Social Security

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Chapter 3
Development of the OASDI System

Chapter 2 described the Old-Age, Survivors, and Disability Insurance (OASDI) system as it stands after amendments through 1992. This chapter describes how the program took its present form through sometimes gradual and sometimes rapid evolution over the more than five decades that it has been in existence. The presentation traces the major legislative changes within each of the broad categories of coverage, benefits, and financing, but it does not consider in any detail the changes and developments in connection with the financing basis, which are discussed in the next chapter. One section presents the recommendations of the 1975 and 1979 Advisory Councils on Social Security, the 1981 National Commission on Social Security, the Reagan administration, and the 1982–83 National Commission on Social Security Reform—and indicates the extent to which these were adopted. The procedures by which legislative changes have been made are also described.

The vast majority of the changes made in the benefit provisions over the years before 1983 were liberalizations (increased benefit amounts, reduced eligibility requirements, new types of benefits, increased exempt amounts, or lower limiting age for the retirement earnings test). However, several significant deliberalizations did occur then, as follows:

1. The elimination of the return-of-contributions provision by the 1939 Act.
2. The greater applicability of the earnings test after the 1950 Act extended coverage to more types of employment.
3. The counting of all earnings (rather than only covered earnings) for the earnings test, as a result of the 1954 Act.

4. The Workers' Compensation Offset provision for disability benefits, as a result of the 1965 Act.
5. The elimination of the monthly retirement earnings test after the initial year of claims receipt, as a result of the 1977 Act.
6. The introduction of a "government pension offset" against benefits for spouses and widow(er)s in the 1977 Act.
7. The revised method of increasing benefits under the automatic-adjustment provisions for persons who have reduced benefits because of early retirement, as a result of the 1977 Act.
8. The decoupling procedure for the computation of initial benefit amounts introduced by the 1977 Act (including the freezing of the regular-minimum PIA).
9. The reduction in the Maximum Family Benefit for disabled workers and the more restrictive method of computing the AIME for disability benefits for young workers, as a result of legislation in 1980.
10. The decrease in the period for which benefits can be claimed retroactively, for all types of benefits except those with respect to disabled workers, as a result of legislation in 1980.

These changes are discussed throughout this chapter (or else were mentioned in Chapter 2). The 1981 and 1983 Acts made several very significant deliberalizing changes (as will be discussed later).

Detailed analyses of several aspects of the development of the program, such as the different treatment by sex under OASDI, are presented in several appendixes to this chapter. Certain details of some significance are relegated to footnotes in the text.

Political philosophies have, quite naturally, played an important role in policymaking for the OASDI and Medicare programs over the years. This has been the case not only for members of Congress but also for political appointees and civil servants who were specialists in the field. An excellent source of historical research and analysis of this matter is *Policymaking for Social Security* by Martha Derthick (Washington, D.C.: Brookings Institution, 1979).

When the Social Security Act was enacted in 1935 at the initiative of President Franklin D. Roosevelt, many people deplored it as a revolutionary move toward socialism. On the other hand, some of the political left wing believed that President Roosevelt advocated this and other elements of the New Deal solely to prevent social revolution. Thus they thought that, rather than being radical, he was profoundly conservative. His views were well expressed in his statement on signing the Act into law on August 14, 1935 (see Appendix C).

In fact, it has been stated that, if he had not been so conservative, we would have had both a more liberal and extensive OASDI program and a national health insurance plan five decades ago. For a vigorous presentation of this view, see Kenneth S. Davis, "The Birth of Social Security," *American Heritage*, April–May 1979. It may also be noted that Chancellor Otto von Bismarck of Germany was similarly accused of instituting, in the 1880s, the first social insurance program—for the purpose of thwarting his Socialist Party opposition by having a more modest plan.

At times, and especially when the Social Security program was first being considered by Congress in 1935, people have urged that employers who have private pension plans should be permitted to opt out of the governmental plan. Such a procedure is allowed in a few countries—for example, the United Kingdom. Perhaps the most serious legislative battle in 1935 was over this issue.

Senator Bennett Champ Clark sponsored an amendment that would permit employers with pension plans which provide at least as liberal benefits to opt out of Social Security. The Senate adopted this amendment, which was strongly opposed by President Roosevelt and by the labor movement. The conference committee between the House and the Senate, after agreeing on all other items of difference between the bills passed in the two bodies, could not agree on this matter. In the end, the dilemma was solved by dropping the Clark Amendment and establishing a special committee to attempt to work out a generally acceptable amendment to accomplish its purposes, to be presented at the next session of Congress.

By the time of the next session, interest in the Clark Amendment had disappeared, and the work of the special committee was ignored, with no congressional action being taken. Apparently, employers and insurance companies came to realize the great difficulties and administrative problems involved, as well as the likelihood of undesirable (to them) federal controls over private pension plans—which came anyhow with ERISA some 37 years later. Interestingly, the largest employer of all, the federal government, opted out of the Social Security program in 1935 on the same grounds—that it had adequate pension plans for its civilian and military personnel!

Two myths have become rather widespread about the origins of the Social Security program. First, it is alleged that this program was enacted to serve as a supplement to private pension plans and savings. Just the reverse is the case, because it serves as a floor of protection on which private-sector economic-security measures can be built. Moreover, in the mid-1930s, relatively few private pension plans were in existence and individual savings had been hard hit by the Great Depression.

Second, many people assert that the main purpose of establishing the Social Security program was to get older workers to retire and make jobs available for younger workers. Again, this was at most a minor factor. Actually, not many workers aged 65 or over would be eager to retire on a benefit of about $15–20 a month (when the average wage was about $90). Moreover, the Social Security program would not be very expeditiously effective in this manner because, under the original 1935 law, monthly benefits would first be payable so long afterward—in 1942!

The following discussion weaves in the very significant changes made by the 1983 Act. Their cost effects, both short range and long range, are set forth in detail in Chapter 10.

Coverage

1935 and 1939 Acts

The 1935 Act covered essentially all employees under age 65 in industry and commerce other than railroad workers. The 1939 Act extended coverage only by eliminating the age-65 restriction.

1946 Act

The 1946 Act provided gratuitous wage credits for those in military service in World War II. Legislation in subsequent years extended such credits through 1956, after which regular contributory coverage was effective.

Legislation in 1948

House Joint Resolution 296 (the so-called Gearhart Resolution) was enacted over President Truman's veto. It amended the definition of "employee" so as to exclude from coverage any person who, under common-law rules, is an independent contractor and is not an employee under such rules. This was done to reverse a decision made by the Supreme Court. About 500,000 to 750,000 persons were affected. Depending on how one looks at the matter, it was a cut-back in coverage or a clarification of the law so that coverage was not extended beyond what Congress intended.

Anyhow, the matter became relatively moot when coverage was extended to the nonfarm self-employed in the 1950 Act.

1950 Act

The 1950 Act brought coverage to virtually all employees of private and public employers including regularly employed farm and domestic workers, except those already covered by some type of government retirement system. Coverage for all employees then brought in was not automatically provided, because for certain categories, such as employees of nonprofit charitable, educational, and religious organizations and of state and local governments, it was available on a group elective basis. Coverage was extended beyond employees to include most nonfarm self-employed persons other than those in certain professions. The geographic limits of coverage were extended beyond the original bounds of the continental United States, Alaska, and Hawaii (plus certain maritime employees) to include Puerto Rico and the Virgin Islands, and also Americans working abroad for American employers.

1954 Act

The 1954 Act extended coverage even further by bringing in self-employed farmers and, on an elective basis, most state and local government employees under existing retirement systems.[1] As a result, relatively few substantially employed persons were not covered or could not be covered by election. Also, ministers were covered (on the self-employment basis, even though they might be employees) on an individual, voluntary-election basis, with strict rules to minimize antiselection. The most important groups still excluded were federal employees (including the military) under an existing retirement system, self-employed persons in the fields of medicine and law, and policemen and firemen under existing retirement systems. In addition, railroad workers were not directly covered, although as a result of amendments to the Railroad Retirement Act in 1951, those with less than 10 years of railroad service were covered under OASDI. In effect, even those with 10 or more years of service were covered from a financial standpoint as a result of the financial-interchange provision.

1. It is interesting that many groups of employees under existing retirement systems had been adamant against even elective coverage in 1950, but some such groups desired coverage, and so the provision in the 1954 Act resulted. In fact, in a few instances after the 1950 Act was passed, the existing retirement system was repealed so that coverage could be obtained, and then very shortly afterward, the previous system (or a modification) was reinstituted.

1956 Act

The 1956 Act brought in the remainder of professional self-employed persons, except for physicians, and gave more opportunities for coverage for state and local government employees under existing retirement systems. Other legislation enacted in 1956 changed the temporary gratuitous coverage of members of the armed forces to regular contributory coverage, beginning in 1957 (along with supplementary gratuitous credits representing an allowance for noncash remuneration).

The original planners of the Social Security Act in 1935 viewed coverage of all types of employment as the desirable goal for the system, after administrative and constitutional problems could be solved. In subsequent years, all studies of the program reaffirmed this principle. Furthermore, all supporters of the program, regardless of their views on the breadth of scope of the benefit protection, believed in this principle. The 1954 legislation meant the almost complete realization of this aim. The 1956 legislation moved even further in this direction.

1958 and 1960 Acts

These added only slightly to the coverage of the program by bringing in a small number of individuals in certain categories, principally in state and local government employment. The 1960 Act added a small amount of coverage, such as employment in American Samoa and Guam and employment of American citizens by foreign governments and international organizations in the United States.

1965 Act

Self-employed physicians were covered. This was done at the same time that Medicare was legislated, both over the strong opposition of organized medicine. Also covered were tips paid to employees, which had been a particular problem over the years (because employers did not want to pay taxes on them, or even account for them).

1967 Act

The coverage basis for ministers was changed to a compulsory basis, but with opting-out permitted on grounds of conscience or religious principles (based solely on the word of the minister). This change was made because many ministers, particularly younger ones, were not electing coverage owing to economic or political reasons, which basis was not the original intent of the provision.

1972 Act[2]

Coverage was provided for members of religious orders under a vow of poverty, on the employer-employee basis, if the order so elected, and for coverage of ministers who were U.S. citizens employed outside the country regardless of for whom they worked. Also, the optional simplified reporting procedure previously applicable to farmers was extended on a limited basis to other self-employed persons. Furthermore, noncontributory wage credits, somewhat similar to those applicable to members of the armed forces, were granted to U.S. citizens of Japanese ancestry who were interned during World War II.

1977 Act

Some important developments in coverage occurred when Congress considered the 1977 Act. The House Committee on Ways and Means proposed compulsory coverage for all state and local government employees and all nonprofit employees for whom coverage had not been elected and for civilian federal employees under retirement systems, such as the Civil Service Retirement plan. Such coverage would have first been effective in 1982 (to give ample time for revising existing pension plans to coordinate with OASDI).

This was proposed in part because of the windfalls going to workers who spend most of their careers in noncovered employment and then obtain covered employment (either by moonlighting or after early retirement from their career job). It was also proposed because of the significant increased taxes that would result (which would greatly alleviate the short-run cash-flow problems of OASDI). Another reason was to recognize and prevent the movement of some state and local governments to terminate coverage under the provision of the law that permitted this. (For an account of this very controversial matter, including discussion of the pros and cons for such action, see Appendix 3-1; although the 1983 Act eliminated the possibility of such withdrawals, it was such an important issue that presentation thereof seems worthwhile.)

This proposal aroused great opposition among federal-employee

2. Actually, there were two important amendments enacted in 1972. Here they will be referred to in combination as the "1972 Act." This also occurred in 1973, although the two amendments enacted then were not nearly so extensive. Similarly, there were four significant amendments in 1980 and two in 1981.

organizations, although the AFL-CIO union for state and local employees supported it. Rather surprisingly (and, to the author, dismayingly), the Carter administration opposed the proposal. When the legislation was debated on the House floor, an amendment proposed by Representative Fisher (representing the Virginia suburbs of Washington, D.C.) to delete the compulsory-coverage provision—and, instead, provide for an intragovernment study of the matter—was adopted by an overwhelming vote (about 10 to 1). As a result, the final legislation provided only for the study.

An interesting and extremely significant aspect of eliminating the compulsory coverage of government and nonprofit employees by House floor action was that the rules of procedure were such that any proposed amendment that increased the cost of OASDI was required to provide the necessary financing. In this case, the increased cost was met by providing in the amendment for increases in the tax rate of 0.1 percent each for the employer and employee (beginning in 1981) and in the maximum taxable earnings base for 1981, from $27,900 as in the bill of the House Ways and Means Committee to $29,700 (which, as a result, is in the present law).[3] It is ironic, although clearly demonstrative of the effect of noncoverage of a substantial number of government employees (and the small number of nonprofit employees), that all other workers in the country were thus required to pay more OASDI-HI taxes!

Nonetheless, the 1977 Act did contain two provisions that have some effect on reducing the windfalls mentioned above. First, the minimum Primary Insurance Amount (PIA) available initially at claim was frozen at its value as of December 1978 (rounded to $122). Second, an offset of an individual's pension under a government-employee plan based on employment where there is not simultaneously OASDI coverage as of the last day of employment of such individual is made against any OASDI spouse's, widow's, or widower's benefit otherwise available (but with certain phasing-in or grandfathering). This offset was not applicable to the other large groups for which coverage was then effective—employees of charitable, educational, and religious nonprofit organizations; this was probably done because many of this

3. The author believes that providing part of the required financing through increasing the earnings base was not proper (or really within the spirit of the rule). Moreover, the combined financing provided was inadequate and should have had additional financing of an increase in the tax rate of 0.05 percent each. The actual financing basis of this amendment was "justified" by inaccurate cost information in a memorandum from the Commissioner of Social Security, dated October 25, 1977, for Representative Fisher (and published in part in the *Congressional Record*, October 26, 1977, p. H11595). The Office of the Actuary, SSA, however, clearly indicated such inadequacy to both the commissioner and the Congress.

group who were not covered under OASDI were part-time workers and did not have private pensions that could be used as offsets, so that much administrative effort would have been involved for little real effect.

The only other important action in the coverage area in the 1977 Act was the provision authorizing international agreements. These can result in combining (or totaling) earnings received in several countries for benefit purposes, when this is advantageous to the individual, and in eliminating the payment of dual social insurance taxes for persons working outside their own country.

1983 Act

Employees of nonprofit organizations were covered on a compulsory basis, as were also federal civilian employees who were hired after 1983.

Existing federal employees as of the end of 1983 (who had been covered by legislation in 1982 for HI only, and not OASDI, beginning after 1982) continued to be excluded except for a few categories—the President, the Vice President, members of Congress, judges, top-level political appointees (such as the Secretary of HHS), and congressional employees who had not elected to be covered under the Civil Service Retirement system. (A new retirement system was developed for the new hires after 1983, but the group of existing employees in service at the end of 1983 who were brought under OASDI can have full benefits under both that program and CSR.)

Another change was that state and local governments that had opted into the OASDI-HI program will no longer be permitted to withdraw (and those that had withdrawn in the past are now allowed to opt in again). Yet another change was the inclusion of more fringe benefits as covered wages (see Appendix 2-13 for the details); sick pay was included as covered wages by legislation in 1981.

Legislation in 1984–1990

In 1984 legislation, churches and church-controlled organizations which were opposed on religious grounds to paying Social Security taxes were permitted to elect not to pay such taxes (as had resulted from the compulsory-coverage provisions of the 1983 Amendments). Under such circumstances the employees involved are to be covered, on a compulsory basis, as being self-employed.

In 1987, additional farm workers were covered by including all such workers (except for hand-harvest laborers) for employers with annual payrolls of at least $2,500. Individuals employed by their spouse were covered, as also were children aged 18–20 employed by a parent. Employers of workers who received tips were required to pay the matching employer tax. The employer premiums on group life insurance in excess of $50,000 face amount (which had been subject to income tax) were made taxable for OASDI-HI purposes.

Legislation in 1988 and 1989 extended the elective exclusion of persons of certain religious sects that are opposed to receiving public insurance benefits. Now, in addition to such persons who are self-employed, such persons who are employees of employers of such sects or of churches and church-controlled organizations who elected not to be covered can themselves elect out.

Legislation in 1990 extended coverage, on a compulsory basis (effective beginning July 2, 1991) to all state and local government employees who are not covered by a retirement system (other than students employed by the institution which they attend).

Monthly Benefit Categories

1935 and 1939 Acts

Monthly benefits were provided only for retired workers aged 65 or over in the 1935 Act. The 1939 Act changed drastically the character of the system by adding benefits for family members and survivors, including the wife aged 65 or over and the child under age 18 of the retired worker, the surviving widow aged 65 or over, the surviving dependent parent aged 65 or over, and the orphaned child under age 18 and the mother of such child. Subsequent legislation broadened and extended these categories, often in minor respects, as particularly "deserving" and "noncontroversial" cases were called to the attention of members of Congress.

1950 Act

A few relatively minor beneficiary categories were added, including dependent husbands and widowers aged 65 or over, and wives of retired workers regardless of the wife's age if a child under age 18 was present. The addition of husband's and widower's benefits was the first of a series of changes with relatively little effect, and thus low cost, that provided greater equality in the treatment of male and female workers and of male and female beneficiaries. This change had relatively little effect because few men were financially dependent on their wives, and even then the man may have previously earned a benefit from his own employment that would be offset against the benefit coming from his wife's earnings.

1952 Act

Included was a provision for a disability freeze, which protects the disabled worker's insured status and average monthly wage for benefit-computation purposes against the diminishing or destructive effect that would otherwise occur because of having no creditable earnings after becoming disabled. This is similar to the disability waiver-of-premium clause in life insurance policies. Because of an unusual legislative maneuver, with the House of Representatives and the Senate disagreeing on the desirability of this provision, it was not actually operative. However, the 1954 Act included such a provision on a fully effective basis.

1956 Act

The eligibility age for benefits payable to women was reduced from 65 to 62, except that for women workers and wives retiring before age 65, benefits were reduced for such early retirement. This change was made because of the pressure to provide benefits to the wives of men who retire at or just after age 65, in which case the wife is often a few years younger. In turn, this required reducing the minimum age for widow's benefits (although there was considerable sympathy for making this change on its own merits) so that no "dry spell" would occur for a wife coming on the roll at or just after the minimum age who became widowed before age 65. Then, in the interest of equity to working women, the minimum retirement age had to be reduced to the same age 62 (because she had made contributions toward her benefit and so should not be required to wait longer to receive it). Reductions for claiming benefits before age 65 were introduced for female-worker and wife's benefits in order to hold down costs. No reductions, however, were made in widow's benefits, because of the general sympathy for widows.

In addition, the 1956 Act added two major beneficiary categories—permanently and totally disabled workers aged 50 to 64 (but with no benefits for family members) and children aged 18 and over who are eligible as auxiliaries or survivors if permanently and totally disabled before age 18 (increased to age 22 by the 1972 Act). These age limitations on the availability of disability benefits were introduced not only because of cost considerations but also because of the uncertainty of how well the program could be administered and whether malingering would occur. The latter was thought to be more likely if the benefit level were high (as it would be if auxiliary benefits were available) and also more likely for younger beneficiaries with long potential periods of benefit receipt. The disability benefits for disabled workers were subject to reduction by the amount of any other federal disability benefit (such as a veterans' benefit) or any workers' compensation benefit. This offset provision was eliminated in 1958, but was partially restored in 1965 (as to partial offset of Workers' Compensation benefits) and fully restored as to partial offset of other disability benefits in 1981 (except as to veterans' benefits).

1958 and 1960 Acts

The 1958 Act made family members of disabled-worker beneficiaries eligible for benefits on the same basis as those of retired workers. The 1960 Act made the very significant change of eliminating the age-50 requirement for monthly disability benefits. Both these changes seemed feasible because the cost experience of the program seemed favorable (although, as it turned out later, it became less favorable as time passed).

1961 Act

The eligibility age for men was reduced to 62, in a manner similar to what the 1956 Act had done for women, except that the "end computation point" for both insured status and benefit amounts was left at age 65, although it had previously been reduced to age 62 for women. This discrimination against men was retained for cost reasons and was not remedied until the 1972 Act (and then only prospectively, because there was completely equal treatment by sex for purposes of insured status and benefit computation only for those attaining age 62 after 1974). (Appendix 3-2 gives more details on this matter.)

1965 Act

Two new beneficiary categories were added—child school-attendance benefits (payable at ages 18–21)[4] and wife's and widow's benefits with respect to divorced wives when the marriage had lasted at least 20

4. The 1972 Act extended the benefit period until the end of the semester or quarter during which age 22 is attained for those who had not completed their undergraduate studies.

years (decreased to 10 years by the 1977 Act).[5] Also, the minimum age for widow's (but not widower's) benefits was reduced from 62 to 60, but an actuarial-reduction factor, at the same rate per month of early retirement as was then applicable for retired workers, was applied to the basic benefit rate (then 82½ percent of the PIA).[6] Also, for widows who remarry after age 60 (for widowers, after age 62—until the 1972 Act), benefits were not terminated, but rather were reduced to the spouse's benefit rate (50 percent of the PIA)[7]—the so-called living-in-sin amendment. A Workers' Compensation offset provision against the amount of the disability benefits was introduced (or, rather, reintroduced, because a somewhat similar provision had been in the 1956 Act but was repealed in 1958). This was necessary to prevent the payment of total benefits that would be excessively high and thus likely to discourage rehabilitation and a return to work.

The 1965 legislation also liberalized the definition of disability by changing it from a "permanent and total" definition to a disability that is expected to last at least 12 months or to result in prior death. The principle of the disability preventing engagement in substantial gainful employment was continued. The 1967 Act clarified and extended this basis by specifying that such inability to engage in employment referred to work in the national economy, and not merely in the locality where the disabled person lives. The change to the 12-month basis was not so great as it might seem, because previously the "permanent" definition was generally considered as really meaning being disabled for a period of about 24 months.[8]

The 1965 Act provided benefits at age 72 at a flat rate that was lower than the regular minimum to the few persons who were then age 72 or older or would attain that age in the next few years and who had at least 3 quarters of coverage (QC) and would have been fully insured except for the minimum requirement of 6 QC.[9] This affected only workers who attained age 72 before 1964 in the case of males, and before 1967 in the case of females. An amendment in 1966 ex-

5. Until the 1972 Act, the divorced wife had to prove that support was being received from the insured worker.

6. This benefit was made available for widowers by the 1972 Act.

7. Such reduction was eliminated by the 1977 Act (so that the full widow's benefit continues to be paid).

8. The definition was further liberalized for blind persons, so that at ages 55–64, it was inability to engage in the usual occupation.

9. The flat benefit rate has been increased over the years by the same percentages as the regular benefits, except in 1967, when the increase was 14.3 percent instead of 13 percent, and in 1971, when it was 5 percent instead of 10 percent. For the future, the automatic-adjustment provisions apply to this benefit in the same manner as to the regular benefits.

tended this benefit to all persons who attained age 72 before 1968, even though they did not have any QC (and to the small number of persons who attained age 72 in the next few years—in any event before 1971—who had a few QC but not enough to be fully insured).

These changes of a blanketing-in nature were made to satisfy those who pointed out the great "actuarial bargains" received by those who were fully insured on the basis of a few QC (at least 6) compared with those affected by these two amendments who had previously not been eligible for any benefit. The provisions, however, were carefully written so as to apply to only a closed group so that they would phase out and not be of a permanent nature that could tempt some persons to avoid, or else not seek, OASDI coverage because they could get these benefits anyhow. These benefits, except for persons with at least 3 QC, are financed from the General Fund of the Treasury; the reason for this is to "maintain the contributory principle of OASDI." (But note that the elimination of the regular-minimum benefit in the 1982 Amendments for persons who attain age 62 after 1982, with a minor exception for members of religious orders who have taken a vow of poverty, which expires for those who attain age 62 after 1991, would cause these special-minimum benefits inadvertently to phase back in again in 1992; however, this anomaly was prevented by a technical amendment in the Omnibus Budget Reconciliation Act of 1990.)

Payment of the costs of rehabilitation services was provided out of the trust funds for disabled beneficiaries where this would be profitable to OASDI by removing persons from the benefit rolls when they recover and can return to productive activity. Originally, there was a limit for such payments for a fiscal year of 1 percent of the benefit payments to disabled beneficiaries in the preceding fiscal year; the 1972 Act increased this to 1¼ percent for fiscal year 1973 and to 1½ percent thereafter.

1967 Act

Widow's and dependent widower's benefits were provided beginning at age 50 if the beneficiary is disabled. Large early-retirement reduction factors were applicable, depending on the number of months that the beneficiary is below age 62 when benefits are first claimed. A more stringent definition of disability is applied than that applied for disabled workers and disabled children—namely, requiring inability to engage in *any* gainful activity rather than in *any substantial* gainful activity. This restrictive basis was adopted because of the possibility of adverse experience with a category of persons who have generally not been in the labor market and whose ability to perform gainful work thus is difficult to test.

The 1967 Act also made two important changes in insured-status requirements. First, these requirements as they apply to women workers for child-survivor benefits were made less stringent by eliminating the requirement of currently insured status for married women generally, so that there would be complete equality between the sexes in this respect. Second, an alternative, more liberal, disability insured-status provision was instituted for young workers, recognizing that they might become disabled shortly after entering the labor market.

1972 Act

Grandchildren can be eligible for benefits on the earnings record of an insured worker, but this will occur only in the very rare case when the parents are dead or disabled and the child was living with and being supported by the grandparent. Generally, under such circumstances, benefits will be payable to the child on the earnings record of the parent; these will be offset against the benefit coming from the grandparent, perhaps to the extent that nothing will be payable on the record of the grandparent.

The 1972 Act significantly increased widow's and dependent widower's benefits (at the same time, making the age requirements the same by sex) by having the basic benefit rate be 100 percent of the PIA when benefits are first claimed at age 65 or after, but with reduced benefits for earlier ages at claim,[10] and with a possible further reduction if the deceased spouse had received actuarially reduced early-retirement benefits. This change was made under the "logic" that the widow needs the same benefit amount as the unmarried retired worker. In many other retirement systems, the widow's benefit rate is lower than that for the retired worker on the ground that the latter "made contributions toward his benefit."

The exception that the widow's (or dependent widower's) benefit, after reduction for claiming benefit before the NRA, cannot exceed the reduced old-age benefit of the retired worker if he or she had received one (or, if larger, 82½ percent of the PIA) was made to be

10. For those claiming benefits between ages 60 and 65, a reduction factor grades in on a linear basis between the 100-percent factor at age 65 and the 71½-percent factor at age 60 that applied under previous law. This results in a factor of 82.9 percent at age 62, compared with the previous one of 82.5 percent. The change was made so as to have the factors move smoothly by age at claim, rather than to have a linear basis between ages 60 and 62 (as before) and a different linear basis between ages 62 and 65.

consistent with the theory that the widow's benefit should be equal to the worker's benefit. However, overriding this, the widow's benefit cannot be reduced below 82½ percent of the PIA (otherwise, it might have been reduced to as little as 80 percent of the PIA), because this was the benefit rate previously applicable for widowhood at age 62 or over. This is a vivid example of how permanent complexities can be introduced into the program to preserve vested rights and prevent deliberalizations!

Court Decisions in 1975–1982

A Supreme Court decision in March 1975 ruled that father's benefits for a widower with young children must be paid on the same terms as mother's benefits for a widow with young children. This was done even though the law contained no such benefit provision, even with a test of dependency, as was the case for aged husbands and widowers.

Then, in March 1977, the Supreme Court ruled that there could not be a dependency requirement for aged husbands and widowers if there was not one for aged wives and widows. As a result, the Social Security Administration began paying husband's and widower's benefits without a test of dependency on the wife.

Subsequently, a number of court decisions struck out other such differences in treatment by sex. Appendix 3-2 presents a detailed account of the past developments and the status in equal treatment by sex under OASDI as it was before the 1983 Act, which eliminated virtually all gender differences.

Legislation in 1981

Legislation was enacted in 1981 largely for the purpose of lowering the cost of the OASDI program, although to a considerable extent for general budgetary reasons. The most important change was to eliminate child-school-attendance benefits for those aged 18–21 (except for those aged 18 who are in elementary or high school); this was done by phasing out benefits for those who were entitled to them before May 1982. At the same time, similar school-attendance benefits, available through the Veterans Administration, were made available with respect to persons who died in military service or as a result of a service-connected cause before August 13, 1981.

Also, actuarially reduced benefits for the month of attainment of age 62 for retired workers and for spouses and divorced spouses without eligible children of retired and disabled workers were eliminated, except when such attainment occurred on the first day of the month.

This change has a short-range positive cash-flow effect for the OASDI Trust Funds (and was thus "favorable" from a General-Budget standpoint when the trust-fund operations were included therein), but no long-range effect, because the persons so affected have slightly larger benefits for their lifetimes (on an actuarially increased basis) as a result of beginning benefit receipt one month later. This is an outstanding example of changing (and complicating) the OASDI program solely to "play General-Budget games"!

1983 Act

Not only did this legislation eliminate all gender differences in the various beneficiary categories, but it also made several changes in benefits affecting primarily women. The benefit rate for disabled widow(er)'s benefits available for disability at ages 50–59 was made a uniform 71½ percent (the same as for nondisabled widows and widowers at age 60), regardless of age at disability—instead of being graded upward from 50 percent for age 50 at disability. Deferred widow(er)'s benefits are indexed during the deferral period by wages or prices, whichever is more favorable. Remarriage is no longer a cause of termination of widow(er)'s benefits for surviving divorced spouses and for disabled widow(er)s—as was the case previously for widow(er)s aged 60 or over. The divorced spouse aged 62 or over of a fully insured worker aged 62 or over can receive benefits even if the worker does not file claim for benefits (because, generally, of being substantially employed).

Legislation after 1983

In 1986, great-grandchildren were made eligible for child's benefits in the same manner that grandchildren are. In 1990 the more restrictive definition of disability for widow(er)'s benefits was made the same as that applicable to workers and to children who are disabled before age 22.

Lump-Sum Benefits

1935 Act

In essence, a money-back guarantee was provided with respect to the employee taxes. If a worker died before reaching age 65 (or if a worker attained age 65 but did not meet the eligibility requirement for monthly benefits), a lump sum of 3½ percent of total covered wages was available. For death after age 65, the lump sum was this 3½ percent, minus the total monthly benefits paid (so that, for deaths some time after retirement, no lump sum would be available). Because the maximum scheduled tax rate was 3 percent, this provision resulted in every worker being "guaranteed" to have at least as much paid in monthly or lump-sum benefits as the employee taxes that had been paid.

1939 Act

The money-back guarantee was eliminated. Instead, monthly survivor benefits and a small lump-sum death benefit were provided. Such lump sum was 6 times the primary (monthly) benefit and was payable only when no monthly survivor benefits were payable for the month of death of the worker (made applicable to all deaths by the 1950 Act). This produced about the same amounts as the previous law did in 1939 or would have done in 1940. However, the original money-back-guarantee basis would have produced increasingly larger amounts over the years. For example, a person dying at the end of 1984 after having had maximum covered wages in all years from 1937 on would have had a lump-sum death payment of $15,127 under the original basis. Under the actual circumstances, the lump-sum death payment was only $255 and was payable only if a spouse who had been living with the worker was present (or else there was a spouse or child who is eligible for immediate monthly benefits). Thus, such a worker who dies without eligible dependents has much lower benefits under the law as it has been changed than under the original law.

1950 Act

The basis of the lump-sum death payment was changed to 3 times the PIA. Because the benefit level was almost doubled by this legislation, the size of the lump sums remained about the same. The 1952 Act established a maximum of $255 for the lump sum, which was the most then possible. In 1974, for the first time, the minimum PIA exceeded $85, so that all lump-sum death payments were based on the $255 maximum.

1981 Legislation

Legislation enacted in 1981 eliminated the lump-sum death benefit except when there is a spouse who was living with the deceased worker or when there is a spouse or child who is eligible for monthly benefits for the month of death.

Benefit Amounts

There have been 29 different formulas for the determination of the Primary Insurance Amount (PIA), which is used in determining all benefit amounts. An important feature in benefit determination is the average monthly wage (or, under the 1977 Act, the average indexed monthly earnings) to which the formula is applied.

Table 3.1 sets forth these formulas through the one applicable for June 1978, along with a general description of the basis of computing the Average Monthly Wage (AMW) in connection with each one. The formulas enacted in 1954 and before were actually stated in the law. Beginning with the 1958 Amendments, a benefit table showing the PIA for each dollar amount of AMW was given in the law, instead of a benefit formula. Thereafter, the PIAs were increased by flat percentages across the board, and new tables were published as regulations. The benefit formulas in Table 3.1 reflect the application of such percentage increases, enacted in various years, to the formula in effect prior to the enactment (plus the effect of adding new bands at the top of the AMW range when the earnings base was also increased). These formulas should be regarded as approximate, due to rounding differences.

Benefit Formulas during 1976–1978

The benefit formulas applicable for June of 1976, 1977, and 1978 as a result of the automatic-adjustment provisions were derived quite simply from the 1975 formula. The procedure was merely to multiply each percentage factor in the 1975 formula successively by the benefit increases promulgated for each year (namely, 6.4, 5.9, and 6.5 percent). At the same time, each January 1, when the maximum taxable earnings base was increased, a new dollar band was added at the end of the benefit formula. The size of this band was one twelfth of the increase in the earnings base. A factor of 20 percent was applicable to the new band. Then, in successive Junes, this 20 percent was increased in the same manner as all the other percentage factors. The resulting benefit formula for June 1979 is described in Chapter 2.[11] Appendix 3-3 traces the development of these benefit formulas.

11. For example, the factor of 155.39 percent applicable to the first $110 of AMW is merely 129.48 increased successively by 6.4, 5.9, 6.5, and 9.9 percent.

TABLE 3.1. OASDI Benefit Formulas under the Social Security Act and Its Amendments, 1935–1978

Formula Enacted in	*Primary Insurance Amount*	
	Basis	*Percentages Applied*
1935*	Cumulative wage credits	½% of first \$3,000, plus 1/12% of next \$42,000, plus 1/24% of next \$84,000
1939	AMW after 1936†	40% of first \$50 plus 10% of next \$200, all increased by 1% for each year of coverage
1950	AMW after 1950†	50% of first \$100 plus 15% of next \$200
1952	AMW after 1950†	55% of first \$100 plus 15% of next \$200
1954	AMW after 1950,† excluding five years of lowest earnings#	55% of first \$110 plus 20% of next \$240
1958	AMW after 1950,‡ excluding five years of lowest earnings	58.85% of first \$110 plus 21.40% of next \$290
1965	AMW after 1950,‡ excluding five years of lowest earnings	62.97% of first \$110, plus 22.90% of next \$290, plus 21.40% of next \$150
1967	AMW after 1950,‡ excluding five years of lowest earnings	71.16% of first \$110, plus 25.88% of next \$290, plus 24.18% of next \$150, plus 28.43% of next \$100
1969	AMW after 1950,‡ excluding five years of lowest earnings	81.83% of first \$110, plus 29.76% of next \$290, plus 27.81% of next \$150, plus 32.69% of next \$100
1971	AMW after 1950,‡ excluding five years of lowest earnings	90.01% of first \$110, plus 32.74% of next \$290, plus 30.59% of next \$150, plus 35.96% of next \$100, plus 20.00% of next \$100
1972	AMW after 1950,‡ excluding five years of lowest earnings	108.01% of first \$110, plus 39.29% of next \$290, plus 36.71% of next \$150, plus 43.15% of next \$100, plus 24.00% of next \$100, plus 20.00% of next \$250

TABLE 3.1 (continued)

Formula Enacted in	Primary Insurance Amount: Basis	Primary Insurance Amount: Percentages Applied
1973§	AMW after 1950,‡ excluding five years of lowest earnings	119.89% of first $110, plus 43.61% of next $290, plus 40.75% of next $150, plus 47.90% of next $100, plus 26.64% of next $100, plus 22.20% of next $250, plus 20.00% of next $100
1975‖	AMW after 1950,‡ excluding five years of lowest earnings	129.48% of first $110, plus 47.10% of next $290, plus 44.01% of next $150, plus 51.73% of next $100, plus 28.77% of next $100, plus 23.98% of next $250, plus 21.60% of next $175
1978‖	AMW after 1950,‡ excluding five years of lowest earnings	155.4% of first $110, plus 56.52% of next $290, plus 52.81% of next $150, plus 62.08% of next $100, plus 34.53% of next $100, plus 28.78% of next $250, plus 25.92% of next $175, plus 24.01% of next $100, plus 22.56% of next $100, plus 21.30% of next $100

*Formula never became operative.

†Total credited earnings divided by months elapsed after year of attainment of age 21 or after "starting year" shown, whichever is more favorable.

‡Total credited earnings divided by elapsed months for a number of years equal to the number in the measuring period.

§Formula in December 1973 amendments effective for June 1974 (which overrode the formula in July 1973 amendments never effective) and formula under December 1973 amendments effective only for March–May 1974.

‖Formula effective as a result of the automatic-adjustment provisions.

#Only four years were excluded under the 1954 Act. This was changed to five years by the 1956 Act.

Benefit Formula for 1979 Cohort

The benefit formula resulting from the 1977 Act was first effective in 1979 (and then only for the cohort of those attaining age 62 in 1979, or dying or becoming disabled before age 62 in 1979).[12] It is in an entirely different form than the June 1978 formula and has quite different percentage factors and dollar bands, because it applies to Average Indexed Monthly Earnings (AIMEs) instead of AMWs. The 1979 AIME formula is:

12. This formula applies regardless of whether benefits are first claimed after 1979 (although the intervening COLAs are added), except when the alternative procedure for widow's and widower's benefits (added by the 1983 Act) is applicable. Under that procedure, the death of the insured worker is presumed to have occurred in a later year (the earlier of the year in which the worker would have attained age 62 or the year in which the surviving spouse is first eligible for widow's or widower's benefits).

90 percent of the first $180 of AIME, plus
32 percent of the next $905 of AIME, plus
15 percent of the AIME in excess of $1,085

The percentage factors are much lower than in the previous formula, but this is due, in large part, to the AIME generally being much larger than the AMW (because the AIME uses indexed earnings rather than actual earnings). The formula for the 1979 cohort involves only 3 terms compared with 10 terms in the previous formula. In the future, even though there will be a new formula for each year's cohort (derived from the 1979-cohort formula and from wage increases after 1977), it will continue to have only three terms, whereas the pre-1979 formula would probably have had one more term for each additional calendar year that elapsed (i.e., one for each year that the earnings base was increased by the automatic adjustments).

The changed structure of the benefit formula was necessitated by the instability of the results under the previous formula, especially as it was automatically adjusted for variations in economic conditions. The reasons that this change (commonly referred to as *decoupling*) had to be made, and certain other procedures that might have been followed, are discussed in detail in Appendix 3-4. It is significant that decoupling, as done by the 1977 Act, results in a considerable decrease in benefit amounts, especially over the long range, compared with previous law. In one sense, this could be called a rationalization of the benefit structure, rather than a deliberalization.

Nonetheless, the 1977 Act did reduce benefit levels for new retirees in the short range as well, by an average of about 7 percent, with somewhat smaller reductions for death and disability cases generally (but much more than that for young workers)—see Appendix 2-9. Most of this reduction was accomplished through the percentage factors in the benefit formula being lower than would have resulted if the 1979 new formula had been such as to produce the same benefit amounts, on the average, as previous law would have done if left unchanged. Both the Ford and Carter administrations had recommended no such reduction, but Congress did so (upon testimony to this effect by the life insurance business, supported by other business groups).[13]

13. The Carter administration proposed that the PIA benefit formula for the 1979 cohort should be: 94 percent of the first $180 of AIME, plus 34 percent of the next $895 of AIME, plus 16 percent of AIME in excess of $1,075. The formula actually adopted used almost the same dollar bands, but the percentage factors were about 5 percent lower, relatively—90, 32, and 15 percent respectively.

The 1972 Act introduced two new (and complicating) features into the computation of primary benefits—delayed-retirement credits and a special-minimum benefit. Both moved in the direction of more individual equity and away from social adequacy.

Delayed-Retirement Credit

The first new feature was a delayed-retirement credit (DRC) of 1/12 percent of the PIA for each month that an insured worker does not receive benefits after age 65 (and before age 72) because of continuing to work. This increase would not be applicable to those who claimed benefits before age 65; the 1977 Act changed this so that, even though a person filed for (and received) benefits before age 65, if there was a later return to work and loss of benefits after age 65, then the DRC would apply. Originally, the DRC did not apply to auxiliary and survivor benefits, but the 1977 Act made it applicable to widow's and widower's benefits.

The DRC was introduced to recognize the public complaint about the apparent inequity of the earnings test in taking away benefits which, some people believed, had been "bought and paid for at age 65," without any concomitant increase when retirement occurred later. The 1977 Act tripled the size of the DRC (but only for those attaining age 65 after 1981). This was not done as a further recognition of the public dissatisfaction with the earnings test or as additional encouragement to continue employment beyond age 65. Rather, it was done to offset the decreasing relative effect of the method of indexing the earnings record for earnings beyond age 65 (see Appendix 2-9).

The 1983 Act made the DRC applicable only after the attainment of the Normal Retirement Age, rather than merely from age 65 on. In addition, DRCs cannot be obtained from age 70 on (previously, not after age 72). Also, the amount of the DRC is gradually increased from the 3 percent applicable to those attaining age 65 in 1982–89 to 8 percent eventually (for those attaining the NRA in 2009—when it will be 66—and subsequently); see Chapter 2 for more details. The 8-percent rate is only slightly lower than the actuarial-equivalent increase factor, so that this change, in the long run, produces virtually the same cost effect as eliminating the earnings test after the NRA (but results in better income-replacement design). The increase in the DRC amount was legislated to be on a deferred basis because of cost considerations—to provide greater assurance that there would be no financing problem in the 1980s.

Special-Minimum Benefit for Long-Coverage Individuals

A feature introduced by the 1972 Act was provision of a special minimum in the computation of the PIA. This is applicable to individuals with long periods of covered employment at a low earnings level. The intent of this special minimum was to counter demands to have a much higher "regular" minimum than the $84.50 that would occur under the 1972 Act. It was argued that such minimum should be $150–200, so that "it would be above the poverty level, and people could live on it." This argument did not recognize that many, if not most, persons getting the regular minimum did so because they were only intermittently in covered employment and often have other pension income from noncovered employment (e.g., under the federal Civil Service Retirement program).

It is also significant that the special minimum initially was not subject to the automatic-adjustment provisions added by the 1972 Act, as were all other monthly benefit amounts. The December 1973 amendments, however, did increase the amount from $8.50 to $9.00 per year of coverage—a rise of 5.9 percent, or well below the general 11-percent increase legislated then. If no subsequent changes were made in the amount of the special minimum by legislative action, it would "wither away" as other benefit amounts are increased when the Consumer Price Index (CPI) rises.

In actual fact, that is what did happen to the special-minimum benefit in the years after 1973. By 1977, it had become practically extinct. The 1977 Act, however, increased its amount (effective in January 1979) to approximately what it would have been if it had, after 1973, been automatically adjusted for CPI changes. At the same time, the special minimum was made subject to future automatic increases. Nonetheless, if wages rise more rapidly than the CPI, it will eventually wither away, because the minimum wages required to obtain the necessary years of coverage to qualify will produce a larger benefit under the regular AIME benefit basis. Legislation in 1990 lowered the requirement (relatively) for the amount of earnings needed for a year of coverage, for years after 1990; this action delayed somewhat the withering-away of the provision.

Minimum and Maximum Benefit Provisions

Supplementary information about each of the past benefit formulas is given in Table 3.2, which shows the minimum and maximum PIAs, the minimum and maximum family benefits, and the minimum and maximum lump-sum death payments. In 1981, the regular-minimum benefit was eliminated for persons first becoming eligible in 1982 and after (except for certain members of religious orders who had taken a vow of poverty[14]). In the future, persons who would have received the regular-minimum benefit instead of the lower amount produced by the regular benefit formula will receive the latter (which in unusual cases can produce PIAs of less than $10 a month). In August 1981, legislation was enacted that would have reduced the benefits for those then on the rolls with minimum benefits so that only the "formula" amount would have been payable in the future, but legislation enacted at the close of the year made this elimination applicable only to newly eligible persons.

In considering this table, the major distinction between the benefit provisions in the 1935 Act and those in subsequent legislation should be kept in mind. The original act provided only retirement benefits for the insured worker. The subsequent amendments, in addition, provided supplementary benefits for the auxiliaries of retired workers and for survivors of deceased workers—a move toward social adequacy and away from individual equity. The 1939 Act adjusted the benefit amounts so that retired workers without auxiliaries would receive, in the long run, less than they would have been paid under the original law and, conversely, so that retired workers with auxiliaries would receive more.

At the same time, the 1939 Act eliminated the money-back guarantee of the 1935 Act, which provided that every worker would get back somewhat more than the employee taxes that he or she had paid. This was one of the few instances when the program was deliberalized, and it was, of course, a distinct move away from individual equity and toward social adequacy. The savings from eliminating this refund benefit were, in effect, used to meet part of the cost of the monthly survivor benefits, which were then added.

It should also be borne in mind that the 1950 legislation gave increasing recognition to presumptive family needs when it raised current benefit levels and at the same time eliminated the increment provision (1-percent increase for each year of coverage). An increment results in the payment of larger benefits in the later years of the program than in the early ones and also larger survivor benefits with respect to workers who die at older ages. This change reflected the increasing emphasis on social adequacy as against individual equity.

14. Special treatment was given to this category because it had first been covered by the 1972 Act (retroactive to 1968 on an elective basis), and the people affected had not had a very long time to build up an earnings record which would yield more than a very low AIME. Even so, this exception only applies to those who first become eligible before 1992.

TABLE 3.2. Minimum and Maximum Benefit Provisions under OASDI, according to Benefit Formula or Benefit Table in Effect (monthly amounts except for lump-sum death payments)

Year of Legislation or Effective Date of Automatic Adjustment	*Primary Insurance Amount*		*Family Benefit*		*Lump-Sum Death Payment*	
	Minimum	*Maximum*	*Minimum**	*Maximum†*	*Minimum*	*Maximum*
1935	$ 10.00	$ 85.00	‡	‡	§	§
1939	10.00	60.00#	$ 10.00	$ 85.00	$ 60.00	$360#
1950	20.00	80.00	15.00	150.00	60.00	240
1952	25.00	85.00	18.80	168.75	75.00	255
1954	30.00	108.50	30.00	200.00	90.00	255
1958	33.00	127.00	33.00	254.00	99.00	255
1961	40.00	127.00	40.00	254.00	120.00	255
1965	44.00	168.00	44.00	368.00	132.00	255
1967	55.00	218.00	55.00	434.40	165.00	255
1969	64.00	250.70	64.00	434.40	192.00	255
1971	70.40	295.40	70.40	517.00	211.20	255
1972‖	84.50	404.50	84.50	707.90	253.50	255
1973‖	93.80	469.00**	93.80	820.80**	255.00	255
1975‖	101.40	522.80	101.40	914.80	255.00	255
1976‖	107.90	577.60	107.90	1,010.70	255.00	255
1977‖	114.30	632.90	114.30	1,107.60	255.00	255
1978‖	121.80	695.40	121.80	1,216.90	255.00	255
1979††	134.10	632.10‡‡	134.10	1,106.20‡‡	255.00	255
1980††	139.50	726.20‡‡	139.50	1,270.80‡‡	255.00	255
1981††	135.70	789.90‡‡	135.70	1,243.10‡‡	255.00	255
1982††	§§	847.80‡‡	§§	1,483.60‡‡	255.00	255
1983††	§§	833.10‡‡	§§	1,545.40‡‡	255.00	255
1984††	§§	901.40‡‡	§§	1,576.90‡‡	255.00	255
1985††	§§	944.80‡‡	§§	1,653.30‡‡	255.00	255

But note the partial reversal of this change in the 1972 Act, which reintroduced an increment for delayed retirement beyond age 65.

In the years since the original law was enacted, the minimum old-age benefit increased so that, in mid-1981, it was about 14 times the original level, while the maximum old-age benefit had gone up to only about 9 times its original level. In fact, the formulas in each of the first three major amendments resulted in a maximum old-age benefit equal to or less than the original amount. As indicated previously, however, consideration of the adequacy of the benefits cannot be viewed solely in terms of the changes in old-age benefits. The introduction in the 1939 Act of family benefits for auxiliaries and survivors

TABLE 3.2 (continued)

Year of Legislation or Effective Date of Automatic Adjustment	Primary Insurance Amount		Family Benefit		Lump-Sum Death Payment	
	Minimum	Maximum	Minimum*	Maximum†	Minimum	Maximum
1986††	§§	$1,001.50‡‡	§§	$1,753.70‡‡	$255.00	$255
1987††	§§	1,044.50‡‡	§§	1,827.20‡‡	255.00	255
1988††	§§	1,074.20‡‡	§§	1,880.20‡‡	255.00	255
1989††	§§	1,144.10‡‡	§§	2,003.20‡‡	255.00	255
1990††	§§	1,212.30‡‡	§§	2,120.70‡‡	255.00	255
1991††	§§	1,261.20‡‡	§§	2,206.30‡‡	255.00	255
1992††	§§	1,314.80‡‡	§§	2,300.60‡‡	255.00	255

*Applicable only to case of one survivor beneficiary (prior to any reduction for early retirement).

†In some cases, slightly larger amounts can be paid as a result of the provision for rounding benefit amounts (to next higher 10 cents for each beneficiary, prior to September 1981).

‡No benefits provided for auxiliaries or survivors.

§No minimum or maximum provided (potential maximum was about $5,000).

||Not including the effect of the delayed-retirement credit or the special-minimum benefit based on years of coverage. Figures for 1975–78 are based on the automatic adjustments made for June of these years.

#Assumes that 50 years of coverage is the maximum possible.

**These are the figures contained in the law when it was enacted, effective for June 1974.

††Figures are those resulting from the 1977 Act. Not included is the effect of the delayed-retirement credit or the special-minimum benefit. Included is the effect of the automatic adjustments made for June or, for 1983, for December, but not for 1984–92.

‡‡Based on AIME equal to one twelfth of earnings base in year (even though such an AIME cannot even nearly be obtained by retirement cases—in fact, only for young death cases as to both the PIA and the MFB and for young disability cases as to the PIA can it even be closely approached).

§§Eliminated for persons first becoming eligible after 1981.

resulted in a better distribution of social protection at roughly the same aggregate cost. Appendix 3-5 gives an analysis of the *relative* liberality of the benefit level under present law compared with that under the original 1935 Act and that under the 1939 Act.

The trend in the regular-minimum old-age benefit until 1981 resulted from two different philosophies as to its purpose. Originally, it was instituted for administrative reasons—as a facility-of-payment provision. Later, it was viewed as a payment applicable to low-income workers and hence, according to social insurance principles, should be raised proportionately more than other benefit amounts.

In more recent years, it was realized that a large proportion of those receiving the regular-minimum benefit were not necessarily low-income workers living at poverty levels, but rather were recipients of other pensions (such as federal Civil Service Retirement and state and local government retirement systems not coordinated with OASDI) or were only intermittent workers (such as many wives whose husbands are eligible for sizable benefits). Thus, in 1969 and subsequently, the minimum was increased by the same percentage that applied to all benefits. This is in contrast with the action taken in the 1967 Act, for example, when the general benefit level was raised 13 percent, but the minimum went up 25 percent.

The 1977 Act froze the size of the regular minimum at $122 per month (its level as of December 1978 rounded) insofar as it related to initial awards. The benefits based thereon would increase in accordance with CPI rises after entry on the roll. This change was made to lessen windfalls for career government employees who, by moonlighting or by working after early retirement from government service, would be employed just enough in covered employment to barely qualify for OASDI benefits. The 1981 legislation went further in this direction, by eliminating the minimum benefit for new eligibles in the future.

Legislation in 1980 provided for a lower Maximum Family Benefit (MFB) for disability benefits than the regular MFB. The cap is the lower of 85 percent of the AIME or 150 percent of the PIA (but in no case less than 100 percent of the PIA). This was done because total family benefits under the regular MFB, considering their generally tax-free nature, could be at such a level that they exceeded previous take-home pay, and thus individuals might be encouraged to go on the benefit rolls and then not be rehabilitated.

The minimum family benefit likewise increased by 12 times during 1940–81, while the maximum family benefit over this period rose to about 16 times what it was originally. The reduction in the maximum old-age benefit from $85 in the 1935 Act to $60 in the 1939 Act is less significant than it might at first appear to be because at the same time a maximum of $85 was made possible for a worker with an eligible wife.

Lump-Sum Death Payments

The current uniform lump-sum death payment is now 4 times the minimum specified in 1939. Similarly, it is about 30 percent lower than the potential maximum under the 1939 law and about 7 percent less than the highest amount actually paid under that law ($273.60).

It is noteworthy that the maximum lump-sum death payment has been fixed at $255 ever since 1952, as a result of the 1954 Act placing this overriding maximum on the "normal" amount of 3 times the PIA, and then such limitation never having been changed. In fact, just before the 1973 Act, there was virtually no spread in the size of this lump sum—only from $253.50 to $255.00—and now there is none at all, because $255.00 is available in all cases where it is payable. The reason this benefit has been frozen, despite the substantial increases in the overall benefit level, is that even those who wish to expand the scope of OASDI greatly have no desire to make more money available for funerals, which they believe will be wasted. Instead, their position would be to spend what funds are available for other benefit purposes.

Computation of Average Earnings for Benefit Purposes

In considering the PIA benefit formulas, it is necessary to recognize that, under the 1939 Act and thereafter, the benefits are based on the career-average wage insofar as the "ultimate" condition is concerned (when persons have the possibility of a full lifetime under the system). Certain modifications in this general principle have, however, been introduced over the years so that, in fact, the average wage has always been based on the earnings in a much shorter period. On the whole, this was done so as not to disadvantage newly covered groups and at the same time to give the same advantages to those workers previously covered.

Thus, in the 1950 Act, the important change was made that the relatively low earnings before 1951 (in many cases of newly covered persons, no earnings at all) could be omitted.[15] Likewise, as a result of the 1954 and 1956 Acts, the five lowest years of earnings are dropped out (in part, to be beneficial to groups newly covered in 1955, such as farmers). This is also done for years in which the individual was disabled.

Legislation in 1980 reduced the number of dropout years for persons under age 47 for the computation of disability benefits. This was done because, otherwise, the period of computation was very short, and overly large benefits could therefore result. Such change was not made for survivor benefits payable after the disabled worker's death.

When the minimum retirement age for women was reduced from

15. The 1960 Act made a significant change by permitting years of high earnings after attainment of the minimum retirement age to be substituted for prior years with low earnings instead of, as previously, having an alternative of computing the average wage up to the actual time of retirement, rather than merely to the minimum eligibility age.

65 to 62 in the 1956 Act, the computation point for retirement benefits for them was also reduced to age 62. For a woman who works until age 65, this resulted in three less computation years than for a similar man. Thus, if she worked until age 65, she could substitute years of high earnings at ages 62–64 for years of low earnings before then, whereas a man could not do so under similar circumstances.

When the minimum retirement age for men was similarly reduced by the 1961 Act, no change was made in the computation point for men (because of cost considerations).[16] Such a change, resulting in equal treatment of men and women, was made in the 1972 Act, but it is applicable only for men attaining age 62 after 1974.

Although the AMW was computed on a career-average basis, the interacting effect of using dynamically adjusted benefit factors (as described previously) was, during the 1950s and 1960s, to produce about the same results for benefits as if a final-average wage had been used in conjunction with static benefit factors. In other words, the basis for the computation of benefits which had been followed adequately offset the apparent illogical approach of having a career-average wage applied in a period of significantly rising earnings.

As it so happened, the counterbalancing effects described in the preceding paragraph occurred largely because of fortuitous circumstances—namely, that economic conditions then were just right to produce such a result. Earnings were then increasing at a rate of about 4 percent per year, and prices at about 1½ to 2 percent. Under these conditions, and with the earnings base being increased to keep pace with wages, the situation happened to work out well—the benefit level remained relatively stable (and rational), and the cost of the system did not get out of control (and showed no signs of doing so in the future). As seen later and as discussed in Appendix 3-4, such a satisfactory, stabilized situation would not have occurred under different economic conditions, such as those in the 1970s and the 1980s. It appears likely that future conditions will not be like those before 1970.

Elimination of Windfall Benefits

As mentioned previously in connection with the regular-minimum benefit provision, there had been a growing concern about the windfall benefits obtained by persons who were in covered employment

16. As an example of the effect of this difference in treatment, consider a female worker and a male worker, both of whom attained age 65 in January 1975 and both of whom had always had maximum earnings. The PIA for the woman was $333.70, while that for the man was only $316.30.

only part of their working lifetime and in noncovered employment most of it. As a result, the regular-minimum PIA was first frozen at $122 by the 1977 Act and then eliminated for new eligibles by legislation in 1981.

Another change in this area was the provision in the 1977 Act that offsets employee pensions arising from government service that is not simultaneously covered by OASDI on the last day of employment against any OASDI benefit that may be received as a spouse or widow(er) of a covered worker (retired, disabled, or deceased). The 1983 Act modified this provision by reducing the offset to two thirds of such governmental pension.

The 1983 Act also went further by dealing with the windfall element in the benefits payable to workers generally (rather than merely the regular-minimum benefit). A different method of computing the PIA is applicable for certain persons who receive pensions (governmental or otherwise) based in whole or in part on earnings from noncovered employment. This provision applied only to future eligibles (after 1985)—and, in no event, to persons with long substantial covered employment. (For more details, including details on how it is gradually phased in, see Chapter 2.)

Legislation in 1988 liberalized this provision by providing for a longer phase-out period, so that persons with 21–29 years of coverage do not have the full reduction (as against 25–29 years in the original law). As before, those with at least 30 years of coverage are exempt from the operation of this provision.

Restrictions on Benefits Payable Abroad

Many people have, over the years, been concerned about the payment of OASDI benefits to persons living outside of the United States (especially those who are not U.S. citizens). The principal reason is the financial drain involved (which, although only about 0.6 percent of outgo, represents large amounts in dollars).

Legislation enacted in the 1950s prevents the payment of benefits to aliens living abroad who had had only short periods of covered employment or had been deported and to all persons living in countries where there is no reasonable assurance that checks can be cashed at full value. Also, if the country of citizenship of the beneficiary has a social insurance system that does not pay full benefits to U.S. citizens living outside it, OASDI benefits will not be paid in that country.

The 1983 Act introduced another restriction. Auxiliary and survivor benefits are not payable abroad after six months of benefit receipt if the alien beneficiary had not lived in the United States for at least five years. This does not apply in the case of countries which have a treaty with the United States which overrides it.

Restrictions on Benefits Payable to Prisoners

Just as in the case of benefits payable abroad, many people have been concerned about the payment of OASDI benefits to prisoners, particularly those who are incarcerated for crimes arising from mental disorders. In 1980, legislation was enacted that prevents payment of disability benefits to persons who have a disability arising or aggravated during the commission of a felony.

The 1983 Act broadened this by preventing the payment of all types of benefits to prisoners (unless in a rehabilitation program). Benefits are, however, payable to any auxiliary beneficiaries who are eligible.

Automatic-Adjustment Provisions[17]

For some years, proposals had been made to adjust automatically both benefit levels and the maximum taxable earnings base (the former by the CPI and the latter by changes in the level of wages in covered employment). There were precedents, because this procedure was followed in several foreign social insurance systems and also, as to benefits, in the retirement plans for federal civilian employees and for the uniformed services. Also, the 1965 Act contained a provision involving automatic adjustment of the maximum on combined OASDI disability benefits and Workers' Compensation benefits. That procedure was similar to the one later adopted in the 1972 legislation with respect to the earnings base. It is also very significant that the manner in which the automatic-adjustment provisions for benefits in the 1972 Act operated was exactly the same as the method that Congress used in making all the ad hoc increases after 1954.

Opposition to Automatic Adjustments

Although there was great popular pressure for such automatic-adjustment provisions, most organized groups opposed them. Politicians frequently were not in favor because then "the actuarial and

17. For a more detailed discussion of automatic-adjustment provisions of all types of benefits, in both public and private plans, and both in the United States and elsewhere, see Robert J. Myers, *Indexation of Pension and Other Employee Benefits* (Homewood, Ill.: Richard D. Irwin, Inc., 1978).

statistical bureaucrats would get credit for benefit increases, rather than us." Most business groups opposed automatic adjustment because they feared that overliberalization would result, with politics producing legislated increases on top of the automatic ones. These groups also opposed the automatics on the grounds that benefit increases resulting from them might come at the wrong time in the economic cycle and thus add fuel to the fires of inflation.

On the other hand, most labor organizations were in opposition because they were afraid that the benefit level would be straitjacketed at its then relative height. They believed that the automatics were desirable only after the benefit level had been substantially boosted. Quite obviously, business and labor views were based on diametrically opposing logic. If one were right, the other would have to be wrong!

Arguments in Favor of Automatic Adjustments

Those who favored the automatic-adjustment provisions argued that the ad hoc procedures of the past had increased benefits about as much as the automatics would have, although in some instances with a significant lag (as during 1958–64, when no increases were legislated, despite some rise in the cost of living), which seemed unfair to the beneficiaries. In certain other instances, the benefit increases exceeded what would be called for by changes in the cost of living, as during the first Nixon administration, 1969–72. It was the hope of those favoring the automatics that these adjustments would better control such political bidding up of the benefit level and thus take the program, to some extent, out of politics.

Development of Automatic-Adjustment Provisions

Shortly after President Nixon took office, he recommended a small number of obviously needed benefit changes. These included a 10-percent benefit increase (to make up for the rise in the cost of living that had occurred since the last benefit increase) and automatic-adjustment provisions to be applicable in the future. The benefit increase was enacted rapidly—at a bargained-up 15 percent.

The automatics were opposed by Chairman Wilbur D. Mills of the House Ways and Means Committee, an extremely powerful and well-informed person,[18] but they were supported strongly by Represen-

18. For an excellent account of the very important role that Mr. Mills played in connection with the development of the Social Security program over more than two decades, see John F. Manley, *The Politics of Finance—The House Committee on Ways and Means* (Boston: Little, Brown, 1970).

tative John W. Byrnes, the ranking Republican member of that committee, who had favored this idea for years. In early 1970, the bill containing the President's recommendation was changed by the Ways and Means Committee to exclude the automatics. However, on the floor of the House, in an unusual and almost unprecedented manner, Chairman Mills was reversed, and the automatics were included. The Senate, too, approved these provisions, but because of long delays for other reasons (principally, a fight over public assistance provisions), the bill was not enacted by the time Congress adjourned.

Provisions for automatic adjustments were included, without any serious controversy, in the 1972 Act. One significant change in the provisions was made as compared with the original recommendations. Congress is to be informed, at least by August 15 (by April 1, as a result of changes made by the 1973 Act, and by October 30, as a result of changes made by the 1983 Act), if the automatic-adjustment provisions would become effective in the next few months. Also, Congress is to be informed whenever the CPI has increased by 2½ percent since the last base quarter.

Under such circumstances, Congress could enact new benefit levels to get the political credit for the benefit increases. Accordingly, political competition can continue, as it did in 1969–72. Nonetheless, it would seem that the automatics give some hope, though no guarantee, of control over unwarranted expansion of the benefit level.

It is interesting to compute what would have been the effect if the automatic-adjustment provisions for benefits had been enacted in 1965, when the first automatic-adjustment provisions were incorporated into the program (for the Workers' Compensation offset with respect to disability benefits). The results of such a study are presented in Appendix 3-6.

The 1983 Act changed the automatic-adjustment provisions in two important respects. First, the COLAs are to apply to benefits payable for Decembers, rather than Junes, beginning with 1983 (and, beginning with the 1984 one, are based on the CPI change between third quarters, not first quarters). This change produced a large portion of the additional financial resources which were believed necessary to solve the short-range financing problem. Unlike what some persons believed, this was not a one-time affair insofar as loss of benefits was concerned. Rather, it is a continuing loss (through deferment) over the years—and may amount to about 2–3 percent in the aggregate.

Second, in years when the trust-fund ratio—assets at the beginning of the year for which the COLA is to be determined (for December) as a percentage of the estimated outgo for the year[19]—is below 20.0 percent (15.0 percent for the 1984–88 COLAs), the COLA will be based on the percentage increase in wages (as measured by the wage-indexing series that is used for various other OASDI purposes), if this is smaller than the CPI rise.[20] Whenever, subsequent to such a reduced COLA, the fund ratio rises above 32.0 percent, any reductions resulting thereby will be restored in future COLAs, on a prospective basis (see Chapter 2 for more details).

The "lesser of wages or prices" basis for the COLA is a stabilizing device, because it can be of assistance in times of declining, and low, trust-fund balances to lessen the financing problem—or, perhaps, even solve it. However, this procedure is *not* a fail-safe device that will almost certainly solve such a problem. If the procedure had been instituted in the 1977 Act, it would not have prevented the bankruptcy of the OASI Trust Fund which would have occurred in 1981 if corrective legislation had not been enacted in 1980 and 1981, because the trigger would have "gone off" too late (not until the time of determining the 1981 COLA). A real fail-safe device—the possible elimination of the entire COLA when the fund ratio is low—was contained in the Senate version of the 1983 Act but was deleted in the joint conference between the House and Senate.[21]

19. The end-of-year fund ratio, without adjustment for amounts owed to the HI Trust Fund, was used for the 1984 COLA. In the recommendations of the National Commission on Social Security Reform and in the House bill, the stabilizer would not have gone into effect until the 1988 COLA. Those who were opposed to the concept of the stabilizer and wanted to see it become operative as little as possible insisted that it be based on the year-end fund balance in 1988, because such balance then would be much higher than at the beginning of the year (due to the tax-rate increase in 1988). In the conference compromise (see footnote 21), the effective date of the stabilizer was logically moved up, to be applicable for the 1985 COLA (after all, if the stabilizer is needed, it is needed as much before 1988 as after!). However, no change was made in the basis for the fund balance in the first year of operation, although it would have made little difference if the beginning-of-the-year figure had been used instead of the end-of-the-year one. The fund ratios are shown to one decimal place, which is a significant matter (e.g., if the test ratio were stated as 20 percent, a ratio of 19.6 percent could be rounded to 20 percent, and thus the trigger would not "go off"—as it would when the ratio is stated as 20.0 percent).

20. It should be noted that the wage and CPI increases are "out of sync." For a given year's COLA, the former is based on the change from the second preceding year to the preceding year, while the latter is based on the change from the third quarter of the preceding year to the third quarter of the current year. This inconsistency of time periods could produce anomalous results—in either direction, undercompensation or overcompensation in the benefit level. A more logical procedure would be to compare the increase in wages as derived under the present procedure with the increase in the CPI for the same year-to-year period. Then, if the wage increase were smaller, the differential would be subtracted from the CPI rise as determined under the "normal" procedure.

21. As a compromise, the effective date of the stabilizing device in the House bill was advanced, so that it would be first applicable for the 1984 COLA, rather than the

Minimum Retirement Ages

1935 Act

The original selection of age 65 as the minimum retirement age for insured workers was, to a considerable extent, arbitrary and empirical. Age 70 seemed too far advanced and unlikely to be achieved, although many private pension plans, particularly those in the railroad industry, had such a minimum age in the mid-1930s. On the other hand, age 60 was too low, in view of both general employment practices and costs. Accordingly, the compromise "even quinquennial" age of 65 was selected.[22]

1956 Act

The minimum eligibility age for wives, widows, and female dependent parents was reduced to 62 in 1956. This action was taken because wives are generally somewhat younger than their husbands, and so it was desired to have wives qualify at the same time that the worker retired. However, this reasoning was based on averages, and many wives are younger than their husband by more than the *average* three-year differential between the ages of husband and wife prevailing at the older ages. Then, by the "domino theory," the minimum age for widows had to be reduced, because it would seem illogical to pay benefits to a woman as a wife and then to cut them off at the husband's death because she was still under age 65. The wife's benefits were reduced when claimed between age 62 and 65 (on close to an actuarial basis, but not quite as much—because, from a political standpoint, too large a reduction would have resulted), but no reduction was made for widows or parents—because of the general sympathy for these categories.

At the same time, it seemed necessary to lower the minimum retirement age for women workers. This was done on the ground that they had made direct contributions, whereas dependents of insured workers had not, and therefore they should be treated just as liberally. The early-retirement provision, however, provided for reduced benefits,

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1988 one. This was accompanied by the undesirable (in the author's view) use of a lower test ratio for the 1984–88 COLAs than for the subsequent ones.

22. For a more detailed discussion of this matter, see Wilbur J. Cohen, *Retirement Policies under Social Security* (Berkeley: University of California Press, 1957). Some people erroneously attribute 65 as the retirement age to Otto von Bismarck, who established in Germany the first social insurance program; however, its minimum retirement age was originally 70.

with the reduction factors being on an approximate actuarial basis, so that no bargain was involved for the beneficiaries, and likewise there was no additional cost for the program. Actually, the only added cost involved was the small one arising from reducing the computation point for insured status and the AMW for women from age 65 to 62, thus requiring slightly fewer QC and a somewhat shorter period for calculating the AMW.

For detailed analyses as to the actuarial equivalence (or nonequivalence) of the various early-retirement reduction factors, see Robert J. Myers, "Appraisal of Early-Retirement and Deferred-Retirement Adjustment Factors under Social Security," *Proceedings*, Conference of Actuaries in Public Practice, 1980–1981 and Robert J. Myers and Bruce D. Schobel, "Early-Retirement Reduction and Delayed-Retirement Increase Factors under U.S. Social Security Law," *Transactions*, Society of Actuaries, 1990.

1961 Act

The minimum retirement age for men was lowered to 62 for insured workers and for dependent husbands, widowers, and male parents, with the reduction procedure for early retirement being the same as for women. No change was made in the use of the year of attainment of age 65 as the terminal point for computing insured status and the AMW. Such terminal point was not lowered for men because of cost considerations, even though this produced illogical results (such as different PIAs developing for males and females with identical dates of birth and employment histories). As mentioned previously, the 1972 Act corrected this anomaly and lowered the terminal point for men to age 62 (but only for those attaining this age after 1974).

1965 Act

The minimum eligibility age for widows was lowered from 62 to 60, but with actuarially reduced benefits (namely, 71½ percent of the PIA at age 60, versus 82½ percent for ages 62 and over). Parallel treatment for dependent widowers was not given until the 1972 legislation.

1967 Act

The minimum eligibility age for both widows and dependent widowers was reduced to 50 if disability was present. The benefit rate, however, was sharply reduced from the 71½ percent of PIA payable for benefits beginning at age 60, to 50 percent for benefits beginning at age 50.

1983 Act

The Normal Retirement Age (the age at which unreduced benefits are first available), which had been age 65 since the program first began, was raised on a gradual phased-in basis for workers, spouses, and widow(er)s, beginning with those retired workers and spouses who attain age 62 after 1999 and widow(er)s who attain age 60 after 1999. Ultimately, the NRA will be 67 for workers and spouses who attain such age in 2027 and after and for widow(er)s who do so in 2029 and after. Chapter 2 gives the details as to how this gradual transition operates.

This change was made in this manner—and with an ultimate age of 67, rather than 68 or higher, as some had proposed in the past—so as to achieve very close long-range actuarial balance for the program (as will be described subsequently in this chapter, it being the final cost element to be considered). The logic behind this change was that it would equitably reflect, at least in part, the increasing longevity over the years (both that which had already occurred in the past and that which was anticipated in the future). Although this change represents an absolute reduction in benefits for current younger workers, relatively they are better off than today's retirees, who have a lower life expectancy from age 65 on than current young persons will likely have from age 67 on.

Benefit Proportions for Auxiliaries and Survivors[23]

1939 Act

When benefits for auxiliaries and survivors were first introduced, the benefit proportion for all categories was 50 percent of the primary benefit payable to the worker (for deaths before retirement, the benefit that would have been payable if the individual had been eligible to retire), except for widows, for whom the proportion was 75 percent.

23. Considered here are only the benefit proportions for those first claiming benefits at the age at which unreduced benefits are first payable. The reduction factors or reduced benefit proportions for early retirements are discussed in the Monthly Benefit Categories section.

1950 Act

The proportions were changed by increasing that for parents from 50 percent to 75 percent and by, in effect, also giving 75 percent to the first child survivor beneficiary (but retaining 50 percent for all other child beneficiaries).

1960 and 1961 Acts

The benefit proportion for all child-survivor beneficiaries was increased to 75 percent in 1960, thus establishing the uniform principle that all survivor beneficiaries receive 75 percent of the primary benefit and all auxiliaries of retired or disability beneficiaries receive 50 percent (subject in all cases to the Maximum Family Benefit and to reduction for early retirement). This principle was changed by the 1961 Act, under which widows, widowers, and dependent parents aged 62 and over at first claim had the proportion increased by 10 percent relatively, to 82½ percent (except that 75 percent was retained for parents in two-parent cases, so as to produce the same 150-percent family benefit as was payable for a retired worker and spouse both aged 65 or over).

1972 Act

Over the years, many people had advocated that widows should receive the full PIA. The change from 75 percent to 82½ percent of the PIA in the 1961 Act was a step toward this goal. The argument made for this was that, when a married couple (where the husband was the insured worker) were both over age 65 at claim, the benefit rate was 150 percent of the PIA while both were living, and when the wife died first, the rate was reduced to 100 percent, so why should the rate for the widow be less than 100 percent if the husband died first? In answer, it was pointed out that this would result in unfair treatment to women workers, who also received a 100-percent benefit and who had *paid* contributions toward it (and, in many cases, their PIA would be low because they received lower wages than married men).

The 1972 Act provided for widow's (and dependent widower's) benefits equal to 100 percent of the PIA for benefits beginning at age 65 or over, with graded-down amounts for benefits beginning before then. There is an additional proviso that the amount payable cannot exceed the larger of (1) the benefit previously payable with respect to the deceased worker (applicable in cases of early retirement) or (2) 82½ percent of the PIA. Thus, for all benefits for insured workers and their living or surviving spouses (but not for dependent parents), the uniform principle was now, once again, that full-rate benefits are payable only if claimed at or after age 65, with reduced benefits for earlier claim.

Insured Status

Fully Insured Status

The initial requirement was aggregate lifetime covered wages of $2,000 and covered employment in any part of five different years in order to be eligible for monthly old-age benefits.

The 1939 Act changed this basis completely so as, in a sense, to require coverage equal to half of the potential period (after 1936 or age 21, if later, up to attainment of the minimum retirement age or death, if earlier) to produce fully insured status and eligibility for old-age or survivor benefits.

In 1950, the requirement was liberalized—in large part, for the benefit of newly covered groups—by changing the measuring period to begin in 1951, but allowing coverage before then to count for the purposes of meeting the "one out of two" requirement, as does coverage before age 22 or after attainment of retirement age.[24]

The fully-insured-status provision was liberalized in 1960 by requiring coverage equal to only one third of the years after 1950 or age 21, if later. Then, in 1961, this proportion was reduced to one fourth. These changes had a largely temporary effect, because the maximum coverage requirement for old-age benefits remained at 40 QC (although only for persons attaining age 62 in 1991 will this "permanent" provision first apply).

Although the 1961 Act lowered the minimum retirement age (as to receipt of benefits) for men from 65 to 62, the measuring point for fully insured status for men was left at age 65, unlike the case for women, where it has been age 62 since the 1956 Act. Just as for the computation of the AMW, cost considerations required that no change be made. The 1972 Act moved the measuring point for men

24. The 1983 Act provided a special, more liberal, alternative to meet the requirement for fully insured status for nonprofit employees who were newly covered. The 1954 and 1956 legislation, which brought more groups into coverage, contained special alternative provisions that would yield fully insured status if there was continuous coverage, but with such provisions "washing out" in a few years.

down to age 62 (but only for those attaining this age after 1974), so that equality of treatment has been achieved.

Transitional-Insured Status

At all times since the 1939 Act, the minimum requirement for fully insured status has been 6 QC. The 1965 act provided special flat-rate benefits at age 72 for persons who would have met the requirement for fully insured status if the minimum provision had been 3 QC instead of 6 QC—the so-called transitional-insured benefits. Amendments in 1966 provided for similar benefits at age 72 for persons with no coverage (or, in some cases, with a few QC being needed, although less than would be needed for fully insured status), but with certain restrictions on the receipt of other government benefits—the so-called transitional-noninsured benefits—and with the provision intended to be applicable only to those who attained age 72 in (or before) the next few years (but see page 157).

Currently Insured Status

Throughout the entire period following the 1939 Act, an alternative requirement—currently insured status—has been permitted for young-survivor benefits. This, in a sense, requires coverage for half the quarters in the last three years. That provision has remained essentially unchanged throughout the entire period. Initially, this was one of the requirements for the "disability freeze" (enacted in 1954) and for monthly disability benefits (enacted in 1956). In the 1958 Act, however, the requirement of currently insured status for both such benefits was eliminated, because in certain cases of gradually progressive disability, it proved to be a difficult requirement to meet.

Also, currently insured status was initially required for eligibility for certain benefits arising from the earnings record of a working woman (child's, husband's, and widower's benefits). However, in the 1967 Act, this special additional requirement was eliminated, which was a significant move in the direction of equal treatment of men and women.

Disability-Insured Status

The requirement for disability-insured status remained unchanged from when it was established in the 1954 Act (20 QC out of the last 40 quarters) until the 1967 Act. Then special lower requirements were introduced for workers under age 31, because they might not as readily have the opportunity to acquire the 20 QC needed. A similar provision had been included in 1965 for the blind, which thus pointed the way for this provision. The 1983 Act allowed the exclusion of a previous period of disability in determining whether the special test for those under age 31 is met.

Quarters of Coverage

In the entire period following the 1939 Act until the enactment of the 1977 Act, the definition of QC remained virtually unchanged. Basically, a QC was credited for each calendar quarter in which at least $50 was paid. Special rules were established for the self-employed and for agricultural workers, because their earnings were reported on only an annual basis.[25]

Beginning in 1978, there was annual reporting (instead of quarterly) for all workers under OASDI (except for employees of state and local governments, for whom quarterly reporting was first instituted in 1982). As a result, the requirements for QC had to be changed. At the same time, the amount of earnings required was updated to reflect the great changes in earnings levels since the $50 figure was first established.[26] The 1977 Act defined QC for earnings in 1978 as the number of full units of $250 of earnings in the year (with, of course, a maximum of 4 QC per year). After 1978, the $250 figure is automatically adjusted according to changes in nationwide wages (but never decreased from one year to the next).

Earnings Test[27]

1935 Act

A test of retirement was implicit in the original act.[28] For any month in which the individual received covered wages from "regular employment," monthly old-age benefits would not be paid. Regular employment was not specifically defined, however.

25. A special rule was also applicable to persons who had earnings at least equal to the maximum taxable earnings base, because after reaching this level at some time in the year, their subsequent earnings were not taxed and thus not reported.

26. Based on nationwide data, $50 of wages in 1940 was equivalent to about $440 of wages in 1977.

27. A rather detailed account of this provision is given because it has always been controversial and widely discussed by the general public.

28. The House-passed version of the bill did not contain such a provision, but this was believed at the time to be an oversight, not a matter of intent.

1939 Act

The 1939 Act permitted payment of benefits if the beneficiary had earnings in covered employment not exceeding $14.99 a month. The test was on an all-or-none basis. Earnings of $14.99 or less did not affect payment of the full benefit, but earnings of even slightly more than this amount meant that the entire benefit for the month was lost—an inequitable situation.

1947 Advisory Council

The earnings test was still $14.99 a month when the 1947 Advisory Council on Social Security was formed. Because of changes since 1939 in the wage level and other factors, it was generally agreed that this amount was too low. Furthermore, there was the important question of working out a basis for the test that would be more equitable than the all-or-none basis and would also be reasonably simple to administer. The advisory council stated that modification was necessary so that beneficiaries would not have their total income from benefits and employment be reduced because of working.

One possibility considered was the general principle of a "one-for-one" reduction. Full benefits would be paid if monthly earnings were $35 or less, whereas if earnings were larger, the benefits would be reduced by the amount of the difference. Operation on this principle would permit a smooth transition from full-time employment to part-time employment and then to full-time retirement. Individuals earning more than the amount permitted for the payment of full benefits would thus, within a certain range, maintain their total income from benefits and earnings combined, instead of having a reduction in total income, as under the all-or-none retirement test. Of course, this approach would not offer any incentive to work beyond the $35 limit, but it was a vast improvement over the all-or-none basis. The council also recognized that minor modifications would be necessary to facilitate administration to some extent, since month-by-month adjustments and calculations would be costly to make. Accordingly, it recommended quarterly adjustments.

The advisory council recognized that some modifications would have to be made for the self-employed, because their earnings would be reported annually. No specific proposals, however, were presented for this group.

Another recommendation made by the advisory council was that the earnings test should not apply to beneficiaries aged 70 and over. It was recognized that this proposal would involve some significant increase in cost, but not nearly so much, of course, as if the test were completely eliminated. In essence, the proposal was a compromise with those persons who held that the test was a restriction on their activity and who regarded the benefits as something that they had paid for and that therefore should be payable automatically as an annuity at age 65. Furthermore, it was expected that the elimination of the test for persons aged 70 or over would be particularly attractive to farmers and other self-employed persons (for whom the advisory council recommended coverage), because it was argued that these groups generally never retire.

1950 Act

The 1950 Act raised from $14.99 to $50.00 a month the amount of wages permitted under the earnings test, but continued it on an all-or-none monthly basis for wage earners. A unit-reduction procedure was adopted for the self-employed, who were brought into coverage and who reported their earnings annually. Benefits were not withheld if the covered self-employment earnings reported for the year were $600 or less, but one month's benefit was withheld for each $50 (or remaining fraction thereof) of the amount of such earnings in excess of $600.

The test was made inapplicable at age 75 and over (to make the program more attractive to the newly covered self-employed); this change, however, represented a breach in the underlying philosophy of the program to provide *retirement* benefits, by having them instead be on an *annuity* basis at age 75.

1952 Act

In 1952 the exempt amount for wages was raised to $75 a month. Correspondingly, the exemption for self-employment income was increased to $900 a year, with $75 units for subsequent withholding of monthly benefits.

A number of situations occurred that aroused considerable criticism, particularly with respect to wage earners. A retired person who had wages of more than $75 a month, but not as much as $75 plus the benefit amount, had a particular problem. If, for example, a man's PIA was $60 and he had a wife aged 65 and over, the benefit for the couple was $90. In the month that this beneficiary had wages of $75, he would have available a total income of $165. If he earned $80, he lost his own benefit and his wife's benefit and had only the $80 from his work, or a loss of $85 because of earning $5 more. The problem became less acute, of course, as his wages approached the amount of his benefits plus $75. In actuality, most beneficiaries who worked and were affected by this test earned substantially more wages than their withheld benefits plus the $75 exempt amount.

There was also a problem for the beneficiary who worked only occasional months at wages that, although moderate, were more than $75. Benefits were lost for such months. Such a beneficiary was, in fact, substantially retired, certainly to the same extent as a $75-a-month, 12-month worker, who perhaps had been able to adjust wages downward so that benefits could be received for all months.

Self-employed beneficiaries did not have the same problem, because the earnings test operated differently for them. They had an undue advantage, moreover, when they had wages as well as self-employment income, because then a "double exemption" feature applied.

Another inequity existed because the earnings test applied only to covered employment. Thus, individuals who engaged full time in noncovered employment and were by no means retired could at the same time receive full benefits. Noncovered employment, for which earnings reports were not available through the collection of payroll taxes, was not counted in the operation of the earnings test principally because of the administrative problems involved under the limited coverage of the system. With the virtually universal coverage achieved by the 1954 Act, such problems would be much smaller.

1954 Act

Accordingly, the 1954 Act drastically revised the earnings test. Wages, as well as self-employment income, were considered on an annual basis. Noncovered earnings were taken into account along with covered earnings. Also, the test was, for the first time, made applicable to noncovered earnings of beneficiaries living abroad. The annual exempt amount was increased to $1,200, and $80 units of earnings thereafter were provided for withholding units of monthly benefits.

Furthermore, under the monthly test, benefits were paid in any event if the beneficiary both had wages of $80 or less (changed to $100 or less by the 1958 Act, and in every instance thereafter maintained at one twelfth of the annual exempt amount) and did not engage in substantial self-employment.

The age at which the test did not apply was reduced from 75 to 72, so that the program would have more appeal for self-employed farmers, who were first covered by this legislation.

1960 Act

In 1960 a significant change was made in the earnings test. In fact, its general philosophy was considerably changed. The $100 monthly test and the $1,200 annual exempt amount were continued, but under the annual test, the first $300 of earnings in excess of $1,200 resulted in a benefit loss of $1 for each $2 of such earnings, while for earnings in excess of $1,500 in the year, $1 of benefits was withheld for each $1 of such earnings.

There was thus established the logical and equitable basic principle that earnings in excess of the annual exempt amount will always result in more total income (from benefits and earnings combined) than if earnings were held down to $1,200, which had not always been the case previously. Nonetheless, there still remained the work disincentive (because of the $1-for-$1 reduction band) to have earnings beyond the $1-for-$2 band—at least until total earnings were sufficiently high to offset the loss of all benefits.

Legislation in the 1960s

The 1961 Act increased the $1-for-$2 reduction band from $300 to $500. The 1965 Act increased the annual exempt amount from $1,200 to $1,500 and the band to $1,200. The 1967 Act raised the annual exempt amount to $1,680 but did not change the $1,200 band.

1972 Act

In 1972 the annual exempt amount was increased to $2,100 and the $1-for-$1 reduction band was eliminated (or, in other words, the $1-for-$2 band was extended indefinitely). This was another important change in philosophy; persons did not merely have no reduction in income from benefits and earnings when they worked, but rather higher earnings always meant higher total income. Moreover, under the former basis, when individuals were in the $1-for-$1 band, an additional dollar of earnings actually produced less *net* income than the dollar of benefits lost, because the earnings were subject to income tax and OASDI-HI tax, whereas the benefits were tax-exempt.

Another significant change brought about by the 1972 Act provided that the annual exempt amount would be adjusted automatically upward from the legislated level of $2,400 in 1974. This would be done only when the automatic-adjustment provisions were effective for the benefit level. The adjustment for the exempt amounts was to be made in the same manner as for the maximum taxable earnings base—from changes in average wages. This is a reasonable procedure because both such elements are related to earnings levels (whereas benefit adjustments are related to changes in the CPI).[29]

1977 Act

The 1977 Act brought about further significant changes in the earnings test—both liberalizations and deliberalizations. Based on the considerable "grass roots" concerns when the legislation was debated on the House floor, an amendment was added (by about a 2-to-1 vote) to eliminate the earnings test after age 65. A similar attempt on the Senate floor resulted in the previous age-72 limit being reduced to age 70. The conference committee between the House and Senate agreed on the Senate version, to be effective in 1982.[30]

This pressure to liberalize the earnings test also resulted in increases in the annual exempt amount, but only for beneficiaries aged 65 or over. Ad hoc increases were legislated for this category, beginning with an exempt amount of $4,000 for 1978 and then with $500 increases each year until reaching $6,000 in 1982. Thereafter, the automatic-adjustment procedure took over again (as it applied for the annual exempt amount for beneficiaries under age 65 for all years after 1977).

The monthly earnings test had been adversely criticized by many people. There was general agreement that it was necessary in the initial year of retirement (so that substantial earnings before retirement could not reduce, or even eliminate, benefits after retirement, even though retirement was complete). On the other hand, some persons believed that, for subsequent years, the monthly test resulted in many unwarranted benefits being paid. For example, highly paid workers—such as movie actors, physicians, lawyers, and college professors—could, as a result of the monthly test, receive benefits for months during which they were on vacation. Yet, employees with much lower earnings who worked in all months of the year could not collect any benefits under either the monthly test or the annual test.

29. Such adjustment originally was based on increases in average wages in covered employment, but it is now based on increases in average nationwide wages.

30. This delay in the effective date, which was present in both versions of the bill, was due to the short-range cash-flow problems of the OASDI system prior to 1982. Not until 1981 did either version of the bill schedule any substantial increase in the tax rates (this being needed to produce the necessary additional funds if the earnings test were eliminated after age 65). Legislation in 1981 deferred the effective date to 1983.

Accordingly, it was argued that the monthly test be eliminated for all years after the initial year of claim. Both the Ford and Carter administrations, as well as the 1975 Advisory Council on Social Security, recommended this, and so it was done in the 1977 Act.

Problems Created by Elimination of Monthly Test

In solving the problems discussed above, however, the elimination of the monthly earnings test created some new ones (which had been foreseen by some, including the author). For one thing, the "initial year of retirement" is not a precise concept, and many individuals actually retire and unretire several times.[31]

Perhaps even more important, some persons who were fully retired by any reasonable standard could no longer receive benefits (until they attained the limiting age of the earnings test). One example is a self-employed store owner who retires completely and turns over the management to an employee. If substantial profits occur, these count as earnings for the annual test and could result in the complete elimination of benefits. Previously, benefits were payable under such circumstances as a result of the monthly test. The only remedy for this inequitable situation was incorporation or sale of the business.

Another example was the self-employed life insurance agent who retired fully and continued to receive renewal commissions, which are considered self-employment income in the year in which they are received.[32] Once again, without the monthly test, no benefits might be payable.

The inequities arising from elimination of the monthly earnings test after the initial year were not confined to retirement cases. For example, a student beneficiary who did not work at all until graduation in June and then obtained a good job might find that the Social Security Administration would seek the return of the benefits paid for the early months of the year.

31. For example, a person might retire on December 1 and receive a benefit for that month, but then return to work in January for six months. The earnings in that period might be large enough, under the annual test, to eliminate all benefits for the year after the second retirement occurs in July. Yet those benefits could have been received under the former basis if the monthly earnings test had been applicable in all years, or even if the individual had not received the one month's benefit for the previous December (if in no other way than by alleging that substantial services in self-employment had been rendered then, even though no net earnings had resulted therefrom!).

32. Renewal commissions of life insurance agents who were employees are considered, for purposes of the earnings test, as being earned in the years of sales of the policies.

Legislation in the 1980s

Legislation enacted in late 1980 largely remedied the foregoing problems, as is described in Chapter 2.

The 1983 Act liberalized the earnings test for persons who attain the Normal Retirement Age for retired-worker benefits in or before the particular year. Beginning in 1990, the rate of reduction for earnings above the annual exempt amount (which continues to be higher than for younger persons) is on a $1-for-$3 basis, instead of $1-for-$2. The delay in implementation was due to the need to assure that the OASDI program would be financially viable in the 1980s.

Legislation in 1988 provided that, for death cases, the full annual exempt amount is available (instead of only a pro rata amount based on the proportion of the year during which the person was alive). Also, the higher annual exempt amount applicable to persons aged 65–69 was made applicable to persons who would have attained age 65 in the year of death, but who died before the month of such attainment (formerly, the lower amount for persons under age 65 applied under such circumstances).

Analysis of Liberalization of Earnings Test

The increases in the annual exempt amount that have been made since 1954 have been due, to a considerable degree, to pressure from the general public. Many people erroneously see the earnings test as preventing them from working. Such is really not the case, however, because if employment conditions are really attractive, the wages involved will usually far more than offset the benefits lost. There is need, though, for the earnings test to be on a flexible, equitable basis, with as little disincentive for work as possible, and it seems that this has been accomplished by the action taken in the 1972 and 1983 Acts, considering also the increases made in the DRCs (as discussed elsewhere).

One might wonder whether real increases have been made in the annual exempt amount over the years since the basis was first adopted to be effective in 1955, at $1,200 then versus $3,000 in 1977, after which time the amount was increased on an ad hoc basis for those aged 65 or over, for 1978–82, and then automatically adjusted by wage trends. The increase in the 22-year period was 150 percent, but during the same time, average earnings in covered employment rose by about 195 percent. Thus, the annual exempt amount did not over-expand greatly during those years, despite the large dollar increases.

Although in many ways the earnings test has been liberalized from time to time, it furnishes some of the few examples of deliberalizations in the OASDI program. In essence, the earnings test was deliberalized in both 1950 and 1954, when it was made applicable to new types of covered employment, and further in 1954, when it was made applicable to noncovered employment as well. Some persons who were receiving benefits in 1950 despite being self-employed were cut off the roll in 1951, when such employment was first covered. They felt that they had been maltreated because the terms of their "contract" had been altered to their disadvantage, unilaterally without their consent. The same thing occurred in 1955, when the test was made applicable to all employment (e.g., in the case of a beneficiary then working for the federal government). The same type of deliberalization occurred in the 1977 Act, which eliminated the monthly test for years after the initial year of claim, as discussed previously.

Income Taxation of Benefits

In the early 1940s, the Bureau of Internal Revenue issued a ruling that OASI benefits are not subject to income tax. This was done largely on the ground that they are gratuities from the government (based, probably, on the fact that the benefits and the taxes which finance them, in large part, are in different titles of the Social Security Act).

From time to time, proposals were made that the benefits should be included in taxable income, just as are private pensions in contributory plans. The basis usually advocated was that 50 percent of the benefits should be so included—on the simplistic, and erroneous, ground that the employee taxes (which are made out of after-tax income) "purchase" half of the benefits. This would be more generous treatment than that provided in a defined-contribution plan with equal employer and employee contributions, under which less than 50 percent of the pension comes from employee contributions (as a result of the interest earnings on the employer-employee contributions), and so more than 50 percent of the pension must be included in taxable income.

Even though a portion of OASDI benefits is included in taxable income for income-tax purposes, a substantial proportion of the beneficiaries would not pay any income tax. Many have little or no other income, and the effect of personal exemptions and deductions will very often result in no income-tax liability.

Several times in the years preceding the 1983 Act, the Congress passed unanimously (or close thereto) nonbinding resolutions to the effect that never, never would OASDI benefits be made subject to income tax. Nonetheless, because sources of additional resources were needed to solve the financing crisis in 1983, the legislation of that year included such a provision. As now contained in the law, it affected only about 8 percent of the beneficiaries initially, and about 16 percent in 1990. However, this proportion will grow slowly over the years, due to the nonindexed threshold amounts at which taxability is first applicable, and will reach about 40 percent ultimately. It was intended that the phasing-in should be very slow, but that eventually virtually all persons would have to include 50 percent of their OASDI benefits in taxable income for income-tax purposes. However, the vast majority of low-income, and even lower-than-average income, persons will not have any income-tax liability.

Some who favored this income-tax procedure as to the treatment of OASDI benefits did so on the grounds that it was good tax policy. They, however, questioned the return of the additional taxes resulting to the OASDI Trust Funds, which they viewed as general-revenue financing, the first injected into the program on a continuing basis. Such procedure of returning the taxes to the pension fund is not followed for private pension plans, so they saw no reason why it should be done for OASDI—other than on the weak grounds that the trust funds "need the money."

Some view the taxation of OASDI benefits as introducing a means or income test into the program. Others view it as a reduction in benefits for higher-income persons, and thus as the introduction of more social adequacy at the expense of less individual equity. Still others view it as good tax policy accompanied by poor Social Security policy as a result of introducing general revenues into the long-range financing of the OASDI program.

In the last few years, because of the problems with the General Budget, proposals have been made to make more of the OASDI benefits be subject to income tax. The goal has been to have such benefits be taxable in the same general manner as private pensions. However, for administrative simplicity (as well as all necessary data not being available to beneficiaries), the proposals frequently are that 85 percent of the benefits—rather than the current 50 percent—should be taxable. (The rationale for the 85-percent figure can be found in Robert J. Myers, "The Proper Basis for Taxing Social Security Benefits," *The Actuary*, Society of Actuaries, October 1989 and March 1990.)

If this change is made, a question remains as to whether the additional revenues should revert to the OASDI Trust Funds (as is done under the 50-percent basis under the 1983 Act) or instead should remain in the General Fund of the Treasury. The author strongly prefers the latter approach, because it *really* helps to balance the General Budget, instead of merely creating more debt obligations that must be met in the future.

Tax Rates

Original Act

The 1935 Act provided a long-range tax schedule, with the combined employer-employee rate rising in three-year steps of 1 percent each, from 2 percent in 1937–39 to an ultimate rate of 6 percent in 1949 and thereafter. The 2 percent rate, however, was frozen by various legislative actions during the 1940s, although it did rise to 3 percent in 1950.

Legislation in the 1940s

Action to hold down the tax rates in the 1940s was taken because the fund was growing rapidly. This resulted from the naturally low disbursements in the early years while the beneficiary roll was building up and from the economic conditions arising from World War II (higher tax receipts due to increased wage levels and lower benefit outgo due to deferred retirements).

Many people, especially in Congress, believed that a large fund was not desirable, or at least was not necessary. Accordingly, they believed that reductions in the tax rates for this "separate and independent" social insurance system should be made to offset partially the high general tax rates necessary to finance the war. This theory of separateness is in sharp conflict with the current economic and budgetary viewpoint on the close interrelationship of the financing of OASDI and the national economy, which is discussed in detail in Chapter 4 in connection with the concept of the unified budget.

Legislation in the 1950s

The 1950 Act set up a new long-range tax schedule, with an increase from a combined employer-employee rate of 3 percent to an ultimate rate of 6½ percent in 1970 and thereafter (see Table 3.3). This change, as well as all subsequent ones until the 1977 Act, had the purpose of establishing a tax schedule with gradually increasing rates that would, according to the best actuarial cost estimates available, fully finance the program over the long-range future on a completely self-supporting basis (i.e., with no government subsidy).

The 1954 Act further changed this schedule by increasing such ultimate rate to 8 percent, effective in 1975. The 1956 Act added a flat ½ percent to the schedule to finance the monthly disability benefits then added. The 1958 Act added a further flat ½ percent to the schedule and advanced future increases, so that they would be at three-year intervals beginning with 1960 (rather than five-year intervals), such increases being necessary in part because of the unexpected higher benefit costs arising from the coverage of farmers.

Legislation in the 1960s

The 1961 Act added yet a further flat ¼ percent to the schedule and advanced by one year the date when the ultimate rate would be effective (from 1969 to 1968). This action was taken to finance the cost of the benefit liberalizations then enacted.

The 1965 Act reduced the combined employer-employee tax rate scheduled for the next few years by about ½ percent, but raised the ultimate rate (whose initial year was postponed from 1968 to 1973) by about ½ percent. At the same time, and somewhat more than offsetting, a new payroll tax was introduced for the Hospital Insurance (HI) portion of the Medicare program enacted then.

The reduction in the OASDI rate in the 1965 Act was made for "economic" reasons. It was believed (quite erroneously) by the economic planners that the nation's problem was deflation, so it was thought desirable to reduce the so-called fiscal drag of the OASDI-HI payroll taxes. Actually, the problem was just the reverse—the coming inflation as the Vietnam War activity increased! This was the beginning of the use of the OASDI and HI programs, as to their tax income, for overall national fiscal purposes (discussed in Chapter 4).

In the 1967 Act, the OASDI tax rates for the first few years were reduced slightly to offset the increase in the HI rates needed to finance the costs for that program, which were higher than had been originally estimated. On the other hand, the ultimate combined employer-employee rate was increased by 0.3 percent (to 10.0 percent) to make up for the decreased rates in the early years and to help finance the benefit liberalizations made in that legislation.

No change was made in the tax rates in the 1969 Act, because the benefit increases enacted then could be financed from the actuarial surplus present (which resulted from the increase in covered earnings since the previous actuarial valuation). The benefit increases in the 1971 Act, however, required additional financing; part of this was derived from increasing the ultimate rate to 10.3 percent, thus for the first time breaking through what some people thought was the absolute maximum tax rate desirable for OASDI—10 percent.

Legislation in 1972–1973

The legislation enacted on July 1, 1972 (providing a 20-percent benefit increase), significantly changed the financing basis by moving to a current-cost approach and also changed the actuarial methodology (as discussed in Chapter 4). As a result, the OASDI combined employer-employee tax rates were decreased for the next four decades (until 2011) by about 1 percent, but they were increased by 0.4 percent (to 10.7 percent) in the ultimate years. At the same time, the corresponding HI tax rates were increased (to finance the long-range, and even short-range, deficiency in the financing of this program) by 0.4–0.6 percent in all future years, with the ultimate rate (for 1993 and after) being 2.4 percent. Thus, under this legislation, the ultimate rate for OASDI and HI (reached in 2011) was 13.1 percent, compared with 12.1 percent under the previous law.

The foregoing tax schedules under the July 1972 legislation never went into effect, because they were changed by the legislation enacted on October 30, 1972. Compared with the rates in effect in the law before 1972, the new combined employer-employee rates for OASDI were lower by about 0.7 percent until 2011 (but only by 0.3 percent for 1973–75), but they were increased by 1.4 percent (to 11.7 percent) in the ultimate years. At the same time, the corresponding HI tax rates were increased by about 0.7 percent for the first five years and about 1.1 percent thereafter over the rate schedule in effect before 1972 (to finance both the previously existing deficiency and the cost of extending benefit protection to certain disabled beneficiaries). Thus, under this legislation, the ultimate rate for OASDI and HI was 14.6 percent, compared with 12.1 percent under the law in effect before 1972.

The December 1973 legislation further increased the ultimate combined employer-employee tax rates for both OASDI and HI—from 11.7 percent to 11.9 percent and from 2.9 percent to 3.0 percent respectively. At the same time, the near-future rates were maintained at the same level for the total program but were increased slightly for OASDI and correspondingly lowered for HI.

1977 Act

Significant changes in the OASDI tax rates were made in 1977. The combined employer-employee rate was increased by 0.2 percent in 1978 (because of the short-range financing problems, particularly for the DI portion of the program), but this was exactly counterbalanced by a decrease in the HI rate (because the program had no cash-flow problems in the very short run). An increase of 0.06 percent over the 1978 rate was scheduled for OASDI for 1979–80, primarily to meet the cost of the liberalization in the annual exempt amount in the earnings test for those aged 65 and over, which was legislated in the 1977 Act. At the same time, the HI rate for 1979–80 was increased by 0.1 percent over the 1978 rate, thus making it 0.1 percent lower than under previous law for those years. The OASDI-HI rate for the employer and employee combined for 1979–80 was thus 0.16 percent higher than under previous law.[33]

A series of increases in the OASDI combined employer-employee tax rate was legislated in the 1977 Act for 1981–90, and the ultimate rate was scheduled for 1990, instead of 2011 as under previous law.[34]

At the same time, the 1977 Act reduced the HI combined employer-employee tax rate by 0.1 percent in all years after 1978, except 1985 (when no change was made). This was done without affecting the financing of HI, because its increased income from the higher earnings bases under the 1977 Act slightly more than offset the decreased income from the lower tax rates.

The 1977 Act reestablished, beginning in 1981, the principle that the OASDI self-employed tax rate should be 1½ times the employee rate.[35] At the same time, the principle was continued for HI that the self-employed rate should be the same as the employee rate. For

33. President Carter, in his campaign in 1976, had taken a strong position of opposition to *any* increase in OASDI-HI tax rates in 1977–80. The House-passed version of the 1977 Act carried out this promise, but the Senate-passed version did not do so—and the latter was the basis adopted by the conference committee. In fact, the final version was based on the *higher* of the tax rates in the two versions of the bill for all years before 1995 (although they did not differ greatly).

34. The Senate-passed version of the 1977 Act would have had further increases in the tax rate in years after 1990—namely, to 13.4 percent in 1995, 14.6 percent in 2000, and 15.6 percent in 2011 (as contrasted with the 12.4 percent in 1990 and after under the final legislation). Such a schedule would have eliminated the estimated long-range actuarial deficiency completely, which the 1977 Act did not do (see Chapters 4 and 10 for more details on this matter).

35. For certain technical, parliamentary reasons, the self-employed rates in 1981–84 were slightly less than 1½ times the employee rates.

1978–80, the 1977 Act left the self-employed rate for OASDI-HI the same as in previous law.[36]

These several increases in the OASDI tax rates were necessitated by the short-range financing problems of the program. In part, these were solved by these increases, and in part the ad hoc increases in the maximum taxable earnings base (discussed later in this chapter) alleviated the situation. The official cost estimates (made by the Social Security Administration) underlying the 1977 Act indicated that, from a cash-flow standpoint, the financing problems would be solved for at least the next three decades and perhaps longer (see Chapter 10).[37]

The short-range financing problems of OASDI, before the 1977 Act, occurred because of the higher cost resulting from the relatively large increases in the CPI as compared both with increases in the general earnings level and with what had been assumed for the 1970s and because of the higher cost of the DI portion of the program than estimated earlier. The tax schedule for the HI program could be reduced by the 1977 Act in the early years thereafter because of the sizable increases in the taxable earnings base made then (which resulted in more tax income but no additional benefit outgo). An increase in the ultimate OASDI rate was needed, however, to maintain a long-range actuarial balance, but it was not made.

1983 Act

The 1983 Act, as part of the solution of the short-range financing problem, moved up the OASDI tax rates scheduled for future years. The 1985 increase in the employer rate (0.3 percent) was advanced to 1984, but the employee rate was left unchanged. However, the OASDI Trust Funds received, from the General Fund of the Treasury, the full amount of the tax receipts based on both the employer and employee rates being so increased—a clear case of a government subsidy to the trust funds. This was the first, even though temporary, instance when the principle of equal employer and employee contributions had been breached. In addition, 72 percent of the 1990 tax-rate increase scheduled under previous law (0.5 percent each on the

36. The division between OASDI and HI was, however, changed (because of the financing problems of OASDI, especially DI). For this reason, the OASDI self-employed rate for 1978–80 rose above the previous ceiling of 7.0 percent.

37. President Carter, in signing the 1977 Act into law, stated that the OASDI system would thereby be adequately financed until about 2030. In the author's opinion, this was not the case. The estimates showed that, beginning shortly after 2010, outgo would always exceed income, and the OASDI Trust Funds would be exhausted by 2030 (with drastically increased tax rates necessary then, if outgo is to be balanced by income).

employer and employee) was moved up to 1988, with the remainder going into effect in 1990.

Trend of Ultimate Tax Rate

Table 3.3 shows a very clear trend in the size of the ultimate tax rate—ever upward. In part, this has been due to a change in the funding philosophy, away from the accumulation of large reserves and toward current-cost financing. It has also been due to the expansion of the program—both an increase in the relative benefit level and the addition of new types of benefits.

As to the first year for which the ultimate rate is to be effective, the tendency has been to keep pushing this further into the future, although this has not always been done (as, for instance, in the 1977 Act).[38] If current-cost financing is to be followed (as many experts in the field believe is desirable and as was done in connection with the financing of the 1972 Act), the tax schedule must be spread out further. Otherwise, as will be discussed in Chapters 5 and 10, unrealistically large trust-fund balances will be built up in the two or three decades following the date when the "ultimate" rate first becomes effective. To spread out the tax schedule, however, results in the required ultimate rate being larger, because having lower rates in the early years necessitates having higher ones later. The enactment of such higher rates poses political problems, because considerable public attention is paid to them (and quite properly so).

Self-Employed Tax Rate

The self-employed, under their initial OASDI coverage in 1951, were required to pay three fourths of the combined employer-employee rate. Beginning in 1962, this was only approximate, because the resulting rates were rounded to the nearest 1/10 percent. In the 1965 Act, the decision was made to provide a 7-percent ceiling for the self-employed OASDI tax rate, regardless of the "three-fourth rule." In 1973, as a result of the 1972 Act, this point was reached, so that for all future years this rate was to be frozen at 7 percent. However, the 1977 Act restored the three-fourths rule, effective in 1981.

This lower tax-rate basis for the self-employed was adopted for

38. It is important to note that, under that act, there was a significant long-range actuarial deficiency, which could be met only by increased financing after about 25 years, unless benefit costs were to be reduced (for more details, see Chapters 5 and 10). Such deficiency was eliminated by the 1983 Act.

TABLE 3.3. Ultimate Tax Rates Scheduled for OASDI and HI Systems under Various Acts

Year of Legislation	Year Ultimate Rate Would Be Effective for Employer-Employee Rate†	Ultimate Tax Rate: Employer-Employee	Ultimate Tax Rate: Self-Employed
Old-Age, Survivors, and Disability Insurance			
1935	1949	6.0%	*
1950	1970	6.5	4.875%
1954	1975	8.0	6.0
1956	1975	8.5	6.375
1958	1969	9.0	6.75
1961	1968	9.25	6.9
1965	1973	9.7	7.0
1967	1973	10.0	7.0
1971	1976	10.3	7.0
1972	2011 (1973)	11.7	7.0
1973	2011 (1973)	11.9	7.0
1977	1990	12.4	9.3
1983	1990	12.4	12.4‡
Hospital Insurance			
1965	1987	1.6%	0.8%
1967	1987	1.8	0.9
1972	1986	2.9	1.45
1973	1986	3.0	1.5
1977 and 1983	1986	2.9	1.45
Both programs			
1965	1987	11.3%	7.8%
1967	1987	11.8	7.9
1971	1987	12.1	7.9
1972	2011 (1986)	14.6	8.45
1973	2011 (1986)	14.9	8.5
1977	1990	15.3	10.75
1983	1990	15.3	15.3‡

*Not applicable.

†For OASDI the ultimate self-employed rate is effective in the same year as the combined employer-employee rate, except for the 1972 and 1973 Acts; figures in parentheses are years of ultimate rate for the self-employed for those acts.

‡But with 50 percent of the tax being considered a business expense for income-tax purposes.

political reasons, to placate this group when it was initially covered. From the standpoint of the overall financing of the system, the proper basis would be to have the self-employed pay the full employer-employee rate (and, at the same time, get credit for the employer share of the tax as a business expense for income-tax purposes). The fact that less than this was payable merely meant that the employer-employee group was paying a higher tax rate for OASDI (by about 0.3 percent of taxable payroll) than it would have paid if the self-employed had paid the full employer-employee rate.

Several fallacious arguments were given for the self-employed paying only three fourths of the combined employer-employee rate. One was that, on the average, about 75 percent of the income of the self-employed came from their own work, with the remainder representing income from their investment; if this were to be the basis, then only 75 percent of their net earnings from self-employment (rather than 100 percent) should be used for determining their benefit. Another was that the self-employed tended to retire later and were, therefore, a low-cost group who should contribute less; this conflicts with the general social-adequacy principle that all pay at the same tax rate, regardless of the "risk" involved (different ages, sex, family composition, etc.).

Thus the three-fourths basis was purely a political compromise between paying only the employee rate and paying the combined employer-employee rate (i.e., going halfway between the two). One justification, however, is that, if self-employed persons were to incorporate, the employer tax would be considered a business expense. In most cases, the net tax effect then, after corporation income tax (which was close to 50 percent before the Tax Reform Act of 1986), would be a tax to the individual (as both an employer and employee) of about three fourths of the gross employer-employee OASDI tax. Thus, although the effect would be about the same to the individual as under the present basis for the self-employed, the trust funds would receive less under the latter (and more would be paid into the General Fund as income tax).

Comparability would be achieved for high-income self-employed persons with what would occur if they incorporated and paid the combined employer-employee rate but could count half of it as a business expense; this would seem more equitable to the OASDI program. However, low-income self-employed persons would be disadvantaged in comparison with the actual procedure adopted, because using the half of the combined employer-employee tax as a business expense would produce little income-tax savings, and certainly not as much as the larger OASDI tax payable.

The 1983 Act changed the basis for the tax rate for the self-employed along the foregoing lines, but with special treatment in 1984–89 to lighten the tax burden on low-income self-employed persons.

The tax rates for the OASDI system, separately as to the combined employer-employee rate and the self-employed rate, for various past years and as scheduled for the future were presented in Tables 2.13 and 2.14.

Allocation to the Disability Insurance Trust Fund

The original allocation (in the 1956 Act) of the combined employer-employee tax rate to the Disability Insurance (DI) Trust Fund was 0.5 percent of payroll for all future years. Early experience seemed to indicate that this financing was not only adequate for the provisions originally enacted, but also sufficient to meet the cost of extending the benefits to disabled workers below age 50 and to auxiliary beneficiaries (both of which were done). However, in the early 1960s, it was found that the experience was more adverse than had been expected, and thus more financing was needed.

Accordingly, the employer-employee allocation was increased to 0.7 percent of payroll by the 1965 Act and then to 0.95 percent by the 1967 Act. A further increase to 1.1 percent was made in the 1969 Act, largely as a result of the substantial increase in the overall benefit level then. The allocation did not need to be changed when benefits were increased in the 1971 Act, so the entire increased financing from the higher ultimate tax rates then provided went to the OASI portion of the system.

The legislation enacted in July 1972 changed the DI allocation basis from a level, uniform one to a graded one that more closely paralleled the future trend of the cost of this portion of the program. This same theory was followed in the subsequent legislation in 1972 and also in 1973.[39]

The serious financing problem facing the DI program when the 1977 Act was being developed—as a result of the adverse disability experience in the 1970s—necessitated a significant increase in the DI allocation, beginning immediately in 1978. The combined employer-employee rate was boosted from the 0.600 percent previously sched-

39. Thus, the allocation was changed by the July 1972 legislation for the employer-employee combined rate from 1.1 percent of payroll in all future years to 1.0 percent in 1973–77, 1.1 percent in 1978–2010, and 1.4 percent after 2010, which schedule was roughly equivalent to the level rate of 1.1 percent. The legislation enacted in October 1972 liberalized the DI program in several ways, so that the foregoing allocation schedule had to be superseded before becoming effective—by a new schedule of 1.1 percent for 1973–77, 1.15 percent for 1978–2010, and 1.5 percent thereafter. The 1973 Act further changed this schedule by recognizing the higher current disability experience—the new schedule being 1.15 percent in 1974–77, 1.2 percent in 1978–80, 1.3 percent in 1981–85, 1.4 percent in 1986–2010, and 1.7 percent thereafter.

uled for 1978 to 0.775 percent (an increase of 29 percent, relatively), with similar or larger increases in subsequent years.[40]

The allocation of the self-employment taxes to the DI Trust Fund was, until the 1972 Act, at a rate equal to three fourths of the allocation rate for employer and employee combined. This applied in all future years, despite the ceiling of 7 percent on the self-employment OASDI tax rate imposed by the 1965 Act.

Under the 1972 Act, the DI allocation basis for the self-employment tax was changed for years when the self-employment OASDI tax had reached the ceiling of 7 percent. In such years, the self-employment DI allocation rate was the employer-employee DI allocation rate times the ratio of the self-employment OASDI tax rate (i.e., 7 percent) to the combined employer-employee tax rate.[41] When the 1977 Act eliminated the 7-percent cap on the self-employment OASDI rate, the same general basis for the self-employment DI allocation was continued for 1978–80. Thereafter, the self-employment DI allocation was set at a rate equal to three fourths of the allocation rate for employer and employee combined.[42]

In late 1980, legislation was enacted that increased the allocation of the OASDI tax rate going to the OASI Trust Fund for 1980–81, and correspondingly decreased the portion going to the DI Trust Fund (for information on the specific amounts involved, see Tables 2.13 and 2.14). This change was made because of the unfavorable financial status of the OASI Trust Fund (see Chapter 4 for more detailed discussion).

The 1983 Act not only increased the combined employer-employee tax rates for 1984 and 1988–89 and made the self-employed rates equal to the combined employer-employee rates for all years after 1983, but also changed the DI allocations significantly. In general, such allocations were lowered—to reflect the more favorable disabil-

40. The relative increases were 25 percent in 1979–80, 27 percent in 1981–84, 46 percent in 1985, 36 percent in 1986–89, 57 percent in 1990–2010, and 29 percent after 2010.

41. The resulting allocation rate was rounded to the nearest 0.005 percent. As a result, the DI allocation for the self-employment OASDI tax rate under the 1972 Act was 0.795 percent for 1973–77, 0.840 percent for 1978–2010, and 0.895 percent after 2010. The last figure was derived by multiplying 1.5 percent by the ratio of 7 percent to 11.7 percent, yielding 0.8974 percent, which was rounded to 0.895 percent. The corresponding schedule under the 1973 Act was 0.815 percent for 1974–77, 0.85 percent for 1978–80, 0.99 percent for 1986–2010, and 1.00 percent thereafter.

42. For all years except 1981–84, the rounding continued to be to the nearest 0.005 percent. For 1981–84, a uniform allocation rate of 1.2375 percent was provided, despite the fact that the standard procedure would have yielded slightly different results—namely, 1.235 percent for 1981 and 1.230 percent for 1982–84.

ity experience since 1975 and to provide somewhat more financing for the OASI Trust Fund (which was at a relatively lower level than the DI Trust Fund).

The combined employer-employee rate for 1983 which was allocated to DI was reduced by the 1983 Act from 1.65 percent to 1.45 percent (which required retroactive book adjustments, just as was done for the 1980 change in allocation enacted at the end of that year). Such combined rates for subsequent years were also significantly reduced, and two steps are introduced after the 1980s—to 1.2 percent for 1990–99 and 1.42 percent thereafter (as compared with the former level rate of 2.2 percent for 1990 and after). Quite naturally, the DI allocation for the self-employed after 1983 is exactly the same as the combined employer-employee one.

Taxable Earnings Base

The maximum earnings of an employee from a particular employer subject to the OASDI tax was $3,000 a year from 1937 through 1950. The 1950 Act increased this amount to $3,600, effective in 1951. This 20-percent increase was far less than the rise in the general earnings level from the mid-1930s to 1951, as is indicated by the fact that the $3,000 base covered 92 percent of all earnings in covered employment when it was first effective, whereas the corresponding figure for the $3,600 base was 81 percent. This is one of the few instances where the program was not, for many years, kept up to date with changes in economic conditions, and it seems to indicate that Congress believed, for some years, that the original base had been too high relatively.

The 1977 Act, however, increased the earnings base by three ad hoc steps in 1979–81 over what the automatic-adjustment provisions would probably have done. The net effect was to raise the base to such an extent that it was virtually at the same relative level in 1981 as it was in the late 1930s. Such action was taken largely on financing and political grounds—namely, to provide a substantial part of the funds needed to solve the short-range (or cash-flow) financing problems, but to impose the burden on only the highest-paid workers (the upper 15 percent). The restoration of the base to the same relative size as it was originally was mentioned as a rationalization for the action taken.

As Table 2.13 indicated, the base was increased several times after 1950. In each instance until the 1972 Act, the increases closely approximated the rises in the general earnings level and thus could not be said to represent a real expansion of the program, although the absolute amounts of the increases might make it seem so. This is shown by the fact that the ratio of taxable earnings to total earnings

TABLE 3.4. First and Last Years for Which Changed Earnings Base Was Effective and Proportions of Total Earnings in OASDI Covered Employment Then Taxable

		Taxable Proportion of Total Earnings, in Covered Employment	
Calendar Year	*Earnings Base*	*First Year*	*Last Year*
1937	$ 3,000	92.0%	79.7%
1951	3,600	81.1	77.7
1955	4,200	80.3	76.4
1959	4,800	79.3	71.3
1966	6,600	80.0	78.1
1968	7,800	81.7	76.3
1972	9,000	78.3	*
1973	10,800	81.8	*
1974	13,200	85.3	*
1975	14,100	84.4	*
1976	15,300	84.3	*
1977	16,500	85.0	*
1978	17,700	83.8	*
1979	22,900	87.3	*
1980	25,900	88.9	*
1981	29,700	89.2	*
1982	32,400	90.0	*
1983	35,700	90.0	*
1984	37,800	89.3	*
1985	39,600	88.9	*
1986	42,000	88.6	*
1987	43,800	87.6	*
1988	45,000	85.8	*
1989	48,000	86.5	*
1990	51,300	87.1	*

*Not applicable.

in covered employment in the first effective year for a new base remained at about the 80–81-percent level up through the 1971 Act (which raised the base to $9,000 for 1972)—see Table 3.4. This table also shows the ratio of OASDI taxable earnings to total earnings in the year before when the base was increased for periods when it remained unchanged for some years. The relative deterioration of the base under such circumstances is evident. For example, for the 1937–50 period, when the base remained fixed at $3,000, the ratio decreased from 92 percent to about 80 percent.

The 1972 Act violated this precedent of more than two decades by making real increases in the earnings base. Thus, the $12,000 base which it scheduled for 1974 would probably have covered about 82.5 percent of all earnings in covered employment, or significantly more than the previous level of about 80–81 percent, but well below the 92 percent of the 1935 Act.

The 1973 Act increased the scheduled base for 1974 from $12,000 to $13,200, which covered about 85 percent of all earnings in covered employment in 1974. This change was made to finance the liberalization made then in the earnings test. It would seem that liberalizations such as this should properly be financed by increases in tax rates, rather than by the indirect method of raising the earnings base.

An extremely important change affecting the earnings base was made by the 1972 Act—namely, providing for automatic adjustment of the base (not until 1975). This would be done only when the benefit level was also automatically adjusted. The adjustment, which can only be upward, is based on the change in average wages in covered employment in the first quarter of the year and is exactly the same procedure that was adopted in 1965 for automatically adjusting the "80 percent of wage" maximum applicable to combined disability benefits and Workers' Compensation benefits. Appendix 3-7 illustrates how these provisions would have operated in connection with the earnings base if they had first become effective in 1965.

Another sharp ad hoc increase in the earnings base was provided by the 1977 Act in three steps during 1979–81.[43] When this was done, it was anticipated that the 1981 base of $29,700 would apply to about 91 percent of all earnings in covered employment in 1981 and would remain at about the same level thereafter due to the automatic-adjustment provision. However, subsequent economic developments, with more rapid increases in earnings levels, have changed this picture. The 1981 proportion was only 89.2 percent (which would have been the case with a $22,800 base in 1978 before the legislated ad hoc increases occurred, as compared with the actual $17,700). The 1977 Act also based the annual adjustments on the change in nationwide average annual wages (rather than average first-quarter wages in covered employment).

Following 1981 and through 1987, the proportion of total earnings in covered employment which were taxable and creditable toward benefits remained at about 89 percent. However, in 1988–89 this proportion decreased significantly, to about only 86 percent. This drop was, at least in part, caused by the more rapid increases in noncash wages (such as income-tax-deferred contributions under

43. The 1977 Act specified that the 1978 base would be $17,700, which had been promulgated before the legislation was enacted. The House-passed bill had provided a higher base, but this was dropped in the conference between the House and the Senate.

Section 401(k) of the Internal Revenue Code) as compared with cash wages. The drop may also be indicative of a trend for higher-paid workers to be receiving relatively larger pay increases than lower-paid workers.

The revised basis for the indexing-wage series that was legislated in 1989, applicable in 1990, increased the earnings base more than would otherwise have occurred (see Appendix 2-8). This resulted in the proportion of total earnings that was taxable for 1990 (about 87 percent) being somewhat closer to the level of about 89 percent that prevailed in 1981–87 (although the 1990 figure is still significantly lower).

The taxable earnings base for the HI program was the same as that for OASDI from its beginning in 1966 through 1990. However, legislation in 1990 increased the base for HI purposes to $125,000 for 1991 (from which it will be automatically adjusted for subsequent years in the same manner as is done for OASDI), as compared with the $53,400 applicable for OASDI. The $125,000 base will cover about 95 percent of total wages in covered employment, as compared with about 89 percent for the $53,400 base.

Coverage under the HI and OASDI programs was identical until 1983, when all federal employees were covered under HI, even though not under OASDI (similar action was taken for employees of state and local governments who were newly hired after March 1986). Because the same taxable earnings base applied to both HI and OASDI in 1983–90, the proportion of total earnings which were taxable was about the same during this period for both programs; actually, the HI proportions were slightly higher (by about 0.6 percentage points).

Combined OASDI and HI Taxes

Tables 2.13 and 2.14 summarized the actual combined employer-employee tax rates and the maximum taxable earnings base in effect in the past and as scheduled in the future for OASDI, for HI, and for OASDI and HI combined (the same earnings base prevailed for both programs in 1966–90). These tables also showed the maximum amount of taxes paid in each past year.

The total OASDI and HI taxes paid by an employee with maximum creditable earnings each year from 1937 on amounted to $41,696.24 at the end of 1990 (without allowance for interest), with the employer having paid slightly more, $41,809.64 (because of the special situation in 1984). The corresponding figure for a self-employed person covered since this was first possible in 1951 was $65,669.55. Although these amounts seem sizable, they do not look so large when compared with the annual benefit rate of $11,700 that would be payable to such an individual who became age 65 at the beginning of 1990 and retired then (or $16,176 for worker and spouse aged 65). In other words, such an employee receives in benefits in 3.6 years what was paid in taxes over a 52-year period (or in 2.4 years if married). The extent of the relative "actuarial bargain," which would be present to a somewhat lesser extent if interest were taken into account, is greater for persons with lower earnings levels and for persons who retired in previous years.

Likewise, the total OASDI-HI taxes paid will be much larger for future entrants than for workers who came into the system at the beginning. For example, an employee entering covered employment at the beginning of 1990 at age 21 and working at maximum creditable wages until the Normal Retirement Age of 67 will pay total taxes of $180,525 for OASDI and HI according to the schedule in the present law, without taking into account any increase in the earnings base after 1990 as a result of the automatic-adjustment provisions.

Advisory Councils on Social Security

The Social Security Act provides that an Advisory Council on Social Security is to be appointed every fourth year, in each year following a presidential election. The council is to consist of 13 members, appointed by the Secretary of Health and Human Services (HHS), representing organizations of employers and employees in equal numbers, self-employed persons, and the public. The council is to report not later than January 1 of the second year following the year in which it is supposed to be appointed.

The council has the responsibility of reviewing the financial status of the OASI and DI Trust Funds and the two Medicare trust funds, as well as the scope of coverage, the adequacy of benefits, and all other aspects of these programs.

1975 Advisory Council

The 1975 council was not appointed until April 1974, more than a year after it could have first been named and well after the deadline of December 31, 1973, specified in the law. As a result, the council had an unusually short time to perform its work and, in fact, did not release its report until March 1975, or more than two months beyond its legal deadline.

The council reaffirmed that OASDI should remain the primary means of providing economic security in the event of retirement, disability, or death and should continue in its same general nature as a floor of protection.

The main concern of the council was the unfavorable financial status of OASDI at that time, which is discussed in Chapters 4 and 10. The recommended solution to this problem was first to correct the flaw in the automatic-adjustment provisions which are applicable to the benefit amounts of those newly coming on the rolls. This would be done by a decoupling procedure, which was along the lines of that contained in the 1977 Act, as described in Chapter 2.[44]

The second step that was recommended by the council for solving the financial problems of OASDI was to reallocate gradually the Hospital Insurance tax rate to the OASDI system because additional financing for the latter was needed. Then, the lost income to the HI system would be replaced by a government subsidy, so that eventually it would be completely financed in this manner instead of by payroll taxes. The rationale behind this recommendation was that the Hospital Insurance benefits were not related to earnings. At the same time, the council recommended that the combined OASDI-HI employer and employee tax rates scheduled in present law should not be directly increased.

A minority of the council opposed this approach and instead believed that the financing problems of OASDI should be solved by direct increases in payroll-tax rates. President Ford, in an unprecedented action, issued a statement immediately after the council made its report public, stating his support of the council's endorsement of the basic principles of the OASDI system and its recommendation for stabilization of the benefit structure, but his strong opposition to the financing of the HI program with general revenues. Such opposition was based on his belief in the "earned rights" principle that had always been a basic feature of the program.

44. The benefit formula recommended by the council was 100 percent of the first $123 of the AIME, plus 31 percent of the AIME in excess of $123. As an alternative, the council mentioned that there might be a third step for the uppermost AIMEs, using a factor of 20 percent. This is notably different from the formula adopted in the 1977 Act, which produces somewhat lower benefits. Complete comparability is not present because the formula of the council was applicable to the 1976 cohort, whereas that in the 1977 Act applied to the 1979 cohort. If the formula recommended by the council were projected to what it would have been for the 1979 cohort, the result is 100 percent of the first $151 of the AIME, plus 31 percent of the AIME in excess of $151, with possibly 20 percent applying for the highest portion of the AIME, based on the assumption that wages rose by an average of about 7 percent per year in 1974–77 (as they did—see Table 2.18).

At one point in its deliberations the council favorably considered obtaining some additional financing for OASDI by increasing the earnings base to $24,000 in 1976. However, after considering that this action would materially reduce the scope for providing economic security through private-sector means, the council rejected this approach.

The council also saw another possible method of alleviating the financing problems of OASDI: by increasing the Normal Retirement Age. However, it believed that such action would not be necessary or even advisable until about 35 years in the future, when the demographic picture would have changed. At that time, the ratio of persons aged 65 and over to the working population will rise significantly as a result of the cohorts of the post-World War II baby boom then reaching retirement age. Accordingly, the council recommended that Congress consider such a change at some later time. Of course, somewhat the same cost effect could be obtained under the then-applicable retirement-age conditions and earnings test if persons worked longer than they now do and if employers imposed less strict compulsory-retirement rules.

The council also made a number of other recommendations for changes in the OASDI program, as follows:

1. The earnings test should be revised so that the reduction in benefits for earnings in excess of the annual exempt amount should be only $1 for every $3 of the excess earnings up to an additional amount equal to the annual exempt amount, and then $1 for $2 for additional earnings. On the other hand, the test should be deliberalized by eliminating the monthly portion for years after the initial year of entitlement. The latter provision was contained in the 1977 Act (and resulted in serious problems later), but the former was not.

2. Equal treatment should be provided for men and women, so that benefits would be payable to aged husbands and widowers without the then-existing test of dependency and also to young widowers with children and to divorced men. At the same time, auxiliary and survivor benefits (for both men and women) would be reduced, under the antiduplication provision, by the amount of any government pension based on the employment of such beneficiary, rather than only by the amount of any primary OASDI benefit as was then the case. The latter change would partially, or perhaps completely, offset the added cost for benefits to husbands and widowers being payable in more cases. Such added cost, however, would not be large because of the earnings test and the antiduplication provision. It should be observed that the first part of this recommendation was carried out by court decisions in 1975–82 (see Appendix 3-2), while the second part

was included in the 1977 Act (even though the Carter administration advised against it).

3. The regular-minimum benefit (for persons with very low AMWs) should be eliminated over a period of time. It would be phased out by being frozen at its present dollar figure instead of being increased by the automatic-adjustment provisions. This would provide more logical treatment of persons with minimal coverage at earnings just sufficient to acquire eligibility, who are in noncovered employment most of their working career and seek to obtain a windfall from OASDI (as they could under then-existing law). Such a provision was contained in the 1977 Act.

4. The definition of disability should be liberalized, so that, at ages 55–61, it would apply to inability to perform work for which the person has had considerable regular experience, rather than inability to perform any substantial gainful activity. The benefit rate for such lesser degree of disability would be 80 percent of the PIA—the same as for early retirement at age 62. This change was recommended on the basis of both liberalizing benefits and easing administrative-determination problems. However, it would seem that moving the definitional boundary would only create new boundary problems. Also, there would be problems in administering two definitions of disability, with different resulting benefit amounts, at ages 55–61. This provision was not included in the 1977 Act or subsequently.

5. The basis for the tax rate for the self-employed should be changed back to the original 75 percent of the combined employer-employee rate. This would be done by eliminating the 7-percent maximum on the rate, which was first effective in 1973. This provision was included in the 1977 Act, effective in 1981.

The net effect of the foregoing recommendations was an estimated increase in the long-range average cost of OASDI of only 0.13 percent of the taxable payroll. The largest increase, also 0.13 percent, was for the change in the definition of disability, with the other changes having relatively small costs, or savings, which counterbalanced one another.

The council also made a number of recommendations and suggestions not involving immediate legislative changes in the OASDI system. These included the following:

1. Coverage should be universally applicable to all types of employment. In particular, ways should be found to extend coverage to all public employment (federal, state, and local), with appropriate coordination with the staff retirement systems for such workers.

2. A study should be made of whether the automatic adjustment of benefits for changes in the cost of living should be done more fre-

quently than annually. Such a provision for semiannual adjustments was contained in the Senate-passed version of the 1977 Act but was deleted in conference.

3. A general study of the program should be made by a full-time nongovernment body. This should cover such matters as funding versus pay-as-you-go financing, effects of the system on productivity, proper size of the trust funds, and incidence of payroll taxes.

1979 Advisory Council

The next Advisory Council on Social Security was, according to law, to be appointed in 1977 (at any time after January) and to report not later than January 1, 1979. However, the Carter administration did not appoint the council until February 1978. Recognizing this delay, the Carter administration in the fall of 1977 requested Congress to extend the deadline for the council's report. As a result, the 1977 Act provided for the report to be submitted no later than September 30, 1979.

The advisory council, however, did not issue its report until December 1979. It made a number of recommendations for sweeping changes in the OASDI system, particularly as to financing. Some of these changes were recommended to be effective in January 1980, although the timing of the report was such that it would have been impossible to legislate these recommendations in sufficient time to be so effective.

Although many of the recommendations were passed unanimously, others were passed by majority vote. In the following summary of these recommendations, unless otherwise noted, there was unanimity (NM indicates that a narrow majority, seven to six, favored the recommendation, while M indicates a larger majority but not unanimity). In some instances, the author's views are given in parentheses following the recommendations. Views reaffirming existing principles (such as support of current-cost financing) are not mentioned.

The financing recommendations of the advisory council were as follows:

1. Some part of the OASDI-HI program should be financed from other than payroll taxes. (The author believes that this is essentially deceptive, because total tax costs will be the same, although perhaps hidden, and probably with about the same ultimate incidence after readjustment of the nation's incomes structure.)

2. HI should be financed completely from earmarked portions of the personal and corporate income taxes, but with no increase in such tax rates. Beginning in 1980, part of the decreased payroll tax rate

(due to the elimination of the HI rate) should be used to increase the OASDI rate (M). Under this approach, the combined employer-employee HI tax rate of 2.1 percent in 1980, 2.6 percent in 1981–84, 2.7 percent in 1985, and 2.9 percent thereafter would be eliminated, but the OASDI rate would be increased to 11.2 percent beginning in 1980 and would continue level at this amount for the next 25 years (as compared with a rising schedule of rates in present law, increasing from 10.16 percent in 1980 to 10.7 percent in 1981, 10.8 percent in 1982, 11.4 percent in 1985, and 12.4 percent in 1990). The required amount of earmarking of the personal income tax in 1981 was estimated at 1.23 percent of taxable income up to $27,000 for single persons and $54,000 for married couples—or, alternatively, a surcharge rate of 6.7 percent, with a maximum payment of $400 for single persons and $800 for couples. (Note that this method of financing HI would mean a reduction of income-tax revenues for general purposes and therefore an increase in the non-Social Security budget deficit.)

3. If the previous recommendation is not enacted, the scheduled increase in the HI tax rate for 1981 (0.5 percent for employer and employee combined) should be eliminated, and the amount that would be so derived should be paid from general revenues.

4. The OASDI tax rate should be increased to 14.5 percent for the employer and employee combined in 2005, so that the system would be in long-range actuarial balance, considering the various recommended changes in financing and in the coverage and benefit structure. The resulting average scheduled tax rate over the 75-year valuation period, on the intermediate basis, was estimated at 13.34 percent of taxable payroll, while the estimated average expenditures for benefits and administrative expenses were 13.30 percent, leaving a small favorable actuarial balance.

5. The ad hoc increases in the earnings base (to $25,900 in 1980 and $29,700 in 1981) should be eliminated. Instead, the automatic-adjustment provisions should apply to the $22,900 base in 1979. Elimination of the base as it applies to the employer tax should be considered when inflation abates (NM).

6. The OASI and DI Trust Funds should be combined into a single fund.

7. Payments from general revenues should be made to the OASDI Trust Funds during periods when the unemployment rate is in excess of 6 percent (so-called countercyclical general-revenues financing); this was apparently similar to the recommendation made by the Carter administration in 1977 (M). (No details on the specific operation of this provision were given, especially on how the amounts would be determined.)

8. Repayable loans would be made to the OASDI Trust Funds whenever the fund ratio (trust-fund balance at the end of the year as a percentage of outgo during the following year) is less than 25 percent (M). Repayment of the loan would be made when the fund ratio reaches 42 percent (five months' balance). In addition, if loans were outstanding and had not been repaid within two years, the tax rate would be increased (by an unspecified amount), but only if the unemployment rate was 6.5 percent or less.

9. The desirable goal for the fund ratio should be 75 percent, unless the proposal for countercyclical general-revenues financing is adopted, in which case the goal would be 60 percent.

The advisory council made recommendations in the coverage area as follows:

1. Coverage should be compulsorily extended to new federal employees, or else an "exchange-of-credit" plan should be developed, similar to that for Railroad Retirement (M).

2. Coverage should be extended on a compulsory basis for newly hired employees of state and local governments and of nonprofit organizations (M).

3. Offset or coordination procedures should be adopted to prevent windfall benefits for persons with both covered and noncovered earnings (M). One method would be to determine the PIA on the basis of all covered earnings plus all noncovered earnings after a certain date, and then to reduce such amount by multiplying it by the ratio of the AIME based on covered earnings to the AIME based on the total of covered earnings plus noncovered earnings after such date. A second method would be to determine the PIA as the excess of (a) the PIA based on covered earnings plus noncovered earnings after a certain date over (b) the PIA based only on such noncovered earnings. (Another feasible approach, paralleling the first one, would be to have the multiplying ratio be based on total indexed earnings rather than on AIMEs.)

4. Payment of the employee tax by the employer should be considered as taxable wages, except in the case of domestic workers. This would close the loophole then present—see Appendix 2-13.

5. Employers should match the employee taxes in the case of covered tips.

6. Coverage of farm workers should be on the basis that all such wages are covered if the farmer pays at least $2,500 of annual wages in the aggregate; this approach was adopted by legislation in 1987. Any worker supplied by a crew leader should be considered an employee of the farmer.

The advisory council made a considerable number of recommendations for benefit changes. On the whole, these were relatively small items, because there was the general constraint that their cost would be approximately counterbalanced by the savings due to extension of coverage and to certain other relatively minor matters. In other words, the net effect of increasing the scheduled tax rates after deducting the loss of income due to lowering the earnings bases would be used primarily to produce long-range actuarial balance.

The council continued to support the principle that the benefit structure should represent a balance between individual equity and social adequacy. It went on to express its belief that the additional benefits generated by any additional earnings should provide a reasonable return on the additional employee tax payments involved. (The author questions whether there can be this exactitude of individual equity in a broad system such as OASDI, and whether it is essential that the highest paid should always get their "money's worth" as long as the return is not too much less than being equivalent.) A majority of the council believed that those with full-time covered employment for at least 30 years should have benefits at age 65 that keep them out of poverty. (The author questions this principle on the ground that the definition of *poverty* is artificial.)

The specific benefit recommendations were as follows:

1. The PIA formula should be revised by decreasing the percentage factor for low AIMEs and increasing it for high AIMEs, although at the same time liberalizing the special minimum for long-term low-earnings workers. The formula that would be applicable for 1979 would be 61 percent of the first $442 of AIME, plus 27 percent of the excess (the dollar figure would be adjusted according to wage trends, just as under present law). This formula would produce lower PIAs for AIMEs of $919–1,154 (but only by 2 percent less at most) and of under $360, but higher PIAs for AIMEs of $361–917 (by as much as 10 percent more) and for AIMEs of $1,156 or more (by as much as 19 percent for an AIME of $2,100, which is the 1979 equivalent of the 1981 earnings base of $29,700). The new formula would be graded in from the present formula over a 10-year period, by computing the PIA under both this formula and the one in present law and using different weighting factors for each cohort. Thus, the cohort of the first year after the effective date would have a PIA of 90 percent of that under the present-law formula plus 10 percent of that under the new formula, while the cohort of the second year would use 80 percent and 20 percent weighting factors, and so on. The cost of the new formula was estimated to be the same as that for the pres-

ent formula. (The author believes that a higher cost must be involved, because there would be increases for most AIMEs—and some substantial ones, too.)

2. The special-minimum PIA would be increased by about 19 percent (to bring the resulting benefit for a 30-year worker up to the poverty standard). The requirement for a year of coverage for purposes of eligibility for this benefit would be lowered for years before 1975—from 25 percent of the earnings base to 25 percent of average nationwide wages—while, in 1984 and after, the level in the then-present law would apply (with an unspecified method of grading in between 1975 and 1984).

3. Earnings should be shared between spouses who die after 1980, and widow's and widower's benefits should be eliminated (M). Also, earnings-sharing for years of marriage after 1980 should be done for marriages that last at least 10 years, and at divorce if neither spouse is aged 62 or over or is entitled to DI benefits when either spouse so desires (M). (In the author's opinion, this limited approach was undesirable, because it would result in anomalies and inequities.)

4. The provisions automatically adjusting benefits for changes in the CPI should be applicable semiannually (NM).

5. The number of dropout years used in computing the AIME should vary from only one year for young workers to six years for those disabled or dying after age 51, and also for retirement cases (M).

6. The definition of disability should be liberalized by applying the same criteria as to vocational factors being controlling to persons aged 55–59 as were then currently being used at ages 60–64 (M).

7. Various work incentives should be introduced so that disabled beneficiaries with residual work capacity will return to work (such as more deduction of work expenses in determining the level of earnings possible, more liberal trial work periods, and more accessibility to Medicare). These provisions generally followed those contained in legislation which was then being considered by Congress and was later enacted.

8. Disabled widow's and widower's benefits should be payable on an unreduced basis (i.e., 100 percent of the PIA), regardless of age at disability. Similarly, disabled spouses should have eligibility for full spouse's benefits regardless of age.

9. The waiting period for disabled-worker benefits should be reduced from five months to three months (NM).

10. The maximum on the lump-sum death payments should be increased from $255 to $500 (NM).

11. Half of the benefits payable should be subject to income tax (M). It should be noted that the additional income taxes would merely

go into the General Treasury and an estimated 60 percent of beneficiaries would have no tax liability. (This proposal created a storm of protests throughout the country, so both the House of Representatives and the Senate passed, by virtually unanimous votes, resolutions stating that OASDI benefits should remain exempt from federal taxation. But note that something along this line was done in the 1983 Act.)

By a narrow majority, the advisory council believed that "serious consideration should be given to enacting in the near future an increase in the normal retirement age to become effective after the turn of the century." Note that this was done in the 1983 Act.

The advisory council also considered some matters in a favorable light, but did not recommend them, largely for cost reasons. Among these were additional dropout years for periods of child care, broader provisions for sharing earnings between spouses, and a less strict requirement as to the recency of work for disabled-worker benefits.

Finally, the advisory council studied several major proposals that had been made in recent months and rejected them. These included financing OASDI in part by a value-added tax and splitting the system into a double-decker plan (a flat benefit financed from general revenues, supplemented by an earnings-related benefit financed by payroll taxes, which would be on a strictly proportionate basis).

1984 Advisory Council

The 1984 Advisory Council on Social Security, which was supposed to have been appointed in 1981 and to have completed its work in 1982, was not named until mid-1983, and it reported in early 1984. As a complete reversal of the course of action of the preceding two statutory advisory councils (which were supposed to study *both* OASDI and Medicare), this one studied only the Medicare program. In large part, this was because the National Commission on Social Security Reform was dealing with the OASDI program.

1988 Disability Advisory Council

Legislation in 1986 provided for the appointment of a Disability Advisory Council, which was to take the place of the quadrennial Advisory Council on Social Security that was to be appointed in 1985, but had not been appointed by April 1986. The Disability Advisory Council was to be named by July 6, 1986 and was to report by December 31, 1986, but it did not submit its final report until March 1988.

The recommendations of the Disability Advisory Council concerned a number of technical matters in connection with the determination of disability for both the DI and Supplemental Security Income programs and with vocational rehabilitation. It did not go into benefit and financing matters, other than to recommend that the amounts for measuring substantial gainful activity and for the trial work period should be raised (which was later done, by regulation).

1991 Advisory Council

The 1991 Advisory Council on Social Security was appointed in 1989 and was to complete its work with a final report in January 1991 (but did not do so until December 1991). Although it studied the OASDI program, its major emphasis was on the Medicare program and the general situation as to the provision of health care for the entire population.

The Advisory Council did not consider in detail the coverage and benefit provisions of OASDI (in particular, it did not refer to such widely discussed issues as the retirement test or the notch-baby problem). Rather, it concentrated on the financing aspects of OASDI, obviously a most important issue.

In July 1990 the Advisory Council issued an interim report entitled "Social Security and the Federal Budget." The findings (quoted directly) were as follows:

A. The Social Security (OASDI) tax on earnings is an appropriate way to pay for Social Security benefits.
B. The Social Security system is adequately financed for the next several decades.
C. The cost of OASDI will rise beginning with the retirement of the baby boom generation.
D. The increase in the cost of Social Security that occurs as the baby boom generation retires is not expected to decline as succeeding generations retire.
E. The best way to ease the burden of paying for future retirement benefits is to increase the productive capacity of the economy.
F. Persistent large deficits in the Federal budget impede the Nation's ability to invest in the future productive capacity of the economy.
G. The buildup of reserves in the OASDI trust funds will not reduce the burden or costs of Social Security in the future unless it is used in ways that help promote economic growth.
H. The buildup of OASDI reserves, on the other hand, can help reduce the burden of supporting future retirees if the buildup

increases funds available for investment to promote economic growth.

The Advisory Council made the following recommendations:

1. It is important to move from large Federal deficits to achieve surpluses in the total Federal budget in order to provide for a strong economy when the large baby boom generation retires. Social Security should be removed from the calculation of deficit targets to focus public attention on the importance of reducing the deficit in the rest of the budget in order to achieve this goal.
2. No action should now be taken to reduce revenues to the OASDI Trust Funds.
3. Partial-reserve financing of OASDI should be continued, and at the same time, a major reduction in the deficit in the non-Social Security portion of the Federal budget should be made.
4. The current policy of investing OASDI reserves in interest-bearing U.S. Treasury securities that are guaranteed as to principal and interest by the U.S. government should be continued.

Three members of the Advisory Council dissented to some extent on the recommendation that partial-reserve financing should be continued. Instead, they believed that, at some time in the near future, pay-as-you-go (or current-cost) financing should be returned to—when an adequate fund balance had been built up (which will likely occur, according to very conservative standards, in the next two or three years). Interestingly, the Advisory Council did not comment or make recommendations on the "roller coaster" which results under the present partial-reserve funding, under which mammoth balances accumulate during the next four decades and then are completely dissipated in the following 15 years.

The author believes that the fund balances by the end of 1991 are adequate to serve as contingency reserves and that the time has come to return to pay-as-you-go financing. More discussion on this subject is given in Chapter 4.

National Commission on Social Security

The 1977 Act provided for a one-time National Commission on Social Security, which would operate for two years. The function of the commission was set forth in broad terms as to studying the OASDI and Medicare programs.

The commission was composed of nine members. Five were named by President Carter, with no more than three being members of the same political party (so that three of these appointees were Democrats, and two were Republicans). The Senate and the House of Representatives each named two members (one Democrat and one Republican).[45] The presidential appointees were to include representatives of the private insurance business, beneficiaries and potential beneficiaries, and individuals with a special knowledge of the programs.

President Carter made his appointments in late 1978, but the Senate did not have time to confirm them before adjourning. The commission began to function in early 1979 and submitted its report in January 1981.

An interim report made in early 1980 recommended that the increases in the tax rates and the earnings base should go into effect as scheduled. (Two members dissented, believing that alternative methods of financing should be developed, such as providing some of the costs of HI from general revenues.)

At the same time, the commission recommended that the OASDI tax rate should be reallocated between OASI and DI to give the former a somewhat larger proportion. It further recommended that the OASI and DI Trust Funds should be able to borrow (at interest) from each other, if needed (and also from the HI Trust Fund), and, if the interfund borrowing would not be feasible, then from the General Fund of the Treasury.

The commission also made recommendations on a number of minor points. These included:

1. Eliminating the gimmick that occurs when the employer pays the employee tax and simultaneously reduces wages by that amount, just as the 1979 Advisory Council recommended (see also Appendix 2-13).
2. Correcting the anomalous results in certain cases due to the elimination of the monthly earnings test after the initial year of retirement (see Chapter 2).
3. Permitting filing for HI benefit protection without simultaneously filing for OASDI.
4. Covering all sick pay as wages, regardless of how paid.
5. Remedying the notch problem for persons working beyond age

45. According to congressional tradition, the member belonging to the minority party, although officially named by the majority leader, is actually appointed on the recommendation of the minority leader. The author was named as a member by the Speaker of the House of Representatives (as the designee of the minority, the Republicans).

62 between those who attained age 62 in 1979 and those who did so earlier (see Appendix 2-9).

Items 1–3 were contained in legislation enacted in late 1980; item 4 was contained in legislation enacted in 1981.

The final report made the following major recommendations as to OASDI coverage:

1. All new federal, state, and local employees after a specified future date would be covered compulsorily (the 1983 Act did this as to federal employees).
2. All present state and local government employees who are not covered by a retirement system would be covered compulsorily.
3. Members of Congress, the President, the Vice President, cabinet members, and the Commissioner of Social Security would be covered compulsorily, with a full offset of OASDI benefits and taxes against the benefits and contributions under their existing retirement system (the 1983 Act did this as to coverage).
4. All employees of nonprofit organizations would be compulsorily covered, except in organizations that are operated by sects that are conscientiously opposed to any form of public insurance (done in the 1983 Act, other than for the exception, which was added by legislation in 1984).
5. The option for state and local governments and nonprofit organizations to withdraw from OASDI would be eliminated after a one-year grace period (done in the 1983 Act, other than for the grace period).
6. The amount of earnings required for coverage would be increased to $600 per year for the self-employed and to $150 per quarter for domestic workers and casual labor.

The major recommendations in the OASDI benefit area were as follows:

1. The minimum retirement age for unreduced benefits would be increased from 65 to 68, gradually phased in, beginning in 2001 and reaching 68 in 2012. The minimum age for reduced benefits would, likewise, move up in tandem, from 62 to 65. The same changes would be made for spouse's, widow's, and widower's benefits. (To some extent, this was done in the 1983 Act.)
2. The credits for delayed retirement beyond age 65 would be increased from the then-existing 3 percent per year to 7 per-

cent. Several other alternatives, including the use of actuarial equivalents, were also presented. (To a considerable extent, this was done in the 1983 Act.)

3. The age at which the earnings test is removed would remain at 72 (but, beginning in 2001, would gradually increase to 75).
4. The windfall benefits under OASDI, available for government employees whose service is not covered by OASDI but who acquire some OASDI coverage by outside employment, would be eliminated as to future employment (done in the 1983 Act).
5. The special-minimum benefit provided for low-earnings persons who are covered for many years would be liberalized by increasing the number of years of coverage creditable from 30 to 35 (resulting in a 25-percent increase in the maximum benefit possible) and by allowing up to 10 child-care years to count as years of coverage.
6. The MFB for disability beneficiaries, which was decreased by the 1980 Act, would be changed back to the former basis (except for a cap of 80 percent of the average of the highest five consecutive years' indexed earnings, which would generally have little effect).
7. Benefits for widows and widowers would be indexed by wages, rather than prices, during any period of deferment (i.e., from the time of widowhood to age 60). (This was done in the 1983 Act.)
8. The automatic-adjustment provisions for increases in benefits for rises in the CPI would be modified when, for a two-year period, wages rise less rapidly than prices. Then the benefit increase would be based on wage changes (but with a catch-up provision later if wages once again rise more rapidly than prices). (This was done to some extent in the 1983 Act.)
9. Child school-attendance benefits, available at ages 18–21, would not be payable when the beneficiary is not attending school full time.
10. Marriage and remarriage would be eliminated as terminating causes for beneficiaries on the roll.

The major recommendations on the financing of OASDI were as follows:

1. The tax schedule would be revised to provide adequate financing over the short range and to bring the system into close actuarial balance over the long range. Specifically, the combined

employer-employee OASDI rate would be increased to 12.1 percent in 1983, 12.6 percent in 1985, but would then *decrease* to 11.2 percent in 1990–99 and 10.0 percent in 2000–2010, and would then increase to 13.4 percent in 2020–24, and thereafter ultimately to 13.85 percent (as compared with 10.8 percent in 1983, 11.4 percent in 1985, and 12.4 percent in 1990 under present law). The total OASDI-HI rate would, however, not be increased over present law before 2000 (and, in fact, would be lower in 1985–2019), because part of HI would be financed from general revenues (see Chapter 7).

2. The maximum OASDI-HI tax rate for the employer and employee combined would be 18 percent. The remaining funds necessary would come from general revenues; under the intermediate-cost estimate, such additional financing would first be needed in 2025. Ultimately, in 2040 and thereafter, this payment from general revenues would be equivalent to 1.75 percent of taxable payroll (plus a general-revenue payment equivalent to 4.15 percent of taxable payroll for HI).
3. Interfund borrowing among the OASI, DI, and HI Trust Funds would be allowed.
4. Borrowing from the General Fund of the Treasury would be allowed, but only until 1985.
5. The maximum taxable earnings base would be frozen for 1985–86 at the level which it would attain in 1984.

Other major recommendations as to the OASDI program were as follows:

1. The operations of the OASI and DI Trust Funds would be removed from the unified budget.
2. The administration of the system would be removed from the Department of Health and Human Services to an independent agency.
3. A refundable income-tax credit would be provided for persons who attain age 65 after 1981, so as to partially offset the OASDI benefits withheld as a result of the earnings test. The rate of the credit would increase as the age of the individual increases.

President's Commission on Pension Policy

President Carter established the President's Commission on Pension Policy in 1978 to examine the nation's retirement, survivor, and disability benefits systems and to make recommendations thereon. The commission reported early in 1981 and made the following general recommendations about OASDI:

1. The minimum age for unreduced retirement benefits should be gradually increased from 65 to 68, beginning in 1990.
2. The special-minimum benefit should be increased.
3. Earnings-sharing between spouses should be provided upon divorce, and inheritance of earnings credits should occur in the event of death (but not addressed was the complex matter of how this should be done without creating anomalies and inequities).
4. Universal coverage for new entrants into federal, state, and local government employment should be provided.
5. The short-range financing problem should be solved by moving up the 1985 tax-rate increase to 1982, by interfund borrowing, and, in an emergency, by borrowing from the General Fund of the Treasury (but not by general-revenue financing).
6. Employee OASDI-HI contributions should be considered as deductions or credits against the personal income tax; on a phased-in basis, benefits should be taxable.

National Commission on Social Security Reform and the 1983 Act[46]

When the Reagan administration took office in early 1981, there was a short-term financing problem to be solved, as also a significant long-term problem, according to the intermediate-cost estimate, beginning about 40 years hence. The administration proposed a package of OASDI benefit changes that would have solved the short-run problem—even under pessimistic assumptions as to short-range future economic conditions. The long-range problem also would have been solved (and, in fact, to such an extent that payroll-tax rates could ultimately be reduced somewhat from those then scheduled in law, if the experience were similar to that assumed in the intermediate-cost estimate). The administration proposal is described in some detail in Appendix 3-8. Concurrently, the Subcommittee on Social Security of the House Ways and Means Committee was working on a bill to deal with the financial problems of OASDI; tentatively proposed, among other things, was a deferred gradual increase in the NRA and the

46. The material in this section is excerpted (with some modification) from an article by the author in *Journal of the American Society of CLU*, January 1984.

injection of general-revenue financing for a few years to solve the short-range problem.

The administration package of recommendations, however, ran into difficulty because a few (although by no means all) of the proposals met with widespread public disapproval. This was particularly the case for the ones involving the almost immediate sharp reduction in the benefit rates for persons retiring at ages 62–64 and the elimination of the minimum-benefit provision for persons currently on the roll. As a result, the Democratic leadership in the House of Representatives, sensing the opportunity for political advantage, put a stop to virtually all efforts to resolve the financing problem, including action of the Ways and Means Committee. A few cost-reduction changes were, however, made in 1981 (e.g., the elimination of the minimum-benefit provision for new eligibles and the gradual phasing-out of child college-attendance benefits).

Formation of National Commission

In order to get things moving again, President Reagan proposed in September 1981 that a commission be formed, with its purpose (as stated later in connection with the Executive Order creating it) being "to propose realistic, long-term reforms to put Social Security back on a sound financial footing and to forge a working, bipartisan consensus so that the necessary reforms can be passed into law." This proposal was accepted by congressional leaders, and the National Commission on Social Security Reform was created in December.[47]

The National Commission had fifteen members, with equal numbers appointed by the House, the Senate, and the President. Its membership consisted of eight Republicans and seven Democrats. The chairman was Alan Greenspan, a former chairman of the Council of Economic Advisers and later chairman of the Federal Reserve Board. The membership included four senators and three representatives, all of whom would play a major role in the development of any legislative changes (as well as two former representatives).

The Executive Order provided that the National Commission should "review relevant analyses of the current and long-term financial condition of the Social Security trust funds; identify problems that may threaten the long-term solvency of such funds; analyze potential solutions to such problems that will both assure the financial integrity of the Social Security System and the provision of appropriate bene-

47. The author was the executive director of this commission.

fits; and provide appropriate recommendations to the Secretary of Health and Human Services, the President, and the Congress."

The National Commission was required to report by the end of 1982 (later extended to January 15, 1983, and then to January 20, so that its report could be completed). The early meetings were largely of an exploratory nature, primarily to determine whether a financing problem existed (and, if so, its magnitude) and to consider possible ways to solve the financing problem, both short range and long range.

Functioning of National Commission

No decisions of a substantive nature were made at the early exploratory meetings of the National Commission. This was intentionally done, so that no schisms would be created. Rather, the foundation was being developed for a consensus to be reached, first as to the size of the OASDI financing problems, both in the short range and in the long range, and then as to how they could be solved.

At the meeting on November 11–13, 1982, a complete consensus was reached as to the size of the financing problems and the amount of financial resources needed, both in the 1980s and over the 75-year valuation period. The specific findings are discussed in detail later in connection with the description of the legislation enacted. However, the National Commission had much more difficulty with the other part of its assignment—namely, to reach a consensus on how to provide the needed financial resources.

The five congressionally appointed Democratic members held a firm, cohesive position. They believed that the vast majority of the financing needed should come from additional income (payroll taxes and general revenues derived in an indirect manner) and that only a small portion should come from reduction in the growth of benefit outgo—by three-month delays in the benefit cost-of-living adjustments (COLAs), making them applicable for benefits for each September, instead of for each June. Moreover, they proposed that any increases in the employee tax rate in future years over those scheduled in existing law should be completely offset by refundable income-tax credits. Obviously, this would be merely a thinly veiled method of introducing massive general-revenue financing!

The remaining Democratic members and the Republican-appointed members did not have nearly as cohesive and uniform views. Some believed that the entire problem should be solved by benefit changes. Others favored a mixture of income and outgo changes.

A strong attempt was made at the meeting in November to reach some compromise between these adverse views, but without success.

In the ensuing weeks, and at the meeting on December 10, such efforts were continued. However, the view prevailed that no consensus was possible unless both the President and the congressional leadership (the Speaker of the House and the Majority Leader of the Senate) would go along with any agreement reached. Otherwise, some felt, members might "bargain away" some of their position to no avail if the top leaders disagreed, and then the matter would have to be fought out in the halls of Congress.

In order to overcome this dilemma, it was found necessary to create an informal, high-level task force, consisting of several members of the National Commission and representatives from the White House and from the congressional leadership. This group met frequently and came somewhat closer to a consensus. In early January 1983, it seemed to be far from a solution. The positions of the two sides (those favoring primarily revenue changes and those favoring more emphasis on benefit changes, or at least a reasonable mix of the two elements) were far apart.

However, in the last week of the life of the National Commission, bargaining efforts accelerated. On the last day possible (January 15), agreement was reached by the task force as to how to meet both the short-range and long-range financing requirements of the OASDI program.

Complete agreement was reached as to how to solve the short-range problem (in the 1980s), but the agreed changes met only about two thirds of the long-range problem. It was further agreed that the remainder of the long-range problem should be met, but that two alternative methods of doing so would be included in the consensus agreement. One alternative would be based on increases in the payroll-tax rates beginning some years hence, while the other would be based on a deferred, gradual increase in the Normal Retirement Age.

Several liberalizations of benefits (with only small cost impacts) were included in the consensus package, so as to satisfy (at least to some extent) those who believed that the existing benefit structure was unfair to women and those who believed that insufficient incentives were being given to encourage later retirement. This package was concurred with by 12 of the 15 members and, as it turned out, was the basis of the legislation which was enacted.

A Fair Compromise?

The question can be raised as to whether the consensus package was a reasonable compromise between those who sought to solve the financing problems entirely through additional income and those who would do so through benefit changes. Unfortunately, a completely precise answer cannot be given because it depends on how certain proposed changes are classified.

Part of the solution of the financing problems is derived from extension of coverage to new categories of workers. Such changes involve both taxes and benefits (including the elimination or alleviation of the windfall benefits which would otherwise occur for those who spend most of their working careers in noncovered employment but have enough covered employment to qualify for heavily weighted OASDI benefits). It therefore seems reasonable to exclude the cost effects of any extension of coverage in the analysis as to which prevailed—revenue changes or benefit changes.

It also seems reasonable to exclude the lump-sum payment from the General Fund (to be made immediately) with respect to the cost of certain gratuitous military-service wage credits earned in the past (which, under previous law, would be paid for in the future when the additional benefits are paid) and of reimbursement of the OASDI Trust Funds by the General Fund for certain uncashed benefit checks.

The question might also be raised as to whether the income taxation of OASDI benefits should be considered as a revenue change or a benefit reduction. However, the former is probably the better classification.

On this basis, the changes involved in the consensus package consisted of about 70 percent in additional revenues and 30 percent in benefit changes in the short run (the 1980s). As to the portion of the long-range financing problem met by the consensus package (about two thirds of the total amount needed), about 88 percent of that remaining after consideration of the savings due to extension of coverage consisted of revenue changes and 12 percent of benefit changes (after netting out the benefit liberalizations which were proposed). If the remainder of the long-range problems were met by benefit changes (as was actually done in the ensuing legislation), the latter proportions would be 54 percent from revenue changes and 46 percent from benefit changes.

On the other hand, if the income taxation of benefits were considered as a benefit reduction (or savings), the changes in the consensus package consisted of about 48 percent in additional revenues and 52 percent in benefit changes in the short run, and of about 23 percent in additional revenues and 77 percent in benefit changes in the long range. When the long-range situation is considered on this basis, but *after* the remainder of the problem was met by raising the retirement age, about 14 percent came from additional revenues and 86 percent from benefit changes.

Finally, let us consider the proportion of the increased revenues in the consensus package which comes from new general revenues (rather than direct payroll taxes), again exclusive of the immediate lump-sum payment referred to previously (which is in lieu of general-revenue payments in subsequent years) and also exclusive of the employer taxes with respect to new federal hires and the tax credits for the self-employed (which they could have obtained anyhow if they had incorporated their business). Such proportion is about 37 percent in the short run and 74 percent over the long range if the income taxation of benefits is considered a revenue change.[48]

Extent of the Financing Problem

The National Commission agreed that there was a financing problem for the OASDI program for both the short run, 1983–89 (as measured using pessimistic economic assumptions), and the long range, the next 75 years (as measured by an intermediate-cost estimate). It recognized that, *under the intermediate-cost estimate*, the financial status of the OASDI program in the 1990s and early 2000s would be favorable (i.e., income would significantly exceed outgo). It also recognized that, *under the intermediate-cost estimate*, the financial status of the HI portion of the Medicare program would become increasingly unfavorable from 1987 on.

The National Commission also recommended unanimously that the fundamental structure and principles of the Social Security program should not be altered. It considered, but rejected, proposals to make the program a voluntary one, or to transform it into a program under which benefits are a product exclusively of the contributions paid, or to convert it into a fully funded program, or to change it to a program under which benefits are conditioned on the showing of financial need.

The National Commission recommended that, for purposes of considering the short-range financial status of the OASDI Trust Funds, $150–200 billion in either additional income or decreased outgo (or a combination of both) should be provided for the OASDI Trust Funds in 1983–89.

The National Commission found that, for purposes of considering

48. For a more extensive analysis of this subject, see Robert J. Myers, "The Extent of General Revenue Financing in the Social Security Program as a Result of the 1983 Amendments," *Employee Benefits Journal*, June 1984.

the long-range financial status of the OASDI Trust Funds, the actuarial imbalance for the 75-year valuation period was an average of 1.8 percent of taxable payroll, which was based on the intermediate-cost estimate.

The members voting in favor of the "consensus" package agreed to a single set of proposals to meet the short-range deficit (with one member dissenting on the proposal to cover newly hired federal employees).

They further agreed that the long-range deficit should be reduced to approximately zero. The single set of recommendations made in the consensus would meet about two thirds of the long-range financial requirements. Seven of the 12 members agreed that the remaining one third of the long-range financial requirements should be met by a deferred, gradual increase in the NRA. The other five members agreed on a proposal for an increase in the tax rates in 2010 of 0.46 percent of covered earnings on the employer and the same amount on the employee, but with the employee's share of the increase being completely offset by a refundable income-tax credit (i.e., the increase in cost would be borne by the General Fund of the Treasury).

The proposed increase in the NRA would be accomplished in the following manner. Such age would be increased one month each year, beginning with persons who attained age 62 in 2000, until it reached age 66 in 2015. Then, beginning with those who attained age 62 in 2012, the NRA would be automatically adjusted (on a phased-in basis), so that the ratio of the retirement-life expectancy to the potential working-lifetime (from age 20 to the NRA) remained the same over the years as it was in 1990.

The original bill introduced in the Senate to implement the National Commission's recommendations (S. 1, by Senator Bob Dole, a member of the National Commission and chairman of the Senate Finance Committee) contained the foregoing provision for increasing the NRA. However, the bill reported out by the Senate Finance Committee and later approved by the Senate—after rejecting the alternative of a tax-rate increase in 2010 instead of an increase in the NRA—contained a somewhat different provision. Under the Senate-passed bill, the NRA would be phased up to age 66 in 2015, beginning the phasing for those who attain age 62 in 2000 (which was the same as in the National Commission recommendation, but there would be no automatic adjustment thereafter).

In lieu of increasing the NRA beyond age 66 after 2015, the Senate-passed bill contained a provision which would reduce initial benefit levels for persons attaining age 62 in 2000 and after (or otherwise first becoming eligible for benefits). This would be done by decreasing the percentage factors in the PIA formula by ⅔ percent (relatively) each year for eight years, so that ultimately they would be 85.2, 30.3, and 14.2 percent (as compared with 90, 32, and 15 percent in then-existing law). Ultimately this would result in a cumulative 5.3-percent decrease in benefit levels.

The bill reported out by the House Ways and Means Committee tackled the remainder of the long-range financing problem, not by raising the NRA, but rather by (1) decreasing the percentage factors in the PIA formula in the same manner as the Senate-passed bill and (2) increasing the combined employer-employee OASDI tax rate in 2015 and after from 12.4 percent to 12.88 percent. An amendment developed by Representative J. J. Pickle, chairman of the Subcommittee on Social Security of the Ways and Means Committee, was proposed in the floor debate as a substitute for the foregoing two provisions and was accepted by a vote of 228 to 202. As it so happens, the Pickle Amendment was exactly the same as the NRA provision in the final law (because the joint House-Senate Conference Committee agreed on it, rather than the provision in the Senate-passed bill or a compromise between the two versions).

Subsequently in the House consideration of the legislation, Congressman Claude Pepper (chairman of the Rules Committee and a member of the National Commission) proposed an amendment that would eliminate the provision raising the NRA and would instead increase the combined employer-employee tax rate in 2010 and after from 12.4 percent to 13.46 percent. However, this amendment was defeated by a vote of 296 to 132.

The "consensus" package of the National Commission would provide an estimated $168 billion in additional financial resources to the OASDI program in 1983–89. This amount is very close to the midpoint of the $150–200 billion range stated previously. Because the economic assumptions which were used in estimating the cost of this package involved a lower inflation rate as to both prices and wages than those which had been used earlier in the deliberations, the resulting $168 billion of additional financial resources was really relatively near the upper end of the desired range. Actually, it was equivalent to about $185 billion under the assumption on which the desired goal of $150–200 billion was determined. The additional financial resources provided by the 1983 Act, estimated on a basis comparable with the $168 billion figure, was $166.2 billion (see *Social Security Bulletin*, July 1983, p. 43).

Provisions of Legislation Enacted

Two years of extensive legislative efforts to resolve the financing problems of the OASDI program reached culmination when, on April 23, 1983, President Reagan signed the Social Security Amendments of 1983 into law. The principal part of this legislation, which was based on the recommendations of the National Commission on Social Security Reform, dealt with the financing problems of the OASDI program and did not address those of the HI portion of Medicare to any significant extent.

By and large, the changes made very closely followed the basic recommendations of the National Commission—neither adding to them nor taking away from them to any significant extent. Complete descriptions of the changes are given earlier in this chapter.

At the signing into law of the legislation, President Reagan brought out clearly the significance of the OASDI program to the nation. He stated, "The changes in this legislation will allow Social Security to age as gracefully as all of us hope to do ourselves, without becoming an overwhelming burden on generations still to come" and "And younger people can feel confident that Social Security will still be around when they need it to cushion their retirement. These amendments reaffirm the commitment of our government to the performances and stability of Social Security." His full statement is given in Appendix H.

Coverage Provisions

Mandatory OASDI coverage is extended to (1) all newly hired federal employees and (2) all current members of Congress, judges, congressional employees who are not covered under the Civil Service Retirement system, and political appointees in the Executive Branch, beginning in 1984. (The National Commission made recommendations only as to the first group.)

All employees of nonprofit charitable, educational, and religious organizations are mandatorily covered. Current employees aged 55 and over have special, more lenient conditions for qualifying for benefits (not in the recommendations of the National Commission).

State and local government entities which are currently covered as a result of their past election to do so will not be allowed to terminate coverage in the future. Entities which had withdrawn in the past are permitted to rejoin.

Certain other smaller coverage extensions were made. Broadened coverage is made possible for employees of foreign affiliates of American employers and for self-employed persons working abroad. Certain fringe benefits were made taxable and creditable for OASDI-HI purposes, including employer contributions under "cash-or-deferred" plans which are made as the result of voluntary salary reduction by the employee (Section 401[k])—see Appendix 2-13 for details as to the treatment afforded other types of fringe benefits. (The National Commission made no recommendations in this area, except as to Section 401[k] plans.)

Benefit Changes

Paralleling, and consistent with, the changes in the coverage provisions, the method of computing benefits for certain persons with pensions from noncovered employment was revised, so as to prevent or, at least, alleviate windfall benefits.

The major immediate benefit change was a six-month delay in the payment of the COLAs. Instead of being for the June checks, payable at the beginning of July, the COLAs will be for the December checks, payable in early January. It is important to note that this does not have merely a one-time cost effect, but rather it affects all beneficiaries each year into the future.

The major long-range benefit change was a deferred, gradually phased-in increase in the NRA for benefits for workers, spouses, and widow(er)s. Such age will eventually be 67 (in 2027 for workers and spouses and in 2029 for widow[er]s). This change was somewhat similar in principle to that proposed by the majority of the members of the National Commission, but different as to the specific details. The Delayed-Retirement Credit is increased in a phased-in manner, from 3 percent per year of delay for persons who attain age 65 before 1990 to 8 percent for those reaching the NRA in 2009 (when such age is 66)—as proposed by the National Commission.

Beginning in 1990, for persons who have reached the NRA (then 65), the reduction basis under the retirement earnings test will be changed to $1 of benefits for each $3 of excess earnings (instead of the previously existing "$1 for $2" basis). (The National Commission made no recommendations in this area.)

A number of minor benefit liberalizations were made. These included the following:

1. Several which primarily affect women. (All but one of these were recommended by the National Commission.)
2. Liberalization of insured-status requirements for persons who

become disabled before age 31, who then recover, and who shortly later again become disabled (not in the recommendations of the National Commission).

3. The offset for pensions based on noncovered government employment of persons against their spouse's benefit or widow(er)'s benefit will be based on two thirds of such pension, instead of on all of it, as under old law (not in the recommendations of the National Commission).

All gender-based distinctions in the Social Security law were eliminated for future beneficiaries (and, generally prospectively, for current beneficiaries). This has practically no real effect, because such distinctions which were not previously eliminated by legislation had already been overturned by the courts. (These changes were not recommended specifically by the National Commission, although there is no question but that it would have strongly endorsed them.)

An important stabilizing mechanism that could go a long way to offset adverse economic conditions was added. Beginning with the checks for December 1984, if the trust-fund ratio is very low, the COLA will be the *lower* of (1) the wage increase for the preceding calendar year or (2) the CPI increase generally used. If the fund ratio later rises to a moderately high level, then prospectively any decrease in the COLA due to using wage increases, rather than CPI increases, will be restored. The author believes that, although the general principle of this change is excellent, the trigger point is too low, and it may not become effective soon enough in times of bad economic conditions. (The National Commission made a similar recommendation, except that it would not have been effective until the December 1988 checks.)

The new law introduced certain restrictions on payment of benefits to aliens living abroad and to prisoners. (The National Commission did not make any recommendation in these areas.)

Revenue Provisions

The OASDI employer and employee tax rate of 5.7 percent scheduled under previous law for 1985 (versus 5.4 percent in 1983–84) is moved up to 1984 insofar as the employer is concerned, but with no change for the employee. However, the OASDI tax rate going to the trust funds in 1984 will be 5.7 percent in both cases. This means that the difference of 0.3 percent in the employee rate will, undesirably, come from general revenues. A clear case of "doing it with mirrors"!

The OASDI-HI employer and employee tax rates in previous law for 1985–87 remain unchanged. Then, 72 percent of the increase in the 1990 OASDI tax rate is moved up to 1988. The corresponding rates for 1990 and after are left unchanged.

Self-employed persons paid 75 percent of the combined employer-employee rate for OASDI and 50 percent thereof for HI under the previous law. Now, they will pay the full combined employer-employee rate, but with certain tax credits during 1984–89. The OASDI-HI Trust Funds, however, will be credited with the full employer-employee rate; the difference will come from general revenues—which will have about the same effect in the aggregate as if all self-employed persons were to incorporate and count 50 percent of the resulting employer-employee tax as a business-expense deduction for income-tax purposes.

After 1989 the self-employed persons will, in many cases, pay the combined employer-employee rate on a lower amount of income than under the previous basis (lower by the amount of the employee tax on their net earnings, except for those well above the maximum taxable earnings base). In addition, they will receive a deduction against their net earnings from self-employment in the computation of their income tax equal to half of the OASDI-HI tax that they pay.

The foregoing complicated procedure for the self-employment tax approximates the overall treatment applicable to persons who incorporate their businesses. The net result, expressed as a percentage of self-employment income, will depend, to some extent, on the individual's top income-tax bracket. (In this area, the National Commission had recommended, for all future years, that the revised procedure for the self-employed should apply only for OASDI and that 50 percent of the taxes should be considered as a business expense for income-tax purposes.)

All OASDI payroll taxes for both employees (other than those of state and local governments) and the self-employed are to be credited to the OASDI Trust Funds at the *beginning* of each month (when the vast majority of OASDI benefits are sent out), instead of as received during the month, as was done under previous law. This situation is not the case for the HI program, under which the outgo is more or less uniformly distributed over the month. (Legislation in 1984 repealed this advance-transfer procedure for HI, which had been provided for it in the 1983 Act. Legislation in 1990 did the same for OASDI, except that this procedure can be reinstated if necessary in the future in order to pay benefits on time.)

The advance-tax-transfer procedure would be a form of general-revenue subsidy, except that interest is to be paid by the trust funds to the General Fund for the advance payments. Thus, over the long run, the trust funds will neither gain nor lose, but they will have a much better cash-flow position. The procedure may properly be described as short-term loans to the trust funds by the General Fund, on a continuing basis, but repayable each month. (The National Commission did not make this recommendation, but rather it was made by the Reagan administration, except that the equitable interest-adjustment provision was added by Congress.)

Part of OASDI benefits will be subject to income taxes, beginning in 1984, for persons with relatively high incomes. The resulting income taxes will be transferred to the OASDI Trust Funds. In the author's opinion, taxing Social Security benefits is good tax policy, but putting the proceeds in the trust funds is merely undesirable general-revenue financing (even though somewhat indirect). One might well ask why this is not done when private pensions are taxed (i.e., putting the resulting income taxes back in the pension fund)!

The estimated additional income taxes from taxing OASDI benefits are placed in the trust funds as the taxes are incurred, not as they are paid—a general-revenue subsidy, because people generally lag their tax liabilities in their tax payments. Even more of a general-revenue subsidy occurs because the transfers involved are made at the *beginning* of each quarter, instead of—more logically and equitably—during the quarter as the liability arises. The Senate version of the bill did adopt the proper approach, but this was dropped in the conference between the House and the Senate. Another equitable solution would be to have the trust funds pay appropriate interest to the General Fund for such advance payment (as is done for the advance transfers of the payroll taxes).

Another source of revenue to the trust funds was the transfer in 1983 of about $21 billion to the OASDI Trust Funds (and $3 billion to the HI Trust Fund) from general revenues as representing primarily the present value of certain military-service wage credits which had been given for past service. Under previous law, the costs of these benefits (and the accompanying administrative expenses) were to be paid for from general revenues only at the time that benefits resulting therefrom were actually disbursed. It seems proper that such costs should be met by the federal government (from general revenues) as the "employer." Payment in a current lump sum seems reasonable and equitable—and probably such payment should have been made previously, when the service was rendered.

About $1 billion of the $24 billion transfer from the General Fund was for uncashed OASDI benefit checks which had not been returned (and interest thereon that would have accumulated if they had not been debited against the trust funds when they were issued). Quite inequitably, in the past the amounts of such checks were, in essence, credited to the General Fund.

The allocation of the OASDI tax rate in 1983 and after as between the OASI and DI Trust Funds was altered, so as to place both such trust funds in about the same relative financial position over future years (as could best be estimated).

Other Financing Provisions

The 1983 Act permitted interfund borrowing among OASI, DI, and HI (repayable with proper interest) for 1983–87. However, restrictions were established such that HI could not make loans if its fund ratio was low, and OASDI must repay the loans if its fund ratio is other than low—and in any event during 1988–89. Interest on the loans must be paid monthly. Similar provisions apply in the event that HI borrows from OASDI. (The National Commission made such a general recommendation, but did not include the mentioned restrictions.)

Both the House and Senate bills had contained provisions for significantly revising the investment procedures for the trust funds. Under previous law, investments were almost always in special issues with arbitrary long maturity periods (even though redeemable at par when the proceeds were needed). The proposed procedure, which had been recommended by the National Commission, would have been similar to money-market funds with varying market interest rates each month, but in all instances based on long-term rates.

This revised investment procedure would have added to the general public's understanding of the investment situation, even though, over the long run, it would probably have had a neutral cost effect. The proposed new basis was dropped in the joint conference between the House and the Senate, because of the belief that there would be a declining trend in interest rates in the next few years. If that did occur, the trust funds would have lower investment returns than under the old procedure. But in the reverse case, a bad choice would have been made by not adopting the new procedure!

The membership of the Boards of Trustees of the several trust funds had always consisted of three cabinet members (political appointees, generally of the same party). The 1983 Act provided for the addition of two public members, of different political parties, nominated by the President and confirmed by the Senate. This new composition of the Boards of Trustees should be of some value in the public-confidence area by introducing more bipartisanship in the general operation of the trust funds.

The Senate bill contained a fail-safe device based on adjusting (or even eliminating) the COLAs when the OASDI trust-fund balance becomes dangerously low. This "powerful medicine" would have virtually assured that benefit checks would continue to go out under even the worst of economic circumstances. However, this provision was dropped in the joint conference between the House and the Senate. The interfund-borrowing provision and the stabilizing device of the COLAs being based on the lesser of wage or price increases in times of adverse experience are very helpful, but they do not *assure* that a financial crisis cannot again occur. (The National Commission had recommended that a fail-safe device should be established, but it did not recommend a specific basis.)

The only provision in the nature of a fail-safe device in the 1983 Act is merely a statement of intent. The Board of Trustees is to report to the Congress whenever the fund ratio of any of the four trust funds (OASI, DI, HI, or SMI) falls below 20 percent after having been above this level (both the OASI and DI Trust Funds were below this level at the beginning of 1984, and OASI will remain below it for at least several years). The Board of Trustees will then give recommendations as to how statutory changes could be made to restore a fund ratio of 20 percent over time. The report is required to give a specific method as to how this result can be achieved, either by benefit changes or tax increases (or a combination of both).

The operations of the OASI, DI, HI, and SMI Trust Funds are to be displayed as separate functions in the Federal Budget. Under the 1983 Act, beginning with fiscal year 1993, the operations of the OASI, DI, and HI Trust Funds will be removed from the unified budget. (The National Commission had recommended that all four trust funds should be so treated, and without delay; legislation in 1986 did this for OASI and DI, beginning with fiscal year 1986.)

New Studies Required

The 1983 Act required the Executive Branch to make several studies, as follows (not recommended by the National Commission, except as to the first one):

1. Feasibility and implementation of the establishment of the Social Security Administration as an independent agency (outside the Department of Health and Human Services). Such study was completed in June 1984 and recommended that this should be done for OASDI and SSI (but not AFDC, Medicaid, or Medicare), to be headed by a single administrator, with a nine-member bipartisan advisory board (with five appointed by the

President, two by the Senate, and two by the House, as was the 1981 National Commission on Social Security). At various times since then, both the House and the Senate have passed legislation along these lines—over the opposition of the Executive Branch—but they were never able to agree on a compromise bill that could be sent to the President for his consideration. The author believes that Medicare should also be administered by such an independent agency.

2. Length of time between issuance of benefit checks and their redemption.
3. Feasibility of daily transfers based on benefit checks paid by the Federal Reserve Banks.
4. Earnings-sharing proposals for OASDI benefit purposes (as between spouses, during the period of their marriage).
5. Implications of the legislated increase in the NRA on individuals who are in physically demanding employment or who are unable to extend their work careers due to health reasons.

The studies for the last four subjects were duly made, but no legislative action has resulted.

OASDI Problems Really Solved?

There is no question but that the very significant financing problems of the OASDI program—identified and agreed to by the National Commission on Social Security Reform—have been greatly alleviated by the 1983 legislation. Some persons, however, believed that another crisis will occur in a few years, while others thought that far more than adequate financing has been provided.[49]

The cost estimates for the short range (the 1980s) were based on fairly pessimistic economic assumptions. They showed that there will be sufficient financial resources to make the program viable then—as

49. For example, the Committee for Economic Development in its report *Social Security: From Crisis to Crisis?* (February 1984) expressed the belief that another financing crisis could develop in the 1980s (and some have taken this to mean by 1985). In large part, the view of the CED is based on the incorrect interpretation that the financing of the program under the 1983 Act was based on the intermediate (Alternative II-B) economic assumptions and that, if the experience were slightly worse, problems would occur. This is not correct, because the financing was based on the pessimistic assumptions, and even thereunder there was some margin of safety if the experience were less favorable. For a view that the 1983 Act provided more than sufficient financing in the 1980s and in the medium-range period (the next 50 years), see Stuart J. Sweet, "A Looming Federal Surplus," *Wall Street Journal*, March 28, 1984. The author does not at all agree as to the alleged overfinancing in the 1980s, but (as brought out in Chapter 4) believes that there may well be overfinancing in the 1990s and the early 2000s.

a result of the presence of a number of elements, including COLA delays, additional income from several sources, the advance-tax-transfer procedure, and reduced COLA adjustments under certain adverse conditions.

Somewhat better economic conditions would result in a desirable buildup of the all-too-low trust-fund balances in the early 1980s. However, it was not inconceivable that there could be significantly worse economic conditions than those assumed in the pessimistic cost estimates. Then, there could be financing problems for the OASDI program in 1985–87. However, there seemed to be only a small likelihood that this would occur.

After 1987, because of the large tax-rate increase scheduled in 1988, and because of the favorable demographic picture then (due to the relatively small number of births annually in 1925–39), the financing situation for OASDI would be favorable *if economic conditions are reasonably good* (i.e., if wages increase significantly more each year than do prices—say, by a differential of 1.5 percent per year). However, if wages increase only slightly more than prices (or less than that), the bright situation of large annual excesses of income over outgo would not materialize in the 1990s—and, under certain circumstances, income and outgo might be, at best, only in close balance (or, conceivably, even worse).

The OASDI system is currently in excellent financial health. The assets of the OASDI Trust Funds at the end of 1989 amounted to $163 billion (and were $110 billion at the end of 1988). The fund at the end of 1989 was $101 billion higher than was estimated for that date in the pessimistic estimate made when the 1983 Amendments were enacted—on which estimate the short-range financing (for the 1980s) was founded in the legislation. Such excess of actual over estimated fund balance was $73 billion for the intermediate estimate.

Chapter 10 presents data on estimated future fund ratios (see Table 10.16), which indicate that, if the real-wage differential is much smaller than the average of about 0.4 percent assumed for the 1990s in the pessimistic-cost estimate, problems would not arise in the next two decades. In this connection, it should be noted that such differential was, on the average, a *negative* 0.6 percent in 1970–82, but was a *positive* 0.8 percent in 1983–90 (see Table 4.6).

If conditions in the 1990s are as favorable as shown by the intermediate estimate, it would be possible—and desirable as well—to reduce the OASDI tax rates for that decade, so as to prevent too large a fund buildup.

Lurking in the wings, however, is the serious financing problem of the HI program. Its financial situation is improved as a result of the

1983 Act—due to the hoped-for favorable effect of the new reimbursement basis for hospitals, to the increased tax income with respect to self-employed persons and to nonprofit employees, and to the lump-sum payment for military-service wage credits. Nonetheless, the HI Trust Fund was then estimated to have continuing cash-flow problems by 1991 under the intermediate cost estimate of the 1984 HI Trustees Report, and perhaps two years earlier under the pessimistic cost estimate of that report. As of 1992 the situation seemed to be very much improved, and no problems seemed likely until at least the early 2000s.

Social Security as an Issue in 1984 Elections

Just as Social Security was an issue in the 1982 congressional elections, so too it became an issue in the 1984 presidential elections. President Reagan had stated in an interview with the *New York Times* on March 24, 1984, that there is a need, at some point, to restructure the OASDI program for new workers coming into it, but that nothing should be done to reduce benefits for those now on the roll. Also, on July 6, he said that there is a probability that many young people now paying in to OASDI will never be able to receive as much in benefits as they paid for in taxes (as reported in the *Washington Post*, July 7, 1984).

Several aides of President Reagan also had made statements questioning the status and solvency of OASDI. David A. Stockman, director of the Office of Management and Budget, was quoted in *Fortune*, October 1, 1984, as having said that the biggest failure in the budgetary area in 1981–84 was that they had not created a much bigger package of spending cuts, including those in the social insurance programs. Secretary of the Treasury Donald T. Regan stated in a television interview that the 1983 Act "was well done and good for the time," but that more would have to be done to eliminate "mammoth" costs and that reexamination would be necessary in the late 1980s (as reported in the *Washington Post*, May 7, 1984). Secretary Regan also went on to intimate that a needs test should be instituted as to the benefits for higher-income persons. However, the White House immediately repudiated these statements of Secretary Regan as being only his own and not those of the Reagan Administration.

In his debate with his presidential opponent, Senator Walter F. Mondale, on October 7, 1984, President Reagan strongly asserted that he would "never stand for a reduction of the Social Security benefits to the people that are now getting them." He also made the point that the OASDI program is (and has always been) "totally funded by the payroll tax." From this, it may properly be concluded that OASDI has not been responsible for creating general budget deficits and should not be used to reduce them. As President Reagan clearly pointed out, reducing OASDI outgo has the effect of increasing trust-fund balances. A few days later, President Reagan amplified his remarks by stating that he "would guarantee that future Social Security recipients, as well as current beneficiaries, would be protected from benefit cuts" (as reported in *The Wall Street Journal*, October 10, 1984).

Senator Mondale, in rebuttal, pointed out that President Reagan had not promised not to reduce Medicare benefits, and that he (Senator Mondale) would not do so, even in view of the looming deficits in a few years in the Hospital Insurance program. However, Senator Mondale did not say how he would do this without raising the HI (or other) taxes or without reducing the quality and quantity of services furnished to Medicare beneficiaries. (The procedure of reducing reimbursements to providers of services and obtaining increased efficiency on their parts can be of limited assistance in solving the problem, because any reductions made cannot be too large if providers are to meet their salary and other costs.)

Legislative Procedures

When the OASDI system was initially developed in 1935, and also in all subsequent amendatory action, no single person or group was ever solely responsible for the action taken. The original act resulted from studies made by the Committee on Economic Security, which was headed by four cabinet members and the Federal Emergency Relief Administrator. The committee had a small technical staff that made the basic studies on which recommendations could be based. In addition, its conclusions were determined from recommendations made by an advisory council representing labor, industry, and the general public. In the legislative process, the proposals of the committee were significantly modified by both the executive branch and Congress before the final legislation resulted.

This same pattern of the influence of many groups and agencies in the legislative process has continued over the years. The procedure of obtaining the views of an advisory council has been followed in a number of instances. In 1937, an advisory council was appointed jointly by a subcommittee of the Senate Committee on Finance and the Social Security Board. In 1947, the Senate Committee on Finance appointed another advisory council. In 1953, an advisory group was convened by the Department of Health, Education, and Welfare.

The 1956 Act provided for periodic advisory councils to review the status of the OASDI system, with particular emphasis on its financing. The first such council was appointed by the Secretary of Health, Education, and Welfare in 1957, and the second was appointed in 1963 (with the specific broad assignment of comprehensively reviewing the entire program).

The law was changed in 1965, so that advisory councils were to be appointed in or after February 1969 (and every fourth year thereafter) to study the financing, the scope of coverage, and the adequacy of the benefits of both OASDI and Medicare. This cycle was established so that the council would be named at the start of each presidential administration and could never be a "lame duck" one. It was also provided that the thirteen members of the council should be selected to represent organizations of employers and employees (in equal numbers) and also self-employed persons and the public.

Action in the Executive Branch

Generally, the legislative procedure involved in any amendments that have been enacted has started with study and recommendations made by the Social Security Administration (SSA) (at times, following the recommendations of an advisory council). In the early years, all the studies of the program that were done in the federal government were made by the SSA and sporadic advisory councils and groups. Currently, several other agencies are active in this field, making studies and recommendations to both the executive and legislative branches. These include the Congressional Budget Office, the Congressional Research Service (Library of Congress), the General Accounting Office, and the staffs and consultants of the House Committee on Ways and Means and the Senate Committee on Finance.

The Secretary of Health and Human Services (formerly Health, Education, and Welfare) and the Executive Office of the President then approve the SSA recommendations (possibly with modifications), and a bill embodying them is introduced in the House of Representatives and sometimes also in the Senate. Under the U.S. Constitution, the House must initiate legislation in the field of taxation—and thus, too, in regard to most OASDI and Medicare matters.

Action in the House of Representatives

The Committee on Ways and Means of the House of Representatives is assigned the responsibility for Social Security legislation and usually holds public hearings on any administration proposals. At many times, the committee itself has initiated legislation without prior administration recommendation. In any event, this committee through its several pertinent subcommittees goes over the pending legislation very thoroughly in its sessions, and there has never been an instance where it did not make a number of significant changes in the legislation proposed to it.

For many years its executive sessions were closed to the press and the public. Now, however, virtually all sessions are open to all. In some ways, this may appear to be a desirable change from the standpoint of doing away with so-called deals in smoke-filled rooms. In practice, though, events that transpired in the executive sessions were not kept very secret and frequently were leaked to the interested public. One problem with open sessions is that committee members may feel hesitant to expound their preliminary and tentative views for fear of being made to look ridiculous in case, on further deliberation, they take another stance. Also, the press might report the initial position but not the final one, or the public might see only the former.

An important new element in the development of Social Security legislation is the budgeting process that Congress has imposed on itself. If increases in benefit outgo are to be legislated, to be effective for the current fiscal year (and to a considerable extent for the next fiscal year as well), they must be planned for in advance and incorporated into the overall budget resolution that is adopted by Congress in advance. If this is not done, it is very difficult to enact legislative changes, even though the trust funds have ample assets and excess income over outgo to do so.

For example, in early 1980 great stress was being placed on reducing the federal budget, particularly the deficit of income in relation to outgo. In the author's opinion, this is a laudable aim. Yet it unduly straitjackets the OASDI-HI program, which is, on the whole, a self-supporting program from the payroll taxes levied. For example, there are desirable changes that would rectify inequities, such as those resulting from the elimination of the monthly earnings test after the initial year of retirement (or other claim), which are thereby made difficult to accomplish.

Yet for fiscal year 1981 the combined Social Security program (OASDI and HI) was estimated to have an excess of income (taxes and interest on government bonds in the trust funds) over outgo for benefits and administrative expenses of $5 billion. Under the budget rules, however, this could not be reduced to correct inequities, even though the Social Security system would have a "budget" surplus.

Thus, illogically, the self-supporting Social Security system must suffer because of the budget deficit of general federal expenditures.

The bill embodying the results of the deliberations of the Committee on Ways and Means was, in the past, almost invariably considered by the House of Representatives under a closed rule that did not permit amendments other than those desired by the committee plus one amendment submitted by the ranking minority member of the committee.[50] This procedure was followed because of the complexity of the legislation and because of the procedural and technical difficulties that might arise if a large number of members of the House wished to amend different portions of the bill under consideration.

A different procedure was followed in the legislation leading to the 1977 Act. The rule followed was such that eight amendments proposed by members of the Ways and Means Committee were considered by the whole House. It was the general understanding that each such amendment would have to be fully financed (i.e., any increasing-cost effect would have to be balanced by provisions for additional revenues). Three of these amendments were adopted over the opposition of the committee leadership. These were the elimination of compulsory coverage of government and nonprofit employees, the removal of the earnings test after age 65 (changed to age 70 in conference), and the establishment of the National Commission on Social Security.

Action in the Senate

After the legislation is passed by the House of Representatives, it goes to the Senate and is referred to the Committee on Finance. This committee, too, holds public hearings and extensive sessions before reporting a bill to the Senate floor. That bill may be (and usually is) significantly modified from the House version. Amendments can be freely made during the debate in the Senate, unlike in the House.

In recent years, this orderly legislative procedure has not been followed. Instead, the Senate has, at times, added Social Security legis-

50. Usually, such an amendment was a motion to recommit the bill to the House Ways and Means Committee (i.e., a polite way of killing the bill by indirect means) and was thus rejected on a more or less straight party-line vote. In 1972, however, the ranking minority member (John W. Byrnes) used this procedure to have the automatic-adjustment provisions included in the pending bill, as President Nixon had proposed, but Chairman Wilbur D. Mills had blocked in the committee. Despite the strong opposition of Chairman Mills, the House voted to include this provision. (Many Democrats crossed party lines to vote for it because of strong support from the general public, even though most business and labor organizations were in opposition.)

lation to tax or similar bills that were developed by the House Ways and Means Committee, passed by the House of Representatives, and sent to the Senate for consideration.

Final Action

The version of the bill enacted by the Senate then goes to a conference committee, which has the responsibility of reconciling the differences between it and the House version. This committee consists of the top-ranking members of both parties from the House Ways and Means Committee and the Senate Finance Committee. The version of the bill that is agreed to by the conference committee is then referred back to both the House and the Senate for approval, which is almost invariably given automatically (although, at times, with vigorous complaints and dissent about items that were deleted or about the general nature of the resulting bill).[51] Then it goes to the President for approval.

Appendix 3-1

Should Public Systems Withdraw from Social Security?[52]

The cry of crisis about Social Security was widely heard in the early and mid-1970s. Great concern had been expressed about its financial problems. These are indeed serious, but not at all to the extent of rightly proclaiming bankruptcy. Now, widespread publicity is given to the withdrawal from Social Security of a number of state and local governments. Is this a case of a run on the bank by those with inside information and ability to act quickly? Or is it mistaken or uninformed action by only a small minority?

First, let us lay to rest the charge that Social Security was bankrupt

51. The vote on the conference agreement in connection with the 1977 Act in the House was very close—189 to 163. The opposition arose to point out to the public the significantly increased taxes which would be imposed in the next few years.

52. Article by Robert J. Myers, reprinted with permission from *Pension World*, August 1977. This article was originally published under the title "Should State and Local Government Desert the Social Security Ship?" in the second-quarter 1976 *Quarterly Newsletter*, published by Edward H. Friend & Company, actuaries and employee-benefit consultants, Washington, D.C., copyright © 1976 by Edward H. Friend & Company. It was revised by the author to take into account subsequent developments. Note that this paper relates to the situation that existed *before* the enactment of the 1977 Act and, of course, also before the enactment of the 1983 Act, which eliminated the withdrawal option. The material on this subject is included here because of its great historical interest.

in 1977 in the usual sense of the word. This would imply that it will shortly have to suspend payments to its 33 million beneficiaries. Social Security does have financial problems, but these are readily solvable by a combination of actions, and beneficiaries need have no worries about getting their checks.

A small amount of additional financing was necessary over the short range. An increase in both the employer and employee tax of as little as ½ percent was essential, and this should not cause any financial hardship on the part of covered persons. Similar action has been taken a number of times in the past. A similar, further increase may be needed in the early 1980s, depending upon what other changes are made (as will be discussed next).

Another problem, applicable only over the long range, is that the present method of computing benefits initially is technically faulty under likely future economic conditions. It will almost surely result in benefits that will, for cohorts attaining age 65 in the long-run future, be excessively large (even more than take-home pay eventually). Thus, if the procedure is not changed, far higher tax rates would be required than are now scheduled. The technical change referred to as "decoupling" or "uncoupling" is needed, and it would eliminate about half to two thirds of the currently estimated long-range deficit, depending upon whether it is done so that the relative benefit level is at the current situation or at that prevailing before benefits were overliberalized in 1970–72. (This was corrected by the 1977 Act.)

The new crisis being "discovered" by some is that a number of state and local governments have pulled out of Social Security insofar as their own employees are concerned. Actually, the number of exits before 1977 were relatively few, involving only 372 groups, with 49,981 employees actually withdrawn. As of the end of 1976, an additional 325 groups, with 505,726 employees (of whom about 400,000 were with respect to New York City), had given notice of intention to withdraw, to be effective after two years following such notice. In the latter case, governments could change their minds during the two-year notice period and not withdraw. (As of September 30, 1979, some 674 groups with 111,988 employees had actually withdrawn, and 222 groups with 98,118 employees were in the notice-of-intention status.)

What really drew attention to this matter was the announcement in March 1976 by New York City, with its thousands of employees, that it would withdraw. However, in January 1977 New York City announced that it would not withdraw and would rescind its notice to do so. Alaska, with 13,000 employees, had similarly given notice, but after completion of a study apparently decided not to withdraw.[53] Others who have actually opted out or served notice consist of relatively small political units, mostly in California, Louisiana, and Texas.

The law provided that, after electing coverage, political units must remain in for at least five years, and then give advance notice of two years before withdrawal becomes effective. Private employers, other than nonprofit charitable, educational, and religious organizations, have no such voluntary-coverage features. Such nonprofit organizations had a similar option, except that they must remain in for eight years and then have a two-year advance notice. Once that withdrawal has occurred, the entity cannot reenter Social Security. Withdrawals were effective only at the ends of calendar years.

Majorities of state and local employees who were under an existing retirement system had to vote in favor when Social Security coverage was obtained. However, somewhat anomalously, only the employing entity made the decision about withdrawing.

This special treatment was given to state and local governments solely on constitutional grounds—namely, that the federal government cannot tax them without their permission. Yet it would have been possible constitutionally for their employees to have been taxed compulsorily for Social Security, just as for federal income tax. The lenient withdrawal privilege was probably granted in the belief that it would rarely be used—and then only for emergencies rather than to take financial advantage of the Social Security system.

Some governments withdrew because they believed Social Security to be a poor buy. Although there were instances where a political entity could provide far better benefit protection for its employees elsewhere by utilizing the money spent for Social Security taxes, these were the exceptions rather than the rule. Such a situation could occur for a group with a very young age distribution, especially if it were composed largely of married women, who would generally expect to draw Social Security benefits from their husbands' earnings record in any event.[54]

Many of the assertions about Social Security being a bad buy for a particular group were based on perfunctory or erroneous analyses. A number of elements operating in different directions were present in such comparisons, because no private plan could be anywhere near identical with the Social Security provisions. For example, in one par-

53. At the beginning of 1978 Alaska filed another notice, which became effective in 1980.

54. But note that, as a result of the 1977 Act, this loophole was closed (by the provision for "government pension offset against spouse's benefits").

ticular plan, it was asserted that a big improvement would be made in changing from a benefit of 55 percent of final salary plus Social Security to 80 percent of salary. Probably for most people, certainly those in the lower and middle salary levels, 55 percent plus Social Security would be well in excess of 80 percent.

Social Security: Not a Bad Buy

A major error committed by those who recommended that state and local governments withdraw was the failure to take into account a number of the features of Social Security, such as the disability and survivor benefits. Also often ignored was the very significant effect of the provisions for automatic adjustment of benefits with rising prices. Pension costs in a private plan that provides fixed or level annuities over the years after retirement were shown to be relatively low in the 1970s, as compared with what they would be under more stable economic conditions, because of the high investment returns of 8 to 9 percent that could readily be obtained. However, such interest rates were at that level because of inflation. Under these conditions, Social Security benefits will not be level, uniform amounts over the future, but rather will rise steadily.

Accordingly, for comparability purposes, any private arrangement being considered in replacement of Social Security should be priced out on the basis of pensions increasing automatically at a rate of 5 to 6 percent a year, rather than on the basis of level amounts. If this were done, the amount of pension that could be bought for the equivalent of the Social Security taxes will be much less and thus would compare less favorably with Social Security than would otherwise have been thought.

Under certain circumstances a government could unfairly and unethically manipulate its coverage so as to take advantage of the Social Security system. It might do this, for example, by staying in for exactly 10 years, so that the vast majority of its employees would be permanently fully insured for all retirement and survivor benefits and also for the Hospital Insurance benefits under Medicare.

Let us look at several illustrations of how individuals fare when they are covered by Social Security for all of their potential working careers. Let us see what windfalls, or alternatively what losses, develop when an entity withdraws from Social Security. Such comparisons are fraught with dangers and difficulties because a very considerable difference can occur, depending upon the assumptions made. For example, the interest rate selected can make a vast difference; the use of a high interest rate will make Social Security look like a bad buy, and vice versa.

The following calculations have been made under rather simplified assumptions, which are believed to be reasonable, fair, and consistent. The situation is examined as of age 65, and no account is taken of past disability and survivor benefit protection. Nor is account taken of the fact that, in many cases, death of an insured worker will produce a small lump-sum death payment.

The first case is that of a man who attains age 65 in early 1976 and who was first covered in 1951, when he had a salary of $3,000, which increased at a rate of 5 percent per year (becoming $9,675 for 1975). Further, we will take two instances—initially, where he is covered for the entire period, 1951–75; secondly, where he is covered for only the first 10 years, 1951–60. In the latter case, the combined employer-employee contributions saved, accumulated at 6 percent interest, amounted to $14,277 as of the beginning of 1976. The benefit payable to the retired worker alone as of the middle of 1976 was $361 per month for the full-coverage case and $181 per month for the partial-coverage case (or, by coincidence, exactly half as much). In both instances, the person qualifies for Hospital Insurance benefits.

The accumulated "excess contributions" for the partial-coverage case would "purchase" on an actuarial basis only $117 per month, so that withdrawal from Social Security would have been a losing proposition, since the Social Security benefit was $180 lower. (The "purchase" factor is based on population life tables and a 3 percent interest rate, so as to allow for the effect of the automatic-adjustment-of-benefits feature of Social Security.) If the individual had an eligible spouse, the "excess" Social Security benefit for full coverage would be larger, and the "purchasable benefit for excess contributions" smaller, so that the "loss" for withdrawing would have been even more.

But what about those then in Social Security at the younger ages or those entering in the future? Here, the question of proper assumptions is much more difficult. Involved are future trends of wages and prices. Even more important is the fact that the financing scheduled under the 1977 Act was not sufficient.

Accordingly, in order to produce rational results, we must assume *static* economic conditions in the future, since this is the only way that the present benefit formula makes sense. Also, let us assume that the average combined employer-employee tax rate for the future for Social Security (including Hospital Insurance) will be 16 percent. Let us take the case of a man aged 25, with a salary of $10,000 per year (remaining level in the future). Again, let us take two instances—one where there is full coverage from age 25 to 65, and the other where coverage is terminated after 10 years.

Many Hurt by Termination

The accumulated "excess contributions" as of age 65 (using a 3 percent rate because of the assumption of static economic conditions) would amount to $77,262. In turn, this would "purchase" a single-life annuity of $632 per month. The benefit payable to the retired worker alone at age 65 would be $474 for the full-coverage case, as against $216 for the partial-coverage case—again, the latter receives about 50 percent as large a benefit, even though he has had only about 25 percent of the coverage. In this instance, it would be "profitable" for the individual to withdraw, because the "purchasable benefit" ($632) is well in excess of the reduction in benefits because of partial coverage ($258).

If the individual had an eligible spouse, the situation would not be advantageous for withdrawal, but only to a small extent. The "purchasable benefit" from the "excess contributions" for the husband and wife combined is $353 per month, or somewhat lower than the reduction in benefits of $387 because of partial coverage. The married-couple case is *not* typical for the long-run cases, because in the future many wives will qualify for Social Security benefits on their own earnings records and thus will not receive full benefits (or any benefits) from their husbands' earnings records.

For many (but by no means all) employees, the money "saved" with respect to future Social Security taxes would buy more benefits than the decrease in Social Security benefits resulting from the terminated coverage. At the same time, many other employees would be hurt by the termination—such as short-service workers, who would thereby have a gap in their Social Security coverage besides having acquired no benefits from the government plan.

Employees who are near retirement age when termination occurs would have a reduction in their Social Security benefits that would be far greater in actuarial value than the taxes that would have been applicable. For example, consider a male employee who was aged 60 when the coverage terminated at the end of 1974 and who had had maximum covered earnings since 1956, when his government employer first elected coverage. When he attained age 62 in January 1976, his Social Security benefit for himself and his wife (of the same age) was $387 per month, whereas if coverage had not been terminated, it would have been $419.50. The additional value of the Social Security employer-employee taxes for 1975 if coverage had not been terminated would have been $1,650. The actuarial value of the reduction in benefits would have been $5,300 (making allowance for the automatic-adjustment feature by using a 3 percent interest rate), or $3,650 more than the taxes.

Is Withdrawal Desirable?

Even though in some cases a government entity could, on the average, profit—or else its employees could, on the average, get more benefits—by opting out of Social Security, there is considerable question as to whether this is desirable.

Generally, any gain so involved could be relatively small, and it might not be worth the extra effort and administrative expenses necessary to take such action. This was especially so considering that the administrative expenses under such a large group operation as Social Security would necessarily be less than under a small, separate plan. Moreover, some employees would be disadvantaged.

Furthermore, if the gain from withdrawing would arise from taking advantage of the Social Security system (due to its generous treatment of short-service workers), there is considerable question as to whether this was morally and ethically proper, even though legal.

Another possible disadvantage of a state or local government withdrawing from Social Security was in the event that a government subsidy is injected into Social Security. If a government subsidy to Social Security should be initiated, those not under the program would be paying part of its cost but would not be getting any return from it. Thus, the only hope of "breaking even" on the taxes paid to provide such a subsidy was to be covered under Social Security!

New York City apparently decided to withdraw *solely* on the basis of the immediate cash-flow savings, and not because it believed that Social Security was a bad buy or was in dangerous financial condition. It was seeking all ways that it could to reduce expenditures, and this seemed to be an attractive short-term way.

State and Local Employment

Finally, let us discuss what should be done about optional coverage for state and local government employees. As a broad, general principle, I am strongly in favor of complete compulsory coverage of both state and local employees and nonprofit employees. I have the same view with regard to federal employees who are under the Civil Service Retirement system. It is an essential characteristic and requirement of a democratic national social insurance system that all employment in the country should be covered thereunder.

This approach is desirable from the standpoint of all parties concerned—the workers, the employers, and the nation as a whole. Social Security is not a magical machine that produces benefits at substantially less cost than any other mechanism. But neither is it a high-cost, low-benefits system. There can really be no better situation than a good Social Security system supplemented by a well-coordinated private pension plan.

My first choice as to coverage conditions for state and local government employees is completely compulsory coverage. There would have to be opportunity for some delay, so as to permit downward adjustment of existing plans, so that the combined benefit level (and the resulting costs) would not be excessive. Naturally, the new plan, combined with Social Security, should not be less liberal than the old plan.

The constitutional problem of taxing the state and local governments could be solved in any of several ways. One approach is to tax the employees at the self-employed rate if the employer does not agree to pay the employer tax. Admittedly, this would be very strong medicine and its adoption is unlikely to be feasible. Still another approach would be to credit the employees with only half of the taxed earnings if the employer does not agree to pay the employer tax.

At the very least, there should be compulsory coverage of all present employees who are not under an existing retirement plan and of all new employees entering in the future, regardless of whether covered under a retirement plan.

The antiselection problem associated with the Social Security coverage of state and local employees will get worse and worse as time passes. This is because of the current-cost financing basis of Social Security, as against the actuarially funded nature of supplementary pension plans. As the Social Security tax rates rise, there will be increasing financial advantages to withdraw and substitute a private plan. Accordingly, in the interest of all parties concerned, prompt resolution of this problem by Congress was essential.

If it is not possible to have compulsory coverage, the best procedure is to require that, once coverage has been elected, withdrawal should not be allowed, as was done by the 1983 Act.

Yet another approach was on the benefits side, so as to prevent or ameliorate the windfalls that employees may get when coverage was terminated. One way would be to compute (1) the Social Security benefit based on actual service with the organization that withdrew and (2) such benefit based on such service plus all service with the organization after the termination date and up to age 62 (or prior death or disability) at the prevailing salary rate then. Then, the "earned benefit" would be computed as: item (2), times the ratio of

(3) the total covered wages with the organization before withdrawal to (4) such total wages plus the presumed ones for service after termination. The "windfall benefit" (the excess of item [1] over the "earned benefit") would be deducted from the computed total benefit based on all covered employment. Such procedures are now not necessary, of course, because termination of coverage is prohibited.

Appendix 3-2

Unequal Treatment of Men and Women under OASDI: Past Developments and Status Prior to 1983 Act

When the OASDI program was first developed in 1935, and then contained only retirement benefits, there was completely equal treatment by sex. However, in the 1939 Act, when dependents (or auxiliary) benefits for retirees and survivor benefits were added, this was no longer the case. No benefits for men were provided to parallel wife's, widow's, and mother's benefits. Also, no child's benefits (either auxiliary or survivor) were provided for women workers, except where the father both did not provide any support for the child and was absent from the home.

The 1950 Act moved toward equal treatment of men and women as to auxiliary and survivor benefits. Husbands and widowers were made eligible for benefits, but only if they could prove dependency on the wife as of the time she claimed benefits (i.e., he had received at least half of his support from her), and if she was currently insured (as well as being fully insured, which is all that is required for such benefits when based on a man's earnings record).

As to child's benefits, the 1950 Act extended eligibility for women workers regardless of the husband's presence or financial support of the family, if the woman worker was *both* currently insured and fully insured. In other words, this was done when she had had a recent attachment to the covered labor market at the time that the risk insured against actually occurred. Finally, the 1967 Act made the provisions for eligibility for child's benefits with respect to men and women workers completely uniform, but did not provide for father's benefits with respect to fathers having eligible children (i.e., under age 18, or over age 17 and disabled before age 22) in their care.

At the same time, the 1967 Act removed the requirement of currently insured status for husband's and widower's benefits, but continued the requirement of dependency.

The 1965 Act also added benefit eligibility for divorced wives (and subsequently for widow's benefits after the former husband died), but not for divorced husbands.

Following this, there was no legislative activity to provide equal treatment by sex as to the spouse and the surviving spouse, but the courts stepped in to do this. In 1975, in *Weinberger v. Wiesenfeld*, the Supreme Court, in essence, added father's benefits to OASDI; the Social Security Administration, however, did not extend this to divorced fathers. Then, in 1977, in *Califano v. Goldfarb*, the Supreme Court struck out the dependency requirement for widower's benefits, and this was extended consistently and logically by the Social Security Administration to husband's benefits. However, husband's and widower's benefits for divorced men were not provided, nor were husband's benefits made payable on account of a husband of a retired or disabled worker having an eligible child in his care (i.e., at any time before age 65 and at the full rate of 50 percent of the PIA).

Later in 1977, in *Oliver v. Califano*, the courts required payment of aged husband's benefits to divorced men under the same conditions as were applicable to women. However, the Social Security Administration did not extend aged widower's benefits to divorced men (even if they had previously been receiving husband's benefits because of this court decision) or to surviving divorced fathers with an eligible child. Later court decisions required such payments to these two categories (and also to the husband of a retired or disabled worker who had an eligible child in his care).

In the provisions as to minimum retirement ages by sex, the equal treatment by sex prevailing from the start was destroyed in the 1956 Act, when such age was reduced for women to 62 but was left unchanged at 65 for men. This was remedied by the 1961 Act, in which the minimum age was also made 62 for men. The minimum age for widows (other than those meeting a definition of disability) was reduced to 60 by the 1965 Act, but this was not done for widowers until the 1972 Act. At the present time, in summary, retirement ages by sex are the same.

As to benefit eligibility and amounts, when the minimum retirement age for women was reduced to 62 by the 1956 Act, the terminal computation points for insured status and for determining the AMW for benefit-computation purposes were similarly moved down. However, when the retirement age was similarly reduced for men in the 1961 Act, the computation points were not changed, largely due to cost considerations.

The 1972 Act moved the computation points for men from 65 to 62, but only for those attaining age 62 in 1975 or after (with a gradual phasing-in for those attaining age 62 in 1973–74). This was challenged in the courts in 1977, in *Califano v. Webster*, but the decision was that the procedure was permissible. The grounds given for this conclusion were that the more favorable treatment of women who attained age 62 before 1975 as to their benefit eligibility and, particularly, their benefit amounts had the purpose of compensating them for previous economic discrimination.

In the author's view, this reasoning was not valid. Any such discrimination was on the average and not necessarily in all individual cases. Also, nothing was thereby done for women who attain age 62 after 1974, and yet they had employment before the 1970s, when they, too, may have been so discriminated against. The real reasons, in the author's opinion, that the phasing-in of the 1972 Act was reasonable were the huge cost involved in the aggregate (though small benefit increases individually) and, more important, the tremendous administrative costs that would have been involved in recomputing benefits for those currently on the roll. (This could not have been done from the computerized records; rather, it would have necessitated going back by hand to millions of individual files.)

The transitional-noninsured, or special age-72, benefits contained two provisions that involved unequal treatment by sex, which, as it happens, have affected only a few people. First, wife's and widow's benefits are provided under these provisions, but not husband's and widower's benefits. Second, the payment made when both husband and wife are eligible for these benefits is divided two thirds to the man (as a primary benefit) and one third to the woman (as a wife's benefit). The obvious solution would be a 50–50 split (just as is done for parents' benefits when two persons are eligible—rather than the one-person rate of 82½ percent to one parent and the balance of the 150 percent to the other). The 1983 Act solved this problem by making both the husband and the wife (in the relatively few cases so involved) independently eligible for the full age-72 benefit.

In recapitulation, at the end of 1982, there still remained seven areas of unequal treatment by sex in the benefit protection provided for the future. Two of these have already been discussed in detail (the two instances for transitional-noninsured benefits mentioned in the previous paragraph). The other five, all of quite minor importance, were as follows:

1. Widows were eligible for benefits on *all* previous husbands' earnings records (but received only the largest one). Widowers were eligible for benefits on only the *last* wife's earnings record. (A federal district court ruled that, in these cases, widowers were eligible in the same manner as widows.)

2. When an auxiliary or survivor beneficiary married a disabled-worker beneficiary or a child disability beneficiary, such auxiliary or survivor benefits were not terminated (as they would be in the case of marriage to another person). If such disabled beneficiary recovered from the disability, the benefits of the auxiliary or survivor beneficiary were not then terminated if the disabled beneficiary was a woman, but they were if the disabled beneficiary was a man.
3. One provision used to determine the status of an illegitimate child could apply only to the father.
4. Widows could waive payment of federal benefits based on military service before 1957, so as to count such service under OASDI, but widowers could not do so.
5. Income from a business operated by a couple in a state with a community-property statute was deemed to belong to the husband, unless the wife exercised substantially all of the management and control of the business.

It is interesting that the House-passed version of the 1977 Act would have eliminated all of these differences, as the Department of HEW had previously recommended. The Senate, however, would not agree, and instead a study on the subject was to be made by HEW.

In summary, for all intents and purposes, there was, just before 1983, virtually equal treatment by sex in OASDI (and also Medicare) as the result of both legislation and court decisions.

The 1983 Act eliminated all of the foregoing minor differences in treatment under OASDI by sex, except for the last one (which was not eliminated because it was not clear how to do so—i.e., in which direction to change).

The unequal treatment of men and women as to the spouse government pension offset for persons first becoming eligible before July 1983 was challenged in the courts (*Heckler v. Mathews*). The Supreme Court ruled that this was constitutional, in essence because of its temporary and transitional nature.

Appendix 3-3

Development of OASDI Benefit Formulas Prior to the Current Formula Based on Wage Indexing

Table 3.1 shows the various benefit formulas that were applicable for determining the PIA before the new formula based on the wage indexing of the earnings record was developed. This appendix describes how each of these formulas was derived.

The benefit formula in the original 1935 Act was developed on the "banking of wage credits" principle—namely, that total lifetime wage credits were entered into the formula. This procedure, however, was not an individual-equity one (as some people believe even now). The formula was heavily weighted for the first portion of lifetime wages, so that proportionately large benefits would result for older workers at the inception of the system (whose coverage would be for far less than a potential working lifetime) and for low-paid workers.

The fact that the original benefit structure was *not* on an individual-equity basis can be readily demonstrated. Consider an individual with a wage equal to about the average prevailing in the late 1930s—$900 a year. If such an individual was aged 60 in 1937, when the system went into effect, the primary benefit after five years of coverage would have been $16.25 per month under the original formula. This benefit would have an actuarial present value of about $1,600, whereas the total employer-employee taxes scheduled for 1937–41 would have been only $108.

The first change in the benefit formula, made in 1939, reflected a change in philosophy. Benefits payable in the early years of the program's operation were made relatively larger, and presumptive family needs were recognized by the provision of supplementary benefits for dependents. To offset these two changes, benefits for long-term contributors and for those without dependents were reduced.

The second change in the benefit formula (in 1950) carried further the philosophy underlying the payment of larger benefits currently by making no distinction in the benefit amount based on years of coverage (for those continuously in covered employment). The change consisted primarily of adjustment for changes in the cost of living. The increase was 100 percent for primary benefits of $10–15, grading down to 50 percent for the highest primary benefit ($45.60), with the average increase for those on the roll being about 77 percent.

The third change (in 1952) was also primarily a result of wage-level and cost-of-living changes (due to the Korean War). The increase in the PIA was the larger of $5 or 12½ percent, with the increase averaging about 15 percent.

The fourth change (in 1954) reflected both an adjustment for higher wage levels and an increase of about 10 percent in the relative adequacy of the benefits. The increase in the PIA was about 9 percent for lower PIAs, ranging up to 10 percent for the highest PIA, with a minimum increase of $5. The average increase in the PIA was about 13 percent.

The fifth change (in 1958) again paralleled the increase in the cost of living since the previous change. The increase in the PIA was the larger of 7 percent or $3 and averaged about 7½ percent.

The sixth change in the benefit formula (in 1965) paralleled the increase in the cost of living since the previous change. The increase in the PIA was the larger of 7 percent or $4 and averaged about 7½ percent.

The next three changes (13 percent in 1967, 15 percent in 1969, and 10 percent in 1971), however, were all somewhat more than the cost-of-living rises—by about 5 percentage points in each case—so that there was a significant "real" expansion in the benefit level of the program in 1967–71.

The next change in the benefit formula, resulting from legislation in 1972, was 20 percent. This was well above the 5.9-percent increase in the cost of living that occurred between the effective date of the previous increase (January 1971) and that of this increase (September 1972).

During the first Nixon administration (1969–72), the three benefit increases amounted to 51.8 percent on a cumulative basis. This compares with a cost-of-living rise of only 23.4 percent between the effective date of the 1967 benefit increase and September 1972, so there was a real increase in benefit levels of 23 percent (151.8/123.4 − 1.00). The Nixon administration urged increases equal to only the rise in the cost of living each of the three times that legislation was being considered, but the actions of Congress produced the significant expansion of the benefit level that occurred.

The next seven (annual) changes in the benefit formula resulted from the two 1973 amendments. The effect of the July 1973 Act would have been an increase of 5.9 percent, based on the change in the CPI from its value in June 1972 to its value for June 1973, which amount was not known when the legislation was enacted. That benefit increase would have applied for only June–December 1974, and then would be overridden by the automatic-adjustment provisions, which were scheduled to go into operation for the first time in January 1975.

The benefit formula under the July 1973 Act never became operative, because it was overridden by the two formulas of the December 1973 Act. The first such formula, applicable only for March–May 1974, was an increase of 7 percent over the formula of the 1972 legislation, while the second one was an increase of 11 percent over the 1972 formula.[55] The 11-percent increase was justified on the ground

55. The two-step approach was taken for administrative reasons. A completely precise procedure for adjusting benefits in payment could not be accomplished in the time

that it would approximate the CPI rise from September 1972 (the date of the last previous benefit increase) to June 1974. The actual rise was somewhat more than this—16.4 percent.

Also, under the December 1973 Act, the automatic adjustments were to be based on CPI changes between the first quarters of various years (second quarter as to 1974), instead of second quarters as under the 1972 Act. As a result of this provision, the benefit formula applicable for June 1975 was derived by increasing all benefit factors by 8.0 percent.

It is interesting and significant that the increase in the CPI from September 1972 to the *first* quarter of 1974 was 12.0 percent, or virtually the same as the 11-percent benefit increase effective for June 1974. On this basis, equity to the beneficiaries with regard to the automatic adjustments could have been achieved by basing the adjustment for June 1975 on the change in the CPI from the *first* (instead of the *second*) quarter of 1974 to the first quarter of 1975. This would have resulted in an increase of 11.7 percent, instead of the actual increase of 8.0 percent. Whether intentionally or inadvertently, this difference of 3.7 percent made up for part of what the author believes were overliberalizations in 1969–72.

One might ask whether the 1973 legislation was yet another expansion of OASDI and thus a further step away from having the private sector bear significant responsibility for economic security. Actually, the 11-percent benefit increase was less than was justified by the change in the CPI, so that some overexpansion of the changes in 1969–72 was "recovered."

Also, one might well ask why the original version of the automatic-adjustment provisions did not provide for them to go into effect in January 1974.[56] When the 20-percent benefit increase was enacted in 1972, effective for September, inflation seemed to be diminishing, so

available before the first effective month (March 1974), so an approximate basis (precise, in most cases) was prescribed for the benefits for the first three months.

56. Interestingly, the Senate version of the July 1973 legislation did provide for the effective month to be January 1974 (but not using the logical method for determining the period for the increase in the CPI—i.e., the basis provided for all future years in the 1972 legislation). The sponsor of moving up the first date for the automatic adjustment of benefits, Senator Ribicoff, had initially proposed this simple (and correct) procedure of merely changing such date to January 1974 and not changing the measurement basis. The first effective month was changed from January to June 1974 at the insistence of the Nixon administration, which was concerned about the increased outgo and the budget (rather than about social insurance principles and social considerations). As to the latter, making the increase effective for June 1974 (with the first increased check going out at the beginning of July) would produce no effect on the budget for the fiscal year ended June 30, 1974. In September 1973, the Senate voted to advance the first payment date for the 5.9-percent increase from June 1974 to whatever would be the month of enactment of the legislation, but the House did not concur.

that another benefit increase did not seem to be needed in the next two years to maintain the purchasing power of the benefits. If this had been done, the benefit increase would have been based on the change in the CPI from the third quarter of 1972 to the second quarter of 1973. The result, as the actual experience has turned out, would have been an increase of 4.5 percent beginning for January 1974, with another increase of 7.1 percent beginning for January 1975. In hindsight certainly, the automatic-adjustment provisions should logically have been first operative for January 1974, and then the 1973 legislation would not have been necessary.

There was one encouraging aspect of the 1973 legislation from the standpoint of those who believe that the automatic-adjustment provisions might take arguments about the magnitude of benefit changes out of politics. The change made was based solely on the change in the CPI. There was no "competitive bidding" between those who wanted much larger increases than the CPI indicated, as there had been when benefit increases were enacted in 1969, 1971, and 1972. Likewise, the automatic increase effective for June 1975 was made without any attempt in Congress to increase its amount, although there was an unsuccessful effort to make it retroactive to January, with the added benefit cost to be met from general revenues.[57] Similarly, all subsequent automatic increases went into effect without challenge (although it could be that no efforts were made to raise the determined amount because of the financial problems that OASDI was then having).

Every change in the benefit formula since 1954 and prior to the development of the new formula based on wage indexing of the earnings record had as its foundation the formula in the 1954 law. The procedure had been merely to increase the various percentage benefit factors in the formula by the uniform percentage increase in the general benefit level of beneficiaries then on the roll. This same method was prescribed under the automatic-adjustment procedure enacted in the 1972 legislation and is continued under the 1977 Act for the pre-1979 cohorts.

Considering that the four across-the-board benefit increases in the 1967, 1969, 1971, and 1972 amendments represented a rise of 29 percent in real terms, after deflating by the change in the cost of living, one can well ask whether the floor-of-protection concept had been

57. President Ford, however, proposed (as an anti-inflationary measure) to limit the increase to 5 percent (before it was determined to be 8.0 percent), but this suggestion met with no approval in congressional circles. In lieu of either of these proposed changes, legislation was enacted to give a uniform $50 payment to all persons aged 65 or over, financed from general revenues.

abandoned in favor of having OASDI be a virtually complete national retirement system. Further in this direction, it should be considered that other OASDI changes made in the 1972 legislation (principally, increased widow's benefits) represented, in effect, an additional increase of about 8 percent.

On the other hand, and counterbalancing to a certain extent, the ad hoc increase made for 1974 by the 1973 Act and the first automatic adjustment (in 1975) fell somewhat short of meeting the rise in the cost of living between September 1972 and June 1975 by about 7 percent. Furthermore, the effect of the decoupling procedure adopted in the 1977 Act represented approximately another 7-percent reduction. The net result, nevertheless, was a significant expansion of the OASDI benefit level in the period 1967–77—about 12 percent. If the comparison had been made for the period 1969–77, the corresponding figure would be 7 percent.

One particular situation was present, prior to the 1977 Act, where OASDI had been expanded to the point where it filled the entire economic-security needs. If a young worker aged 29 or under died at the end of 1977 after having had the $15,300 maximum creditable annual earnings in 1976 and $16,500 in 1977 and left a widow and two children, the family benefit was $1,089 per month. Compared with this, his net take-home pay in 1977 (after considering federal and state income taxes[58] and OASDI-HI taxes) was about $1,115 per month. Thus the survivor benefit was 98 percent of take-home pay, and the family income needs were less because of no work expenses and one person fewer. The same general situation prevailed for disability benefits for young workers. As shown in Appendix 2-9, the 1977 Act considerably remedied this situation for deaths and disabilities after 1978.

The foregoing situation arose because of a technical defect in the benefit provisions, as discussed in Chapter 2 in connection with Table 2.11 and in Appendix 2-5. For a similar family, except that the worker was aged 43–61 in 1977 (and had had maximum covered earnings in all years from 1951 on), the corresponding survivor benefit would be $785 per month, or only 70 percent of the final take-home pay.

The special benefits for certain persons at age 72, as legislated in 1965 and 1966, have always been payable in a flat amount. The amount of these benefits was always increased by the same percentage as all other benefits when ad hoc changes were made, except that the

58. The provisions of a typical state income tax are used here.

1971 Act provided for a 5-percent increase for them as compared with 10 percent for all other benefits. The automatic-adjustment provisions, established in the 1972 legislation and first effective in 1975, continue this practice of the special benefits being increased at the same rate as the regular ones.

Appendix 3-4

The Problem of Instability in the PIA Computation Procedure Prior to 1977 Act; Various Decoupling Proposals for Its Solution

This appendix summarizes various aspects of decoupling the OASDI benefit structure, which was found to be necessary in the mid-1970s to alleviate the financial problems of OASDI. First, the term *decoupling* is defined. Second, the problem that necessitated decoupling is described. Third, the several methods of decoupling are analyzed, along with their pros and cons. Fourth, the actual decoupling procedure adopted in the 1977 Act is described (along with discussion of why this approach was selected). Finally, potential problems and difficulties with the legislated decoupling are considered. A bibliography of the most important papers and reports on the decoupling issue is appended.

What is Coupling?

The basis for computing benefits before the 1977 Act was "coupled," not only for the automatic-adjustment provisions instituted in the 1972 Act but also in the ad hoc legislation in the preceding years back to the mid-1950s. In fact, the 1972 Act was patterned after the previous procedure, which had worked out well both administratively and financially.

Under a coupled system, when the beneficiaries on the roll receive a certain percentage benefit increase, the percentage benefit factors in the formula for the PIA applicable to new retirees are increased similarly. For example, the first term in the benefit formula applicable for June 1975 through May 1976 was 129.49 percent of the first $110 of AMW. When the 6.4-percent benefit increase for June 1976 was given to beneficiaries on the roll, this term became 137.77 percent of the first $110 of AMW.

The coupled procedure has the advantage of giving equal treatment to beneficiaries who have the same average earnings, regardless of when they enter the benefit roll. It is also easily explainable.

What is Decoupling?

The term *decoupling* (at times, *uncoupling* has been used) merely means that the method of computing the amount of the OASDI benefit at the time of the initial claim will not be related to the method of increasing benefits in current-payment status to reflect changes in the CPI. Thus, benefits for new retirees are computed in a different, unrelated manner that will not be sensitive to differing rates of change in prices and wages.

The Problem Necessitating Decoupling

Following the enactment of the automatic-adjustment provisions in 1972, the long-range actuarial status of OASDI steadily worsened, as shown by the annual Trustees Reports. Thus, the actuarial imbalance was reported at 0.32 percent of taxable payroll in the 1973 report and at 2.98 percent, 5.32 percent, 7.96 percent, and 8.20 percent in subsequent reports. A substantial part (but by no means all) of this increase in the deficit was caused by changes in the underlying economic assumptions about increases in the CPI and in earnings. This had a considerable effect on the coupled method of computing initial benefit amounts as it would apply over the future. In general, these changes not only increased the assumed rates of increase of both the CPI and earnings but also narrowed the differential between the two rates. (Other changes in the assumptions underlying the cost estimates that produced larger actuarial imbalances were related to fertility, mortality, and disability rates.)

As it happened, the coupled method of computing the initial benefit amounts had produced reasonable results during the 1950s and 1960s. This, it turned out, was because economic conditions as to the CPI and earnings were fortuitously "right" then—namely, on the whole, earnings increased about 4 percent annually, and the CPI rose by about half as much. The result was that *relative* benefit amounts remained roughly constant, and so there was financial long-range stability (on the assumption that such economic conditions would prevail in the future).

Studies by the Office of the Actuary, Social Security Administration, made it clear that the replacement rates at the time of the initial retirement claim would be unstable over the years under the coupled procedure involved in the automatic-adjustment provisions inaugurated by the 1972 Act. (The replacement rate is the initial benefit as a percentage of the earnings just before retirement or other claim.)

For example, based on the coupled benefit structure as of 1976, and considering a worker with average earnings in all years (past and future), the replacement rates for future cohorts of retirees will be relatively constant at the current level if the rates of annual increase in earnings and prices are 3¾ and 2 percent, respectively. On the other hand, if such rates are 7¾ and 6 percent (or, alternatively, 5 and 4 percent), the replacement rates 75 years hence will be about 105 percent higher relatively; this will, of course, mean substantially higher long-range costs than under a stable benefit structure and will result in a large actuarial imbalance under the tax schedule in the law. However, if such rates are 5 and 2 percent (an unlikely possibility), the replacement rates 75 years hence will be about 30 percent *lower* relatively; this will mean, if such decreasing relative benefits are allowed to occur, a reduction (or even elimination) of the actuarial deficit that was present at that time.

The foregoing results under the coupled procedure for computing initial benefit amounts have been criticized by stating that they involve a so-called double-indexing advantage. This is said to arise from the fact that higher benefits result from both (1) the increased percentage benefit factors and (2) the likely larger earnings credits that the beneficiary has had as a result of the higher level of general earnings and the increases in the earnings base due to the automatic-adjustment provisions.

Such criticism is, however, not valid. Two offsetting factors should also be considered. One is the weighted benefit formula (such that the benefit amount decreases relatively as the AMW increases). The other is the career-average nature of the AMW (such that it is computed over many years, ultimately 35).

Depending upon the relative trends in the CPI and earnings, these various factors can exactly offset one another. More likely, however, instability in the benefit level will result over the long run. Correspondingly, under the latter circumstances, there will be instability in the financing of the system.

If earnings rise at about twice the rate that the CPI does, but not at the 3¾/2 percent conditions, then the replacement rates will be stable but at a different level ultimately than that currently applicable. If the CPI rises at a rate of 2 percent per year, and if the increase in wages is in excess of 3¾ percent, the ultimate level of the replacement rates will be lower than at present—and vice versa.

The situation changes drastically when the rates of increase of earnings and CPI are not in the foregoing 1.9-to-1 relationship. Thus, if earnings increase more than twice as rapidly as the CPI, then the replacement rates will decrease over the years. That would not be satisfactory because it would mean declining benefit adequacy.

On the other hand, if earnings rise much less rapidly than 1.9 times the increase in the CPI—which was the case in the mid-1970s and seemed likely for the future—the replacement rates would increase steadily over the years. In fact, eventually, they would rise to such heights that benefits would exceed final take-home pay (or, later, even final gross pay). At the same time, and of course as a result, the cost of the program would mount steadily and be far more than could be financed by the scheduled tax rates.

Accordingly, it seemed essential that the benefit-computation procedures for new beneficiaries under the automatic-adjustment provisions should be revised. This should have the effect of producing a rational benefit structure and, at the same time, a sound financing basis. Although the effect of such action would be to prevent excessive benefit levels in the long-distant (and, even, intermediate) future, it should not be characterized as a "deliberalization," because under certain conditions it could produce *higher* replacement rates than under the coupled procedure.

It was generally agreed that the method of adjusting the benefits for those on the roll was working satisfactorily. In other words, the benefit results would be reasonable, and the cost would be stable. Accordingly, the following discussion relates only to the computation procedures for initial benefits.

Different Methods of Decoupling

Several possible solutions to this problem of instability of the benefit structure were proposed. One proposal would merely have legislated a maximum on the replacement rates, possibly varying inversely with the earnings level. It would seem that this approach would have difficulties of application when benefit levels rose near the prescribed maximums and appeared to be heading higher except for this restriction (which would seem "unfair" to some). Also, it would not seem to be effective or politically viable to prescribe maximum tax rates and to reduce benefits so that they could be financed by such tax rates.

Another proposal would have made use of the aforementioned effect of a 1.9-to-1 relationship between earnings and CPI increases in stabilizing replacement rates. The same procedure for adjusting the benefit formula as it applies to new retirees as that under the 1972 Act would be followed, except that the percentage benefit factors would be increased by the *lesser* of the CPI increase or 53 percent of the increase in wages. This approach would produce more stable replacement rates (and thus the cost of the system would be more stable), but by no means complete stability.

Yet another proposal would have made use of a final-average wage in the benefit computations and then would have a new benefit formula of a dynamic nature. The final-average wage might be the average of the highest 5 years in the last 10 years. The new benefit formula would have constant percentage benefit factors in the weighted formula, but the dollar band limits would be increased in the future as the general earnings level rises. This approach, too, would result in more, but not necessarily complete, stability. Moreover, the use of a final-average wage would not work out satisfactorily or equitably for persons with greatly varying *relative* earnings over their lifetime work careers.[59]

The complete goal of stable replacement rates can be achieved only by indexing the earnings record by means of past wage trends. The AIME derived from such an indexed record would be applied in a new dynamic benefit formula (of the type described in the previous paragraph). This approach was proposed by the 1974 Advisory Council on Social Security. (By "indexing the earnings record" is meant that each year's recorded earnings would be multiplied by the ratio of a certain economic index for the year of computation to that index for the particular year.)

Another approach using indexing of the earnings record, along with automatic adjustment of the dollar band limits in the benefit formula, was proposed by the Consultant Panel on Social Security to the Congressional Research Service. The indexing and the adjustments would be made on the basis of the CPI (rather than earnings).

As the public discussion of decoupling intensified in 1974–77, it centered on only the last two of several proposals—namely, wage indexing and price indexing. (In theory, there could have been a compromise between these two approaches—by wage-indexing the earnings record and by adjusting the dollar band limits by changes in the CPI, but this was not considered.)

Relative Merits of Price Indexing versus Wage Indexing

Before discussing the relative merits of price indexing as compared with those of wage indexing in the decoupling of the OASDI benefit structure, it might be well to consider the effect of each on replacement rates for future cohorts of retirees.

Regardless of which method of indexing is used, the benefit formula can be geared so that about the same level of benefits will be

59. A final-average basis can be very successful in the pension plan of a single employer, because the employee's work history with that employer will generally involve a steady progression of salary.

produced at the initiation of the new procedure as the previous coupled procedure would have produced (or else, any desired percentage thereof). This being the case, the only matter to be examined is the future trend of replacement rates from the starting level.

If wages increase more rapidly, on the average, than the CPI (which seems likely), price indexing will result in gradually *decreasing* replacement rates (as measured at the time of retirement) over the years for new cohorts of retirees. On the other hand, wage indexing will, by its very nature, result in the *stabilization* or *leveling-off* of such replacement rates (which can be mathematically proven).

On the other hand, when the CPI rises more rapidly than wages over an extended period of time, price indexing will result in gradually *increasing* replacement rates (as measured at the time of retirement). Wage indexing would still result in stablized, level replacement rates. However, this situation as to wage and CPI trends seems most unlikely, and, if it did occur, the country would have many other worries in dealing with a steadily falling standard of living. (There would also then be a question of whether it would be appropriate to adjust benefits for those on the roll by the CPI, rather than by the lower increases in wage levels.)

A merit claimed for price indexing (under the assumption that wages will rise more rapidly than the CPI) is that the cost-reduction effect will be much larger than that under wage indexing. In fact, such reduction might be sufficient to eliminate any long-range actuarial imbalance that would otherwise remain under wage indexing. Or else, the ultimate tax rates necessary to finance OASDI could be lower if price indexing, rather than wage indexing, were used.

It is also argued in support of price indexing that the beneficiaries are being treated equitably, because the real value (or purchasing power) of the benefits is maintained by this procedure, even though the relationship of the benefits to final earnings is not. Further along these lines, it is argued that price indexing is more equitable to beneficiaries who have been on the roll for some years as compared with new retirees, because these groups have the purchasing power of their benefits more nearly equalized than they would under wage indexing.[60]

The proponents of price indexing also argue that, considering the likelihood of strong public disapproval of declining replacement rates,

60. Under wage indexing, the benefits of the most recent retirees tend to have larger purchasing power than those of earlier retirees, because benefits in current-payment status are adjusted only by CPI changes. This happens because the benefit at retirement is a certain percentage of what is, in essence, final pay, and because earnings levels have increased more rapidly than the CPI. For example, if, over a decade, earn-

this approach is more flexible and allows Congress significant leeway to liberalize the benefit levels. In other words, the reduction in cost due to price indexing as against wage indexing offers the opportunity to do this, thus increasing costs to the level that would result under wage indexing.

Those who support the wage-indexing procedure point out that it both produces a significant cost reduction compared with the coupled procedure of the 1972 Act and results in a rational, reasonable benefit structure that can be maintained into the indefinite future. They go on to point out that, under price indexing, as a result of the likely declining replacement rates, the benefit level will have to be increased from time to time (as its proponents themselves admit). Thus, its apparent large cost savings are probably illusory and are not likely to materialize. In fact, the apparently necessary sporadic revisions by Congress if price indexing were used might produce *higher* costs than would arise under wage indexing.

The advocates of wage indexing point out that its characteristic of stable replacement rates is considered sound in the design of private pension plans and therefore should be used for OASDI. Furthermore, there are great difficulties in designing private pension plans (including adequate financing provisions) if they are to coordinate or integrate with an OASDI system which is known in advance to be unstable and certain to need changes in benefit levels and design in the future.

With regard to the matter of merely maintaining the purchasing power of the benefits (as the price-indexing procedure does), the advocates of wage indexing argue that the important thing in people's economic lives is to maintain their *relative* preretirement standard of living. This is done by having stable replacement rates for each of the various levels-of-earnings classes and then indexing benefits in current-payment status by the CPI.

Actual Decoupling Procedure Adopted

All major organizations interested in the OASDI program, as well as the various branches of the federal government concerned with it, believed that decoupling was essential. Both the Ford and Carter administrations, after thorough consideration, recommended wage indexing rather than price indexing. So, too, did all major business

ings rose by 50 percent and the CPI rose by 40 percent, then the *initial* benefit of a person who retired a decade ago would have been only two thirds that of a current retiree, and currently (after the 40-percent increase) would still be only 93⅓ percent as large (140 percent of 66⅔ percent).

organizations (Chamber of Commerce of the United States and National Association of Manufacturers), insurance organizations (American Council of Life Insurance and National Association of Life Underwriters), and labor (AFL–CIO) and senior citizen groups (American Association of Retired Persons and National Council of Senior Citizens).

Bills embodying price indexing and bills embodying wage indexing were introduced in Congress by several members. However, both the House Ways and Means Committee and the Senate Finance Committee overwhelmingly supported the wage-indexing approach, and all versions of the 1977 Act as it was being enacted were of this form.

Within the general context of the wage-indexing procedure, there were several options as to a specific way to implement it. Perhaps most important was the question of what level of replacement rates should be attained over the long run. Both the Ford and Carter administrations advocated a smooth-junction approach, such that, in the initial year of operation, the decoupled method would, on the average, produce the same benefit amounts for retirees as the previous coupled method would have done. For cases where the new method would produce a lower amount, there would be a guarantee applicable for a few years' cohorts that the PIA would not be less than the PIA determined from the previous coupled formula frozen at the time of the changeover (with CPI adjustments only after entry onto the roll).[61]

The foregoing approach was supported by all groups except business and insurance, which advocated a 10-percent reduction ultimately in the replacement rates under the decoupled formula, but with a long phasing-in period. The justification for the proposed reduction was the overliberalization of the benefit level since the early 1970s, due both to legislation and to the gradual operation of the technically faulty automatic-adjustment provisions.

The 1977 Act did reduce the level of replacement rates by an average of about 7 percent. This was done by a decrease of 5 percent in the benefit percentage factors that were adopted and by a further 2 percent, on the average, for another reason (to be described subsequently).

Another important decision was whether to index the earnings record for retirement cases to the time of retirement (defined as the

61. The proposal of the Ford administration would have done this for disability and survivor cases. The proposal of the Carter administration provided for a sharp break for these categories (particularly for those at the youngest ages, but not at all at the middle and older ages) by having the ultimate (and lower) level of replacement rates effective immediately for 1979 deaths and disabilities; this was done because, due to a technical flaw in the previous law, the benefits for those at the youngest ages were unduly high compared with those for older persons.

initial month of entitlement, based on filing a claim) or to the earliest time of eligibility (i.e., age 62).[62] At first glance, the time-of-retirement or entitlement basis seems more logical, and the proposals of both the Ford and Carter administrations used this approach. However, it contains significant difficulties, because "retirement" is not a precise matter, and quite different results would occur under this basis when different filing dates were involved. People often could not make the best decision because of the complexities involved and because future events could have important effects. At the same time, Social Security offices could not always give the "right" advice.

Accordingly, it seemed preferable to adopt the time-of-eligibility approach for determining the indexing year, because it involves a fixed year for each individual for the indexing based solely on year of birth (actually, year of attaining age 60) for the computation of the retirement benefits. Congress adopted this basis, and it is contained in the 1977 Act.

One feature of indexing on the time-of-eligibility basis is very significant. Those who continue in covered employment beyond the minimum retirement age of 62 do not have their earnings after the year of attaining age 60 indexed, and they use the same benefit formula regardless of year of retirement. They do, however, receive the benefit of all CPI increases that occur in and after the year of attaining age 62. The net effect is that the replacement rates as measured against the final earnings (which have been assumed to be increasing from year to year) are lower than at age 62, and also lower by a greater amount than they would have been under the previous coupled procedure.

For retirement at ages beyond 65, the increase in the Delayed-Retirement Credit as a result of the 1977 Act (from 1 percent per year of deferment to 3 percent) substantially offsets this decreasing effect of the indexing procedure.[63]

As a result of this feature of the indexing procedure for those who retire after age 62, there is a further lowering of about 2 percent (on

62. Actually, for administrative reasons and due to the necessary lag in obtaining the data needed for the indexing process, the indexing year is the *second* year before the year of disability or death if prior to age 62, or before the year of retirement or of attaining age 62 (whichever of those two alternatives is adopted). The effect of the two-year lag as against indexing to the year before the event (or even to the year of the event) is offset and virtually counterbalanced by the use of somewhat larger benefit percentage factors than would be used if less of a lag were involved.

63. Thus, despite widespread belief that the increase in the deferred-retirement increment was for the purpose of encouraging delayed retirement, actually it was done primarily to offset the decreasing effect of the indexing procedure on replacement rates. On the other hand, the increase in the DRC to 8 percent (ultimately) as a result of the 1983 Act was definitely done to encourage delayed retirement.

the average when measured against all beneficiaries) in the replacement rates as compared with previous law, making a total reduction averaging about 7 percent. Actually, this varies from 5 percent for deaths and disabilities before age 62 and retirements at age 62 to about 10 percent for retirements at age 65 or over.

Still another option is as to which people will have the new decoupling procedure applicable. One way would be to make the procedure applicable to all who are not entitled (by filing a claim) to benefits before the effective date (January 1, 1979). This, however, would involve problems of choice (as mentioned previously for indexing by entitlement date). Accordingly, the demographic or eligibility basis was adopted, and the new decoupled procedure is applicable only to disabilities and deaths of persons who had not attained age 62 by January 1, 1979, and to retirement benefits for persons who attain age 62 after 1978.[64]

Another question is what series of wages is to be used for the indexing of the earnings record. The best data for the past (1951–77) were those for average *taxable* wages per person with covered employment in the first quarter of each year (annualized). These were closely indicative of average *total* wages, because the maximum taxable earnings base has little effect in the first three months of a year. Because of the change from quarterly to annual reporting of wages in 1978, the basis for the data had to be changed. From 1978 on, the wage data to be used will be those on an annual basis for all workers in the country (whether or not in covered employment) as reported for income-tax purposes. Naturally, these two series (1951–77 and 1978 and after) are not comparable, and they have been linked together in a consistent manner.[65]

Finally, there is the matter of what transitional-guarantee provision should apply for those to whom the new decoupling procedure is first applicable, so that there is not too sharp a difference in benefit amounts as compared with what would have occurred under previous law. The guarantee would involve the coupled computation method under previous law, but with the limitation that the benefit table (i.e., benefit formula) thereunder would be frozen in its form as of the end of 1978. CPI increases would not apply until the year of entry onto the roll if indexing is done on the entitlement basis, or until the year of attaining age 62 if indexing is done on the eligibility basis.

One alternative would be to make this transitional guarantee appli-

64. All other persons continue to have the benefit-computation procedures of the previous law applicable to them.

65. Note that what is important is the relative year-by-year changes in the series, and not the absolute sizes of the figures for average wages.

cable to all future beneficiaries, although recognizing that its advantages would rapidly "wash out" in a few years for almost all persons. The 1977 Act took the restrictive approach of making the guarantee applicable *only* to persons who attained age 62 in 1979–83, and then only for retirement benefits and for survivor benefits where death occurred in or after the month of attainment of age 62.

Another matter in connection with the transitional guarantee is whether computations or recomputations of benefits may use earnings in or after the year of attaining age 62. The 1977 Act does not permit this, thus resulting in a more rapid phasing-out of the guarantee, but causing certain anomalies (as discussed next).

Potential Problems and Difficulties with Decoupling Procedures

Those who believed that the wage-indexing decoupling procedure was the proper action think that the 1977 Act did an excellent job and that no crucially important problems and difficulties remain. On the other hand, the advocates of price indexing continued to believe that this approach is needed to further reduce long-range costs and thus lower (or even eliminate) the estimated long-range actuarial deficit which remained after the enactment of the 1977 Act. The supporters of wage indexing countered with the arguments that the reduction of long-range costs by price indexing is illusory (because ad hoc increases will be made to offset the falling replacement rates which would probably occur) and that other means could be adopted to eliminate any actuarial deficit arising (e.g., raising ultimate tax rates or increasing the NRA).

One problem with the existing computation method is the significant difference in retirement-benefit amounts between those retiring at age 65 in 1982 and those retiring at age 65 at the end of the previous year (or at any later ages, as between these two cohorts). For example, for persons with maximum covered earnings in all past years, the PIA at the time of the award in the early part of the year for the 1982 cases was \$679.30, as compared with \$789.20 for a person who attained age 65 at the end of 1981 and retired in early 1982. The reason for this difference is that the 1982 case used the transitional-guarantee method (as being slightly more advantageous than the AIME formula) but could *not* use the wages at ages 62–64 in the computation. If the law had permitted such wages to be used, this notch problem would have been solved, or at least greatly alleviated. In the foregoing case, the PIA for the 1982 case would have been \$782, instead of \$679, and thus comparable with the PIA of \$789 for the 1981 case.

Although the approach just described would have solved the problem in an adequate manner, it had two disadvantages. First, it would have involved a substantial additional cost to the program over the next few years. Second, because it was not enacted in 1979, it would have been difficult and costly to administer if it were enacted much later.

Another solution would have been to approach the problem from the other direction—namely, to give smaller benefit increases with regard to the benefit recomputations based on earnings after 1978 for persons who attained age 62 before 1979. Such increases would have been determined from the *increase* in the PIA computed under the AIME method which is derived from earnings after 1978 (this would be done even though the original PIA computation could not be under the AIME method). At the same time, the 3-percent DRC would be applicable for all years after 1978 for all individuals.

This latter approach would have resulted in a considerable savings in cost to OASDI. Note that it would not have had any effect on persons who attained age 62 after 1978. It would not have been unfair to those who attained age 62 before 1979, because they would have received increases in benefits with respect to earnings after 1978, but not the overgenerous increases under present law.

Even though this proposal was not enacted in 1979, it could still have been partially effective if enacted in 1981. Then, it would have had to be modified by relating only to earnings after 1980 for those who attained age 62 before 1979. Likewise, the 1-percent DRC would apply through 1980, and the 3-percent one would apply thereafter. Actually, the administrative personnel of the Social Security Administration, who had opposed this approach at congressional hearings in 1980 because of alleged administrative problems, agreed in 1981 that it was feasible—and, in fact not at all difficult to administer. But, by then, it would have been only marginally effective in diminishing the notch; nonetheless, the Reagan administration did include such a proposal in its legislative program for 1981, but due to the legislative deadlock because of the political controversy over the administration proposal for major changes in May 1981, there was no vehicle for enacting it.

The only other problem with the present decoupled benefit-computation method was mentioned previously—namely, when the CPI increases more rapidly than wages over an extended period of years. This unlikely situation, if it should occur again (as it did in 1978–81), would probably necessitate revision of the method of automatically adjusting benefits for those in current-payment status. The 1983 Act does this in part, but only when the trust-fund ratio is very low.

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Appendix 3-5

Analysis of Replacement Rates under 1935 and 1939 Acts Relative to Those under Present Law[66]

In recent years, considerable emphasis has been placed on the relative gross replacement rates of the OASDI benefits when the scope of the

66. The idea for the analysis presented here was first suggested to the author in 1977 by Lawrence H. Thompson, Associate Commissioner for Policy, Social Security Administration in 1981.

program is discussed. The material in Chapter 2 in connection with Tables 2.10 and 2.11 deals broadly with this matter with regard to present law, and Appendix 2-10 examines it in more detail.

At times, people assert that the OASDI benefit level has been overexpanded over the years.[67] They tend to believe this because they consider only the dollar figures involved—for example, the average old-age benefit (without allowance for auxiliary benefits) was about $23 per month at the end of 1940, compared with $602 in early 1991. What is significant, for proper analysis, are the relative levels, because both the value of the dollar and general wage levels have changed so drastically over the years.

This appendix analyzes the replacement rates for various earnings levels under the original 1935 Act (which was superseded by the 1939 Act before it became effective for benefit payments) and under the 1939 Act. The results will be compared with the replacement rates that will ultimately apply under present law, to see whether or not relative expansion of the benefit level has occurred.

Table 3.5 presents the results of this analysis for three earnings levels and for the minimum and likely maximum coverage periods (applicable only to the 1935 and 1939 Acts, because under present law, the benefit amounts for steady workers do not depend on length of coverage). The replacement rates for minimum-coverage periods were quite low for both the 1935 and 1939 Acts, especially the former (because the latter had as one of its goals more adequate benefits in the immediate future).

For the maximum-coverage periods, the 1939 Act significantly *lowered* the replacement rates for single workers. This law placed more emphasis on the benefit level in the near future. Also, auxiliary and survivor benefits were added. As a result, the replacement rate for a male worker with a wife of the same age was higher in the short range and somewhat higher even in the long range.

A significant comparison is between the maximum-coverage rates under the 1939 Act, as representing the long-range initial goals of the program after auxiliary benefits had been provided, and the rates under present law. As can be seen from the last two columns of Table 3.5, there is quite a close correspondence of the figures. The slope of the curve moving from low earnings to maximum earnings has been slightly reduced,[68] meaning that, insofar as the primary ben-

67. For example, William E. Simon, formerly Secretary of the Treasury, in his book *A Time for Truth* (New York: Berkley, 1979), stated about the OASDI system: "Originally conceived of as a modest assistance plan to supplement individual savings, an earned right, it is now conceived of as a state-financed lifelong pension" (p. 219).

68. The maximum earnings level used for the figures for present law (based on $29,700 in 1981 and the comparable bases for subsequent years) is somewhat lower

TABLE 3.5. Comparison of Replacement Rates for Single Steady Workers Retiring at Normal Retirement Age under 1935 Act, 1939 Act, 1950 Act, and Later Laws for Various Earnings Levels and Lengths of Coverage*

Act	Earnings Level* Low	Average	Maximum
1935			
Minimum coverage	30.0%	20.0%	10.0%
Maximum coverage	73.0	58.0	34.0
1939			
Minimum coverage	41.2	28.8	16.5
Maximum coverage	57.2	40.0	22.9
1950	44.7	30.0	26.7
1952	45.2	30.3	28.3
1954	47.6	34.0	31.0
1958	46.7	34.2	31.8
1965	44.2	33.5	30.5
1967	46.9	36.3	33.5
1969	51.7	40.3	38.6
1971	53.5	43.0	39.4
1972	62.7	51.2	42.7
1975	70.2	55.9	42.6
1977 (present law)†	55.5	41.1	27.4

*As to earnings level, the average is taken as $1,000 for both the 1935 and 1939 Acts (because wages were relatively stationary in the late 1930s); the average for the 1950 Act and for present law is based on the wage-indexing series (see Table 2.18). The low level is taken as approximately 45–50 percent of the average level, and the maximum is taken as the $3,000 earnings base for both the 1935 and 1939 Acts and the $29,700 earnings base in 1981 for present law (as it would be automatically adjusted in future years). The minimum coverage was five years for the 1935 Act and three years for the 1939 Act; length of coverage for steady workers has no effect on benefits under present law. The maximum coverage was taken as 43 years (from age 22 to age 65) for both the 1935 and 1939 Acts (actually, 43 years was the maximum creditable for the maximum-earnings case under the 1935 Act). See Table 3.1 for the benefit formulas for the 1935 and 1939 Acts.

†From Table 2.10.

Note: *Replacement rate* is defined as the ratio of the annual rate of benefit payment as of the date of retirement at the beginning of the year to the annual earnings in the previous year.

efits are concerned, current law stresses social adequacy somewhat less. However, in the aggregate—and especially for workers with

relatively than that used for the 1939 Act ($3,000 as of the late 1930s). The $29,700 base covered 90 percent of all earnings in covered employment, while the $3,000 base covered 92 percent. An earnings base of about $36,000 in 1981 would have been needed to cover 92 percent of all earnings in covered employment.

about average earnings—there has been little *relative* expansion of the primary benefit level over what was ultimately intended in the 1939 law.

It is more significant to make a comparison between the replacement rates under the 1950 Act and those ultimately anticipated under the present law. As compared with the 1939 Act, a significant change, especially with regard to steady workers, was made in the 1950 Act by eliminating any dependence of the benefit amount on length of coverage. As a result, benefits in the early years were increased, while at the same time benefits payable in years in the distant future were decreased, as a trade-off. In fact, this is why the change was made—so as to increase benefits in the early years[69] and yet not increase the average long-run costs of the program. Thus, the replacement rates for workers with average earnings (and also for workers at other earnings levels) were increased by the 1950 Act for the near-future years as compared with the replacement rates under the 1939 Act for workers with relatively short coverage, including not only those newly covered by the 1950 Act but also (to a somewhat lesser extent) those whose coverage began in 1937.

After 1950, and up through the 1965 Act, the replacement rates under the various laws remained relatively unchanged (although there was a significant increase for the average and maximum cases in the 1954 Act). Then, subsequent legislation up through the 1972 Act (which also affected the situation in 1975, as the PIA benefit formula was automatically adjusted) significantly increased the replacement rates for all earnings levels. In the 1969, 1971, and 1972 laws, this resulted from the ad hoc changes, while in 1975, it resulted from the faulty benefit computation method (which was corrected and partially compensated for by the 1977 Act).

The ultimate replacement rates under present law (which have now been achieved, after the transition from the higher level resulting from the faulty method contained in the 1972 Act) are at about the level under the 1969 Act but are significantly above the levels in the 1967 Act and in the acts of the preceding period back to the 1950 Act.

In summary, the analysis of the data presented in Table 3.5 could be considered in two separate ways, with different results. On the one hand, it is correct that the present benefit level is about the same as that *ultimately* contemplated in the 1939 Act (when the situation is considered from a relative standpoint).

69. Part of the rationale for increasing replacement rates for those with short covered careers after 1950 was to take into account the fact that coverage was extended to new groups of workers in 1951. Under the new benefit formula of the 1950 Act, the newly covered workers were not penalized for their lack of coverage before 1951.

On the other hand, it can be argued that the 1950 legislation involved the theory, which has been continued ever since, that the same relative benefit level should be applicable in all future years. This was achieved in 1950 by raising the relative benefit level in the early years and lowering it over the long run. Under this approach, it could then be argued that, properly, the current relative benefit level should not be as high as that initially contemplated in the 1939 Act for the ultimate condition. The reason for this is that there had been the trade-off of higher benefits in the early years of operation under the 1950 and subsequent laws for lower ultimate ones and that now there should not be a shift so that the ultimate level would be higher than the average level which was "bargained for" in the 1950 Act.

The level of primary benefits for the ultimate condition under the original 1935 law is actually significantly higher than under present law. The addition of auxiliary and survivor benefits, of course, accounts for this difference; this was a move away from individual-equity principles and toward social-adequacy ones.

Appendix 3-6

Comparison of Actual OASDI Benefits Payable in 1975 with Those That Would Have Been Payable if Automatic-Adjustment Provisions Had Been Enacted in 1965

Table 3.6 shows the annual increases in the OASDI benefit level that would have occurred after 1965 (and through 1975, when the automatic-adjustment provisions first became effective) if the automatic-adjustment provisions for benefits had been enacted then instead of in 1972. It is assumed that the provisions would have been first effective for June 1967 (because the 1965 Act increased the benefit level effective for January 1966) and that no ad hoc benefit increases would have been made.

The result would have been benefit increases for June of each year except for 1967, when the 3-percent trigger point would not have been reached. The cumulative real increase in benefits through 1975 is indicated by the fact that the benefits payable for June 1975 as compared with those for 1966 would have been 63.6 percent higher under the automatic-adjustment method, or only about 60 percent of the actual increase of 105.6 percent. To put it another way, there was a real increase in the benefit level over what was called for by adjustment only for changes in the cost of living of about 26 percent from 1966 to 1975 (205.6 relative to 163.6).

TABLE 3.6. Derivation of OASDI Benefit Increases Which Would Have Resulted if Automatic-Adjustment Provisions Had Been Enacted in 1965, Effective for 1967

Year	CPI for First Quarter of Year*	Increase in CPI		Actual Benefit Increase Legislated†	
		From Previous One	Cumulative	In Year	Cumulative
1966	95.9	—	—	—	—
1967	98.7	2.9%	2.9%	—	—
1968	102.3	3.6	6.6	13.0%	13.0%
1969	107.3	4.9	11.8	—	13.0
1970	113.9	6.2	18.8	15.0	30.0
1971	119.5	4.9	24.6	10.0	42.9
1972	123.7	3.5	28.9	20.0	71.5
1973	128.7	4.0	34.1	—	71.5
1974	141.4	9.9	47.4	11.0	90.4
1975	157.0	11.0	63.6	8.0	105.6

*On the base of 1967 = 100.
†Shown in the year when first effective.

Appendix 3-7

Illustration of How Automatic-Adjustment Procedure Would Have Affected Maximum Taxable Earnings Base if Enacted in 1965

An interesting demonstration can be performed with regard to the level of the earnings base in 1965–78 and the effect that automatic-adjustment provisions might have had as compared with the ad hoc legislative changes actually made. It is assumed that the procedure was adopted in 1965, when the procedure for the Workers' Compensation offset against disability benefits was enacted (effective for 1966 and thereafter). Let it be assumed that the procedure was based on the $6,600 earnings base that was then enacted for 1966 and was thus first effective for 1967. The requirement that the earnings base cannot be changed unless an increase in the cash-benefits level is made will be ignored.

Table 3.7 shows the average wage for each year during 1965–75 and the percentage increase from one year to the next. Also shown are the resulting earnings bases that would have resulted from the application of the automatic-adjustment provisions, as contrasted with the actual bases that were in effect. The bases resulting from the automatic-adjustment provisions closely parallel the actual ones for 1967–72 (except for 1970–71), but are significantly lower for

TABLE 3.7. Derivation of Maximum Taxable Earnings Bases Which Would Have Resulted if Automatic-Adjustment Provisions Had Been Enacted in 1965, Effective for 1967

	*Annualized Average Wage in First Quarter**			
Year	*Amount*	*Increase from Previous Year*	*Base Resulting from Automatic Adjustment*	*Actual Base*
1965	$4,658.72	—	†	†
1966	4,838.36	3.86%	$ 6,600	$ 6,600
1967	5,213.44	5.57	6,900	6,600
1968	5,571.76	6.87	7,200	7,800
1969	5,893.76	5.78	7,800	7,800
1970	6,186.24	4.96	8,400	7,800
1971	6,497.08	5.02	8,700	7,800
1972	7,133.80	9.80	9,000	9,000
1973	7,580.16	6.26	9,000	10,800
1974	8,030.76	5.94	10,500	13,200
1975	8,630.92	n.a.†	11,100	14,100

*These data are used in the indexing of earnings records for benefit-computation purposes under the 1977 Act (see Table 2.18).

†Not applicable.

1973–75. In fact, the $13,200 base actually in effect for 1974 would have been only $10,500 if the automatic-adjustment provisions had been applicable since 1966, or about the same level as the actual base for 1973. The same relationships would have held true for 1976–78 when the base was automatically adjusted from the foundation of the 1975 base.

Appendix 3-8

OASDI Proposals of Reagan Administration in 1981

When President Reagan took office in early 1981, he made certain preliminary proposals affecting the OASDI program as part of his Program for Economic Recovery. Among the guidelines for reducing the national budget were two which would affect any OASDI proposals—to "preserve the social safety net" and to "revise entitlements to eliminate unintended benefits."

These preliminary proposals were as follows (those actually enacted being indicated by an asterisk):

1. Eliminating the regular-minimum benefit, effective in August, for current and future beneficiaries.* The administration noted that this benefit, to a considerable extent, provided windfalls for individuals whose employment was primarily covered by other retirement programs. (Legislation in December 1981 modified this change, so that it only applied to persons first becoming eligible after 1981.)
2. Eliminating benefits to students aged 18–21 pursuing higher education, effective for August, with a three-year phaseout for current beneficiaries, and eliminating benefits for students in elementary or secondary school upon attainment of age 19.* The administration observed that such payments were unrelated to educational costs incurred and that other federal student assistance programs were a more appropriate source of educational assistance.
3. Establishing a "Megacap" for disability benefits, an extension of the Workers' Compensation offset to apply to various other types of public disability benefits.* This change assured that the disability benefits that a person receives from various public sources will not exceed prior net earnings. The offset applies until age 65 is reached (rather than until age 62).
4. Tying eligibility for disability benefits more closely to recent work under OASDI by reinstituting the "currently insured" test—6 QC in the 13-calendar-quarter period ending with the quarter of disability.
5. Eliminating the use of trust-fund monies to pay for vocational rehabilitation services for disabled beneficiaries. (Later legislation reduced such reimbursements, by restricting them to cases where successful rehabilitation occurs.)
6. Eliminating the lump-sum death payment unless there is a spouse who was living with the worker, or there is a spouse or child eligible for immediate monthly survivor benefits.*
7. Rounding of benefits to the nearest multiple of 10 cents, rather than the next higher dime.* (Later legislation went beyond this, by providing for rounding the final benefit amount—after deducting any SMI premium—to the next lower even dollar, if not already exactly an even dollar.)
8. Providing for reimbursement to the trust funds for expenses incurred in providing earnings information required to enable employee benefit plans to comply with the Employee Retirement Income Security Act (ERISA).*
9. Allowing retroactive payment of widow's or widower's benefits for one month (but not before the month of death of the

worker)—an exception to the general bar to payment of retroactive reduced benefits.*

10. Continuing the benefits of a disabled widow or widower who marries a retired or disabled worker.*
11. Correcting a technical error in the maximum-family benefit provision to avoid possible benefit reductions when earnings rise more slowly than the CPI.*

On May 12, Secretary of HHS Schweiker announced a package of OASDI reform proposals designed to encourage work at later ages, reduce windfall benefits, relate disability benefits more closely to work history and medical condition, reduce welfare elements, and adjust financing provisions. The proposals as to coverage and benefits were as follows:

1. Tax and credit toward benefits all sick pay during the first six months of illness (enacted in December 1981).
2. Change the closing point for calculating the AIME for benefit-computation purposes from age 62 to 65.
3. Increase the dollar bend points in the PIA benefit formula for each year during 1982–87 by 50 percent of the increase in the average annual wage, instead of by 100 percent.
4. Reduce the benefit rate for early-retirement benefits at age 62 from the present 80 percent of the PIA to 55 percent (with proportionate changes for other ages at retirement between 62 and 65), effective for persons attaining age 62 after 1981.
5. Eliminate benefits for children of retired workers while the workers are aged 62–64.
6. Provide that the MFB provision currently applicable to disability beneficiaries (lowered as a result of the 1980 Act) would also be applicable to retirement and survivor beneficiaries.
7. Eliminate the windfall portion of benefits for persons with pensions from noncovered employment by using a more proportionate PIA benefit formula, instead of the existing heavily weighted one in such cases (specifically, by changing the first benefit factor from 90 percent to 32 percent, the same as the second benefit factor). This change was essentially made in the 1983 Act, except that the first benefit factor was made 40 percent.
8. Consider only medical factors in making determinations of disability (i.e., do not consider nonmedical, vocational factors), which was the original concept.
9. Require that a person's disability be expected to last for at least 24 months, instead of only 12 months as under present law

(roughly equivalent to the original concept), for the person to qualify for disability benefits.

10. Increase the waiting period for disability benefits from five months to six months (the original requirement, until 1972).
11. Increase the insured-status requirements for disability benefits from 20 QC to 30 QC in the 40-quarter period preceding disability (with a proportionate change for those disabled before age 31).
12. Change the automatic cost-of-living benefit adjustments to a fiscal-year basis, by moving the date for the adjustment from June to September. The 1983 Act went beyond this by providing for a six-month delay.
13. Increase the annual exempt amount under the retirement earnings test for persons aged 65 and over to $10,000 in 1983, $15,000 in 1984, and $20,000 in 1985 and then eliminate it in 1986.

As to financing provisions, the proposal would institute interfund borrowing between the OASI and DI Trust Funds and from the HI Trust Fund. Also, the scheduled OASDI employer and employee tax rates would be reduced by 0.1 percent each in 1985–89, by 1.2 percent each in 1990–2019, and by 0.1 percent each in 2020 and after (with corresponding proportionate reductions for the self-employed rates). Also, automatic tax-reduction procedures would apply when the ratio of trust-fund assets to annual expenditures exceeds 55 percent. After such a ratio has been achieved, tax-rate increases would occur when the fund ratio drops below 50 percent. As a result, the ratio would stay at a relatively constant level over the years.

These proposals—particularly the elimination of the regular-minimum benefit and the reduction in early-retirement benefits—created considerable political conflict. Many persons were opposed to any benefit reductions, and some believed (quite wrongly) that the OASDI program did not have any financing problem, and so the intent of the Reagan administration was really to do away with the program.

The elimination of the regular-minimum benefit was criticized on the ground that this was "hurting poor people" (despite a "safety-net" provision related to the SSI program). Actually, the vast majority who qualified for this benefit were not "poor"; they were people who had been in covered employment for only short periods and often were receiving substantial pensions from noncovered work. Nonetheless, it is humanely and politically difficult to take benefits away from people, and so the final result of eliminating this benefit only for future new eligibles was a reasonable compromise.

The sharp reduction in early-retirement benefits, to be effective almost immediately, was met with a storm of criticism from those near age 62 (and even from those then aged 62–64, who would actually not be affected). This sudden effectiveness was, at least in part, due to the very sizable budget effects that it would have (which is not, in the author's view, a proper argument for such a change). Some persons argued that, although this procedure might be desirable in the long run, it should be slowly phased in over several years.

But there was a much more important argument against this proposal which was not brought out by the critics. Persons who retire early are not compelled to take reduced benefits at age 62, but rather they can delay accepting benefits until age 65, when no reduction would apply. As a result, persons with ample resources or, more important, with a private pension (which could be adjusted actuarially so as to give larger amounts before age 65 in exchange for smaller amounts thereafter) could avoid the proposed larger-than-actuarial reductions by not taking their OASDI benefits until age 65. Thus, those who would be discriminated against by this change would tend to be lower-income persons, because others could avoid it—hardly an appropriate situation in a social-benefits program!

There was considerable public criticism—especially by those of the expansionist philosophy—that benefits were being cut drastically by the proposals of the Reagan administration. The figure of a 25-percent reduction was often used—and, in fact, was quoted by Senator Mondale in his campaign for the presidency (in his debate with President Reagan on October 7, 1984). The impression was often given that this was an immediate or near-future cut for present beneficiaries.

In fact, the package, along with a few other proposals made earlier in 1981, would have resulted in a decrease of 21.7 percent in benefit costs over the long run (75-year valuation period). But at the same time, the tax rates payable by employers and employees would have been reduced by 7.0 percent relatively—and the financial solvency of the program over the long run would have been restored. Under the intermediate-cost estimate, benefit costs in 1982–86 would have been reduced by only 8.1 percent (not 25 percent), while the tax reductions would have been 5.1 percent.