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THE SOCIAL SECURITY CONTROVERSY AND THE 1983 AMENDMENTS

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INTRODUCTION

As domestic political crisis go, the Social Security crisis has had a rather long run. The little monster made its first formal appearance in the 1974 Annual Report of the Trustees (1974), (1) and retained its ability to generate headlines and political grief until March 1983, when passage of the current Amendments put it to rest, at least for the time being. There is some measure of irony here. The original Social Security Act of 1935 was a rather modest venture, as these things go. Over time, the Act was expanded to cover more people, insure against more contingencies, and provide higher real benefits (Munnell, 1977). Changes since 1977 are more in the nature of reductions than growth, except for coverage which is slightly expanded by the 1983 Amendments. In 1972, Congress added what were believed to be the final touches to the structure. It provided an ultimate boost in benefits and, to take Social Security "out of politics", indexed the benefit computation formula and the benefit to price changes.

Two years later, things began to come apart. The very possibility that Social Sec-

urity could not continue functioning without major changes had not been seriously contemplated by policymakers or the public since the end of World War II. The notion that Social Security could be soundly financed on a current rather than on a fully funded basis had become acceptable since the 1939 Amendments had led to this change.(2) Each increment to the law had been legislated with considerable care. The political mechanism for effectuating changes had been built around the idea of consensus, and involved interest groups (including the program executives of the Social Security Administration), legislators who developed special knowledge, and administrations which, regardless of political party, were not unfriendly to Social Security (Derthick, 1979).

ORIGINS AND DEVELOPMENT OF THE CRISIS

In order to understand the nature and dynamics of the Social Security crisis, at least with respect to cash benefit payments, a few generally accepted principles must be reviewed. (3) The first principle is that Social Security is a set of promises for the future, and the future is uncertain. The second is that, at each point in time, taxes currently levied upon employers and workers are largely used to pay current benefits to claimants, i.e., the system pays as it goes. That is to say, it is not comparable to an annuity contract under which an insurance carrier receives premiums, invests them, and guarantees an income stream to the annuitant that is based on the amount of the premiums, the expected rate of return on accumulated premiums, and the life expectancy (or probability of other contingencies of the insured group. In Social Security there is no kitty full of cash to be paid out - no stock of assets accumulated over a lifetime to be drawn

down for retirement purposes.

Social Security promises are backed - if that is the right word - by the future taxing power of government. (4) So are government bonds, but the owner of the bond has a contractual right to payment which is protected by the Fifth Amendment to the Constitution. The "buyer" of a Social Security "annuity" has no comparable property right. His or her rights are defined by statute and may be changed by legislation. For example, in *Flemming v. Nestor*, 363 U.S. 603, the Supreme Court said that "the non-contractual interests of an employee (who had paid FICA taxes) cannot soundly be analogized to that of the holder of an annuity . . ." 363 U.S. 603, at 616. The case pheld a law depriving Communists and their dependents of benefits. Hence, if promises made at an earlier point in time cannot be kept, they can legally be modified or eliminated by Congress.

A third principle, which follows from the above, is that the taxing power of government is constrained by the willingness and ability of tax-payers to bear the burden of the tax. Willingness and ability are not fully separable concepts, but it is safe to say that they are functionally related to the real incomes of taxpayers. These, in turn, depend on the ability of the economy to generate output, preferably at a growing rate.

And there, of course, is the rub. The economy began to slow down in the late 1960's, but only hindsight showed that this was a trend and not a cyclical aberration. There were, to be sure, economists who worried in the decline on growth of output per labor hour from 2.96 percent in 1960-64 to 1.76 percent in 1965-70 (Economic Report of the President, 1982). The next two half decades saw further declines in growth, including some years when the decline was absolute rather than relative.

Give or take some swings in the business cycle, the 1970's were a decade of economic stagnation, as evidenced by the data on growth of real Gross National Product (3.88 percent in the 1960's and 3.12 percent in the 1970's), and more dramatically, by a decline in average real weekly wages from \$186.94 in the 1960's to \$164.97 in the 1970's (Economic Report of the President, 1982). That's a decline of close to 12 percent, and it is not trivial. Taxes, however, are levied on nominal income, not real income, and they began to hurt.

Let us now step back in time. During the 1950's and most of the 1960's, benefit levels remained roughly in line with price changes, being adjusted by ad hoc legislation from time to time. Toward the end of that decade - just when the economy was beginning to slow down - real benefits began to rise. Nominal adjustments in 1968 and 1970 were 13 percent and 15 percent respectively, or 30 percent for the period when compounded. The Consumer Price Index rose 16 percent during that time, leaving a real benefit increase of 14 percent. The 1972 Amendments, which were intended to depoliticize Social Security by introducing indexation in 1975, gave nominal benefits another upward push of 20 percent, well above the rate of inflation (Social Security Bulletin, 1977-79). In short, the aged, survivors, and disabled got a larger slice of the pie just about the time that the pie had ceased to grow.

I am not prepared to argue that most or at least many claimants did not need or deserve these benefit increases. In the 1960's, benefits replaced 30 percent of the earnings of the median wage earner retiring at age 65, not counting dependents' benefits or the tax free status of the benefit. By 1975 the corresponding figure was 40.4 percent (Munnell, 1979). Social Security has been of

enormous importance in eliminating poverty for all but a small segment of the aged. All I am saying is that by the mid 1970's the Social Security system had reached a point where it could not keep its promises for the immediate future, however virtuous these might have been, without some change. Moreover, it had become apparent that it would probably also not be able to keep its promises to the population cohorts born during the baby boom that followed World War II.

The particular symptoms of the stagnation of the 1970's (and early 1980's) were concurrent high rates of inflation and unemployment. The financing of Social Security was and is peculiarly sensitive to these phenomena. The indexation of benefits to prices, effective in 1975, caused outlays to rise with inflation. Unemployment, in turn, reduced revenues. If the system was to be self-supporting, that is, if it could rely on other sources of revenues, then the combination of unemployment and inflation had to be deadly. And so it was.

In 1977, after much agonizing, Congress responded to the threatened bankruptcy of the OASI Trust Fund by increasing the scheduled payroll tax increases, raising the maximum taxable wage, and indexing the latter to average annual wages. Congress also corrected the flaw in the benefit computation system that drove benefits higher than intended. This action involved a reduction in benefits for new retirees, effective 1983, and for new survivors and disabled claimants, effective in 1987. The last two groups were politically weaker than the first. What it rejected is also of interest: it did not accept the Carter proposal to tax all of the employers' payrolls, and it chose not to introduce funding from general revenues. Finally, it did not raise taxes enough to eliminate the actuarial deficit in the long run, when the war babies

would reach retirement.

CRISIS REDUX

Within a couple of years it became evident that the labors of Congress had been insufficient. Short term projections of price and wage changes, as well as unemployment, on which the legislation was based, turned out to have been wildly optimistic. The OASI Trust Fund was again heading for extinction, and would reach illiquidity levels by 1982. However, the 1982 elections had now drastically altered the consensual politics of Social Security, mixing it with the politics of the federal budget.

These politics called for sizable cut in income taxes, which was legislated, increases in defense spending, and compensating reduction in non-defense outlays in order to minimize the size of the federal budget deficits. Social Security is a rather large item in the unified federal budget, and the Administration proposed to solve the Social Security crisis by reducing the expenditure. This would also have enabled it to reduce the size of future budget deficits. Its package consisted of twelve cuts and one item of cost increases. The major cut, which led to an uproar, was a reduction in benefits for new claimants at age 62, from 80 percent of the normal benefit to 55 percent, with corresponding reductions at age 63 and 64 (U.S. Congress, 1981). Congress shuddered, and the package was withdrawn.

This left Congress with the need to do something - anything - in an atmosphere that can be characterized as one of hysterical near paralysis. The usual mechanism of amending the Social Security Act had consisted of having the House Ways and Means Committee

draft a bill, negotiate with the Senate Finance committee, and produce a compromise acceptable to Congress as a whole. This mechanism went down with the rest of the Committee process. In its place was the budget reconciliation process, long ignored until then. The outcome was series of cuts aimed at politically weak constituencies. Since this was far from sufficient to solve the near term crisis, let alone the long term problem, Congress put off the day of reckoning by authorizing the OASI Trust Fund to borrow from the other two Trust Funds in 1982. (5) After complex negotiations between Congressional leaders and the Administration, a bipartisan National Commission on Social Security Reform was to be appointed and charged with making legislative proposals to get everybody off the hook. It succeeded.

THE CRISIS SUBSIDES

The policy options that existed had been widely discussed and studied by a variety of commissions, (6) think tanks, academics, and others. No magical solutions were possible, and few politically weak targets remained. The business before Alan Greenspan's National Commission, and for the Congress, was one of how to apportion the pain among different segments of the population, now and in the future. In essence, the options that were available were:

1. raising more revenues through the payroll tax mechanism;
2. reducing benefits for present and future claimants, relatively or absolutely;
3. finding other revenue sources, e.g. general revenues;

4. devising some combination of the above;
5. introducing some flexibility into the financing mechanism to cope with the possible future shocks.

The Commission's recommendations, Report of the National Commission on Social Security Reform, 1983, which Congress speedily adopted (with only minor changes), consisted of all of the above, except that general revenues play a trivial part and are disguised as bookkeeping changes. The major ones can be summarized as follows:

Revenue Changes

Acceleration of the scheduled payroll tax increases; coverage of new federal employees; coverage of all non-profit institutions (most are covered, but this prevents them from leaving the system); prohibition of state and local governments that opted into the system from leaving it.

Benefit Changes

Postponement of cost-of-living adjustments from June to December of each year; taxing 50 percent of benefits of claimants with threshold incomes of \$25,000 (single filers) or \$32,500 (joint filers) and returning these revenues to the Trust Funds; raising the age at which full retirement benefits are available to age 66 for workers who are between 29 and 40 years old in 1983, and to age 67 for those who are twenty years old now, with a phase-in for those in between.

Flexibility

A "stabilizer", triggered by a fall in

the ratio of assets to outlays in the combined Trust Funds to 15 percent (20 percent after 1988), by which cost-of-living adjustments are based on the lower price or wage increases, with provision for catch-up benefits should the ratio rise above 32 percent; a provision that the Trustees of the Fund (the Secretaries of the Treasury, Labor, and Health and Human Services, plus two public Trustees added by the 1983 Amendments) must make recommendations to Congress in the event that Trust Fund balances fall dangerously low.

(7)

As the foregoing shows, considerable ingenuity went into the matter of distributing the pain of revising Social Security. On the revenue side, current and future workers (and employers - depending on the incidence of the tax) will pay more. Higher paid workers face a continuation of higher tax rates and rising maximum taxes. Future federal civil servants also bear some pain, but most people in this group probably do not know their future vocation and thus are not yet in a position to protest.

On the benefit side, the principal suffers are young workers, who do not think much about retirement, and workers who have yet to enter the labor market or who have not been born as yet. The higher retirement age acts, on average, as a reduction in the present value of future retirement benefits for younger workers and their successors. This is on top of the decreased rate of return on their FICA tax "investment" that would occur in any event as Social Security matures. Current retirees also bear some of the burden in terms of the deferral of the cost-of-living adjustment. Upper income retirees absorb some of the burden through the taxation of benefits, a measure that is really a benefit cut. The size of this last group is small, but it will grow through time as inflation and

higher wages push up pension incomes and yields from capital. This group is hit twice, since its members are likely to have had high average indexed earnings over their work life, and thus receive relatively lower benefits by virtue of the benefit computation formula that favors lower wage workers.

In short, although the pain of readjustment has been spread broadly, Congress did not miss the opportunity to place parts of it on politically weak groups: young workers and workers yet unborn; and the as yet relatively small number of retirees who enjoy high nominal incomes.

WHAT NEXT?

As seen above, Congress responded to the financial crisis in the Social Security cash transfer system by a combination of payroll tax revenue increase, benefit reduction, and provision for future emergencies. (8) The Reagan administration played a relatively passive role once it had agreed to the appointment of the National Commission. At present (1983), the financing crisis appears to be over. What happens next? This question involves speculation regarding both economics and politics.

On the economic side, the reforms should get the system through the rest of the 1980's--at least, there is a good chance that it will. In the decade or so that follows, the OASI Trust Fund will build an enormous surplus as a result of a shortfall in retirements, (the 1930's had a low birthrate) together with higher total employment and the higher tax rates. Whether or not it will survive the years following 2010, without further change, will depend on how closely the economic and demographic assumptions about the future that underlay the Amendments approximate reality.

These assumption strike me as a bit optimistic, but seventy-five year projections are chancy, at best.

Politically, a number of possibilities for change exist. The treatment of working versus non-working spouses may assume greater importance. Congress did not open this can of worms, but provided for a commission to study the problem. A second possibility is that younger workers will become aware that they will be paying in more and receiving less than their predecessors. If so, pressures for change may occur that can undo the revised financial structure. The AFL-CIO, traditionally a major lobbying power on Social Security matters is unhappy with the extension of the age of full benefit eligibility, and may spearhead a drive to return it to age 65 when the Trust Funds look healthier. Since the higher age constitutes a major cost saving for the long run, its abolition would require a substantial change in the method of financing the system. Unions of federal employees are likely to lobby for a return to full exclusion from Social Security. And, of course, Medicare remains a financial time bomb.

In short, the problems of Social Security are not likely to disappear. The 1983 Amendments are not the last word. Those policymakers who once thought that a social insurance system could be set up on a once-and-for-all basis, subject only to incremental improvements, have learned a bitter lesson. The future is uncertain, today's promises may not be kept when tomorrow comes, and compacts between generations are subject to amendment. But then, nothing is forever.

NOTES

- (1) The trustees were, ex-officio, the Secretaries of Health, Education and Welfare (now Health and Human Services), Labor, and Treasury. The 1983 Amendments provide for two additional Trustees to be appointed by the President. The 1974 Advisory Council on Social Security also referred to the impending difficulties. This is no coincidence, since both bodies drew their information and analysis from the same source, the program executives of the Social Security Administration.
- (2) For a discussion of the shift from more-or-less full funding to pay-as-you-go (i.e., current FICA taxes pay current benefits) see Bruno Stein, "Funding Social Security on a Current Basis: The 1939 Policy Change in the U.S." C.V. Starr Center for Applied Economics, New York University, Economic Policy Paper PP 04, 1982.
- (3) Medicare, a transfer-in-kind to the aged and disabled has some additional properties that complicate any analysis and is best dealt with separately. Costs of service delivery have been rising sharply, and there appears to no end in sight for this phenomenon. In this paper, focus will be restricted to the cash transfer programs of Social Security.
- (4) The promises of an annuity are ultimately backed by the expected future earnings of its portfolio of assets. Individual items in that portfolio may fail to deliver on the promise, hence the need for the annuity writer to assemble a diversified portfolio, prudently selected, on the hypothesis that most of the assets will be sound.

- (5) The major cuts included ending the minimum benefit for new claimants, ending student benefits under Survivors Insurance, and ending the parents' benefit under SI when the youngest child reaches age 16 instead of 18 (Svahn, 1981).
- (6) Such as the National Commission on Social Security and the President's Commission on Pension Policy, both of which issued lengthy reports in 1981. See Social Security in America's Future: Final Report of the National Commission on Social Security. (Washington: Government Printing Office, March 12, 1981) and President's Commission on Pension Policy, Coming of Age: Toward a National Retirement Income Policy. (Washington: Government Printing Office, February 26, 1981). For an analysis of these reports, see Bruno Stein, "Changing the American Retirement System," in Dallas L. Salisbury, ed., Retirement Income and the Economy: Policy Directions for the 80's. (Washington: Employee Benefit Research Institute, 1981), pp. 11-39.
- (7) For a convenient summary of the 1983 Amendments, see Social Security Administration, Office of Legislation and Regulatory Policy, Legislative Bulletin No. 98-15, March 28, 1983. A complete text, including the differences between the House and Senate versions, is found in Congressional Record - House, March 24, 1983, pp. H1724-H1779.
- (8) Changes were also made in the Medicare reimbursement system in an effort to contain costs. These changes will not suffice to solve the Medicare financial problem, and may lead to a reduction in the quality of service delivery. But this is a separate story.

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