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THE CRISIS IN SOCIAL SECURITY

Problems and Prospects

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San Francisco, California

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Library of Congress Catalog Card Number: 77-72542

ISBN 0-917616-16-2

III

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THE ROLE OF SOCIAL SECURITY IN INCOME MAINTENANCE*

Sources of retirement income. Government expenditures on directed transfers. Social security structure. Earnings to benefits ratio. Intergenerational resource transfer. Savings, insurance, pensions, and social security. Payroll tax inefficiencies and disincentives. Labor force participation rates. Analysis of the earnings test. Demographic projections and future social security burdens.

INTRODUCTION

Social security is the principal program for assisting the elderly. This analysis examines its justification as an income support program, and assesses its effectiveness in assisting its target population. We shall argue that social security does fulfill a valuable mission, although there are obvious defects in its present structure.

*This paper is distilled from Viscusi and Zeckhauser (forthcoming).

Until recently, social security enjoyed a favorable reputation, particularly when judged in comparison with other government income support programs. But critics now carp from many quarters. Conservatives complain that, as a coerced savings program, social security both infringes on individual freedom and generates inefficiencies by imposing choices that individuals would not make for themselves.¹ Liberals, joined by an occasional conservative, attack its perceived regressive structure—the ceiling on income subject to the payroll tax; and the benefit structure, which favors those who have earned more in the past and ignores present unearned income.² Most recently, some economists have blamed the pay-as-you-go nature of social security for depressing the savings rate for our society (Feldstein 1974). We shall not dwell on these important issues here, in part because we believe they can be remedied by reforming the social security program and by policy changes in other areas, particularly taxation. This analysis will focus on policy recommendations relating to social security's role as an income support program.

THE PRESENT PATTERN OF ASSISTANCE TO THE ELDERLY

Total Levels of Support

Social security contributes impressively to the financing of an individual's elderly years. Average monthly benefit levels in 1975 (the last year for which data are available) were \$205 for retirees and \$96 for their spouses.³ Since 1975 benefits have increased with the cost of living; in July 1976 average benefits were \$236. Benefit levels depend on past earnings (positively) and earnings in elderly years (negatively). The maximum in monthly benefits a worker could receive in 1975 was \$316.50; for 1977 the figure was raised to \$422.40.

Social security has traditionally been viewed as a source of replacement income for the elderly. In 1972 the ratio of the social security primary insurance amount (the benefits a fully insured single retiree receives) to earnings in the year before retirement was .45 for low-earnings workers and .32 for all private industrial

workers.⁴ The relatively greater support for less affluent individuals seems to be appropriate, since they can draw on fewer alternative income sources in financing their old age.

The low replacement rate for all workers (averaging only a third of their pre-retirement income) overstates the income loss associated with retirement. The increase in leisure accompanying retirement enables many individuals to substitute uncompensated personal labor for previous expenditures on market-traded goods and services. Moreover, the loss of income makes many elderly individuals eligible for a range of in-kind aid programs. Finally, the elderly have a variety of other income sources that provide considerably more income than does social security.

Table 1 shows that, depending on the type of household unit, social security provides from 30 to 40 percent of the money income for the average elderly household. The program plays a smaller role for married couples than for individuals, because the per capita income for couples is larger and their range of alternative sources of income is broader.*

Besides social security, only earnings and income from assets contribute more than 10 percent of any group's income. Perhaps most striking is the small role played by personal contributions, which provide 2 percent of the income of unmarried women and less than 0.5 percent of the income for elderly couples and unmarried men; contributions would play a somewhat more significant role if in-kind aid were included.

Social security is a partial substitute for the retirement income which would be contributed to, or earned or saved by, the elderly in the program's absence. This suggests that, were there no social security, the figures for these alternative sources of income would be greater in absolute terms. It is difficult to estimate just how much greater they would be. (Sherwin Rosen elaborates this point elsewhere in this volume.)

*Elderly couples tend to be younger for two reasons: because they may include one pre-elderly spouse, and because they are younger than their unmarried survivors, widows and widowers. The tendency of employment to decline with age explains much of the earnings disparity between married and unmarried elderly. Whereas married couples derive almost as much income from earnings as from retirement benefits, unmarried individuals receive about three times more retirement than earnings income.

Table 1
Percentage Distribution of Money Income
for Aged Units, 1967

Source of Money Income	Married Couples ^a	Unmarried Men	Unmarried Women
Earnings	39	17	14
Retirement benefits:			
OASDHI	30	40	39
Other public pensions	6	10	7
Private group pensions	<u>6</u>	<u>6</u>	<u>2</u>
Total retirement benefits	42	56	48
Veterans benefits	3	5	4
Public assistance	2	5	8
Income from assets	13	14	19
Personal contributions	(b)	(b)	2
Other sources	2	2	4

Source: Bixby (1970, p. 10).

^aA couple is defined to be a married elderly couple if at least one of the spouses is aged 65 or over.

^b0.5 percent or less.

The general character of financing for old age is clear-cut. The elderly provide significantly for themselves through earnings, assets, and retirement benefits. The large role played by assets and earnings casts doubt on the argument that social security imposes an inefficiently high level of savings on individuals. The importance of income from assets is all the more impressive since market imperfections as well as our tax system discourage individuals who wish to provide for their own old age.

The impressive benefit levels for social security may understate the program's worth to those covered. Unlike most household assets, such as bond or corporate stock investments, social security has an annuity function which, in effect, insures against a life span of uncertain duration. Given that actuarially fair annuities are not available, risk-averse individuals will value social security much more highly than its mere expected return, which is roughly comparable to that yielded by private investments.⁵ Conservative critics of the program frequently suggest that it should be subsumed under some form of negative income tax. For all but low-income individuals such a policy would sacrifice the insurance aspect of social security—an assured income of earned benefits in each year of life.

Social Security and the Elderly Aid Mix

Excessive government expenditures on directed transfers can pose problems for the intended beneficiaries—here, the elderly. There are several dangers. Since society's total willingness to support any particular group is limited, directed transfers compete with cash assistance efforts. Welfare budgets in many jurisdictions are now substantially smaller than expenditures for medical care of the poor.⁶ Moreover, experience with such programs as Medicaid, manpower training programs, and low-income housing shows enormous potential for inefficiency in directed transfer programs. Unfortunately, public hostility toward nonaccomplishment, fraud, and waste is often directed at the target group rather than the policymakers who misformulated the program, or the administrators who ran it poorly. Among directed transfer programs for elderly assistance, care in nursing homes is most suspiciously regarded. Because of this, such care may threaten the generosity of support for programs of more general assistance to the elderly, including social security.

Fortunately, the total pattern of assistance for the elderly has not evolved to a point where it disproportionately favors directed

transfers, although there is a danger in the funding structure for elderly programs. General revenues contribute to all but social security. Since increases in the payroll tax supporting social security are highly visible, political forces may make it easier to increase other, directed areas of expenditure on behalf of the elderly. Medicare—by far the largest directed program and the greatest threat as a wasteful effort—has strong theoretical justifications as insurance, particularly since society undoubtedly would spend equivalent monies for the medical needs of many elderly without Medicare. Unlike most other programs of medical assistance to the poor, Medicare wisely contains deductibles and coinsurance provisions in an effort to limit demand.

Though social security and Medicare have received most attention, several government agencies have other assistance programs targeted at the elderly, including the Foster Grandparent Program, the food stamp program, manpower programs, Department of Transportation demonstration grant programs, and ten HUD housing programs. Cash grant efforts are equally diverse.

Table 2 summarizes the major breakdowns of cash and service programs for FY 1973, the latest year for which detailed information is available.⁷ Services and other in-kind aid to the elderly totaled \$13.13 billion, of which the largest component—\$9.09 billion—went to Medicare. Cash transfers of \$45.33 billion exceeded in-kind aid by more than a factor of three. By far the largest of these income transfer programs was social security, which awarded \$33.03 billion to the elderly. Most other cash transfers came from retirement programs for individuals not covered by social security—civil service workers, railroad employees, veterans, and the elderly poor. Overall, cash transfers accounted for 77.5 percent of all elderly assistance in FY 1973; 56.5 percent were social security benefits to the elderly.

Updated estimates would show a substantial role—roughly \$5.8 billion per year—for Supplemental Security Income (SSI). SSI is a new program, administered by the Social Security Administration, to provide cash grants to the indigent elderly who were formerly served by state-run income support programs, and to railroad and military people not covered by social security.⁸

Table 2
A Profile of Elderly Aid Programs

Agency or Program	FY 1973 Budget (in millions)	
	Sample Specific Programs	Total Govern- ment Agency
SERVICES AND RESTRICTED CASH GRANTS		
Civil Service Commission		\$ 76.05
Action		40.00
Dept. of Agriculture		412.50
Food Stamp Program	\$ 299.10	
Dept. of Transportation		2.49
Dept. of Labor		19.70
Dept. of Housing and Urban Development		563.72
Low-Rent Public Housing	388.50	
Veterans Administration		617.86
Veterans Hospitalization	401.07	
Office of Economic Opportunity		100.82
Dept. of Health, Education, and Welfare		11,296.72
PHS-SRS Medical Assistance for Aged	1,637.00	
PHS-SRS Social Services	224.00	
PHS-SRS Development of Programs for the Aging	200.99	
SSA Hospital Insurance Payments	6,645.00	
SSA Supplementary Medical Insurance Payments	2,445.00	
TOTAL SERVICES AND RESTRICTED CASH GRANTS		\$13,129.86
CASH TRANSFERS TO THE ELDERLY		
Civil Service Commission (Retirement and Disability Fund)		\$4,293.42
Dept. of Defense		515.50
Dept. of Labor (Unemployment Insurance)		281.60
Dept. of Transportation (Coast Guard Retirement Pay)		10.23
Veterans Administration		2,520.00
Railroad Retirement Board (Retirement Benefits)		2,102.00
Dept. of Health, Education, and Welfare		
Retirement/Survivors Insurance Payments	33,032.00	
Grants to States for Maintenance Insurance	1,224.44	
TOTAL CASH TRANSFER		\$45,325.63
TOTAL AID TO THE ELDERLY		\$58,455.49

An Overview of the Structure of Social Security

The basic structure of social security has remained unchanged since its inception. Workers are taxed to fund the benefits for the current elderly population. In the Great Depression when the program was founded, this was the only conceivable means of operating, since a lump-sum initial endowment was out of the question. The social security program at the outset was designed to support an impoverished group—thereby putting purchasing power into the economy—and to remove the elderly from the shrunken labor force to make room for younger workers.⁹

In contrast, today the program's primary purpose is to transfer resources from the relatively affluent working population to the relatively poor elderly beneficiaries. The program could be—and indeed has been—justified as a means of letting all individuals in society benefit from an expanding population and growing productivity. Basically, the program is like a chain letter, with successive generations serving as the next round of letter recipients. Recent declines in the birthrate and in productivity growth reduce the attractiveness and security of such a scheme, at least in the short run, though the increased entrance of women into the labor force may offset losses to the base of support.

Social security also has distributional consequences within an age group. The employee payroll tax consists of an 11.7 percent tax on the first \$16,500 of income, with the tax split between employer and employee. The division of the tax is economically irrelevant—except perhaps in collective bargaining contexts, where labels may matter, or if other institutional constraints which make wage determination noncompetitive. It is the combined tax contribution that is important. Because of a falsely perceived relationship between the paying and bearing of the tax, the framers of the social security program decided to split the difference in setting the tax rate for self-employed individuals; their 7.9 percent rate is discriminatorily favorable. The lowest average taxes are paid by individuals with incomes well above the \$16,500 ceiling, and the self-employed—a category that includes many high-income professionals

But to assess the distributional consequences of social security we must consider the structure of benefits as well as costs. Benefits are positively related to past earnings, but at a less than proportional rate. This pattern in itself is not fully informative. To assess the degree of progressivity of social security, we would have to look at lifetime-earnings profiles for different classes of individuals. The profiles would include statistics on entry and exit from the labor force and on mortality rates, to determine how likely and for how long individuals will receive benefits in their elderly years. Appropriate calculations require data not presently available.

Extrapolating by the use of econometric techniques, Aaron (1974) compared the ratio of discounted expected benefits to discounted expected costs for various groups in the population. For most workers, the high-income earners tended to reap the greatest expected benefit per dollar contributed. Married white males, for example, have an expected social security benefit/cost ratio of .95 if they have not completed grade school, and 1.15 if they have completed at least four years of college. Since the ratio's denominator is greater for the high earners, a look to absolute benefits would show an even more regressive pattern. Nonwhites show a different pattern. Because the benefit/cost ratio tends to decline with years of education in all categories considered, the highest benefit/cost ratio observed in any race/marital status group is 1.49, which goes to married nonwhites who have completed 9-11 years of education. We have found no calculations imputing the cost to an individual of curtailing work, or even retiring altogether, in order to qualify for benefits. This imputed cost should, of course, be included.

Social security has been severely criticized for its regressive structure. Proposals for reform most often recommend that contributions be made more progressive. Steps in this direction include removing the income ceiling on contributions, or financing social security out of general tax revenues.¹⁰

We do not agree that social security should be changed to ensure progressive distributional consequences. Social security is but one of many instruments—including primarily transfer programs and the tax structure—that the society employs to redistribute income. While it is appropriate to ask that the overall structure of govern-

ment benefits and costs be progressive, we should not demand that of each component program. Indeed, it could be argued that many of the past decade's most wasteful government efforts have attempted to promote redistribution through programs not well tailored to that purpose. If the total mix of government programs is to be efficient in redistributing resources—if, in effect, the mix is to provide the greatest benefits to the poor at any given level of cost for the rest of society—then across all programs the trade-off between benefits to different interest groups must be the same. To assure a constant trade-off, programs that are effective in promoting net benefits predominantly for the middle classes should specialize in that activity. Such programs would be complemented, of course, by programs that were most effective in helping the poor. That social security is not entirely progressive in its structure would be more disturbing if there were evidence that it could be made an effective instrument of income redistribution.

Proposals have been made to turn social security into a tool of redistribution within generations. The most persistent recommendation is that benefits be funded in part from general revenues. This would undoubtedly inject new political considerations into a system that has worked well in the past. Such tampering might also destroy one of social security's most attractive aspects: the widespread belief that it is a system whereby, on an actuarial basis, individuals provide for their own old age. The persistence of this myth helps social security to maintain its positive image and contributes to the dignity of social security recipients.

Transferring resources to the elderly is social security's dominant redistributive accomplishment. Those most concerned about distribution should not forget that social security contributes the largest proportion of family income for those elderly who were formerly poor. Moreover, it is complemented by many specific aid efforts such as the SSI program, Medicaid, and food stamps, which are targeted at the needs of the elderly poor. It is unnecessary to make social security, the single most successful program, simultaneously promote all objectives of elderly assistance.

RATIONALE FOR SOCIAL SECURITY

Social security's role in financing the individual's elderly years is well established. In the program's four decades of operation there have been no major changes; policymakers have confined themselves to tinkering with benefit and payroll tax levels. Although transition to any other system would be both politically difficult and painful, it is still instructive to ask why a program such as social security would be instituted today. In conducting this assessment, one must be aware of the limitations of other institutional arrangements. For example, the welfare system is highly inefficient and poorly regarded. And to date the nation has had no success in implementing a negative income tax program.

The first motivation for assisting the elderly is that, as a group, the aged are poor, even with the help of income and in-kind transfers.¹¹ Although government transfer programs have eliminated abject poverty among the elderly, the number of near-poverty elderly is quite large.¹² Thus, 50.2 percent of married elderly have after-transfer incomes below \$5,000; for single males and females the figures are 83.6 percent and 86.7 percent, respectively. By almost any standard, the elderly are the nation's most readily identifiable impoverished group. To illustrate, wherever one draws the poverty line between \$3,000 and \$5,000, there will be a greater proportion of the elderly below that line than of blacks of similar sex and marital status.

One reason why aid to the elderly is politically acceptable as well as desirable is that they are restricted—physically, through the market, and by government policy—in their ability to improve their own plight. Both in pre-elderly and elderly years, there are substantial barriers to providing for one's own old age.

Consider first an individual setting aside funds for his old age. The principal characteristic of this problem is uncertainty: he doesn't know how long he will live, what his other income sources will be, or what his medical needs will be. In short, he has highly imperfect information about an intrinsically probabilistic process. And, unlike most of his consumer choices, he has no opportunity for learning through trial and error.

When risks are important, insurance can play a useful role. Annuities, for example, if available on an actuarially fair basis, would be helpful in guarding against the risks of an uncertain life span. Without such a mechanism, an individual setting aside funds for his old age risks running out of funds if he “unfortunately” lives a long time; alternatively, if he dies early, he would be in the wasteful position of leaving an excessive estate. Unfortunately, because of large transactions costs and problems of adverse selection (those with long life expectancy would be most likely to join the insurance pool), private annuities are not available on an actuarially fair basis. Individuals saving privately for their own old age must strike a balance between saving too much if they die early or consuming too swiftly if they die late.¹³ Uncertainties about expenditure needs (for example, housekeeper services, should minor disability occur), the ability to earn income, and returns on investment complicate their decision problem. A compulsory social insurance program such as social security can be justified as a response to imperfections in the markets for capital and in the type of insurance represented by annuities. Compulsion eliminates adverse selection and will likely reduce the costs of drawing contracts.

Social security plays a second role quite different from any insurance function. It offers what, in effect, is an attractive savings opportunity. This opportunity is important because of government policies that discourage savings and therefore any effort to provide for one’s old age. Income from savings is taxed, of course, which means that individuals must invest at net rates that are well below effective rates of return on capital—the rates that would be available in a freely competitive system. In an inflationary period this problem is compounded, for both interest rates and capital gains in part reflect efforts to maintain real dollar values. Our tax system, unfortunately, is not structured to recognize that these inflation-compensating gains are not elements of income.

Pensions are a more effective means of providing for old age, particularly since they receive favorable tax treatment. However, only a small fraction of American workers have significant pension coverage. In 1968, for example, only 55 percent of all nonfarm

employees were covered by any type of pension. For many, the amount of benefit rights earned so far is quite low (Beier 1971). The recently introduced Keogh plans and Individual Retirement Accounts offer many of the tax advantages of pension plans to individuals who are self-employed or whose employers have no pension program. Programs of this sort should be encouraged, since they enable individuals to provide for their own futures at close to market rates of return. At some far future date it is conceivable that the prevalence of these programs, together with fair annuities, will make self-provision for old age a potentially attractive alternative to social security. For now, it must be recognized that imperfections in insurance and capital markets and poorly chosen tax policies conspire to make self-provision unattractive.

Even with unhindered self-provision possible, there still might be justifications for compulsory savings. Individuals may selfishly fail to allocate substantial funds to promote their own future well-being. John Smith at 25 may consider himself quite different from—and not fully sympathetic to—John Smith at 65, as the activities of smokers and LSD imbibers make clear. Even if individuals are fully altruistic towards their future selves, there is some incentive for self-beggaring behavior. They may not save at all, or may fail to allow for unfavorable contingencies, in the expectation that society at large will always provide funds should their future conditions prove unattractive. Society, unable to bind itself not to provide such assistance, can protect itself only by requiring the individual to provide for himself.

Self-provision in old age itself is not a reliable alternative. There are many impediments to earning income. Technological advance is likely to have rendered obsolete many skills of the elderly. Where capabilities remain relevant, they are unlikely to be in the most productive, advanced industries. Widespread mandatory retirement rules eject many elderly from their former places of work, where they had developed skills and personal contacts specific to the enterprise. It may not be possible to find a job with a similar establishment, either because that firm has a similar mandatory retirement rule, or because a worker may lose pension benefits if he works for a competitor, or because institutional fac-

tors—such as the need to provide medical benefits—make it unattractive to hire older workers. Moreover, new employees often begin in entry-level positions that would not be comparable to an elderly individual's former job. Not only may the older worker's skills be irrelevant to the available job openings—a phenomenon in part due to technological change and advance—but the enterprise may be unwilling to make a hiring or training investment in a worker who is expected to depart sooner than a junior counterpart.

Ill health, though overemphasized in elderly employment analysis, also may impede the ability of the elderly to engage in work activities or more strenuous forms of work. Only a small percentage of the elderly give ill health or disability as a reason for being outside the labor force—16.4 percent for males 60 and over, and 8.5 percent for females 60 and over.¹⁴ The ill health or death of the principal family breadwinner may prompt elderly women to decide to enter the labor force, but if they have been unemployed for a long period their opportunities will be limited. Finally, many government programs for the elderly—social security and SSI in particular—impose substantial penalties on elderly earnings in terms of foregone benefits. We shall return to this problem in the next section.

As a group, then, the elderly are predominantly poor, in part because fair markets were not available to enable them to save and insure for their old age, but also because their present earning capabilities are limited and discouraged. The combination of these factors suggests that it is reasonable to consider transferring resources to individuals in the elderly population. Such aid has other attractive features. Unlike aid to most impoverished groups, assistance to the elderly is widely accepted, in part because of general recognition of the group's inability to help itself. Perhaps equally important, the elderly comprise a minority group we all can hope to join. Helping the elderly has a strong implicit contractual element, with future self-interest being the quid for the quo of present support. Because policymakers as a group tend to be both mature and affluent and can expect to join the elderly in disproportionate numbers, they have a strong personal stake in an assistance program like social security.

Assistance on an age-related basis also has strong theoretical appeal, since age is an immutable personal attribute. Unlike income-related assistance, no disincentives need arise from aid based on age. (Unfortunately, the present structure of social security penalizes the earnings of the elderly, partially subverting this advantage.) Finally, age is a readily monitorable variable that cannot easily be misrepresented. The government has at its disposal an array of personal information files, social security records in particular, which document an individual's age.

In short, a program of income support for the elderly has strong merits either on distributional grounds or to compensate for market imperfections and distortionary tax policies. In addition, income assistance based on age has political and economic advantages not shared by other forms of aid to disadvantaged groups.

THE COSTS OF SOCIAL SECURITY

In an earlier section, we detailed the principal benefits of social security in terms of providing a retirement income for the elderly. Because of the low administrative costs of the program (just over 1 percent of total benefits), the dollar values of benefit payments and of payroll taxes roughly cancel out. From society's standpoint, we would argue, the benefits from the transfer outweigh the payroll tax costs, both because of the redistributive gains derived from assisting the elderly poor and because of the market improvement made possible by instituting a compulsory annuity system. In particular, as already mentioned, the insurance benefits of social security will lead the elderly to value the benefits at more than their dollar cost.

An additional and less visible program cost is the inefficiency that the payroll tax causes by altering the work incentives of those contributing to the program. Although there is no empirical evidence that these disincentive effects are extensive, the significance of this aspect of program cost will increase as the payroll tax rate continues to rise and as working wives, now entering the labor force in large numbers, become better informed on how limited are the benefits that they receive in return for their payroll tax contributions.

Since the beginning of the program, its most widely discussed inefficiency has been that it forces individuals to save involuntarily. However, the low level of social security benefits and the continuance of individual saving despite strong discouragement weaken the argument that individuals would have chosen to allocate their funds very differently.

Disincentives for the Elderly Worker

The costs associated with the inefficiencies thus far discussed appear to be rather minimal. However, a final program cost—the discouragement of work by the elderly—is of particular concern for two reasons. First, the magnitude of the efficiency loss may be quite large. Second, the nature of the problem is critical to the welfare of the elderly. By inhibiting the elderly from working, social security deprives them of a principal means of financial support, partially undermining the income maintenance objective of the program.

The disincentive comes from the penalty on earnings of beneficiaries under age 72. Although the earnings penalty has been liberalized repeatedly, it remains harsh. After an elderly person's earnings reach \$250 per month (in 1977), he foregoes 50 cents in social security benefits for each dollar earned. If he earns enough, he may lose his entire benefit. The penalty is incurred in addition to the usual deductions from earnings, such as payroll and federal income taxes. The net result is that the elderly may face marginal tax rates of 80 percent or more. Since the earnings test is removed for those 72 and over, this group does not suffer the 50 percent social security penalty. But those who have been outside the labor force (or working substantially reduced hours) for a prolonged period during the early portion of their elderly years will find reentry difficult.

The patterns of elderly labor force participation rates (LFPRs: the sum of the rates of employed and unemployed) reflect the influence of these kinds of forces. During the past century, for instance, a dramatic drop occurred in the percentage of elderly males and females in the labor force in the decade 1930-1940, when the

social security program was instituted.¹⁵ Elderly male LFPRs dropped from 73.9 percent of the elderly population in 1890 to 58.3 percent in 1930. The rate of decline accelerated during the next decade, with labor force participation dropping to 41.5 percent in 1940. By 1970 only one-fourth of all elderly males were in the labor force.

The female elderly have exhibited a very different pattern, with their LFPRs since 1890 fluctuating between 8 percent and 10 percent. As with their male counterparts, the largest drop (from 8 percent to 5.9 percent) occurred from 1930 to 1940. Though one might attribute this pattern to the generally depressed economic conditions of the 1930s, the changes were much starker for the elderly than for any other age group. Indeed, female LFPRs for those aged 25-64 rose significantly in that period. Although the richness of accompanying trends makes this historical evidence less than conclusive, it suggests the negative long-run impact that social security has had.

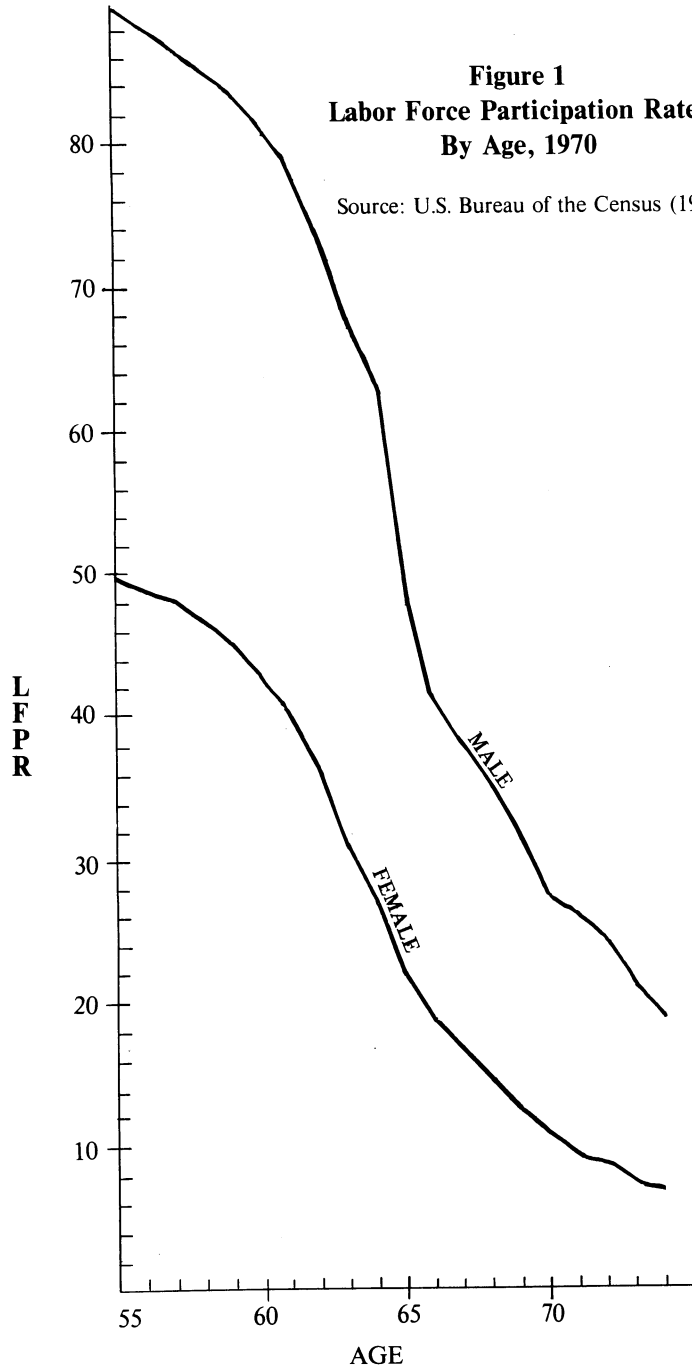
Our examination of more recent time series data on a monthly basis from 1966 to 1974 and on an annual basis from 1952 to 1971 yielded similar results. In particular, a strong negative relationship was evident between elderly LFPRs and the level of average social security benefits per recipient. For elderly males aged 65-69, a \$100 increase in average benefits would be accompanied by a drop of 7.4 points in that group's rate of participation.¹⁶ The older males are influenced less starkly, as a \$100 benefit increase would lower the employment rates of males aged 70 and over by only 1.1 points (a small effect, which is not statistically significant at the 5 percent level). Removal of the earnings penalty for much of this latter group no doubt helped reduce the program's impact.

In addition, higher permissible earnings amounts under social security were found to have a somewhat weaker positive influence on the fraction of elderly in the labor force. Boskin (1977) reached similar conclusions regarding social security's impact on retirement, using data on individual retirement behavior of the elderly.

Social security's dramatic effect is seen by the LFPRs of the different age groups as shown in Figure 1. For both males and females there is a steady decline in participation as the age cohort becomes older. The sharp drop at age 65 is particularly interesting,

Figure 1
Labor Force Participation Rates
By Age, 1970

Source: U.S. Bureau of the Census (1973).



since that is when an individual can receive full social security benefits. Declining participation is less steep at age 72, when the earnings penalty is removed. The 1960 data we examined showed a more dramatic flattening of the relation between age and employment rates at age 72. The absence of a jump in LFPR at this age range reflects the difficulty of reentry into the labor force.

These results show that the primary impact of the earnings penalty is not to keep the few high earners off the benefit rolls, but to force a substantial portion of the elderly into retirement. Apart from its inefficiency, this impact also seems inequitable, since the elderly poor are hit hardest by the disincentives: they are poor in part because they respond to the disincentive. The professionals and managers, on the other hand, are able to earn enough above the penalty so that work may remain an attractive option. One cost of any transfer program results from the distortion of behavior to gain eligibility. Since this cost falls most heavily on the poor, including it in previously cited calculations for expected rates of return on contributions among different income groups would aggravate any disadvantage for the poor.

ELIMINATING THE EARNINGS TEST, AND OTHER TIMELY REFORMS FOR SOCIAL SECURITY

Removing the earnings test would clearly be desirable. It would permit the elderly to do more to help themselves, and would promote the efficient use of society's employment potential.

Three quite different arguments might be made in favor of an earnings test. First, it promotes a spreading of risk among the elderly. An individual who faces an uncontrollable event that may lead him to lose his work—perhaps a deterioration in physical condition—might prefer reduced benefits while he can work in order to buy protection when work is not possible. This argument would be compelling if most departures from the labor force were involuntary, or if the option of whether or not to retire were little influenced by the earnings test. But the evidence points in the opposite direction, particularly if we consider that the impact of the earnings test may extend to the employer's actions as well—say, when he formulates a retirement policy.

The second potential argument for an earnings penalty is that it removes the elderly from the work force, creating openings for younger workers. As traditionally posed, the argument is that society's unemployment rate can be reduced if the elderly are removed from the labor force; moreover, those remaining will be those who need work most. This line of reasoning is fallacious, however; in the long run, removing the elderly from the work force only reduces the scale of the economy, not the rate of unemployment. We would do as well to remove those whose names start with V and Z. A major unplanned experiment confirms our assertions. In the recent past, women have entered the labor force in unprecedented numbers; and while only preliminary analyses are available, no evidence suggests that this phenomenon will have more than a transitory effect on unemployment rates.

The third argument for an earnings test is that it improves the functioning of a labor market hindered by rigidities that prevent downward job mobility. Such mobility would be desirable if workers' skills obsolesce, or if their capabilities deteriorate with age. The structure of social security benefits, with the system's earnings test, establishes a target retirement age for the population. It relieves managers of the problem—particularly difficult, given likely worker or union opposition—of distinguishing which workers should be retired and which not. This is a rather crude use of the earnings test as a tool to improve labor market function. We have seen no evidence of its efficacy.

On balance, we believe these three arguments are weak, relative to those supporting removal of the earnings test. Our view is based in part on the increased need for society to allow—indeed encourage—the elderly to do more to help themselves.¹⁷ Taxpayers are already complaining about the burdens imposed by assistance to the elderly, and the complaints would be far more bitter if the burden of the employer's tax share were correctly perceived.

Unfortunately, burdens on the work force to support the elderly will increase substantially in the medium range future, though imprecise demographic projections make estimates uncertain. To be concrete, assume that total future aid levels per elderly person remain the same as in FY 1973, the year for which the aid mix break-

down was given earlier. All projections will be cast in real 1972 dollars, enabling future inflation rates to be factored out of the calculations. Total aid to the elderly is calculated by multiplying the average aid per elderly person in FY 1973 by the total number of elderly for the year in question. The supporting working population is estimated by projecting population structure in conjunction with 1972 age-specific and sex-specific employment rates. Future increases in productivity and shifts in employment rates are not considered.

The aid burden by the year 2000, under these assumptions, will not change appreciably. Since the elderly population for that time is now alive—as are most future workers for that period—selecting the appropriate census projection has little influence on the results. Census Bureau (1972a) Series E assumes an average of 2.1 births per woman, close to the average for women aged 18-24 in 1972.¹⁸ Given the projected population in the year 2000 with FY 1973 aid levels and 1972 employment rates, the aid burden would be \$659—or only 1.003 times the 1972 burden. A lower birthrate has little influence on the calculations. Using Census Bureau (1972a) Series F, which assumes 1.8 average births per woman, yields a total aid burden per worker of \$673, or only 1.025 times the 1972 cost.

The invariance of the aid burden from 1972 to 2000 is interesting but not surprising. In the year 2000 the percentage of elderly persons in society will decline, because of the entry of the low-birth, depression-era generation into old age. Those presently in their forties and older can look forward to fairly secure funding in old age.

Things are much bleaker for the individuals who are now in their twenties or thirties. During the decade 2010 to 2020, the aid burden will rise as members of the postwar baby boom enter old age. Projections for this period are particularly sensitive to assumed birth-rate patterns. Employing Census Bureau (1972b) Series W (with immigration)—which is an intermediate projection that assumes a fertility rate of 2.11 births per woman—and assuming the FY 1973 aid level, the aid burden per worker would total \$955 by the year 2025, or 1.454 times the 1972 level.

The actual burden, of course, could rise or fall from these levels depending on the pattern of future birth and death rates, LFPRs,

and the productivity of different economic inputs. The proportional burden of elderly aid would be increased by any efforts that limit the growth of the economy. Uncertainty about the projections' accuracy should not lull us into ignoring their implications. The most likely outcome is that even current levels of aid will impose substantially greater burdens on future workers. When this happens, taxpayer resistance may force a reduction in per capita aid to the aged.¹⁹

Increasing the efficiency of existing aid might seem to offer a promising way to avoid increasing the tax burden. Suppose, for example, that all in-kind transfers other than Medicare, Medicaid, and VA aid programs were eliminated and that all of the funds were reallocated to pay social security benefits. The total amount gained by abolishing food stamps for the elderly, the Foster Grandparents Program, housing programs for the elderly, and all other efforts of this type would only save \$3.42 billion in FY 1973, permitting cash grants to the elderly to be increased only 7.5 percent.

Redesigning the three sets of health programs might produce other economies. However, even eliminating the total amount allocated for in-kind aid, including Medicare, Medicaid, and VA aid programs—which would, of course, reduce elderly welfare—would still leave the 2015 aid burden 12.7 percent greater than in FY 1973. Even a substantial overestimate of possible economies does not eliminate the increase in costs to society of supporting its elderly population. The important lesson about in-kind aid to the elderly is negative. The present balance of cash and in-kind aid is not conspicuously out of line. However, the current tendency to move away from money assistance will be aggravated by political pressures to hold the line on the payroll tax for social security, and therefore policymakers should be vigilant in preventing any substantial shift towards in-kind programs and the strong potential inefficiencies they entail.

The solution to providing for the elderly is not merely to let the elderly get more from the expenditures we make for them but to encourage them to help themselves. Innovative policies should be considered. Opportunities certainly should be expanded for the elderly to make untaxed allocations for their old age. The govern-

ment might even subsidize such savings, assuming that social objectives would be served by increasing elderly as opposed to mid-aged consumption.

A major direction of reform should be to remove criteria for receiving elderly assistance. Removal of the earnings test for social security should be the first priority. Although benefit costs would increase as a result, sources of revenue do exist to finance the change. We would suggest that the income taxes of the working elderly be earmarked for social security, to preserve the program's image and the dignity of recipients.²⁰

Second priorities would be removal of asset, residence, and marital status requirements. Even with demonstrated physical incapacity, home care may not be paid for in situations where substantially more expensive nursing-home care would be. Payments to a married couple of retirees are frequently below payments that the two would receive as single beneficiaries. Anecdotal evidence suggests that for financial purposes many widowed individuals may be "living in sin" while preferring remarriage, and the long-married may even be getting divorced for that reason. Restructuring programs to link benefits predominantly to age, to past contributions (where appropriate), and to medical condition would eliminate present incentives that discourage both self-help in old age and attempts to provide for retirement in prime earning years. Beyond the purely economic issues, weighing the full social and psychological costs of pushing the elderly into dependency make policies encouraging the elderly to help themselves substantially more attractive.

CONCLUSION

Four decades after its inception, social security remains the most important mechanism for supporting a predominantly disadvantaged group, the elderly. Over this period, however, the economic underpinning of the program has changed dramatically. Social security was enacted as one component of the attack on problems created by the Great Depression. Today it is justified as an effec-

tive response to the problems and discouragements of providing for one's own old age.

Unfortunately, by imposing a significant tax on elderly earnings, social security forces its beneficiaries into dependency. For too long we have treated the elderly as a burden to be borne by the rest of society. It is time to let the elderly make their contribution to society—and through past as well as present efforts, to their own welfare.