thresholds and assumes that we are using \$7000 as the need measure for a family of four; \$4100 for an aged couple; and \$3300 for an aged single person.

poverty threshold. For the aged living alone, nearly three-fifths—57.9 percent—are near poor or worse.

Economists are fond of reminding us to look at the whole distribution of income, not just the bottom.<sup>7</sup> The column labeled “Comfortable” is an effort in that direction. It gives the percentage of persons or aged families whose income is at least three times its respective poverty line. While nearly half—44.1 percent—of the nonaged are comfort-

able, particularly whites (47.7 percent), less than a third—31.1 percent—of the aged are comfortable, and only 1 in 7—14.3 percent—of the aged who are living alone are comfortable. Far fewer blacks are comfortable, aged or nonaged—only 1 in 30 aged blacks living alone is comfortable.

These data are strong evidence that, first, current adequacy of income for the aged as a whole is roughly comparable to that for the nonaged. However, subgroups of the aged fare much too poorly by any reasonable definition of need—the poverty threshold, three-fourths of it or one and one-half times it. The subgroups of greatest concern are those aged persons living alone, especially if

7. See A. B. Atkinson, *Social Justice and Public Policy* (Cambridge: MIT Press, 1983), esp. chap. 1, “On the Measurement of Inequity.” See also A. K. Sen, “Poverty: An Ordinal Approach to Measurement,” *Econometrica*, 44:219-31 (1976).

TABLE 2  
RATIO OF INCOME TO POVERTY LEVEL IN 1981:  
PERCENTAGE OF PERSONS BY FAMILY STATUS, RACE, AND AGE

Race	Very Poor (under 0.75)	Poor* (under 1.0)	Near Poor* (under 1.5)	Comfortable (over 3.0)	Total (thousands)
<b>All races</b>					
Under age 65	9.4%	13.9%	23.6%	44.1%	(201,926)
65 and over	6.3	15.3	33.7	31.1	(25,231)
Families	4.0	9.1	23.1†	38.2	(9,403)
Alone	12.1	29.8	57.9	14.3	(8,134)
<b>White</b>					
Under age 65	6.9	10.8	19.8	47.7	(171,713)
65 and over	5.3	13.1	30.7	33.0	(22,791)
Families	2.8	7.2	20.1	40.6	(8,511)
Alone	10.7	26.5	54.7	15.5	(7,267)
<b>Black</b>					
Under age 65	25.8	33.8	49.1	20.3	(24,732)
65 and over	17.7	39.0	65.4	9.8	(2,102)
Families	16.8	29.8	57.1	11.8	(763)
Alone	25.0	58.8	85.7	3.5	(792)

SOURCE: Compiled from U.S., Department of Commerce, Bureau of the Census, *Characteristics of the Population below the Poverty Level: 1981*, Current Population Reports, ser. P-60, no. 138 (Washington, DC: Government Printing Office, 1983), tab. 7, pp. 27-28.

\*Note that the percentages for these columns are cumulative.

†This figure should be interpreted as follows: “23.1 percent of all the families with an aged head were ‘near poor’ in 1981, that is, had gross money income less than one and one-half as much as the family’s poverty threshold.”



black, and all other aged blacks, even if they are in families.

There have been sharp changes in poverty among the aged in the last 25 years. The incidence of poverty among the aged and subgroups of aged was much higher in 1959 than in 1981: over twice as high for all aged; over three times as high for aged families; twice as high for the aged living alone. The decade of the sixties saw a slow but steady decline in poverty rates for all groups; the period from 1970 to 1974 saw an extremely rapid decline in poverty rates. Since 1974 most poverty rates have remained quite stable, an exception being some decrease in poverty among aged Hispanic persons and increased poverty in black families headed by an aged person.

The rapid reduction in poverty in the 1970-74 period was due to two factors: (1) increases of 15 percent, 10 percent, and 20 percent in social security benefits in 1970, 1971, and 1972, respectively; and (2) the inauguration of the federal Supplemental Security Income program in January 1974. The relative stability in poverty rates since 1974 is due to the fact that, beginning that year, social security and SSI have been increased each year by the percentage increase in the consumer price index, which is also the index that changes the poverty thresholds themselves. The insulation of those income sources from inflation is the bright side. The fact that the poverty rates of the aged are not apt to decline at all without new initiatives with respect to social security or SSI is the dark side. The absolute level of the poverty rate among the aged as a whole is not the problem; the problem is that poverty rates for all persons living alone and for blacks and Hispanic persons are such high multiples of the 8.4 percent rate for all families.

### *Individual equity*

The other traditional goal of social security is individual equity. As can be expected, there are many ways that equity can be conceptualized and measured. All relate the stream of taxes paid over the working career to the stream of benefits due at retirement, disability, or death. One convenient measure of that relationship is the internal rate of return. A mental experiment can explain it. Imagine the following retirement case. A person earns a certain wage and pays the appropriate taxes each year of the working career; all the taxes paid go into an account and earn a certain interest rate, as yet unspecified. That account, made up of principal and interest, equals a certain dollar value at age 65; call it T. We then use the benefit formula and that earnings history to calculate the person's expected benefit year by year. To determine the value of that total benefit stream as of age 65, we must use a certain rate of discount, as yet unspecified, to calculate its value. Call the benefit stream B. The interest rate/discount rate that equates B and T is called the internal rate of return. If the streams of taxes and benefits are both adjusted for inflation expressed in real purchasing-power terms, that rate is called a real internal rate of return.

Most social security systems pay quite generous real rates of return to the early cohorts of beneficiaries because, compared to subsequent cohorts, early cohorts pay relatively lower taxes per year and pay them for fewer years, especially in pay-as-you-go systems. Rates of return also vary by earnings, which determine taxes paid; by age of retirement, which affects the streams of both taxes and benefits; and by life expectancy, which especially determines the duration of benefits.

Table 3 displays real rates of return only for worker beneficiaries, retiring in the years 1967-70. We see that for these beneficiaries the mean real rate of return was 14.8 percent. This means that for them the value of social security was equivalent to obtaining a 14.8 percent rate of return on their taxes—14.8 percent more than the rate of inflation. The rate of return is higher for low earners than for high earners; persons in the lowest quartile of lifetime earnings received a 25 percent return while persons in the highest quartile received 8 percent. This is the intended operation of the adequacy goal: the benefit formula is skewed, set to give a proportionally higher benefit to low earners. Moving across the columns, we see that women have higher returns than men due to women's lower earnings and their greater longevity.

We have seen that the rates of return for previous retirees are both generous and quite variable by sex, and especially and intentionally by earnings. We have looked at how people have fared using actual earnings histories. How are fu-

ture generations expected to fare? One method of looking at future experience is to calculate ratios of taxes to benefits using the representative-case method. In Table 4 the building blocks of such calculations are shown. This table shows the separate values at age 65 of earnings, taxes, and each type of potential social security benefit.<sup>8</sup>

First, we focus on the median-earnings cases in Table 4 with the caveat that

8. The assumptions underlying these calculations are as follows. The man and woman both start their occupational careers in 1978 by receiving that year's median earnings, \$9,654, and their earnings then grow at 5.75 percent per year, 1.75 percent of which is real growth because inflation is 4 percent. The earnings and taxes paid are accumulated forward to age 65 using an interest rate of 6.6 percent—4 percent inflation, 2.6 percent real interest. The amount of taxes paid are based on 1977 statutory combined rates. Each type of benefit is based on the 1977 benefit formula. The annual retirement and disability benefits amounts are multiplied by the probability of receiving them to obtain their expected values. The survivor and dependents benefits, calculated for the male worker only, assume that the male worker has a nonemployed spouse and two children.

TABLE 3  
MEAN REAL RATES OF RETURN TO WORKER BENEFICIARIES OF OLD AGE  
INSURANCE, 1967-70, BY LIFETIME EARNINGS QUARTILE AND SEX

	Mean	Men	Women
Total	14.80	11.67	17.57
Lifetime earnings quartile			
First	25.22	21.93	26.30
Second	14.40	14.22	14.48
Third	11.19	10.74	11.56
Fourth	8.41	8.24	9.39

SOURCE: Alan Freiden, Dean Leimer, and Ronald Hoffman, *Internal Rates of Return to Retired Worker-Only Beneficiaries under Social Security, 1967-70*, Studies in Income Distribution, no. 5 (Washington, DC: Department of Health, Education, and Welfare, Social Security Administration, 1976), app. tabs. A1 to A7.

the assumption that women earn the same as men is unrealistic. The value of the female's retirement benefit, \$32,187, is over 50 percent greater than the male's \$20,856; this is due to her greater life expectancy. The woman's retirement and disability benefits are thus nearly equal to the values of her taxes paid. This is not true for the man. The woman's ratio of benefits to taxes is 0.95; the man's is 0.71.

The expected value of dependents' benefits—\$35,105—is more valuable than the male's personal benefits—\$27,504; the size of the former is particularly due to the nonearner spouse's retirement benefit, \$25,084. For the assumed maximum earners at the bottom of the table, all the values are greater but the values of the various benefits in-

crease by less than the value of taxes paid; this is because taxes increase proportionally to wages while benefits increase less than proportionally.

Calculations like these for various earnings levels result in the expected-benefits-to-taxes-paid ratios given in Table 5. The third and sixth rows are ratios based on the illustrative values given in Table 4. If the ratio is close to 1, the case fares reasonably well; ratios above and below that are a reasonable index of comparative treatment.<sup>9</sup> The scarcity of values above 1.0 in Table 5 indicates that the very favorable treatment of the past is coming to an end.

9. If the ratio is 1.0, then the real internal rate of return is 2.6 percent, the real interest/discount rate used in these calculations.

TABLE 4  
PRESENT VALUES OF LIFETIME EARNINGS, TAXES, AND BENEFITS  
FOR WORKERS AGE 22 IN 1978

	Female	Male	His Dependents' Benefits
<b>Median earnings</b>			
Covered earnings	\$343,465	\$329,414	
Combined taxes	40,842	39,114	
Retirement benefit	32,187	20,856	\$25,084
Disability benefit	6,713	6,648	1,313
Survivors benefit	—	—	8,708
<b>Total Benefits</b>	<b>\$38,900</b>	<b>\$27,504</b>	<b>\$35,105</b>
<b>Maximum earnings</b>			
Covered earnings	\$866,737	\$830,730	
Combined taxes	103,308	98,878	
Retirement benefit	53,453	34,635	\$41,658
Disability benefit	11,138	11,003	1,924
Survivors benefit	—	—	14,477
<b>Total Benefits</b>	<b>\$64,591</b>	<b>\$45,638</b>	<b>\$58,059</b>

SOURCE: Orlo Nicols and Richard Streitmueller, *Some Comparisons of the Value of a Worker's Social Security Taxes and Benefits*, Actuarial Note no. 95 (Washington, DC: Department of Health, Education, and Welfare, Social Security Administration, 1978).

Only earners with very low wages—\$2000—can expect a favorable benefits-to-taxes ratio independent of gender, entry, and dependents. The ratios fall sharply as earnings increase. For median earners, unmarried women fare well; males fare well only if they have dependents.

The weakness of the representative-case approach for judging equity is that no case is typical. Few persons are single throughout their lifetime; few spouses are dependent in the sense used in the third column: that they never are employed. However, this approach is useful for purposes of comparison. Table 5 shows the low expected value of benefits for single men and the sharply higher expected value enjoyed by workers with dependents.

FUTURE POLICY GOALS  
AND OPTIONS

The primary policy goals of the social security system are adequacy and eq-

uity, providing beneficiaries with a decent standard of living while at the same time giving beneficiaries an acceptable return on their contributions. As the previous discussion shows, both of these goals are likely to become increasingly difficult to achieve. Although there is a direct conflict between the goals of adequacy and equity, this conflict can be sidestepped in the first generation of a pay-as-you-go pension system such as social security. This is particularly true when the economy is booming and the birth rate is high; relatively low tax rates will finance adequate pensions for the first generation of retirees with a resulting rate of return that is more than generous. We are now beginning to face some of the problems of a mature pension system in which those presently retiring have worked their whole lifetime under the system and the rate of return begins to drop. The maturation problem is severely aggravated by slow

TABLE 5  
RATIOS OF PRESENT VALUES OF EXPECTED BENEFITS TO TAXES  
FROM COVERAGE UNDER OLD AGE, SURVIVOR, AND DISABILITY INSURANCE

1978 Initial Earnings	Unmarried Female	Unmarried Male	Married Male with Dependents
Age 22			
\$ 2,000	1.90	1.40	3.17
5,271	1.19	0.88	1.98
9,654	0.95	0.71	1.60
16,000	0.78	0.58	1.31
17,700	0.63	0.46	1.05
Age 27			
\$ 2,000	2.21	1.63	3.82
5,271	1.38	1.01	2.39
9,654	1.11	0.81	1.94
16,000	0.91	0.67	1.59
17,700	0.73	0.53	1.26

SOURCE: Nicols and Streitmueller, *Some Comparisons of Taxes and Benefits*.  
NOTE: Taxes include employee taxes and employer taxes.

economic growth and a declining fertility rate.

Due to the relative affluence of the economy during the 1960s and early 1970s, benefit increases were enacted that improved the adequacy of the social security system and at the same time provided reasonable equity. While the current beneficiaries have been able to reap these benefits, the costs have been borne by the current workers.

A primary policy goal of adequacy can only be paid for by reducing the return on contributions for higher earners; or, conversely, absolute equity can only be achieved by allowing low earners to subsist with very low benefits. Any future policy decisions therefore must be focused toward either adequacy or equity. Economic and demographic conditions mandate that both goals cannot be served simultaneously.

There are essentially three options available for dealing with the long-run problem. These are: (1) raising payroll taxes; (2) cutting benefits; and (3) developing external sources of funding.

A good example of how these options would affect social security is found in a study by Leimer and Petri.<sup>10</sup> This study uses the real internal rate of return approach for past and future generations. Furthermore, the calculations compare how generations fare for various policy options aimed precisely at solving the long-term imbalance between benefit outlays and tax revenues. Their calculations are summarized in Table 6. Option A assumes that the adjustment is made by increasing taxes sufficiently to balance benefits and taxes annually; this means sharp tax increases in the year 2010. Option B assumes that

the adjustment is made entirely by decreasing benefits; this implies sharply decreased benefits after the year 2010. Option C makes up the imbalance as an equal mix of A and B. Option D assumes that a trust fund of five times the current amount of benefits is built up between now and 2000 and maintained thereafter.

Table 6 shows the effect of these four options in terms of the various real rates of return to generations born between 1920 and 2000. Comparing the real rates of return to the birth cohorts in 1920 and 2000 across all four of the options shows that no matter which option is implemented the real rate of return will continue to fall from about 6 percent to 2 percent. The reason for this is that regardless of method of finance, the overall rate of return to a universal pension scheme tends to converge to the real per capita rate of growth of the economy.

More interesting, and surprising even to experts, option B does not have as great an effect on the real rate of return as one might expect. This option amounts to telling the baby-boom cohort and later generations that the system will renege on a large fraction of benefits beginning in about 2010. That drastic action only implies that the rates of return get driven to 2 percent 40 years sooner than under the opposite solution, option A, which lets the future young pay those baby-boom retirees in full. We must realize that the difference between a real rate of return of 2.1 percent—1960, option B—and 2.7 percent—1960, option A—is considerable. It represents benefits about one-third lower under option B, and it would involve serious social-adequacy problems unless only higher earners were penalized.

10. Dean Leimer and Peter A. Petri, "Cohort Specific Effects of Social Security Policy," *National Tax Journal*, 34 (2) (1981).

### *Reducing the COLA*

Plans to lower benefits also assume a number of forms. One of the most popular is to limit the present automatic indexing via the consumer price index. Two proposed methods are to set the COLA at 60 percent of the increase in the consumer price index or, alternatively, at 1.5 percent less than the average increase in annual wages.<sup>11</sup> The latter option would imply modest annual decreases in the standard of living of retirees in each year of their retirement. The former option would be progressively more costly to the living standard of retirees, the greater the inflation and the longer they lived. Thus its impact would be greatest on women, especially widows, who are, at present, the most impoverished of all the aged.

### *The retirement test*

Tightening the retirement test is also a possible benefit reduction proposal. In

11. See Peterson "Social Security."

1982 the retirement test provided a benefit reduction of \$1 for every \$2 earned in excess of \$6000 for those individuals between the ages of 65 and 69. There is no benefit reduction for any income earned by those age 70 and over. Lowering the \$6000 disregarded or raising the benefit reduction factor will reduce benefit outlays. However, recent changes to the Social Security Act have resulted in a liberalization of the retirement test. The idea of tightening the retirement test is clearly contrary to current policy trends.

### *Changes in the retirement age*

Another method for achieving benefit reduction focuses on raising the retirement age. At the present time the retirement age is set at 65 with reduced benefits available at age 62 and increased benefits available when retirement is postponed beyond age 65. The rationale for raising the retirement age is based upon a number of factors.

The first of these is the long-run demographic problem discussed pre-

TABLE 6  
REAL RATES OF RETURN FROM SOCIAL SECURITY RETIREMENT BENEFITS BY  
BIRTH COHORT AND METHOD OF BALANCING LONG-TERM FINANCES (Percentage)

Birth Cohort	Increase Taxes (A)	Lower Benefits (B)	Mix of A and B (C)	C plus Funding (D)
1920	6.1	6.1	6.1	6.0
1930	4.4	4.4	4.4	4.1
1940	3.5	3.6	3.5	3.2
1950	2.9	2.7	2.8	2.6
1960	2.7	2.1	2.4	2.4
1970	2.7	2.0	2.3	2.4
1980	2.4	2.0	2.3	2.2
1990	2.2	2.0	2.1	2.0
2000	2.1	2.1	2.1	1.9

SOURCE: Supplied by Dean Leimer; for a graphic representation, see Dean Leimer and Peter A. Petri, "Cohort Specific Effects of Social Security Policy," *National Tax Journal*, 34(2) (1981), chart 8.

viously. Raising the retirement age will reduce the beneficiary-to-worker ratio, which will be a positive step in terms of reducing costs. Second, the demographics of the late twentieth century may create a labor shortage. While the present age distribution, which includes a large number of younger workers, has resulted in a labor surplus and hence pressure for early retirement in order to create new job opportunities, 25 years from now this country may be facing a labor shortage. At that time increasing the retirement age may be an important factor in keeping needed older workers in the labor force.

Increasing the retirement age may also be warranted on the basis of increased longevity. In 1935 the life expectancy for males at age 65 was 11.9 years. By the year 2000 this is expected to have increased to at least 15 years.<sup>12</sup> A slightly smaller increase is expected for women. This approach is based on the concept that length of retirement years should remain constant. If the life span increases, then more time should be spent gainfully employed.

Increasing the retirement age is a controversial plan and some of the assumptions behind this proposal are problematic. The potential problem of a labor shortage in 30 years is a weak reason for acting now. This labor shortage is only an assumption and might never materialize. On the other hand, most proposals to raise the retirement age suggest that this should not begin until the year 2000, should be phased in

gradually at that time, and should not raise the retirement age past 68.<sup>13</sup>

Second, the success of this approach may be confounded by the fact that increased longevity may be the result of advances in medical science that have rendered many illnesses less fatal but leave them still chronic and debilitating, hardly a situation that would warrant increased working years. Furthermore, studies of factors influencing retirement age suggest that the primary cause of early retirement is poor health. Those in poor health also tend to be at the lower end of the earnings scale. Workers in good health holding relatively prestigious jobs already retire at a later age. Given this, raising the retirement age would impact primarily on the chronically ill and the poor.

#### *General revenue financing*

A somewhat more radical solution to the long-range problem is to provide funding from general tax revenues. Such a move would signal implicit recognition that social security as a system of insurance is largely a myth and that there is some broadly based desire to see benefits remain at their current level with no increase in the earmarked social security tax. Unfortunately, social security's performance as an uncontrollable cost in the federal budget makes it unlikely that explicit general revenue funding will occur.

However, other general-revenue funding schemes have been proposed. One scheme is to provide general revenue funding for hospital insurance (HI) and transfer the HI portion of the social

12. Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, *1982 Annual Report* (Washington, DC: Government Printing Office, 1982), tab. II, p. 35.

13. For one such proposal, see 1979 Advisory Council on Social Security, *Social Security Financing and Benefits* (Washington, DC: Government Printing Office, 1979), chap. 8.

security tax over to OASDI. More subtle forms of general revenue financing are likely to be used, if indeed any general revenue financing is used at all.

#### POLICYMAKING AND THE SHORT-TERM CRISIS

Since the inception of social security, policy innovations have been left primarily to technical experts, such as actuaries, economists, and career executives.<sup>14</sup> While social security policy decisions were not made without the consent of Congress or the president, the initiative to define relevant issues and options for change has been left to individuals within social security. This has been due to the complex technical nature of the program and the consistent push for program expansion that has characterized the social security leadership.

At the same time, system maintenance and growth have taken place within a framework of classic incrementalism. After the original adoption of the Social Security Act, changes in the social security system have been small, at least until 1977. System expansion has also been fostered—until recently—by steady national economic growth and the almost universal popularity of the program.

While the incremental nature of program expansion has provided a reliable model for explaining social security program growth in the past, its utility for explaining future program changes is questionable. The classic incremental model of program growth has been focused almost entirely upon cases of incremental expansion. This is not sur-

prising since, until recently, program growth was the overwhelming norm and program contraction was almost nonexistent.<sup>15</sup> In fact, very little has been written about organizational and program contraction, especially with respect to programs at the federal level.

The real question facing the social security system is not if social security will be cut back but rather how it will be cut back. Furthermore, it seems unreasonable to assume that simply because program change has been incremental in an environment of expansion, patterns of program change will continue to be incremental in an era of retrenchment. Recent events suggest that it is far easier to build a coalition for program support when each member can expect to receive a small piece of an expanding resource pie than to construct a coalition to deal with retrenchment.<sup>16</sup>

Another important aspect of change in the social security system is the timing of policy changes. This is especially clear in the cases of the short-run and long-run problems. The long-run problem has been clear since as early as 1971 and the short-run problem has been under discussion since 1977. However, no legislation has yet emerged that solves these problems. In fact, it is only recent-

15. Discussions of the budgetary process, which is in many ways the heart of the policy process, are concerned exclusively with program expansion. See Aaron Wildavsky, *The Politics of the Budgetary Process* (Boston: Little, Brown, 1979); see esp. chap. 2 on calculations and chap. 3 on strategies.

16. For a discussion of this issue, see David Stockman, "The Social Pork Barrel," *Public Interest*, no. 39, pp. 3-30 (Spring 1975). Recent legislative events suggest that even to achieve a consensus on some aspects of retrenchment requires that coalition members be rewarded with program expansions in other areas. See William Greider, "The Education of David Stockman," *Atlantic*, 248(6):27-54 (Dec. 1981).

14. Martha Derthick, *Policy Making for Social Security* (Washington, DC: Brookings Institution, 1979).



ly that social security's problems have been taken seriously by the Congress and the president.

The primary factor propelling social security on to the political agenda is the pressing nature of the current (short-run) problem. In 1977 a prediction of bankruptcy by 1985 could be treated with a wait-and-see attitude. Today it is clear that something must be done and done soon. Social security became a genuine crisis by 1981, and crises are extremely effective in moving issues to the top of the legislative calendar.<sup>17</sup>

It should be noted that solutions to social security problems have impact on both the short-run and long-run problems. For this reason any legislation that addresses the short-run problem—the crisis—is also going to include the long-run problem. However, it is unlikely that any legislation enacted in the near future that addresses the long-term problem will remain unchanged for the next 30 years and emerge as the solution to what we see today as social security's problem in 2010. In fact, given the regularity with which the Social Security Act has been amended over the last 40 years, it seems quite likely that we can expect considerable policy changes in the future.

### *The role of interest groups*

An important consideration here is the groups that will form the basis for social security's political support in the coming years. The major groups involved in this process are (1) organized labor, especially the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO); (2)

17. See Jack Walker, "Setting the Agenda in the U.S. Senate: A Theory of Problem Selection," *British Journal of Politics* (Oct. 1977).

groups organized to advocate for the aged such as the National Association of Retired Persons and, more recently, activist groups such as the Gray Panthers; and (3) the business sector, represented by such groups as the U.S. Chamber of Commerce. Each of these groups takes a different point of view in assessing current and future problems in the social security system.<sup>18</sup>

The old-age activists appear strongly opposed to any changes that tend to force or deter retirement. They are likely to be less opposed to legislation that raises the retirement age than other groups since they see the current retirement age as a restriction on the aged's right to work. At the same time they want the right to work to remain purely an option. Their support for an increase in the retirement age is only likely if it is coupled with an option of reasonable benefits available for those who desire or are forced to retire early.

In examining the role of the aged in the politics of social security it is important to note that while the demographics of the twenty-first century will have a negative role on the financing of the system, these same demographics will also have a positive effect on the political power of the elderly. Note the present championing of the elderly shown by representatives from the state of Florida, especially Claude Pepper. The present age distribution in Florida is representative of the U.S. age distribution in the year 1995.<sup>19</sup> Clearly, the aged have the potential to become an even more powerful political force than

18. See Peter Stearns, "Political Perspectives on Social Security Financing," in *Social Security Financing*, ed. Felicity Skidmore (Cambridge: MIT Press, 1981).

19. See John Naisbit, *Megatrends* (New York: Warner Books, 1982), p. 7.

they are today. Whether they can maintain their cohesiveness remains to be seen.

Organized labor, especially the AFL-CIO, has been and may continue to be an important force in social security policymaking.<sup>20</sup> Given labor's long involvement with social security it is not surprising that labor has developed the most clearly defined position on social security's current problems.

First and foremost, organized labor is strongly opposed to any increase in the retirement age. Historically the unions have been highly dependent on the present retirement process as a means for creating opportunities for younger workers. Any deviation from that would be viewed as an attack on younger union members as well as a benefit reduction for older members. This position on retirement makes labor vulnerable to an internal split along age lines. This is especially true if economic conditions become such that older workers desire to postpone retirement due to economic necessity—that is, if they cannot afford to retire at age 65. Given this, organized labor may take a somewhat lower profile in the social security policy debate if they perceive that any position taken will result in a significant split in the membership.

Some attempt at coalition building among social security advocates should be expected but will not necessarily be successful. It would appear that the old-age activists and the labor unions would be closely aligned as a result of their traditionally liberal perspective. However, issues such as an increase in the retirement age may produce considerable conflict between these two groups.

20. For a discussion of the AFL-CIO's role in social security policy, see Derthick, *Policy Making for Social Security*, chap. 5.

The fact that the old-age activists are increasingly female, a group that has never been well represented by the unions, may also contribute to the conflict.

The business sector has assumed a somewhat more conservative position on social security. As Derthick points out, while the business sector has not been in outright opposition to social security, it has been concerned with holding the line on social security, wherever that line might be at a particular time.<sup>21</sup> At the same time the social security system has provided the business community with retirement procedures. Because the procedures constitute an easy, systematic method, they have allowed the business sector to substitute younger for older workers without taking any of the political heat for doing so. At the present time it is difficult to say exactly how the business community will respond to future changes in social security. If past performance is any indication, we can expect the business sector to oppose any measures to increase social security costs.

This examination of the traditional actors in the policymaking process suggests that these actors will find themselves in a very different type of relationship in the coming era of re-trenchment-oriented decision making. In facing the question of program cuts the historical supporters of the social security system are each likely to maintain their own set of priorities. The prospects for building a coalition that is able to institute incremental program cuts appear dim. When one considers that the business sector, never an ally of

21. Derthick, *Policy Making for Social Security*.

social security, may now turn into a strong force for extensive program cuts, the situation looks even worse.

It is impossible to predict exactly what form policymaking will assume in

the future. The pressures of retrenchment will, in our judgment, produce a policymaking process that is quite different from the incremental model of the past.