

## SOCIAL SECURITY: MYTHS AND REALITIES

*Paul Craig Roberts*

Shortly after the inauguration, the Reagan administration faced a crisis in Social Security, despite the 1977 amendments that President Carter promised would make Social Security sound through the turn of the century. The largest of the system's three programs, Old-Age and Survivors Insurance (OASI), was likely to run out of money during Reagan's term of office unless economic growth proved robust. The long-run prospects of the combined system (OASDHI) included large perpetual deficits and were even more dismal.

The Treasury recognized that Social Security was an unfunded system of taxes and transfer payments that was unaffordable at the current rate of growth in benefits, and the Office of Economic Policy developed a plan for putting Social Security on a realistic basis. However, other parts of the government had different goals, and the opportunity was lost. The Office of Management and Budget concentrated on short-run budget savings in order to lower current federal budget deficits. The Department of Health and Human Services was preoccupied with its effort to rid the system of various welfare elements. Robert Myers and the Social Security Administration were determined to keep Social Security on an expanding course as the main source of retirement income. As a result the Treasury was frustrated in its effort to focus attention on the realities of the system. Instead, the myth that Social Security is an affordable pension system was perpetuated, and a new myth was born—that the government will deal responsibly with the long-run Social Security problem.

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This article is drawn from his forthcoming book, *The Supply-Side Revolution: An Insider's Account of Policymaking in Washington* (Cambridge, Mass.: Harvard University Press, 1984).

## The Source of the Problem: The 1972 Social Security Amendments

There are two major areas of Social Security that involve indexes. The one most people think of is the annual cost-of-living adjustment (COLA), which occurred each July 1 until the 1983 Social Security Amendments moved the date to January 1. This adjustment increases benefits going to current retirees by the amount of inflation each year, as measured by the consumer price index. Thus, whatever benefit the worker receives upon first retiring is preserved in real terms and protected from inflation. This cost-of-living adjustment is often blamed for the deficits in the Social Security accounts and the overall federal budget, but it is not the real culprit.

The other area of indexing is the real source of the system's long-run troubles. When a worker retires, the amount of his first Social Security check, or initial benefit, is computed by a formula that involves wage indexes. These indexes cause the real value of each retiring generation's initial benefits to rise over time. The COLA merely preserves the real value of these benefits over the individual's retirement period. It is the buildup of the real levels of the *initial* benefits, generation after generation, that is leading to the system's ruin.

Prior to the 1972 amendments, Congress had raised Social Security benefits over the years on an ad hoc basis. However, a 15-percent benefit increase in 1970, a 10-percent increase in 1971, and a 20-percent increase in 1972 represented quantum jumps in benefit levels. These were reinforced by the 1972 Social Security Amendments, which were supposed to preserve these increases with automatic inflation adjustments each year, beginning in 1975.

Unfortunately, the 1972 amendments contained a major formula error, which has become known as the "double indexing" or "decoupling" problem. It resulted in sharp increases in benefits for new retirees just entering the system and caused benefits to rise faster than wages. An average worker retiring in 1969 could expect to receive a tax-exempt Social Security benefit equal to 31 percent of his last working year's gross income. By 1972, ad hoc increases by the Congress raised this so-called "replacement rate" to 38 percent. As a result of the automatic adjustments in the 1972 amendments it rose to 41 percent in 1974, 44 percent in 1976, and 55 percent in 1981.<sup>1</sup>

<sup>1</sup>These historical replacement rates are taken from unpublished tables prepared by the Office of the Actuary, Social Security Administration, August 1981.

The source of the problem was fairly straightforward. The initial Social Security benefit a worker received upon retiring was computed in two steps. First, the worker's gross wages from 1951 until the date of retirement were added up and averaged over the number of months worked to determine an average monthly wage. This wage, split into several "brackets," was then multiplied by an array of percentages called the "marginal benefit rates," which were set by law. The product was the worker's initial Social Security check. For example, if the benefit rates averaged 0.40, then the worker's first retirement check would equal 40 percent of his average wage. The 1972 amendments provided for the annual adjustment of the marginal benefit rates for each year's population of retirees by the amount of inflation over the year. For example, if inflation had been 10 percent and the old benefit rates had averaged 0.40, the new benefit rates would average 0.44. Unfortunately, complete adjustment of the benefit rates for inflation overadjusted benefits. Over time, wages tend to rise with inflation. While wages earned in the distant past were, of course, not adjusted for recent inflation, wages earned in the years immediately preceding retirement would have been largely adjusted for inflation. Consequently, one part of the benefit computation, the average monthly wage, was already partially adjusted for inflation by the marketplace.

The correct way to increase the product of two numbers by, for example, 10 percent is to increase one number or the other number by 10 percent, but not both. By adjusting the benefit rates completely when the average monthly wage had already received partial adjustment for inflation, the formula made the resulting benefits grow faster than inflation.

### The Perpetuation of the Problem: The 1977 Social Security Amendments

The 1977 amendments stopped the initial benefits from rising faster than wages but allowed the initial benefits of each retiring generation to keep pace with real wages over time. This was not enough of a reduction in benefit growth to deal with the long-run problem.

The modifications made in 1977 left the system on a path of expansion that will carry outlays significantly beyond currently scheduled tax rates. Under the economic assumptions (Alternative II-B) in the 1982 Trustees Report, OASDI benefits were scheduled to rise as a percent of payroll from between 10 percent and 12 percent near term to between 17 percent and 18 percent long term. This compared with

a scheduled OASDI long-term tax rate of 12.4 percent of payroll after 1990. After a few years of surplus, beginning in the 1990s, a deficit appeared shortly after the year 2010, widening to a permanent gap of roughly 5 percent of payroll between outlays and receipts in OASDI after the year 2025.

Adding in Hospital Insurance (HI) makes the deficit worse. The combined OASDHI system's outlays were projected to rise as a percent of payroll from 15 percent near term to between 27 percent and 30 percent long term. This compared with the scheduled OASDHI long-term tax rate of 15.3 percent after 1990. A deficit appeared shortly after 1995, widening to a permanent gap of roughly 12 to 15 percent of payroll between outlays and receipts in OASDHI after the year 2025. This translated into an annual deficit in excess of \$300 billion by 2025 and in excess of \$600 billion by 2060, measured in real 1983 dollars.<sup>2</sup>

The source of the long-run deficits is twofold. First there are the demographics. As the population grows more slowly over time, the population ages, and there are more retirees per worker. Second, the indexing formula allows initial benefits to grow indefinitely in real terms at the same pace as wages. With real benefits per retiree rising along with real wages, but with the number of retirees rising faster than the number of wage earners, the cost of the system must rise as a percent of payroll. Consequently, either payroll-tax rates must rise sharply, taking more out of each dollar of wages, or the growth of real benefit levels must be reexamined.

The Social Security system is in crisis because it is scheduled to pay ever-rising real benefits to successive generations. One way to deal with the problem is to reduce the scheduled rise in benefits. A switch from wage indexing (under which real benefits per retiree would triple in three generations) to price indexing (under which real benefits per retiree would roughly double) would essentially eliminate the long-run OASDI problem.

Price indexing was recommended in the 1976 Hsiao report.<sup>3</sup> The Finance Committee under Senator Long was receptive to the proposal. The Treasury, led by Secretary William E. Simon, was also eager to take the more responsible course. However, there was an

<sup>2</sup>1982 *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, House Document No. 97-163, 97th Cong., 2d sess., April 1, 1982, table 27, p. 64.

<sup>3</sup>See William C. Hsiao, "An Optimal Indexing Method for Social Security," in Colin D. Campbell, ed., *Financing Social Security* (Washington, D.C.: American Enterprise Institute, 1979), pp. 19-40.

election approaching. President Ford, at the apparent urging of his political advisors and with the apparent blessing of his chairman of economic advisers, Alan Greenspan, wished to appear more generous. Ford opted for the much more expensive wage-indexing procedure. This single mistake added well over \$2 trillion in unfunded liability in present-value terms to the system's long-run deficit. It accounts for more than 100 percent of OASDI's deficit.

### The Misleading Concept of Actuarial Balance

The long-run problem is hidden by a misleading statistic. It is called the "actuarial balance" of the OASDI system. (The HI portion is generally excluded.) The Social Security Administration (SSA) generally reports on the condition of the OASDI trust funds over a 75-year future planning period. It says the system is in "actuarial balance" if the average income of the system measured as a percent of payroll equals the average cost of benefits measured as a percent of payroll over 75 years. In 1982, the OASDI system was reported to have a deficit of 1.8 percent of payroll. In other words, the system needed a tax rate 1.8 percent of payroll higher on average over 75 years than was scheduled in the law, to match promised benefits.

This "average" gives the impression that raising tax rates or cutting benefits by 1.8 percent of payroll would make the system financially sound. This was the theory that guided the recent *National Commission*. But nothing could be further from the truth.

The year-by-year surpluses and deficits in the system are not uniformly spread over the 75-year planning period. Neither are projected receipts roughly in line with projected outlays decade by decade. Instead, the surplus years all fall roughly between 1990 and 2010, with widening deficits thereafter. The SSA was relying on the buildup of a large trust fund between 1990 and 2010, which would be drawn down after 2010 to cover the long-term deficit until the money ran out (between 2030 and 2040). What was the system to do then, when it would suddenly face annual outlays 5 or 6 percent higher than annual receipts, with no trust fund to pay the difference?

In fact, the OASDI surpluses either would be spent by Congress or would have to be borrowed to finance HI deficits in the 1990s, and the whole OASDI system would be bankrupt by about 2015. It would then face ongoing annual deficits of 12 to 15 percent of payroll under the 1982 Trustees Report II-B assumptions. (The 1983 *Social Security* legislation did not significantly alter these prospects, particularly if the Census Bureau's new lower fertility and population estimates are employed in the calculations.)

With or without HI, the 75-year average is merely camouflage for a deteriorating system. Only if the system is brought roughly into balance on a year-to-year basis can it be permanently fixed. This balancing means either slowing the growth rate of real benefits and raising hospital insurance premiums and deductibles for future retirees so that benefits only rise to 15 percent of payroll (the currently scheduled 1990 tax rate), or else roughly doubling the payroll tax to match the growth of benefits.

This fundamental imbalance in the system is largely hidden by the 75-year summary statistic. A 75-year average moves very slowly from one year to the next. Nonetheless, as each year goes by, the summary statistic decays a bit. As the planning period shifts forward, a year of near-term surplus goes by and a year of long-term deficit is added. For example, in 1985, the planning period will run from 1985 to 2060. The year 1985 will show a surplus, 2060 a deficit. In 1986, the planning period will be 1986 to 2061. The surplus year 1985 will fall out of the average, and the deficit year 2061 will be rolled in. The result is a deterioration in the system's "balance."

Every year in the Trustees' Report, the SSA gives a list of reasons for any year-to-year change in the summary statistic. These reasons include changes in economic and fertility assumptions. One reason that appears every year is "change in valuation period." This is the admission that the 75-year average is not stable. It is a moving average that was headed toward a basic deficit of 5 or 6 percent of payroll for OASDI and 12 to 15 percent of payroll for OASDHI, under the 1982 assumptions.<sup>4</sup> This is why the summary statistic is a poor measure of what needs to be done for the system. This is why the tables showing the annual deficits in the system over time and the pattern that is emerging provide the only meaningful way to view the system. Bringing forward payroll-tax increases already scheduled, as was done in the 1983 Social Security bill, reduces the system's long-run deficit as measured by the summary statistic. But such steps do nothing to improve the system's real balance over time.

As long as the summary statistic is used as a guide to policy, we will have periodic crises in the system. Each time the trust funds start to run out, the summary statistic will be "balanced" by some short-run transfers and tax-rate increases. Near-term benefits will be cut very little, both because it is not fair to cut benefits without adequate warning and because current retirees are active voters. This

<sup>4</sup>Under the 1983 amendments, the deficit is projected at 2 to 3 percent of payroll for OASDI and at 8 to 9 percent of payroll for OASDHI. The deficit would be larger if the calculations were based on the Census Bureau's fertility estimates.

process will be enough to bring the 75-year average into "balance" with short-run surpluses and long-run deficits. Then since the system is apparently in balance, why do anything to bring long-run benefit growth under control? And nothing is done until the next crisis, when it is again too late to touch benefits.

### The President's Goals Defeated

The 1983 Social Security legislation was a defeat for the president's Social Security goals. Little was done to improve the long-run prospects of the system. Instead, Reagan was forced to accept an enlarged system, which he had eloquently opposed in the past. Coverage was extended to new federal workers and employees of nonprofit organizations, and state and local governments were prohibited from withdrawing from the system. The increase in the payroll-tax rates was partly offset out of general revenues by such measures as an income tax credit. The result is a combination of higher tax rates and general revenue transfers, neither of which the president wanted.

The taxation of half of Social Security benefits as provided in the 1983 amendments introduced a means test into the system for the first time. Worse yet, the method of taxing the benefits was totally inconsistent with the president's desire to increase the incentives to work, save, and invest.

The correct way to tax half of Social Security benefits is simply to add half of the benefits to taxable income. If it is desired to give people with lower incomes special treatment and reduce their burden, part of the benefits could be excluded from tax, with only the benefits in excess of the exclusion entering taxable income. This method may push a recipient into a higher tax bracket, but the resulting disincentive would be mild compared to the way the proposal was actually implemented.

As recommended by the commission, the method of taxing half of benefits was a farce. The commission proposed that a single retiree with \$20,000 (\$25,000 for a married couple) in outside income from savings, private pensions, or wages be required to add half of his Social Security benefits to his taxable income. A single retiree earning \$19,999 would pay no tax on his Social Security benefits. A single retiree earning \$20,000 would have to add perhaps \$4,000 to taxable income and pay nearly \$1,000 in additional tax. That is an expensive dollar of income. The marginal tax rate would have been 100,000 percent.

After loud complaints about the commission's proposal, the House version of the bill took away part of the problem and left merely a

major disaster. The House phased in the taxation of half of Social Security benefits as other income exceeds certain thresholds. Like the commission's blunder, this action has the effect of raising the marginal tax rate on other income. But the effect is less spectacular: The marginal tax rate on income of Social Security recipients increased 50 to 77 percent. The Republican Senate could not wait to join the House in delivering this punishing blow to a major Republican constituency—retired people with a median income or higher. One Republican senator (Chafee) even got an amendment passed that included tax-exempt interest in the income measure used to determine whether the taxpayer's income exceeded the threshold! The senator was determined that no old person who had managed to save anything for his retirement would escape the net.

The result of the 1983 Social Security legislation was to move a retired individual with \$26,000 in private retirement income from a 30-percent marginal tax rate to a 45-percent rate. A retired couple with a private retirement income of \$38,000 was moved from a 28-percent to a 50-percent marginal tax rate. Social Security recipients with private retirement income who are still working and have "earned income" in excess of the Social Security earnings limitation can face marginal tax rates in excess of 100 percent until 1990.

To understand how this happens, consider the case of the single retiree currently in the 30-percent bracket. Since his private income is above the allowable threshold, his Social Security income is subject to tax. For every dollar in private income above the threshold, he has to pay tax on 50 cents of Social Security income until he is paying tax on one-half his Social Security benefits.

In other words, above the threshold, every dollar of private income results in \$1.50 of additional taxable income. That raises the tax rate on his additional dollar of private income by half, from 30 cents to 45 cents ( $\$1.00 \times .30 + \$0.50 \times .30$ ). The increase in the tax rate may be even higher if the added income pushes him up a bracket. This continues until one-half of the benefits are taxed, at which time the effective marginal tax rate drops back down.

This approach to the taxation of Social Security benefits makes little sense, and it is inconsistent with President Reagan's desire to lower marginal tax rates and to increase saving and investment. Once people planning their retirement realize that the penalty for providing a private retirement income in excess of the threshold is to be hit with 50-percent to 77-percent increases in marginal tax rates, their saving rate is likely to drop. The result will be to make people more dependent on Social Security, thereby worsening the long-run problem.

The horror story worsens when you consider the interaction of the taxation of benefits with the existing limitation on *earned income*, which costs retirees one dollar in reduced Social Security benefits for every two additional dollars earned by continuing to participate in the work force. This is equivalent to an additional tax of 50 percent on additional earnings, over and above the marginal federal income tax rate. In this case, due to the loss of benefits, many retirees will experience marginal tax rates on additional earned income in excess of 90 percent. If payroll and state income taxes on additional earned income are taken into account, the marginal tax rates can exceed 110 percent. One has to ask: What happened to the Reagan administration that was going to improve incentives for people to work?

Senator Armstrong got the Senate to adopt an amendment to repeal the *earnings limitation*, but the Senate delayed the repeal until the 1990s. The House, however, insisted on retaining the earnings limit. The final compromise lowered the loss-of-benefit penalty for exceeding the earnings limitation from one dollar in reduced Social Security benefits for every two dollars earned above the limit to one dollar for every three dollars. This dropped the implicit tax on "excess earnings" from 50 percent to 33 percent, bringing the maximum tax rates faced by a retiree who continued to participate in the work force down from around 110 percent to the range of 83 to 98 percent.

What we have here is a form of age discrimination that perhaps manages to avoid technically violating the *antidiscrimination laws* but nonetheless violates the spirit of the law. The entire thrust of the Social Security package is to deny the aged any incentive for being independent of the government.