SPECIAL REPORT: CONTINUING PARTICIPATION IN SOCIAL SECURITY

The following report is reprinted from the October, 1976 issue of College and University Business Officer, *the newsletter of the National Association of College and University Business Officers (NACUBO). It was written by William T. Slater, vice president, and Thomas J. Cook, research assistant, of Teachers Insurance and Annuity Association (TIAA) and its companion organization, College Retirement Equities Fund (CREF). TIAA-CREF are nonprofit service organizations that provide retirement and insurance benefit plans for colleges, universities, independent schools, and related educational and scientific institutions.*

Unlike nearly all other American employers, private, nonprofit organizations and units of state and local government enter the social security Old Age, Survivors,' Disability and Hospital Insurance benefits program (OASDHI) on a voluntary basis. Once entered, they have the option of dropping out after a minimum period of participation (five years for public employers and eight for private nonprofit organizations) and a two-year waiting period preceded by a notice of intent to withdraw.

Nonprofit and state and local employers were originally exempted from participation because of questions of whether the federal government could legally tax such employers. Since voluntary participation became possible, in the early 1950s, 90% of the employees of nonprofit organizations (roughly 3.6 out of 4 million) and 70% of the employees of state and local governments (some 8.4 out of approximately 12 million) have become covered. About one-half of one percent of these covered employees have had their participation terminated.[1]

Recently, social security tax increases and widespread publicity about decreases in the trust funds have stimulated interest in the withdrawal option. Although we do not know of any educational institutions that have dropped out, budget-conscious administrators on college campuses are beginning to show some interest in considering the feasibility of this option. The purpose of this article is to review some of the pitfalls and risks for both employers and employees in dropping out of social security.

Financial Stability of Social Security

Charges that social security benefit payments will soon be in jeopardy stem in part from confusing the operations of the trust funds in the financing of old-age benefits with the financing of benefits under pension plans.[2] Social security is a "pay-as-you-go" income transfer system, not a funded system: today's workers support the current retired generation with their tax contributions, with the expectation that their turn to receive benefits will come and that taxes will be collected from future workers to provide the benefits stipulated by law at that time. In addition, social security benefits incorporate "social criteria" through weighting benefits in favor of lower-paid workers and providing much higher benefits for workers with eligible dependents than for those without, although all employed workers pay at the same tax rate.

The social security system does not require a large reserve fund because it operates as a national system that assumes a continuing and sufficient flow of new entrants. There was never any intention that the trust funds should accumulate reserves comparable to the actuarial reserves of pension programs. The trust funds accumulate from money derived each year from an excess of receipts over disbursements and administrative expenses, with the bulk of annual payroll taxes disbursed currently as benefit payments. The trust funds act as a buffer that is available to absorb the initial added expenses of benefit increases and to compensate for decreases in social security tax receipts during periods of high unemployment.

The system is, however, currently confronted by two problems, one short range and one long range.

Short-Range. As a result of recent economic conditions (a high rate of inflation, a high level of unemployment, increased disability claims, and recent benefit increases) current receipts could, if no action were taken by Congress, soon fall below current benefit payments and expenses by amounts greater than the trust funds could cover. This financing problem can be corrected with a small increase in the employer-employee tax rate, or, as has been proposed, by applying the present hospital insurance tax (Medicare, Part A) to support the old-age benefits and using general revenues to finance the hospital insurance benefits. Past congressional actions have maintained the buffer function of the trust funds, and there is no reason to doubt that this will continue.

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Long-Range. The 1972 Amendments introduced, apparently unintentionally, a double application of the cost-of-living increase. This resulted in a sharp rise in projected future costs and an accompanying change in the traditional ratio of the old-age benefit to final average salary that within a few decades could produce old-age benefits higher than preretirement earnings levels. It also seems likely that Congress will act within the next few years to rectify the longer-range financing problem. A correction, generally referred to as "decoupling," would reduce projected long-range costs and restore initial benefit amounts for future newly retired beneficiaries to about the traditional percentages of final average salary.

In summary then, social security is not going broke, since Congress can be expected to pass legislation to deal with the financial problems. This brings us to the many other matters that should be considered by any institution studying the question of dropping out. For example, are there provisions and features of social security that cannot be duplicated? Would employers and employees be helped or harmed by withdrawal? Could they get a better buy through private insurance? These and other points are discussed below.

Tax-Free Benefits

One valuable feature of the social security program often overlooked is the fact that benefits are received tax-free. There is a considerable dollar value to this "hidden" part of the benefits. Any attempt to replace or equal the old-age benefit, such as with annuity contracts or a state retirement system, would have to aim at providing an *after-tax* benefit equal to the social security benefit.

Cost-of-Living Benefit

Another important feature of social security, rarely found in pension plans, is the cost-of-living escalator, added to the program by the 1972 Amendments.[3] In the few pension plans that have escalators, there is usually a ceiling on annual benefit increases, such as 3% or 4%. It should be emphasized that the social security cost-of-living provision is open-ended, without a benefit ceiling. So far, it has produced benefit increases of 8% in 1975 and 6.4% in 1976.

Any cost-of-living escalator for retirement benefits is expensive. A rough rule of thumb is that for each 1% of annual escalator guaranteed to retirees for life, about 10% is added to the total cost of a pension plan. For example, the total cost of a pension plan is increased by about 40% if the plan is to increase benefits by 4% each year in retirement, 50% if the increase is to be 5% a year, etc.

Who Pays for Social Security?

There is a real possibility that dropping out would have the ironic effect of excluding employees from the benefits of a program they might nevertheless be supporting in the future through their federal income taxes. The 1975 Social Security Advisory Council recommended that hospitalization (Medicare, Part A) benefits be paid for out of general revenue funds. Voluntary Medicare (Part B), which covers physicians' and other services not included in Part A, is already financed by "premiums" from enrollees with matching contributions from the federal government. Every year Congress considers bills that propose use of general revenues to support social security benefit payments, and there are increasing indications that Congress may prefer such support to further increases in employer and employee contributions.

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With or without general revenue support, there is the point made by some that wage taxes (such as social security taxes) are actually borne by consumers. To the extent that the employer's cost of social security is passed through to consumers along with other labor costs, this results in consumers paying for social security, through the prices of goods and services, whether they are covered by the program or not.

No Re-entry

Under present law, once coverage has been terminated for a nonprofit or public employer, the employer cannot again provide social security coverage for its employees. If a college, university or school drops out, there can be no re-entry for it under present law, even if re-entry is desired by future administrators and by every one of its employees. This rule is particularly important in light of the possible use of general revenue financing and the potential for future increases in the scope of benefits under Social Security.

An Expected Benefit

Employers who drop out may face difficulties in hiring new employees under conditions that do not include social security as part of their benefit program. A potential new employee considering two or more otherwise similar offers of employment might well hesitate to join an employer who was permanently out. No employee knows for sure how long he or she will stay, and absence of social security coverage could mean a considerable sacrifice of personal and family security.

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Present employees, even those who are "fully insured," have much to lose from dropping out. A fully insured status (ten or more years of covered employment) entitles the worker to *some* benefits, but not to full benefits if there are substantial gaps in coverage.[4] The benefits formula is based on average *covered* wages earned over an entire working lifetime. Years of noncoverage are counted in the formula as years of zero earnings, thus lowering the average. Also, Robert J. Myers, former chief actuary of the social security system, has aptly noted: "It is not generally understood that employees who are nearing retirement age when coverage is dropped will suffer a reduction in their social security benefits because of lack of coverage during those few, final years before retirement, which would be far greater in actuarial value than taxes they might save by dropping out of the System."[5]

Since the amount of social security survivors' benefits is also based on average covered wages, for persons already fully insured, years of noncoverage reduce their survivors' income protection as well as their own future social security retirement income. Employees not yet fully insured—generally younger staff members with the greatest need for family protection—would not be eligible for *any* survivor benefits within two years of the date their participation was terminated.

Dropping out would also mean that employees, present and future, who had already met the eligibility requirements for social security disability income would lose this coverage entirely in five years from the time their participation terminated. Once lost, eligibility for the disability benefits could not be regained by employees who shifted jobs to other employers until they had again participated for a continuous five-year period.

OASDHI BENEFITS

The Social Security Old-Age, Survivors', Disability, and Hospital Insurance Benefits in brief:

Old-Age benefits—payable to a retired worker and to a worker's wife or dependent husband. A person now retiring at age 65 can receive a maximum annual tax-free social security retirement benefit of about $4,700, or $7,000 a year if eligible for a couple's benefit, assuming an earnings history at or above the OASDHI earnings base. Future maximum benefits will be even higher as the CPI escalator and average covered earnings increase.

Survivors' benefits—in case of the worker's death, income for spouses with eligible children in their care, for eligible children, and for elderly widows. For a widow or widower with two young children the survivors benefits can be the equivalent of as much as $150,000 of life insurance.

Disability benefits—income for a disabled worker under age 65, with added amounts for eligible spouse and children. For a young eligible employee who becomes totally disabled these disability benefits can be as much as $6,000 a year, or as much as $11,000 a year if the employee has a spouse and two children, not including the automatic benefit increases related to inflation; and all of the benefit is tax free.

Hospital insurance—in old age and for disabled workers. Everyone who is fully insured for old-age social security benefits at age 65 is automatically entitled to the hospital insurance of Medicare, Part A, without further charge, since it is financed through a portion of the regular employer-employee social security tax. Persons not eligible for the hospital insurance coverage beginning at age 65 can then purchase it at whatever the current premium level happens to be. The premium for such coverage has increased by 36% since 1973, from $33 to $45 a month.

Can You Duplicate Social Security?

It is sometimes argued that covered employees—particularly younger people—would do better financially if their money were placed in a pension plan, an annuity contract or personal investments rather than social security. Actually, it is impossible to compare the costs of social security with pension or insurance plans. As pointed out earlier, there is really no way to compare a social program of income transfers with an actuarially sound insurance or annuity plan. There are basic differences that arise from the social concepts of social security: its weighting in favor of lower incomes, its nontaxability of benefits, its open-ended cost-of-living escalator, and of course the varied array of social security benefits themselves.

A major part of the problem of trying to duplicate or estimate the cost of social security benefits is that the program has experienced many dramatic changes over the years and is likely to continue being changed. Survivors' benefits were not part of the original legislation: disability benefits were added in 1954 and extended further in 1958, and Medicare was added in 1965; average monthly payments to retired workers increased 137% between 1964 and 1974. No one can say what future changes will be made—perhaps the addition of national health insurance for persons of all ages—but it is certain that any attempt to hypothesize a set of benefit substitutes today would result in a static model without applicability to future changes.

Although side-by-side comparisons are out of the question, we have developed some cost estimates in the hope that figures which reflect the cost of pension benefits approximating no more than the system provides as presently structured would be helpful as a general guide. It is estimated, based on an inflation rate of 3% a year, that to purchase an annuity to replace just the old-age portion of the social security benefit for an unmarried, 30 year old male would require a yearly outlay of about 18% of covered earnings from age 30 to age 65.[6]

The cost of buying the 30-year-old an annuity to equal the couple's benefit at age 65 jumps to roughly 31% of salary. [The total OASDHI tax rate (employer plus employee) is presently 11.7% of covered earnings.] Older employees who dropped out with fully insured status would receive some benefit from social security when they reached age 65. The costs for replacing the lost portion of the benefit are less for them than for the 30-year-old, but are nevertheless substantial.

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For an unmarried, fully insured male who drops out at age 40, providing the lost portion of the primary insurance amount (PIA) at age 65 would require about 13% of covered salary or 22% of covered salary for the couple's benefit. Percentages for 50- and 60-year-old drop-outs would be higher than for the 40 year old employee because of the shorter time remaining to retirement for the funds to earn interest. Attempting to replace survivors', disability, and hospital insurance would be an additional expense.

These estimated replacement costs would of course be in addition to the contribution rates of the employer's existing pension plan. Since most institutions with TIAA-CREF retirement plans are already contributing a combined employer-employee rate of at least 10% of salary toward pension benefits, adding the cost of substitute social security benefits would be prohibitive. Moreover, under ERISA rules the maximum amount that may be contributed to an employee's "defined contribution" annuity contract within any one year without being taxable as current income to the employee is, generally, the lesser of 25% of salary or the maximum exclusion allowance under the previous law (the old 20% rule), *including* annuity contributions under the regular plan.

The limitation on tax-deferral is not the only ERISA problem involved in establishing a pension or insurance plan to replace social security benefits. ERISA imposes strict requirements for reporting and disclosure of plan provisions as well as requirements governing participation, vesting, benefit accrual, funding, and fiduciary responsibility. Separate welfare plans providing disability, survivor, and medical benefits also must meet prescribed reporting, disclosure and fiduciary requirements under ERISA. Attempts to replace social security with other programs would subject employers (presently only private institutions) to all of these regulations for benefits not now covered by ERISA. By contrast, the employer faces none of them under social security.

In addition to limits imposed by ERISA, employers could expect to run up against other restrictions in attempting substitutes. As noted elsewhere, the life insurance value of social security survivor benefits is high, reaching as much as $150,000 under present law. Attempting to provide these benefits by group life insurance may pose a legal problem. In many states, insurance laws limit the amount of group life insurance that can be provided by an employer, often to two or two-and-one-half times salary, or to a specific dollar amount well below the value of the social security survivor benefits. Some employers would therefore find that these survivor benefits simply cannot legally be replaced through group life insurance. Also, the Internal Revenue Code specifies that whenever more than $50,000 of group life insurance is provided an individual, the premium for insurance above that amount must be included as taxable income to the employee.

Congressional Action

The possibility of Congressional action to further discourage or prohibit OASDHI withdrawals cannot be overlooked. The Social Security Administration has estimated that just for the employees of New York City there would be a $3.1 billion loss in contributions and interest to the trust funds during the period of 1978 through 1982 if their coverage is terminated in March 1978.[7] The concept of a national income transfer system such as social security assumes universal participation across society and across generations. There is some question of the propriety of public or private educational institutions opting out of a national program on the strength of a special concession that originated a quarter of a century ago because of their historical exemption from federal taxes.

The commissioner of the Social Security Administration has stated that consideration of increased withdrawals may well lead to a re-examination of the public policy on which the present coverage provisions are based. "We are very much concerned," he has observed, "about the effects that these terminations have on the benefit protection of workers whose coverage is terminated and on the financial and programmatic integrity of the Social Security trust funds."[8]

To prevent crippling losses of revenues, it is likely that Congress will consider proposals that coverage be made compulsory for all employees, including currently exempt government employees. The 1975 Advisory Council on Social Security recommended that Congress immediately begin developing ways of making the system applicable to virtually all gainful employment. Of course this and other proposals being made will face opposition, but the point to bear in mind is that Congressional committees are already seriously considering all aspects of the withdrawal process and its implications for the future of social security.

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1. U.S. Congress, House, *Background Material on Social Security Coverage of Governmental Employees and Employees of Nonprofit Organizations*, Subcommittee on Social Security, 94th Congress, Second Session (April 26, 1976), pp. 3, 22.
2. There are three trust funds—for old-age and survivors' insurance, disability insurance, and hospital insurance—which are respectively financed by tax rates of 4.375%, 0.575% and 0.9% to make up the total 5.85% rate levied on both employees and employers.
3. The monthly benefit is increased in June of any year in which the Department of Labor's Consumer Price Index shows an increase of 3% or more as measured from the first quarter of the preceding year or since any other quarter of the previous year for which Congress legislated a benefit increase to the first quarter of the year in question.
4. To be "fully insured" a person must have at least one quarter of coverage for each calendar year (4 quarters) elapsing after 1950, or if later, after the year in which he attained age 21. A person who has 40 quarters of coverage is fully insured for life. To be "currently insured" a person must have at least 6 quarters of coverage during the full 13-quarter period ending with the calendar quarter in which he died, most recently became entitled to disability benefits, or became entitled to retirement benefits.
5. *Employee Benefit Plan Review*, (June 1976), p. 62.
6. Cost estimates are based on the following assumptions:

Initial Salary:	$15,300 per year
Future Salary Increases:	5% per year to age 65
Future Wage Base Increases:	5% per year
Future CPI Increases:	3% per year
Interest Rate:	6% per year
Mortality Table:	A-74 mortality tables set back 1.0 years for males and 2.5 years for females

Cost of the old-age replacement benefit (PIA) for single employees and for married employees whose spouses qualify for benefits in their own right will vary resulting from the requirement of different tax tables for married and single persons in calculating the tax free benefit and the differences in male and female longevity. In examples given in the text, the calculations assume current tax tables are applied in future years and a private pension plan income equal to the PIA is received. Cost of the old-age couple's replacement benefit includes the PIA plus 50% assuming the presence of a wife/dependent husband qualifying for the spouse's benefit at age 65.

The 30-year-old employee is not assumed to have achieved fully insured status; for the 40-, 50-, and 60-year-old employees, coverage is assumed since the later of 1950 or attainment of age 21.

7. U.S. Congress, House, *Background Material on Social Security Coverage*, p. 5.
8. Statement of James B. Cardwell, Commissioner, Social Security Administration, before the Subcommittee on Social Security of the Committee on Ways and Means, House of Representatives, Monday, April 26, 1976, pp. 1-3, (mimeographed).