

# FINANCING OLD-AGE INSURANCE

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SECRETARY MORGENTHAU'S statement before the Ways and Means Committee on March 24 marks a new phase in the consideration of old-age insurance financing in the United States. The statement of the Secretary of the Treasury presented information and recommendations based on studies and experience of the Social Security Board and the Treasury in the past 2 years. This phase is not yet closed, however, because any change in present financial provisions requires legislative action by the Congress. In order to understand the proposal, which is in essence a shift from the self-sufficient system with a large interest-earning reserve to one with a small contingency reserve, it is important both to review the earlier recommendations and experience and to take stock of the present situation.

The original proposal brought forward by the President's Committee on Economic Security called for a reserve of considerable size. The Committee's estimates postulated a reserve of more than \$15 billion to be accumulated by 1960 and held at about that level in subsequent years. This reserve was to be built up out of accumulated differences between contributions and benefit payments, invested at interest. In making its report, the Committee recognized that the plan outlined would call for a Government contribution by 1965 because of the excess of benefits over contributions in later years. Their proposal represented, in effect, a compromise between a contingency reserve and a self-sustaining system. The Committee did not recommend that the Government pay a subsidy currently because "to do so would create a reserve which would reach a total of about \$75 billion." They did indicate that "if it is deemed desirable to reduce the burden of the system upon future generations, the initial rate [of taxes] may well be doubled and . . . each higher rate advanced by 5 years."

In the course of the hearings in January and February 1935, the deficiency between definitely specified income and estimated outgo caused some concern. It led to a revision of the proposal along

somewhat different lines and put the reserve squarely on a self-sufficient basis. One reason for this modification was the limitation of coverage to workers in industry and commerce which was brought forward as a reason for a self-sufficient system. Two changes were adopted to make the plan independent of the subsidy. The benefit base was changed from average to aggregate wages, and the rate at which taxes rose in the early years was accelerated. Instead of spreading the increases in tax rate over a period of 15 years, with the consequent lower accumulations in the course of this period, the step-ups were to take place at 3-year intervals over a 9-year period. These changes increased income and cut costs for the early years. Secretary Morgenthau brought forward this new plan in the hearings before the Ways and Means Committee in February 1935.

These changes, a second step in the development of policy, called for a more rapid building up of the credits of the fund and consequently for a steeper rise in the interest earnings on this fund. In the report of the Senate Finance Committee in May 1935 tables were introduced which showed the famous \$47 billion estimate for 1980 which has been used and misused by various critics of the act and has been misunderstood even by some advocates of this manner of financing.

The Social Security Act was passed in August 1935. The tax provisions under title VIII, providing for the first 3 years a tax of 1 percent on employers and 1 percent on employees, became effective in January 1937. In the 26 months of operation through February 28, 1939, tax receipts under title VIII by the Bureau of Internal Revenue totaled \$1,097 million. Congress, in carrying out the provisions of title II, made appropriations to the old-age reserve account for the fiscal years 1937, 1938, and 1939 totaling \$1,125 million. Monthly transfers have been made from the appropriation to the account, and by the end of February 1939 a total of \$944 million had been transferred. On February 28, 1939, the old-age reserve account held Government securities totaling \$944 million, all in the form of 3-percent special United States Treasury notes. During the 2-year period, interest of \$17.7 million on the investments

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of the account was credited. About \$17 million was held in the form of cash in the disbursing account for the payment of lump-sum benefits. The difference between the transfers and the tax collections corresponds approximately to estimates of the costs of administration. Thus it is clear that the reserve account became an actuality fully incorporated into the framework of Treasury procedure.

The third step in developing policy in connection with the old-age insurance financing was the appointment in May 1937 of the Advisory Council on Social Security to consider, among other problems, the method of financing old-age insurance. The Council held six sessions in which financing was discussed at great length. In April 1938, before reaching final conclusions, the Council issued a statement intended to set at rest fears expressed in some quarters that the funds were being mishandled. After careful examination, the Council found that the procedures were not only legal but were normal operations in the course of Treasury financing and that the safety of the funds was not endangered.

The final report of the Advisory Council, issued in December 1938, goes further in analyzing the financial problem.<sup>1</sup> It indicates that the system adopted was entirely proper and justifiable on the basis of certain assumptions but that it was clearly not the only possible method of financing and that others might be equally appropriate in various circumstances. In view of this conclusion, the Council recommended further study. The members of the Council indorsed the contributory principle and urged the continuance of the tax step-up as scheduled at least until after 1940. They indicated, however, that there was not complete unanimity on this point and expressed the opinion that the reserve account was unnecessarily large and that a trust fund would be preferable because it would give greater assurance to the beneficiaries that their contributions were being handled along lines already familiar to the American public. The Council also urged a contribution out of general revenues to help finance old-age insurance and made recommendations for the liberalization of benefits.

The fourth step in this development was the report of the Social Security Board to the Presi-

<sup>1</sup> For a brief summary of the report see *Social Security Bulletin*, Vol. 2, No. 1 (January 1939), pp. 2-3.

dent and the Congress in January 1939.<sup>2</sup> While the Board declared that it was not making detailed recommendations on financing old-age insurance because of the Treasury's primary responsibility in this field, the report called attention to the highly significant relation between the extent of the coverage, a subsidy out of general tax sources, and the present self-sustaining system. The Board indicated that it was of the same opinion as the members of the Advisory Council both with respect to an eventual Government contribution to the system and to the continuance of the step-up in the tax rate.

On the matter of a Government contribution the report declared:

The Board is of the opinion that it would be sound public policy to pay part of the eventual cost of the benefits proposed out of taxes other than pay-roll taxes, preferably taxes such as income and inheritance taxes levied according to ability to pay.

The portion of the total costs to be met by taxes other than pay-roll taxes should depend upon the proportion of the general population covered by the insurance system. The wider the coverage, the more extensive this contribution from the other tax sources might properly be.

The next development, certainly one of the most important, was the recent proposal of Secretary Morgenthau to the Ways and Means Committee. The Secretary recommended, for reasons he outlined, that the reserve to be accumulated be no "larger than is necessary to protect the system against unforeseen declines in revenues or increases in the volume of benefit payments." Simultaneously he precluded possibilities of misunderstanding by asserting, in no uncertain terms, that "a sound old-age insurance system must be on a contributory basis."

Mr. Morgenthau proposes a new plan of financing which is based, on the one hand, on long-standing Treasury precedent, and, on the other, on new industrial and economic information which could not have been anticipated before actual operation of the system. His three major recommendations comprise (1) setting a standard which operates so that the size of the reserve is limited in effect to a few billion dollars, (2) changing the legal status of the fund to make it more like hundreds of trust funds now held by the Federal Treasury, and (3) changing the terminology so that the collections from pay rolls under title

<sup>2</sup> *Social Security Bulletin*, Vol. 2, No. 1 (January 1939) pp. 4-10.

VIII will be termed "contributions" and distinguished from taxes levied for general revenue purposes. The reasons for modifying the present system of financing are grouped under two broad headings, which comprise the experience so far gained in old-age insurance and the present economic situation as it affects business, the beneficiaries, and the old-age insurance program in particular.

The reasons presented by Secretary Morgenthau refer to the relation between the coverage of the system and the method of financing:

Operation of the act has provided significant information bearing on this question. This information shows that the extent of migration, temporary or permanent, from uninsured to insured employment is far greater than was assumed by the President's Committee on Economic Security in 1935. In my last annual report I pointed out that the consequence of this migration was that the scheduled tax rates were insufficient to maintain the system on the actuarial reserve basis provided by the law.

There is, however, another and more cheerful result of this migration. As a consequence of the migration, a much larger proportion of the total population of the United States is qualifying under the contributory system to receive old-age benefits than had been expected. My latest annual report presented the estimate that, without extension of the coverage under the present law, 80 percent of the population of the United States ultimately will have qualified during their working life for at least the minimum annuity under title II of the act.

In emphasizing this point, Mr. Morgenthau made plain at once the reasons for the original adoption of a self-financing system and the present changed situation. It has long been recognized that if only a limited portion of the population were to be benefited by the old-age insurance system, they should not depend to any considerable extent on tax revenues secured partly at the sufferance of noncovered individuals and certainly at their expense. Equity and sound social security finance therefore required that the financing from general revenues be held at a minimum and indicated a system which would be self-sufficient, self-perpetuating, and relatively independent of the general fiscal program of the Government.

Estimates of the scope and coverage prepared in 1935 were probably low even on the basis of material then available, and figures in 1935 and 1936 referred to 26 million persons as the likely coverage. It was not possible for the Committee to make exact estimates of the extent of turn-over

and interchange of occupations which would be of significance in connection with the specific exclusions provided under the act. Experience has shown that this particular type of migration was greater than was anticipated. It has, in fact, brought into the system for longer or shorter periods 8, 10, 12, or even 16 million persons in the course of a few years, in addition to the 26 million referred to in the early statements as to coverage. Now that it is evident that there are covered earnings yielding rights and forming the basis of benefits for probably as many as 32 million workers in the first year,<sup>3</sup> it is apparent that migration over a longer period will tend to bring a very large proportion of the working population within the scope of the system.

This unexpected factor has altered somewhat the arguments for a self-sustaining system. A corollary to this fact appears in Mr. Morgenthau's comment that the scheduled tax rates are "insufficient to maintain the system on the actuarial reserve basis provided by the law." The reason behind this statement lies in the nature of the benefit formula. There is in fact a "bonus" in the benefits in the lower range of annuity payments in that the benefit formula provided in title II of the Social Security Act specifies that monthly benefits shall represent one-half of 1 percent of the first \$3,000 of aggregate taxable wages, plus one-twelfth of 1 percent of the next \$42,000, and one twenty-fourth of 1 percent of amounts in excess of \$45,000. It now is evident that many more beneficiaries than were anticipated will have benefits based on the lower amounts of aggregate wages. This concentration below the middle of the range of payments will cause considerable drains on the old-age insurance system or on the Federal Treasury until coverage is extended to more types of employment so that beneficiaries will qualify for the larger, but relatively less burdensome, benefit amounts. In the hearings (page 928) on the Treasury Department appropriation bill for 1940 before the Subcommittee of the House Committee on Appropriations, Russell Reagh of the Treasury stated that if, under present tax and benefit provisions, appropriations to the old-age reserve account were limited to the amount of title VIII tax collections, the reserve, instead of supporting

<sup>3</sup> *Social Security Bulletin*, Vol. 2, No. 3 (March 1939), pp. 3-9.

the system in perpetuity, "would ultimately be exhausted."

The second ground on which Secretary Morgenthau explained his proposals is the state of American business at the present time. It has been urged on many occasions that fear of certain financial operations could depress and delay business recovery. The statement made by the Secretary sets for the reserve fund a "standard" indicating that it is unlikely that the amount in the reserve would be substantially above \$5 billion at any time in the next 15 years. The table submitted by Secretary Morgenthau and all other calculations made on the basis of his recommendation indicate the probability that the reserve would be even below \$4 billion.

Although this standard represents a new philosophy rather than a new fact, the significance of this modification should not be underestimated. Coupled with the suggestion that modification of the pay-roll tax might be considered, it reveals an attitude both towards the relations of the contributions and investments under old-age insurance and to the general economy which may have been misunderstood in the past but can hardly be misconstrued in the future.

It is in this setting of information gained from operation under the Social Security Act and of the current state of business that the recommendations of the Secretary were brought forward. Mr. Morgenthau said:

1. We should not accumulate a reserve fund any larger than is necessary to protect the system against unforeseen declines in revenues or increases in the volume of benefit payments. Specifically, I would suggest to Congress that it plan the financing of the old-age insurance system with a view to maintaining for use in contingencies an eventual reserve amounting to not more than three times the highest prospective annual benefits in the ensuing 5 years.

2. The method of administering the old-age insurance reserve fund should be changed so that it will be made clearer to everyone that it is a trust fund established for the benefit of the insured who have contributed to it. I recommend the creation of a board of trustees for the fund to be composed of the Chairman of the Social Security Board, the Secretary of Labor, and the Secretary of the Treasury. The Secretary of the Treasury should be the managing trustee for the fund. Such a board of trustees would be similar to that set up in the Postal Savings Act.

I also recommend the establishment of an "old-age insurance trust fund" to be held in trust by a board of trustees and to be deposited in a special account in the Treasury. The old-age insurance trust fund would be made up of (a) contributions collected under title VIII

of the Social Security Act, (b) income accruing to the trust fund, and (c) any other money appropriated thereto by Congress, including the balance now carried in the old-age reserve account.

Although this statement clearly indicates that there is no departure from essential principles and no marked change in the method of handling the funds as they flow from contributors into the trust fund, it shows the desire to follow more closely other Treasury precedent and to use experience under other trust funds held in the Treasury.

A further recommendation with regard to the word "contribution" also follows precedents in this country and abroad:

3. To improve public understanding of the purposes for which the funds are collected, I recommend that the taxes under title VIII be termed "contributions" levied under the Government's taxing power. This terminology has already been used in the Railroad Unemployment Insurance Act.

These statements with regard to the nature of the modification in the present plan are followed by a suggestion as to choices with respect to the tax schedule. Mr. Morgenthau indicated that these are offered as illustrations without any attempt to indicate approval or disapproval of the benefit plans on which the estimates are based but in a desire to put before the Ways and Means Committee suggestions to amplify some of the earlier testimony. The alternatives offered by the Secretary are as follows:

1. Leave the present rate schedule unchanged, that is, 1 percent on employees and employers each from 1937 to 1939, inclusive, increasing to 1½ percent on each in 1940, to 2 percent in 1943, to 2½ percent in 1946, and to 3 percent in 1949.

2. Increase the tax rate on each, employees and employers, from 1 percent to 1¼ percent in 1940, to 1½ percent in 1941, to 1¾ percent in 1942, and follow the present schedule thereafter.

3. Increase the tax rate from 1 percent to 1¼ percent in 1940, to 1½ percent in 1941, 1¾ percent in 1942, and follow the present schedule thereafter.

4. Omit the increase in tax rate from 1 to 1½ percent scheduled to take place in 1940, but step up the rates in 1943 and follow the present schedule thereafter.

The tabulation illustrating the estimated effect of the first alternative is quoted below. Other tabulations submitted projected the effects of a slower tax step-up but the same benefit disbursements, with consequently lower estimates for the reserve fund to be accumulated in these years.

## ALTERNATIVE PLAN I<sup>1</sup>

1. Tax schedule of present law: 1 percent on employee and 1 percent on employer through 1939, increasing to 1½ percent in 1940, 2 percent in 1943, 2½ percent in 1946, and 3 percent in 1949 and thereafter.

2. The benefit estimates used are for illustrative purposes only and are the intermediate estimates based upon the proposals outlined by the Social Security Board in its Report to Congress.

[In millions of dollars]

	Calendar year					
	1940	1941	1942	1945	1950	1955
Net tax receipts (gross receipts minus administrative expenses).....	\$707	\$780	\$781	\$1,078	\$1,751	\$1,840
Less: Benefit payments.....	175	400	555	914	1,697	2,320
Net cash receipts of Government.....	532	380	226	164	54	-471
Add: Interest accrued.....	51	66	77	110	147	135
Total addition to fund..	583	446	303	274	201	-336
Fund at end of year <sup>2</sup> .....	2,013	2,459	2,762	3,846	5,004	4,395

<sup>1</sup> Presented by Secretary Morgenthau in his testimony before the Ways and Means Committee, March 24, 1939.

<sup>2</sup> Fund at end of year 1939 is estimated to be \$1,430 million.

It is clear that the public has sometimes been puzzled by the more technical aspects of the financing of old-age insurance. Those unaware of the nature of actuarial estimates have failed to grasp the meaning of the year 1980 and have, therefore, misunderstood the meaning of some of the figures used to measure the liability under the act. In commenting on past and proposed provisions for the old-age reserve account, Arthur J. Altmeyer, Chairman of the Social Security Board, testified before the Ways and Means Committee on March 30 as follows:

The reserve system, in essence, consists of two aspects: It is an attempt to show on the Government books the true situation as regards the operation of this old-age insurance system. Secondly, it is an attempt to budget

the costs over a long period of years of this old-age insurance system.

I have said many times, and I say again, that I think both from a bookkeeping standpoint and from the budgeting standpoint the reserve system is sound. That is entirely separate, however, from the question of the pattern of benefits and the question of how those benefits shall be paid; but because of misunderstanding concerning the reserve system, it has failed largely in its purpose in presenting to the American people a fair picture of the financial aspects of this old-age insurance system, and it has failed, apparently, to impress many people with the sort of budgeting that is provided.

I have never said that I consider that the reserve system is the sole way that a system of old-age insurance can be constructed. There are other ways of showing on the books of the Government the true financial picture, and other ways of budgeting the cost of the old-age insurance system.

I think, however, any system must carry out the objectives of the reserve system, that is, to show annually to each Congress the true picture, not only of the costs that you are incurring in a particular year, but the cost that you are likely to incur in all the years to come.

And, secondly, I think there should be thought given at this time to some system of budgeting those costs, not only in the present fiscal year but for all of the years to come.

But I say that this question of bookkeeping and of budgeting is a separate question from what pattern of benefits you will provide and whether you will liberalize benefits in the early years or not.

There may, therefore, be a real advantage in the proposed method of depositing contributions in a trust fund and of focusing the emphasis of those concerned with safeguarding the plan more on the years just ahead and less on the period of maturity some forty years hence. The effect of the proposals would be to abandon a special theory as to the premium necessary to finance insurance payments in the distant future. What may be gained is a more widespread understanding of the method of handling contributions and benefits now and in the years just ahead.