

“Some Observations on the United States Social Security System ”

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Summary

The paper would concentrate on the US Old-Age Insurance program with side comments on the survivors, disability, and medicare programs. The thrust of the paper would be that the fundamentals of the current system were well thought out before the programs were enacted, that the system has served well, that the current attention to "fix" the program is unnecessary and perhaps politically rather than logically motivated, and that suggestions to change the program to an individual investment accumulation would both do violence to some fundamental goals and possibly not lead the expected results of the proponents. It is possible that these thoughts would be of interest to actuaries from other countries who are helping to design social programs for their country.

"Quelques observations au sujet du système américain de la sécurité sociale"

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Résumé

Le caractère du système américain de sécurité sociale reflètent de façon logique les attitudes du peuple américain envers leur gouvernement. On a fait les lois bien pensées après suffisamment d'avis actuariel. Pour la plupart, le système opère comme prévu, quoiqu'il y ait des propositions de changements qui visent une meilleure réalisation des buts originaux. En dépit de la rhétorique des hommes politiques, les programmes qui assurent les prestations en cas de décès, d'invalidité et pendant la vieillesse n'éprouve aucun problème financier qui ne peut être remédié par un ajustement de l'âge de retraite.

Les propositions d'adoption d'un système de comptes individuels se basent sans doute sur des hypothèses fausses au sujet des rendements d'investissements. Un tel système irait d'ailleurs à l'encontre des buts de base du système originel. On peut raisonnablement attribuer au système de livraison des soins médicaux, plutôt qu'au système de la sécurité sociale, les problèmes d'assurance-santé des citoyens âgés.

Mots-clés

Sécurité sociale, assurance-santé, fiscalité, âge de retraite, capitalisation, couverture universelle, prestations mensuelles, niveau de subsistance, régime de prestations lié aux ressources, survivants, invalidité, comptes individuels.

SOME OBSERVATIONS
ON THE UNITED STATES SOCIAL SECURITY SYSTEM
OASDI and MEDICARE

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SOME OBSERVATIONS ON THE UNITED STATES SOCIAL SECURITY SYSTEM

OASDI and MEDICARE

Government sponsored social security systems abound throughout the world, with major differences in approach. It might be useful to actuaries in other countries to hear a discussion of why some parts of the U.S. system were designed as they were. Social problems abound in the U. S., including racism, drug abuse, single mothers, illegal immigration, and the inevitable problem of the few who fall “between the cracks” of programs. There are well over a dozen federal social security programs, but the only ones discussed here are the old age, survivors and disability income programs referred to here as OASDI, or OA for the retirement portion alone, and in a later section, Medicare which provides medical and hospital assistance to the aged.

There has been plenty of recent political discussion about OASDI, including debate in the last Presidential elections. Most discussions begin with an assumption that it must be saved by “fixing it”. It is this author’s contention that there is nothing fundamentally wrong, that the system has operated as designed for over six decades and that the system should basically be left alone, with only some minor problems that need to be addressed.

The opinions expressed here are those of the author alone, and disagreement with many of the observations might not be hard to find. Also, these comments are mostly a result of the author’s memory rather than a study of the records, leaving the possibility of omissions or mistakes in details. However, this paper concentrates on concepts, not details .

A fundamental concept which permeates all U.S. government institutions is a deep-seated distrust of concentration of power or control. This distrust probably follows directly from the reasons the USA was formed, by declaring independence from the government of Great Britain, which at that time treated the colonies in the Americas very highhandedly. Checks and balances are everywhere in U.S. government institutions: Federal vs. State’s rights; three branches of government with essentially equal power, legislative, judicial and administrative; three somewhat independent military branches plus National Guards with some state control; and police forces answering to local control. Even in the private sector, monopolies when needed are regulated, and anti-trust laws force competition to exist in commercial areas.

Concerns about concentration of power were at the forefront of thinking about the Social Security System during debate about its formation. A basic principle formulated early was that whatever government programs resulted from the debate should interfere with the private lives of the citizenry as little as possible. It will be evident in the descriptions which follow how these ideas permeate the resulting programs.

The original idea for social security programs seems to have stemmed from thoughts that it would be a good thing if every worker in the USA had a monthly income for life when no

longer physically able to work effectively. Such income would lessen or eliminate the need for the “dole” which was the name given to government programs for the destitute.

After much debate, a number of principles were established for such a system:

1. The benefit was to be one of three sources, each of which was to play a part in providing financial independence for the elderly. This was referred to as the “three legged stool” of financial security. First, it was expected the worker would accumulate private savings, an important part of which was to be ownership of a home, debt free if possible, and much legislation over the years has promoted that goal. The income tax laws provide incentive to own with, for example, mortgage interest and property taxes full deductible from taxable income. Numerous other programs help with mortgages, especially for first time buyers; Second, tax laws were to promote employer pension plans and private accumulations for retirement purposes, and many private and employer programs have been in place over the decades; and Third, OASDI was to provide a “floor of protection” from destitution with a monthly benefit not intended to be a major part of most retirement earnings.
2. The benefit would be as small as practical (minimum government interference). “Subsistence Level” was the phrase used to describe the intended amount, which would vary with earnings, with amounts tilted toward the lower paid. One often hears complaints from various sources that OA benefits are really not enough to live well; of course, it was not designed for that.
3. The income would be monthly, guaranteed for life, legally protected against creditors and other legal proceedings against it.
4. The program was to be paid for with contributions from the covered wages of the workers to establish a sense of entitlement, and to make it politically difficult to make changes that would reduce or take away benefits of workers after they had become eligible. The tax was to be shared equally by the worker and employer.
5. The tax was to be paid on “covered wages” intended to be maintained at about the average wage level of the country. This was intended to make the program more fair to those whose earnings were above the average level, and to make it more obvious that the plan was not a welfare program, but a benefit earned by the worker.
6. There would be no general fund contributions; the program was to be self-sufficient from worker and employer taxes.
7. Coverage would be universal, covering all workers in the country. This principle was not followed well in the beginning, but about 95% are now covered, and most of the rest are members of other plans such as state plans. Only about 1% of current workers, mostly in irregular employment, are not now covered by some plan. However, the extent to which these figures are affected by undocumented aliens, a growing problem in the USA, is not well known.

8. The retirement age was set at 65 with provisions for reduced early benefits and later in the program for increased benefits for postponed retirement. There is more discussion of this later in this paper.
9. Advance funding of the system was to be avoided, intending the system to accumulate a small fund equal to only a few months of benefits. This was a surprising decision to most actuaries, so it is important to review the reasoning behind it, and an extended discussion of that and other subjects follows this list of principles.
10. There would be provision for protection of those workers who become disabled and for the families of the workers who are disabled or who die before or after retirement. Such adjuncts to the basic program are in place and are functioning satisfactorily.
11. It was decided as a matter of principle that the benefits were to be looked at as “earned” by the worker’s contributions, thus available without requiring proof of need; or in other words, no “means test” was required. This was different from our northern neighbor Canada, who made their benefits available at 65 with a means test, and at 70 with no test.
12. In the original program any earned income after retirement was deducted from the OA benefit. Over the decades that was changed to allow earnings up to a certain level, sliding into full deduction above a higher level. A recent change in the law did away with any penalty, a mistake in the author’s view, as motivating workers to start collecting early seems counterproductive. Further, since adjustment of the retirement age (discussed later) is the major way to keep costs reasonable, this change will make the adjustment in retirement higher than it would have to be if there were restrictions against working after retirement.
13. The question of income taxes could have gone either way, but the decision was to make the worker contributions not deductible, with benefits tax free. The employer half of the contributions were automatically deductible to the employer as necessary business expenses. Since it is a general rule that all income is taxed eventually, this situation left the employer provided part of the benefits untaxed. A little over a decade ago this situation was recognized by making the benefits tax free only up to certain income levels, and on a sliding scale taxable up to 85% at higher income levels. The logic of this was that the half from employer taxes should be taxable, while the extra 35% was to account for the time value of the employer contributions made about 3 to 4 decades before receipt of benefits. The sliding scale part of this method added a partial “means test” to the program.
14. Although the problems of losses from inflation in cost of living was not addressed in the original legislation, probably because inflation was not perceived as a problem in the U. S. economy until after the OASDI program was started, a cost of living adjustment was added about 4 decades into the program. The increases are based on a consumer price index, and it was recently concluded that the index is flawed, overestimating the actual cost of living increases. The first attempt to change the

calculation failed, mostly because the index is used for so many other purposes. Actuaries will recognize the economic danger of leaving a flawed index in place for extended periods. One solution for SS might be to define “subsistence level” directly and to study it periodically to provide a basis for adjustments. The concept is a difficult one as there are major cost differences between say, a major city and rural areas. It is the authors belief that the maximum current OA benefit is above what would reasonably be defined as subsistence level in many rural areas.

DISCUSSION OF SOME CONTROVERSIAL ASPECTS

During planning, it was recognized that even with benefits equal to subsistence level, assets developed from advance funding would be large, probably the largest single accumulation in the country. If so, what was to be done with it? In other plans, trustees are charged with investing in whatever they deem appropriate, which has developed over the years into portfolios balanced between equity (i.e. ownership such as stocks or real estate) and fixed-income (i.e. promised returns such as bonds or mortgages), and almost exclusively in securities traded on the major exchanges.

A system for investing in capital markets is a feature of all developed countries, and in the USA the system is highly developed with a large body of law and regulation controlling against misuse and dishonesty, trading with insider knowledge as one example. It is crucially important to maintain a market system that provides the same opportunity to all with no special advantages to any, and maintenance of that system in the USA is almost exclusively the province of the federal government at all levels, legislative, judicial and administrative, and on a continuing basis.

So, the question for the designers of the OASDI system was, should the federal government, the primary policeman and watchdog over the investment community, also be charged with being a major investor in the same investment community? How could the inherent conflict of interest be dealt with? In the debate, it became evident that many if not most were uncomfortable with the idea, especially with an organization as political as the federal government. Investment of such a program would inevitably concentrate an enormous amount of power in the hands of a few people, with political intrigue in their appointment and actions more than possible. For those and probably other reasons, the decision was that if there was to be pre-funding, having federal government appointees invest the assets in commercial markets was not appropriate.

So, if the regular markets are not appropriate was there any other way invest that wouldn't have those problems? Well, of course the assets could be placed in US Federal Securities. Does that solve the problems? To test that, consider what happens with the funds. Excess of contributions over benefits would go to the federal government who would issue bonds, and the government then has cash. What would then happen? Investing the funds in commercial markets is no

different than described in the previous paragraph. If the funds were just kept as cash many undesirable economic results would occur. So the only thing left is to spend. The funds then substitute for other taxes, or worse, result in spending without responsibility. For any but minor amounts of funds this approach is, or at least was considered, undesirable.

Off the main subject for the moment, there is currently occurring in the USA a situation like that described above. The ratio of workers to retirees is high now from an unusually high birth rate in the decade following World War II. This will lead to an unusually high ratio of retirees to workers for a few decades. From worries about high taxes, congress decided to partially advance fund for a few decades. As a result, taxes are now unusually high, so there is an accumulation of SS taxes which are “invested” in federal securities. The result is an appearance of surplus in the federal budget (it was cash and it was spent) which led to a recent law “refunding” some income taxes. Without the OASDI taxes the federal budget has actually been mostly in a deficit position, so the refund is really a return of some OASDI taxes to the income taxpayers. Since the average income taxpayer is in a higher economic strata than the average OASDI taxpayer, the result is a transfer from lower paid to higher paid workers, or in other words, is tax regressive. Since the overall tax system in the USA is progressive, and the transfer is small compared to overall taxes, the result is only a move toward a less progressive system, but to an extent probably not completely understood by anyone. Not, in the author’s opinion a very desirable situation. This situation points out a truism, “an organization cannot advance fund any debt, pension or otherwise, by issuing its own securities. That is merely substituting one debt for another, and moving the payment from one generation to another. The only way OASDI could be advance funded is by investing in anything but federal securities. The income taxpayers in a few years will be required to pay for the cost of running government and part of the OASDI costs of that time by paying for the maturing bonds,.

Back to the main subject, if investment in both general market and federal bonds have undesirable consequences, are there other alternatives? The only other possibility seems to be to invest in purely foreign markets, either commercial stocks and bonds or foreign government bonds. For commercial securities one problem would be to find a large enough supply, as many corporations are traded world-wide, so are in the USA markets. Probably of more importance, the economic and psychological difficulties of investing funds belonging to USA workers in foreign countries government bonds or corporate securities make this an impossible or at least unlikely solution.

So, if any investment of such funds leads inevitably to undesirable consequences, what is the alternative? Is advance funding really required in this situation?. For actuaries, whose education is centered on advance funding, any suggestion to not fund is likely to cause an instinctive negative reaction. For OASDI, since all avenues of investment create undesirable results, it is necessary to analyze more deeply the reasons for and consequences of funding or not funding.

The fundamental reason to fund a plan is to have the plan’s ability to pay benefits be independent from the funding organization. Without advance funding, a pensioner is dependent

on both the continuation of the organization and the willingness and ability of management and workers of that organization to devote current income to that end. Since organizations change size, merge, fail or change in various ways, advance funding is the logical way to provide some assurance for payment of promised pensions. Is the same true of the U. S. federal government? Absent some natural or man-made catastrophe, growth of the population and maintenance of the taxing power of the government seems assured for many generations, and it seems that only something catastrophic would significantly change that, perhaps making failed pension promises the least of the problems of whatever remained of that society.

So, if continuation of the promising organization is not a problem in this situation, are there other concerns? Obviously, without advance funding, any payment of benefits is a transfer from current workers to the retired population, and that will work only if the current workers are both willing and able to do that. If such a burden were to become too large, the system would fail regardless of the taxing power of the government, as in the extreme the workers would perhaps start trading in kind between themselves, or find other ways to protect themselves. So, the workers need to be both willing and able. Do current workers owe something to previous generations? Well, certainly! Each generation owes a tremendous debt to previous generations. The first emigrants on these shores and those that followed cleared the land, connected the shores, became independent of foreign ownership, and devised and protected by fighting numerous wars a stable democratic and fair government. Anyone beginning life in the USA is given, literally free, a marvelous economic system complete with transportation, communication, and education infrastructures in place and working, with clean water, sewage disposal systems, food, health care, and employment opportunities available. In addition there are no legal restrictions on traveling or moving to find employment anywhere within the enormous geographic extent of the country. The USA education system has been harshly criticized of late, but the failures of the system are concentrated on the part of the population that for various reasons, mostly social, cause lack of motivation or inability to take full advantage of the system. For those willing to work hard, education opportunities are almost unlimited. The system isn't perfect but it is good enough that many around the world go to desperate extremes to enter the country. So, even if the workers don't often think of the debt they owe to the previous generations, it can be pointed out to them. Further, an even more potent argument is to point out to current workers that the current retired group provided for their previous generation and "if you will do the same, your turn will come".

Even if the worker can be persuaded by moral arguments or promises to be willing, the taxes must be reasonable or the program will fail. So far, the largest tax has been 6.5% of covered (roughly average) wage from the worker and from the employer. Total taxes are slightly higher to cover Medicare, but that part is a separate issue. It seems likely that doubling OASDI taxes would strain the system, and some projections show such results or worse for the present plan. So is there any solution? Of course! Every actuary will recognize the significant cost effect of raising the retirement age. The original age of 65 has been changed only slightly - under the current law workers born after 1959 have a normal retirement age of 67. Most studies of the relative lengths of working and retired lives conclude that an age around 71 would give the same

relationship today compared with the start of the system because of the dramatic improvement in health and the life span during the last century. Further, the average job in the early part of the last century was far more physical than today, so it is easier to remain employed to higher ages today. A recent magazine article studying the differences between the beginning and end of the last century stated that 63% of males over 65 were in the labor force at the beginning, and 17% at the end. It is a good bet that many of the 63% were working because they had no choice, the income being necessary for survival.

It seems that a change sometime in the future to a retirement age near 71 would keep the taxes within reasonable limits, and that, in the author's opinion is the most logical and "fair" way to keep costs reasonable. However, a common reaction to the suggestion of raising the retirement age is, "Hey, that's not fair. They got to retire at 65, why not me?".

What is fair? Consider how two generations might view "fairness" in the OASDI situation, using the generation retiring at the start of the program, in about 1937, and one retiring a century later in 2037. The latter says it's not fair if we don't get to retire at 65. The former's counter is "My generation entered the work force at 15, worked at very difficult physical jobs to 65, then got an average of 15 years of retirement. Your generation entered closer to 25, had much easier jobs, and upon retiring at 65 get 25 years of retirement. You get over twice as many retirement years for each year of work as we did, and your health at 65 is much better than ours was so you don't even need to retire at 65. That's not fair". This argument and the facts about cost leads the author to the following conclusion: If a requirement of all future generations is that age 65 (or 67 which is now the age for those born after 1969) be a permanent feature of OASDI, the plan will fail as workers will not be willing to pay the taxes required. If, on the other hand, all generations are willing to use a retirement age that balances working life with retired life in a reasonable way so that taxes are reasonable, the plan can and will work, resulting in a floor of income for all workers in accordance with the original design. The balance between working and retired life is something that must be worked out by the political system over successive generations.

Assuming the above compromises will be reached, the system to set taxes that is the most logical in the author's opinion, and one which has been used much of the time, is to project the cash flows for low, medium and high estimates out to 75 years, then set rates so no negative periods result and the plan is just balanced for, say, 40 years on the medium estimate. The period of 40 years is 10 presidential terms which is plenty of time to adjust to changing conditions, and the intent would be to periodically reset rates always aiming for the 40 year horizon.

That approach, which accumulates only modest funds most of the time, has two unfortunate consequences:

The first is that one often hears a speech containing the statement "In 40 years this plan is BANKRUPT". Though literally true, the statement is misleading and use of the word

“bankrupt” implies disaster, while the truth is the plan is always aiming for the 40 years as a moving target. The method is merely a means of keeping tax rates as low as possible while providing plenty of time to adjust. Thus, when that statement is heard it is certain the speaker either doesn’t understand, or is promoting some political agenda, or perhaps some of both.

The second is that one often hears the statement “Don’t trust the OASDI Trust Fund. It’s gone, spent, the money’s not there!” That statement is also literally true, but is not misleading. It is a fact that follows from using federal securities as the “investment” holdings of the Trust Fund. Money comes in, U.S. bonds are issued in exchange, and the money is spent, relieving the government that much of the need to collect taxes or issue other bonds to run the government. There are exactly three choices here: don’t accumulate excess funds, invest excess funds elsewhere (violating a previously discussed decision to keep the federal government out of the investment business), or ignore it. So long as the amounts are small compared to the total budget, ignoring it seems the best course, although current funds are not trivial, which has led to problems discussed earlier. This problem is merely a restatement of the fact that an organization cannot advance fund obligations using its own securities. Put more bluntly, an unfunded OASDI system transfers cost between generations. Any attempt to advance fund using federal securities fails because excess OASDI contributions just lower some other taxes for the current generation, transferring costs to a later generation (assuming the government doesn’t spend more than it otherwise would have done). Although the transfer of costs is between generations, it is of course true that different segments of the population are affected differently within each generation. Since income tax affects the higher paid more than the lower paid and vice versa, attempts to advance fund are probably tax regressive in effect. The consequence that the trust fund has been spent is also often used for political agendas, but perhaps also is often just not understood.

Political agendas abound in the current debates about OASDI. Many want to change the plan to a defined contribution type of plan, with the worker able to make decisions about the type of investments for his or her account. It is easy to see why the investment community would favor such a change as potential new clients would number in the tens of millions, but would it would be a good for society as a whole? The idea seems to be that with proper investment of the normal OASDI taxes, everyone will be rich. This idea doubtless stems from the remarkable, and certainly unusual, results of the stock market in the period from about 1982 to 2000. However, results of a longer range and of the last couple of years are not nearly so rosy, and addition of funds as large as a funded OASDI system (which this would be) into the markets would result in much more competition. Would that have a dampening affect on stock prices? It seems axiomatic that not everyone can be rich! A more disturbing concern is that when choices are given an inevitable result will be some winners and some losers. For society as a whole, having some winners is fine, but what will we do with the losers? It is a good bet that the losers will be concentrated more in the lower paid than in the higher paid. A final concern is that it is difficult, perhaps even impossible, to provide rules that assure that defined contribution accumulations won’t be exhausted before the end of the workers life. Overall, the changes proposed seem to be a significant step backward. The original concept of providing a floor of

protection with minimum government interference seems to be lost in the proposals. We could also ask why we need a federal government involved in such a plan?

Thus, in the author's opinion, the present well thought out system provides the best floor of protection for the most of the population that needs it, and no fundamental changes should be made. The proposals are almost certain to harm the lower paid portion of the population.

There are, in the author's opinion, some areas that need attention in the present plan. The aforementioned use of a flawed index to adjust for inflation is one. Allowing workers to remain in the work force while collecting benefits is another, and that will create difficulties when, inevitably, the retirement age is raised to keep taxes reasonable. The benefits are designed to vary with the income of the worker before retirement, but not proportionately, as the system is tilted toward providing nearly the same amount for everyone. The formulas to provide that have become complicated over the years, so much so that one wonders if each office or person will calculate the same benefit in the same circumstances. Further, with the intent to provide a floor of protection, and then with further protection against inflation after retirement, there seems to be no logic to having two workers both of whom always paid the maximum taxes, have different benefits just because they had different retirement years, but that is the present situation. Some simplification seems to be in order.

MEDICARE

Medicare was formed as an adjunct to the OASDI plan to provide medical care to those covered by OASDI. It has evolved beyond that. There are two parts, hospital insurance (HI) and supplementary medical insurance (SMI). HI is compulsory for those in OASDI, while SMI is voluntary and available to everyone. No general fund support is given to OASDI, but well over half of Medicare costs come from the general fund. About 95% of the population over 65 is covered by Medicare, but again undocumented aliens would affect these figures in ways not well understood.

Although Medicare is connected to the OASDI plan, the problems are so fundamentally different they can hardly be discussed in the same context. The problems of Medicare are inextricably bound up with the problems of the overall health care delivery system, which in the process of rapid change. The current system works well for workers whose jobs provide medical insurance coverage, but a significant portion of the population is denied full access to needed care. Health costs in the USA are higher as a percentage of gross national product than those of most other developed countries and climbing, so some kind of major change is inevitable and in process. The USA has steered away from socialized medicine such as that adopted by Great Britain, apparently desiring that significant free enterprise aspects should remain a part of the system. There was a failed attempt in the last presidential term to force

legislation to “fix” the system. It is probably appropriate that the attempt failed as it does not seem that solutions that would achieve wide acceptance are clearly understood.

In the circumstances only a few general comments are possible:

1. Medical coverage for the aged population is a critically important problem for the USA, and solutions must and will be hammered out in the political arena over the next few decades.
2. Use of general funds for Medicare require that the program be available to everyone, so the connection to OASDI, while perhaps convenient, is not necessary.
3. Tying the starting age for Medicare to the OASDI retirement age is, in the author’s opinion, probably doomed, as the OASDI age will inevitably increase, while political pressure to decrease the Medicare starting age will increase. Disconnecting the Medicare age from the OASDI retirement age and reducing it would probably force solutions to the health care delivery system more rapidly.
4. In discussing the cost of Medicare, money measurements sometimes just confuse the issue, as the benefits are services, not money. There are really only four elements to funding; who will be given services, what those services will be, who will provide those services, and how much the providers will be paid.. The solution to Medicare problems involves the hammering out of the compromises between those four elements. There are already elements of socialized medicine in Medicare, as limits are set on the payment for procedures.
5. The medical community is continually experimenting with extraordinary procedures to prolong life, which are enormously expensive especially at high ages. There are some hard choices ahead because unrestricted use of such procedures is not affordable, which will inevitably lead to unpopular limitations.

Whatever the final solution to USA health care delivery, Medicare will undoubtedly be a catalyst toward that solution.