An examination of the major problems confronting Title II of the Social Security Act

Karen A. Washington
Atlanta University

Follow this and additional works at: http://digitalcommons.auctr.edu/dissertations

Part of the Public Affairs, Public Policy and Public Administration Commons

Recommended Citation

This Thesis is brought to you for free and open access by DigitalCommons@Robert W. Woodruff Library, Atlanta University Center. It has been accepted for inclusion in ETD Collection for AUC Robert W. Woodruff Library by an authorized administrator of DigitalCommons@Robert W. Woodruff Library, Atlanta University Center. For more information, please contact cwiseman@aucr.edu.
AN EXAMINATION OF THE MAJOR PROBLEMS
CONFRONTING TITLE II OF THE
SOCIAL SECURITY ACT

A DEGREE PAPER
SUBMITTED TO THE FACULTY OF ATLANTA UNIVERSITY
IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR
THE DEGREE OF MASTER OF PUBLIC ADMINISTRATION

BY
KAREN A. WASHINGTON

DEPARTMENT OF PUBLIC ADMINISTRATION

ATLANTA, GEORGIA
JULY 1985
ABSTRACT

PUBLIC ADMINISTRATION

WASHINGTON, KAREN A. B.A., Spelman College, 1977

An Examination of the Major Problems Confronting Title II of the Social Security Act

Advisor: Dr. George Kugblenu

Degree Paper dated July 26, 1985

The primary intent of this degree paper is to discuss the current problems confronting Title II of the Social Security Act. An attempt has also been made to highlight the four major problems, namely the short and long-term financing problems, the negative effects on savings, the benefit increase dilemma, and the mandatory nature of the program, as well as presenting divergent viewpoints of many authorities on these problems.

The social security program is very important to millions of elderly and disabled Americans. Without it, the economic hardships for these groups of people would be unbearable.

The data for this study were obtained from books, periodicals, newspapers and unpublished materials.

-i-
CONTENTS

ABSTRACT ......................................................... i
I. INTRODUCTION............................................. 1
II. THE PROBLEM AND ITS SETTING ....................... 5
   Internship Experience
III. STATEMENT OF THE PROBLEM ....................... 7
IV. REVIEW OF THE LITERATURE .......................... 9
V. METHODOLOGY .............................................. 22
VI. ANALYSIS OF THE PROBLEM ............................. 24
   Short and Long-Term Financing Problems
   Mandatory Nature of the Program
   Negative Effects on Savings
   Benefit Increases Dilemma
VII. CONCLUSIONS AND RECOMMENDATIONS ............. 50
BIBLIOGRAPHY .................................................. 53
I. INTRODUCTION

On August 14, 1935, President Franklin D. Roosevelt signed into law the Social Security Act. This legislation was originally intended as a social insurance to guarantee replacement of income loss through retirement, disability, or death. In the beginning, the program was based on the equal relationship between the worker's contribution to the system and benefits received after his or her working years. The Social Security Act of 1935, therefore, established a federally mandated retirement program primarily for workers in industry and commerce.

The legislative history of the act makes clear that the Social Security program was intended to provide only a basic type of income in old age, allowing individuals to build further income protection by other alternatives. As the years passed, the system evolved into a huge and virtually uncontrollable income redistribution system guaranteeing a minimum retirement income to almost all Americans and eligible aliens.

The Social Security Administration administers three separate and distinct programs. The first, Title II deals
with Old-Age and Survivors Insurance (OASI). The second, Title XVI deals with Disability Insurance (DI), better known as Supplemental Security Income (SSI), and the last program is the Health Insurance (HI).

Title II deals with the insurance component of Social Security. The trust fund of this program pays benefits to beneficiaries as a result of retirement, death, disability, or illness. This trust fund is paid for by the payroll tax, and benefits are received based on the amounts an individual pays into the system. An individual must be insured under the Social Security program before benefits can be paid to him or any member of the family. The number of quarters (The twelve calendar months are divided into 4 quarters) of coverage credited to an individual's Social Security record determines the insured status. The quarters of coverage are earned by working at a job covered under Social Security. Different formulas are used to determine the amount of earnings that will equal a quarter of coverage depending upon the year. The more one pays into the system, the more one receives in income benefits. Since these benefits are considered earned, they are paid regardless of need.

Title XVI is the welfare segment of Social Security. The trust fund for this program pays benefits to beneficiaries
solely because they need these benefits and not because they have paid for them. This trust fund is paid for by the taxpayers. In order to receive benefits under Title XVI, an individual has to provide evidence of financial need and must be 65 or older, blind, or disabled.

The final program under the Social Security system is the Health Insurance, commonly known as Medicare. Medicare provides comprehensive hospital and medical insurance protection to the aged, disabled, and those suffering from chronic kidney disease.

The hospital insurance benefits are paid for a person who has attained the age of 65 or older who is eligible for, but not necessarily receiving, a monthly benefit from Social Security. For a person 65 or older who is not eligible for Social Security monthly benefits that person pays the full cost for the insurance protection. The Social Security Handbook states that, Medicare hospital insurance helps pay for four kinds of care. The four kinds of care are: (1) inpatient hospitalization, (2) medically necessary inpatient care in a skilled nursing facility after a hospital stay, (3) home health care, and, (4) hospice care.¹

The medical insurance benefits are paid for through monthly premiums automatically taken out of the monthly benefits of the person enrolled in the program. In some cases, the state will pay the premium for the person.

Medicare medical insurance can help pay for (1) doctor's services, (2) outpatient hospital care, (3) outpatient physical therapy and speech pathology services, (4) home health care, and (5) many other health services and supplies which are not covered by Medicare hospital insurance.\(^2\)

The problem confronting Social Security is so closely tied with our daily lives that one tends to forget the impact the social security system has made on our society and the achievement it represents in satisfying peoples' desires for security. Access to Social Security has become a fundamental human right. The challenge that faces the government today is restoring confidence in the Social Security system. The Social Security program is absolutely essential to the economic survival of millions of elderly and disabled persons. In recent years, however, the Title II program has come under attack for several reasons, one being its financial problems. The purpose of this study, therefore, is to examine the major problems confronting Title II of the Social Security program.

\(^2\)Ibid., p. 365.
II. THE PROBLEM AND ITS SETTING

The Social Security Administration (SSA) is housed under the Department of Health and Human Services. Its functions are to provide assistance to the general public in areas such as retirement, death, illness or disability.

The Region IV headquarters office of the Social Security Administration is located in Atlanta. This office serves as the headquarters for Social Security administration offices in the states of Alabama, Florida, Kentucky, Mississippi, North Carolina, South Carolina and Tennessee. In the metro-Atlanta area, there are four district offices and four branch offices.

The writer served as an intern in the district office located in downtown Atlanta. The personnel in this office consists of a district manager, an assistant district manager, a staff assistant, an administrative assistant, a field representative, two operations supervisors, a clerk, six service representatives, ten claim representatives, a teletypist, two claims development clerks, two data review technicians, and four student workers.

Internship Experience

The writer served as a co-operative education intern with SSA from October 1, 1984 to January 18, 1985. It was
the responsibility of the writer to interview clients and provide information to the public on programs that involve benefits, and obligations of the claimants. The writer explained the requirements of benefit programs and informed claimants of necessary action to take. The writer also assisted claimants in preparing required documents, and explained the agency's eligibility and appeals procedures.

Part of the internship responsibility included reading assignments dealing with Title II and Title XVI regulations and attending all training sessions in both programs.
III. STATEMENT OF THE PROBLEM

To millions of Americans, the Social Security program provides them with a monthly check that helps to alleviate their financial burdens. To millions of others, the program gives assurance that they too will be taken care of in their old age or when they are not able to work. According to George Church, Ronald Reagan . . . called it "a political football" kicked around by "demagoguery" and "falsehoods." To one of the President's advisors it is "the most sacred cow we have around here."³ What is this sacred cow? It is the social security system, the nation's largest and most criticized social program.

The sacred cow has come under severe attacks recently due to what many critics believe to be shortcomings of the current system. Critics have scrutinized the program from all angles. For example, Martin Feldstein has emphasized the program's negative effects on the economy through its impacts on savings and capital investment. Milton Friedman

has emphasized the program's negative impact on the poor and its compulsory, coercive nature. Arthur Laffer and David Ranson have focused on the program's financial insolvency and its negative impact on the economy because of the effects of the payroll tax on the labor supply. Edgar Browning has noted the political instabilities associated with the program.⁴

In light of the above criticisms, this study focuses on several of the issues that provide the basis for criticism. Among those issues selected for discussion are short and long-term financing problem issues, the system's negative effects on savings, benefit increases dilemma, and the mandatory nature of the social security program.

IV. REVIEW OF THE LITERATURE

The Constitution of the United States does not specifically assign the responsibility of social welfare to the Federal government. Article I, Section 8 contains a rather general clause empowering the Congress to provide for the general welfare of the people and did not refer to the creation of public social services.

Prior to the 1930's, American social welfare was managed by private social agencies, churches and counties. The major advantages of the Charity Organization Societies (COS) with regard to public poor relief were as follows:

1. COS were able to operate cheaper than poor law authorities and would save taxpayers money.

2. Private charities had a wholesome moral influence upon the clients, and were directed by devoted people, not by "bureaucrats" or political appointees and,

3. They relied upon endowments, donations, and voluntary contributions, and often
had only minor expenses for salaries and wages. 5

In spite of these advantages enjoyed by the COS, economic conditions within the country compelled the government to assume responsibilities for public welfare.

The economic depression, brought about by the crash of the New York Stock Exchange in 1929, changed the way that American social welfare was regarded. With the depression, came an overwhelming increase in the number of unemployed workers and their dependent families needing assistance of some kind. It became obvious that the reserves of private social agencies and churches were dwindling rapidly, due to the tremendous strain placed upon them by the unemployed and their families. Unemployment increased so drastically in the fifty states that several of them applied for federal aid. According to Josephine Brown, President Hoover refused to consider federal aid to states which applied for help. He thought the American way of handling the emergency, which might be of only short duration, was through private charities, supported by voluntary donations not by tax money. 6


6Ibid., p. 114.
However, when Franklin Delano Roosevelt was elected President in November 1932, the economic depression was definitely at its peak. It was during the Roosevelt administration that the New Deal programs were instituted and ushered in a new confidence that was critical to the survival of the economic system of this country.

In the words of Wilbur Cohen, although temporary emergency measures for relief land work projects under the Federal Emergency Relief Administration (FERA) were legislated, it became evident that a permanent organization of the welfare system of the country, with the Federal government sharing in its expenditures, was necessary. On January 15, 1935, President Roosevelt sent to Congress the Economic Security Bill. After certain amendments and changes the bill was passed under the title of the Social Security Act and became law on August 14, 1935.\(^7\) This act, therefore, brought the federal government into the field of social welfare.

President Roosevelt was deeply concerned and worried about the welfare and security of the elderly. Although people needed governmental intervention during this crisis, President Roosevelt still believed that private alternatives

\(^7\)Ibid., p. 127.
were equally important. The president emphasized this point when he stated that the government was not attempting to preempt the field and that private alternatives would still play a major role. He stated that ample scope was left for the exercises of private initiative. In fact, in the process of recovery, he was greatly hoping that repeated promises of private investment and private initiative to relieve the government in the immediate future of much of the burden it had assumed, would be fulfilled.  

The Social Security Act introduced three main programs. They are:

(1) A program of social insurance, consisting of a federal-state system of unemployment compensation.

(2) A program of public categorical assistance supported by Federal grants-in-aid for three groups, including Old-Age Assistance, Aid to the Needy Blind, and Aid to Dependent Children, to which a fourth category, Aid

---

to the permanently and Totally Disabled was added in 1950, and

(3) A program of Health and Welfare Services, providing for Maternal and Child Health Services, Services for Crippled Children and Child Welfare Services. 9

The Social Security Act placed the administration of these programs under the direction of the Social Security Board (SSB). The Board was created as an independent agency which reported to the President, but an amendment in 1939 placed the Social Security Board under the newly created Federal Security Agency (FSA). In 1946, a reorganization of the FSA abolished the SSB and replaced it with the Social Security Administration under a single Commissioner for Social Security. In 1953, the SSA was placed under the newly established Department of Health, Education, and Welfare (HEW). 10 In 1980, HEW was abolished and some of its functions were placed under the newly established Department of Health and Human Services.

---

9Ibid., p. 128.

10Ibid., p. 129.
From its enactment to the present, the Social Security Act has been amended many times to improve the protection Social Security provides for workers and their families. According to Robert J. Myers, the most fundamental revisions occurred in the first amendments enacted in 1939. First, benefits were provided to certain dependents of aged beneficiaries and to survivors of covered workers. Second, the law was changed so that the payment of benefits would begin in 1940 rather than in 1942. Third, benefits were tied to average earnings over a minimum covered period, thus breaking the link between total lifetime contributions and benefits. The effect of the amendments was to permit payment of benefits immediately to families currently in need. However, the most far-reaching change in the 1939 amendments occurred in the financing policy of the system. Robert Myers also stated that, the explicit intention of creating a large trust fund was abandoned. Instead, current benefits to the aged, their dependents and survivors were to be financed almost entirely out of contributions of current workers. Thus,

---

the system was moved toward a cash basis (often called a pay-as-you-go system).\textsuperscript{12}

In recent years, the amendments that have had an effect on Social Security are the 1972, 1977, and 1983 amendments. The amendments of 1972 established an automatic benefit increase system, with the intent of protecting benefits from inflation. It also raised benefits provided by Title II of the Social Security Act by 20 percent. The amendments of 1977, adopted decoupling procedures to correct a flaw in the existing benefit formula that over-adjusted for inflation. The decoupling procedure changed the existing law which permitted increases in both wage levels and prices to influence benefit schedules for retirees. The amendment of 1977 was the country's largest peace time tax increase ever. The amendments of 1983 extended coverage to employees of the Federal government, allowed inter-fund borrowing by the trust funds, and included taxation of social security benefits.

In the past, social security has been virtually immune from serious criticisms. Most people accepted the program's

\textsuperscript{12}\textit{Ibid.}, p. 34.
basic structure and method of operation. Recently, however, the program's popularity has waned, and it is experiencing severe criticisms from virtually all directions within the society. According to Peter Ferrara, social security is plagued by many problems which are resulting in substantial negative impacts on many dimensions of our economic and social lives. These programs primarily stem from the attempt by the program to pursue both welfare and insurance objectives. Ferrara also maintains that, an equally serious problem is the developing inferiority of the program to private alternatives.\(^{13}\)

The system was originally devised, as a supplemental income system to be used in conjunction with personal savings and private pension plans. In the opinion of Richard Shultz, the social security system as it presently exists is disastrous. He maintains that the original concept was well designed but as with so many government programs, politicians allowed relatively unchecked growth in the benefits promised and made no provision for a cost benefit analysis.\(^{14}\)


\(^{14}\)Ibid., p. 46.
On the other hand, Richard Keating shares a different perspective on the social security system. He maintains that the basic concepts of the present system are proper. However, social security is faced with severe short-term and long-range problems. This is due to the general lack of public understanding as to how the system works and the fact that the billions of dollars in social security trust funds are sufficient for only a few years.\textsuperscript{15}

Social security is funded through trust funds earmarked from taxes on wages, and these funds are not accumulated and saved but paid out immediately; allowing only a small reserve to be maintained in cases of temporary shortfalls in revenues. According to June O'Neill, because social security is funded through the formal mechanism of the trust fund, financing problems are highly visible. In addition to the visible short-run problems associated with maintaining the cash flow of benefits, other basic long-run problems of social security finance can have profound effects on economic growth and the distribution of income. One concern focuses on the size of the program and the desired level of benefits. Another

\textsuperscript{15}Ibid., pp. 46-47.
concern deals with the role of social security in redistributing income and involves the appropriate structure of benefits as well as taxes.\textsuperscript{16}

It is quite obvious that the main causes of the problems confronting the program are the recent combination of inflation and recession, which together raised social security benefit costs and reduced tax receipts. The shortfall in the OASI fund occurred because of a combination of lower than anticipated revenues, due to rising unemployment and negative real wage growth, and higher than anticipated benefit expenditures, due principally to high inflation rates. According to Janice Halpern the rate of wage growth approximately determines the rate at which revenues grow, while the rate of the Consumer Price Index (CPI) growth determines the rate at which benefit expenditures increase since benefits are indexed to the CPI. Moreover, higher unemployment implies that fewer people contribute revenue into the trust funds and generally leads to higher benefit expenditures since the unemployed are more likely to take an early retirement.\textsuperscript{17}


The central question of the current social security controversy is whether benefits should be curtailed to ensure the financial stability of the system. There is some disagreement over the degree of seriousness of the financial condition of the social security system. There is a strong consensus that exists in this country that some action must be taken to enhance the financial status of the social security system. Opinions vary considerably. There is little support for raising payroll taxes, but few favor benefit cuts. Contrary to the later thought, former Social Security Commissioner Robert Ball and Florida Congressman Claude Pepper, maintain that the only answer to the social security dilemma is a substantial reduction in the growth of benefits and considerable long-term savings that could be achieved with comparatively modest changes, such as raising the retirement age to 68 for those who will retire after 2010 and reducing the benefit formula.18

Numerous options have been under consideration for restoring solvency to the social security program. Three options suggested by Janice Halpern involve the reallocation of a portion of the disability insurance tax to Old Age

---

Survivors Insurance (OASI), merging two or three of the trust funds, and pay benefits out of the combined fund, and lastly structural changes should involve either reducing the rate of increase of total benefit payments or finding an additional source of revenue for the program. One interesting idea that has gained support is a scheme developed by Robert Myers. He wants to tie the annual adjustment to wages instead of prices. The annual cost-of-living adjustment would be 1.5 percentage points less than the increase in average wages. Henry J. Aaron offered the following proposal in order to protect the social security system from unanticipated economic fluctuations. These are: (1) index benefits to the lesser of the rates of growth of prices or of wages, (2) grant the social security trust funds authority to borrow from each other and the Treasury if reserves sink to unacceptably low levels, and lastly, inject some general revenues into the social security system in a carefully limited manner.


According to Peter Ferrara, the best way to reform the program should entail separating out the welfare and insurance functions of social security into two entirely distinct programs. The welfare functions could then continue to be performed by a single government program, while the insurance functions could be performed by private, market institutions.22

The diversity of opinions that exists within this country as to what is the best way to "save" the social security system also prevails with respect to defining the nature of the problem. These divergent viewpoints are dealt with in the analysis section of this paper.

V. METHODOLOGY

The methodological approach utilized in conducting this study is descriptive analysis. The descriptive methods of research attempt to describe phenomena in detail (to describe what happened). The researcher will usually not have a formal hypothesis but the research questions presuppose much prior knowledge of the problem to be investigated.

According to Claire Selltiz, et. al., descriptive studies are not limited to any one method of data collection. However, the fact that descriptive study may employ a wide range of data collection techniques, it does not mean that they are characterized by the flexibility that marks exploratory studies.23

The methodological approach utilized in this study allowed the writer to examine and describe the contending perspectives and the circumstances that led to the problems that currently confront the social security system in the United States.

The primary data for this study were collected through participant observation and two high ranking individuals in

the Social Security Administration who are very knowledgeable about the Title II program. These individuals are Messrs. Cornelius Burke, District Manager and Carl Walker, Regional Administrator.

Secondary sources of information were obtained from government documents, periodicals and books.
VI. ANALYSIS

Short and Long-Term Financing Problems

Although the social security system is plagued by both short and long-term financing problems, it is important to emphasize that these problems are caused by different factors. The short-term problems are caused by fluctuations in wages, prices, employment, inflation and periodic recessions facing the system. On the other hand, the long-term problems result from future demographic changes.

The immediate crisis facing social security is its potential bankruptcy, and both the elderly and workers find this situation disturbing. Bankruptcy is defined by Peter Ferrara "as the inability of the program to fulfill all the benefit promises it is currently making to beneficiaries."24 According to Ferrara, these promises were made to today's taxpayers to convince them to continue paying their taxes. In his view, today's workers were being lulled into making their future plans based on such promises. The inability of the program to fulfill these promises would, therefore, be a major, social, economic, moral and political problem.25

25Ibid.
The short-term financing problems have been caused by the recent failure of wages to rise faster than prices. Therefore, without an adequate contingency reserve, the social security system is affected by the fluctuations in wages, prices, and the rate of employment. The system is especially sensitive to fluctuations in employment. Employment levels are a major factor in the wage base and have an effect on the number of benefit claims. High unemployment encourages more people to retire early and start collecting benefits sooner. A study by a Congressional Committee states that: "For every 1 million workers laid off for one month in 1980, the social security fund loses about $100 million in contributions—in other words $1.2 billion a year.  

The major cause of the shortfalls mentioned above is due to the recent combination of inflation and recession, which together raised social security benefit costs and reduced tax receipts. Inflation erodes real wages for employed workers, which also hits the social security system, because benefits are adjusted for inflation. Payments into the system have not been keeping up with inflation. This is

due to the fact that wages have been going up much less than prices.

Moreover, the growth and expansion of the social security program over the years have also affected the financing of the program. Part of this growth was due to extending coverage to more types of employment and also adding on new types of benefits. According to June O'Neil, the preceding decade, 1966 to 1976, had been one of enormous expansion in the Social Security cash benefit program. Beneficiaries increased by 45 percent to 33 million persons and real annual cash benefit payments increased by 115 percent.27

In reviewing the literature, several options have been suggested by noted writers for restoring financial solvency to the social security program. Janice Halpern has suggested three options for short-run solutions that would reallocate income among the trust funds. The first option is to reallocate a portion of the DI funds to the endangered OASI fund. The second option is to merge two or three

of the trust funds and pay benefits out of the combined fund, or allow interfund borrowing. The final option concerns structural changes in the social security program that would involve either reducing the rate of increase of total benefit payments or finding an additional source of revenue for the program.28

June O'Neill has also offered several options that would allow the social security system to be on the lookout for short-term financing problems. O'Neill suggests combining the OASI and DI funds into a single fund, while maintaining separate cost analysis for each. Furthermore, O'Neill states that a more permanent solution for avoiding constant crisis is to build up the trust fund reserves to a level that would enable the system to remain solvent during several years of spending deficits, thereby providing time to evaluate the situation and make any necessary adjustments.29


Richard Keating's suggestions are similar to those made by Janice Halpern. According to Keating, the OASI trust fund should be allowed to borrow from the other funds. Keating further states that a more basic change has to deal with the automatic increase (indexing) of pensions. Although the over-indexing of the 1972 Social Security law was fortunately corrected by the 1977 Social Security law, Keating still believes that over indexing still exists.

The long-term financing problem will not be felt until after the turn of the century. The pressure will come from a population that is aging and thus will make more demands on social security. The problem will be compounded at the same time by a decline in birth rate which will bring fewer new workers into the system. Since the life expectancy is greater now than before, retirees will be collecting benefits longer. According to Jason Berger, in 1900, the average person at 65 could expect 11.9 more


31Ibid., p. 49.
years of life; in 1978 a 65 year-old had 16.1 years remaining -- a 35 percent increase, compared with a 55 percent increase in life expectancy at birth. 32

The Roosevelt Administration created the Social Security system as a program dedicated to a long-term commitment to the American people. Young people entering the labor force now will be paying taxes into the system for forty or fifty years. As such, the issues concerning long-term financing should allow ample time for individuals to adjust. According to June O'Neill, demographic variables -- fertility and mortality -- have a highly significant impact on the future financial status of social security. Because under a pay-as-you-go system such as social security, an increase in the ratio of beneficiaries to workers has direct implications for the relation between benefits and taxes. O'Neill further states that as the relative size of the taxpaying population shrinks, the tax rate must rise to compensate, if the average benefit is to rise as fast as the average wage. 33


The financial status of the social security system over the next fifty to seventy-five years is extremely sensitive to the fertility rate and the mortality experience of those born already who will, in fact, be the future retirees.

The future could possibly see an ever shrinking work force paying steadily increasing social security taxes in order to support a growing number of recipients. A completely different view has been expressed by Ed Boorstein. Boorstein believes that many factors can influence what happens to the population between now and 2025 -- changes in the rate of marriage and birth, immigration, etc. To Boorstein, immigration consists mostly of young people who can have a particularly strong influence.34

Not only is the composition of the population important, but also the rate of employment. Boorstein states that the arguments about the future problems of social security seem to assume that even by 2025 the problem of teenage unemployment will not be solved and the participation rate of women in the labor force will be no greater than it is now.35

---


35Ibid.
In spite of the divergent viewpoints expressed by these writers as to the nature of the long-term financing problems, the fact still remains that the social security program cannot afford to operate in the same fashion in the future without disastrous consequences for the system.

**Mandatory Nature of the Program**

In addition to the problems already discussed, another major one is the mandatory nature of the program. Individual contribution to the social security system is mandated by law. Whether individuals should be free from government coercion in saving for their old-age is a major issue currently being debated about the program. There are supporters and opponents of the compulsory nature of social security. In the words of Peter Ferrara, "a law or government program that unjustifiably restricts individual liberty, is immoral and unjust."\(^{36}\)

One of the major arguments against the social security program is that if a person feels that he has better uses for his money, he cannot voluntarily drop out of the program and forgo both taxes and benefits. It is believed by

critics that if young workers were allowed to save and invest in a retirement account the amounts they would otherwise pay in social security taxes they could earn far greater retirement benefits than they are currently promised under social security. Critics of the program believe that even the promised benefits may never be paid. Cornelius Burke, District Manager of Social Security Administration, asserts that "one of the disadvantages of the system is that one can pay into it and never get a cent out of it."\(^{37}\) This is due to the fact that there is no contractual agreement between the government and the taxpayer who contributes to the social security system. Moreover, since no insurance policies have ever been issued, Congress can abrogate the whole program at any time or revise the system as it sees fit. Although the likelihood of this happening is very remote, it is theoretically possible.

In spite of the fact that critics concede that on the basis of the levels of real income prevailing in the 1930's, it was appropriate, perhaps even necessary, for the preservation of the society that the government should by law guarantee to the aged, disabled, and their dependents

\(^{37}\) Interview with Cornelius Burke, Social Security Administration, Atlanta, Georgia, 3 January 1985.
replacement incomes sufficient to avoid severe hardships during that period, such a measure is not necessary today. Moreover, critics argue that it was necessary to have required workers and their employers to finance this system with a kind of forced savings through payroll tax contributions; however, as real incomes continue to rise it is not so easy to justify the requirement that workers and their employers save through payroll tax contributions to finance ever higher retirement incomes, all workers may not want to save that much, or to save in that particular time pattern and form detailed by present law.

Borrowing from the analytical framework provided by Milton Friedman in his book entitled, *Capitalism and Freedom*, Peter Farrara broke down the social security system into what he classifies as the system's various elements of coercion into the following:

1. The requirement that individuals must make some provision for their old age and other contingencies

2. The requirement that this provision be made by buying one type of insurance—social security and,

3. The requirement that this one type of insurance be purchased from one "seller"—the federal government.38

Ferrara states that if any one of these elements were to be eliminated, freedom and individual liberty would be enhanced. According to him if individuals were required by the government to accept the first element, freedom would still be assured if individuals were allowed to drop out of social security and pursue this goal by alternative means of their own choice, which would eliminate the remaining two elements. 39

On the other hand, there are important arguments for government intervention in the savings and insurance arenas. The federal government offers a return on savings that is free of inflation risk, and the rates of returns are fair to the majority of Americans. In an interview with Carl Walker, Regional Administrator of the Office of Family Assistance, he stated that social security has several advantages as compared to pension plans. He maintains that "in the first place, social security is universal and 'portable' because individuals can take those credits with them wherever they go."40

39 Ibid.

40 Interview with Carl Walker, Social Security Administrator, Atlanta, Georgia, 19 December 1984.
He further stated that, "benefits were received without regard to other sources of income and were weighted in favor of the less wealthy people. Benefits were available to individuals without regard to income, race, creed, color, or nationality."\(^{41}\)

Laurence Kotlikoff and Lawrence Summers have recently conducted some research on the mandatory nature of social security. Their findings indicate that forced government saving is effective in redistributing individuals' lifetime consumption from their youth to their old age. Furthermore, they demonstrated that in the absence of social security, individuals would consume significantly more in their youth than in their old age and would consequently face an old age of relative impoverishment.\(^{42}\)

### Negative Effects on Savings

Another problem that has received considerable attention is the negative effect that social security has on savings. The notion that social security contributes to decreased savings is advanced by Martin Feldstein and is called the

\(^{41}\)Ibid.

asset-substitution effect. On the other hand, the opposite viewpoint that social security tends to increase savings is championed by Alicia Munnell and is called the retirement effect. Both viewpoints have their own merits with regard to the effect that social security has on savings.

The asset-substitution effect proponents argue that not only does social security contribute to severe losses in savings and capital investment, but also reduces national income, economic growth and decreases employment. Peter Ferrara states that part of the problem is that social security was tailored to the unique economic circumstances of the 1930's. He maintains that although these underlying economic circumstances have changed dramatically since then, the basic structure of the program has remained the same. The flaw that Ferrara believes is responsible for the serious negative economic impact of the program is the operation of social security on a pay-as-you-go-basis. The money currently paid into the social security system is not saved and invested, but immediately paid out


44Ibid., p. 76.
to recipients. To Ferrara, this causes a massive decline in capital investment, and in turn, a decline in national income and economic growth.45

Social Security was brought into existence because of the economic crisis facing the American people in the 1930's. Since then the economy of the United States has undergone many drastic changes. These changes are due to several factors such as the rapid growth of real income (until the early 1970's), the growth of the government, increase of women in the labor market, shift toward smaller families and single households, increase in life expectancy, and yet a sharp decline in the birth rate following the baby boom. All of these changes have had an impact on social security, particularly in the way it interacts with the economy as a whole.

The social security system, critics argue, is in competition with private savings. In the words of Michael J. Boskin, if the promise of future social security benefits had led people to save less privately for their own retirement, and if the amount of this decrease had not been

45Ibid.
offset by adjustments in private intrafamily intergenerational transfers, then social security would have substantially reduced private savings in the United States over the last several decades. Boskin further states that despite the rapid spread of the ownership of capital to the general population, the national rate of saving had fallen sharply in recent years. By the end of 1978, personal saving was less than 5 percent of personal income compared with the average rate over the preceding half dozen years of almost 7 percent.46 Boskin also believes that there are many other possible explanations for the decline in private savings in the U. S.: the changing age structure of the population; the growth of government programs, including social security; the heavy taxation of income from capital, especially when our unindexed income tax system is combined with our high rate of inflation; and inflation itself.47

Martin Feldstein is one of the staunchest critics of the pay-as-you-go basis of the social security system, which


47 Ibid., p. 164.
he believes results in the negative effect on the economy. Feldstein has conducted several econometric studies in this area and documented the declines caused by social security in savings caused by social security. He first focuses on taxes, and then on benefits. According to Feldstein, these two arguments are perfectly consistent with the traditional life-cycle theory of individual consumption-saving behavior that forms a fundamental part of modern economic theory.\textsuperscript{48}

The reduction in savings caused by social security Feldstein argues, can be seen by looking at taxes. Feldstein uses the example of a person with an annual income of $10,000 who wants to save 10 percent of his total income for his retirement without social security. With social security such an individual does not have to save at all for his retirement because the program already requires him to pay more than 20 percent of his income into the program. His savings will, therefore, be reduced by the full amount of his social security taxes.\textsuperscript{49}

In assessing the impact of social security on savings, Feldstein states that the individual taxpayer may focus on

\textsuperscript{48}Martin Feldstein, "Toward a Reform of Social Security," \textit{The Public Interest} 40 (Summer 1975): 74.

\textsuperscript{49}Ibid., p. 75.
benefits instead of taxes and reason that with the promise of these benefits, he needs to save less for his retirement on his own. The taxpayer can think of his potential social security benefits as the equivalent of an annuity, giving him the right to annual benefit payments of a certain amount when he reaches sixty-five. Feldstein further states that the taxpayer can therefore reduce the amount of personal wealth he would otherwise have earned to accumulate, increasing his present consumption and reducing his savings while still attaining his previously desired level of retained wealth.

Again, because social security operates on a pay-as-you-go basis, there is no offsetting effect through the program to increase savings. The result is that total saved wealth will decrease by the full amount of the total present value of promised social security benefits. Feldstein defines this total present value as social security wealth. According to Feldstein this "wealth" does not actually exist anywhere.

50Ibid.
51Ibid., p. 77.
in the economy. It is not real wealth represented by any tangible assets. It is merely an implicit promise that the next generation will tax itself to pay currently promised benefits.53

The retirement effect, an entirely different view from above, argues that social security tends to increase savings not reduce it. The retirement effect can be attributed to three factors, according to Alicia Munnell. First, social security benefits raised the lifetime income of the first generation, encouraging older workers to consume more leisure. Second, the earnings test made it impossible to receive full benefits without significantly cutting back on work effort. Finally, social security may also have affected retirement patterns by conditioning both employers and employees to the idea that 65 is a normal retirement age. Thus, by encouraging earlier retirement, the introduction of social security could have an offsetting positive effect on savings, as individuals increase savings over shorter working lives in order to provide for a longer retirement.54

53Ibid., p. 917.

Robert Barro studied the proposition that social security depresses private saving. Barro notes that the private economy was characterized by a variety of intergenerational transfers before the introduction of social security and that to the extent that social security simply replaced the existing intrafamily transfers the program should have no impact on saving. In the words of Barro, if the pay-as-you-go social security system exceeds the desired level of existing intrafamily transfers, people will undertake offsetting measures. For low income families, this offsetting behavior may take the form of reduced support for elderly parents. In the case of high income families, the parents may increase bequests to their children to offset the children's additional payroll tax burden. Thus, to the extent that the social security program is nothing more than an orderly rearrangement of the transfer of funds across generations, the system will have no impact on saving.


56Ibid., pp. 2-3.
Robert Eisner rejects the notion that social security decreases saving. In a paper, Eisner argues that when individuals' responses to the increased wealth from the introduction of social security is considered in the context of a macro model, it appears that the program may actually have increased saving. According to Eisner, in an economy characterized by high levels of unemployment, a program which encourages individuals to save less and consume more will actually increase aggregate saving and capital formation. Even under conditions of full employment, Eisner argues that the introduction of social security need not decrease saving.

The major critic of Feldstein's asset-substitution theory is Alicia Munnell. Her response to the argument that social security has a negative impact on savings is that little evidence exists to support the contention that the social security program has depressed personal savings.

---


58 Ibid.

According to Munnell, three factors tend to undermine the contention that social security has had a significantly negative impact on saving and capital accumulation. First, the saving rate has not declined since the introduction of social security. Second, if the promise of social security benefits significantly affected individuals' incentive to save, resulting in a substantially smaller capital stock, then one would expect a secular rise in the rate of return on real assets. Finally, survey data show that people retiring today have saved about the same proportion of their income as people who retired thirty years ago, indicating that social security has not led to a drastic reduction in saving.60

**Benefit Increased Dilemma**

The final problem addressed in this section deals with benefits that social security provides. One of the most complicated elements surrounding the social security program has been its benefit structure. The basic principle of the benefit structure is that it should have a definite relationship to the earnings of the beneficiary.

60Ibid.
The benefits formula determines the basic pensions or primary insurance amount (PIA). According to Pechman, Aaron and Taussig the formula has three key features. First, a worker with low earnings history or with small earnings, who has achieved fully insured status, receives a minimum benefit. Second, a worker with average monthly earnings (AME) above the minimum receives benefits that are graduated with respect to earnings. Third, earnings in excess of the taxable earnings maximum are ignored in computing benefits. In determining a family's benefit the PIA is increased or reduced depending on age, sex, or family status of the beneficiary.61

If prices and wages did not change over time, benefits could be based on a worker's history of money earnings without raising any problems. But since real wages grow, the inclusion in benefit computations of earnings received early in life makes benefits out of date to later level of earnings. Inflation does not help solve this problem, because the difference in the wage level in the early years of the working life and that in later years is even greater.

The problem arises with keeping benefits up to date due to changing economic conditions when a worker retires with an initial benefit properly related to his earnings record already established. It is the adjustment of benefits after retirement that has brought about the benefit increase dilemma. Prices will change and productivity and real wages will continue to grow after the worker retires.

It is necessary to understand how benefits are computed. Benefits are based on a worker's lifetime average earnings that were subjected to the social security tax. The PIA is based on the average indexed monthly earnings (AIME). According to an article in the *Congressional Digest*, the first step in computing the AIME is to index the worker's taxable earnings, i.e., earnings up to the maximum amount subject to social security taxes for all years after 1950 and up to the year he or she attains age sixty (in retirement cases). The actual amount earned in each previous year is increased by the percentage that average annual earnings of all workers have increased between that year and the year the worker turns sixty. Earnings are indexed to two years before a person becomes eligible for benefits (for a retired worker, age sixty) because lags in the availability of economy -- wide data prevent
indexing to the year immediately preceding eligibility.62 The article further states that the PIA is computed from the AIME according to a formula originally specified in law and automatically up-dated every year to reflect increases in economy wide average wage levels. The percentage figures in the formula remain constant but the dollar amounts rise each year as average wages rise.63

In 1972, Congress enacted into the social security program a mechanism that allowed the benefit formula to be adjusted automatically in response to changes in the cost of living. Unfortunately, this adjustment contained a technical flaw. According to Alicia Munnell, the adjustments not only over compensate workers for inflation, but make replacement rates (the ratio of benefits to pre-retirement earnings) highly dependent on the interaction of price and wage increases.64 Munnell further states


63Ibid., pp. 197; 224.

that the instability of the replacement rates is reflected in the alarming estimated future costs of the social security program, a large portion of which are unnecessary and simply due to this intended feature of the 1972 legislation.65

In 1977, Congress realized that the benefit formula needed to be changed because each year the social security benefits were being increased by as much as $50.00 to $100.00 a month. This was adding to the cost of the program and the benefits being paid were replacing a larger and larger percentage of a worker's earnings. The replacement rates were much larger than ever intended under the original Social Security Act and were adding greatly to the financial problems facing the social security system. The 1977 Social Security Amendments, therefore, provided for a change in the computation methods that would correct the situation mentioned above. According to Henry J. Aaron, in 1977, Congress enacted a system for adjusting social security benefits over time which ensures that workers with any given level of real earnings, who reach retirement in

65Ibid.
successively later years, will receive progressively higher real benefits. Aaron further states that Congress chose this method of adjustment because it concluded that the ratio of social security benefits to wages -- that is, the "replacement rate" -- for workers at any given relative position in the earnings distribution should remain the same in the future as it is today. An implication of this method of adjustment is that workers at any given level of real earnings will receive progressively higher benefits, through operation of the weighted benefit formula.

The problems discussed in this section are the major ones confronting the social security system. These problems have led critics to assert that the "safety net" that most Americans expect to ease their financial burden during retirement is crumbling. The extent to which effective policies will be enacted at the national level will determine the viability of the system.


67 Ibid.
VII. CONCLUSION AND RECOMMENDATIONS

During the first four decades of the establishment of the social security system, the program did not experience any controversies. The main reasons for this state of affairs are due to the scale, ingenuity, and the attractiveness of the program to the public and the Congress. The major factors that contributed toward the program's popularity were the initial low cost and the assurance of benefits as a right and the overwhelming support that the program received.

Although the current problems facing the social security system are complex, the system can be saved. In the first place, interfund borrowing should become a permanent fixture of the social security system. Secondly, the mandatory nature of the system should be maintained. However, the system should be revised in order to offer attractive benefits that will rival other pension plans, such as Individual Retirement Account (IRA).

The social security program is absolutely necessary for the economic survival of millions of elderly and disabled citizens. As such, the challenge that confronts the American government today is restoring confidence of the youth
and the elderly in the social security system. It is the opinion of this writer that such a challenge could be met through rational deliberations and planning. This could be accomplished without undermining the basic assumptions of the social security program and without reneging on the promise made to the taxpayers.

**Recommendations**

The following recommendations are offered in the hope that they will address the major problems that currently affect the social security program.

1. Public education programs should be offered to the citizens so that they would become conversant with every aspect of the social security program.

2. The retirement age should be increased to, for example, age 68 since most Americans are living much longer.

3. Interfund borrowing should become mandatory or alternative financing should be provided for the system, e.g., general revenue financing; especially if the trust fund levels drop below 20 percent of what is needed to keep the system afloat.
4. Congress must insure that changes within the system are made incrementally rather than abruptly.

5. The formula for determining benefits and average earnings upon which benefits are determined should be restructured in such a way that increases in benefits should be gradual.
BIBLIOGRAPHY


Burke, Cornelius. Social Security Administration, Atlanta, Georgia. Interview, 3 January 1985.


"How Benefits are Structured." Congressional Digest, August-September 1981: 197, 224.


Walker, Carl. Social Security Administration, Atlanta, Georgia. Interview, 19 December 1984.