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THE END OF SOCIAL SECURITY SELF-FINANCING:  
What Does It Portend for Social Security's Future?

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Charles Blahous



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## ABSTRACT

IN DECEMBER 2010, Congress passed and President Obama signed legislation to reduce Social Security's payroll tax collections and allow the program to draw on substantial direct subsidies from the government's general fund. This is a departure from historical practice dating back to President Franklin D. Roosevelt, carrying the potential to transform the future policy debate. For most of Social Security's history, bipartisan support remained for FDR's self-financing principle, both to ensure fiscal discipline and to ensure benefits enjoyed special political protection from near-term pressures arising elsewhere in the federal budget. It remains to be seen what lasting policy effects will arise from lawmakers having waived the longstanding requirement that payroll tax assessments be sufficient to finance benefit payments. Continuation of recent practice could prompt renewed consideration of policy options such as means testing and other cost controls traditionally applied to what have been popularly thought of as welfare programs.

*JEL* codes: H1; H2; H3

**F**ROM ITS INCEPTION Social Security was intended to be, and has since been perceived to be, distinguished from a welfare program. Under a welfare program a recipient collects benefits based on need while revenues are provided by others based on their ability to pay. Under welfare there is no necessary connection between individuals' own contributions to the program and their benefits from it. One individual might be entitled to benefits without ever having contributed tax revenues whereas another might contribute tax revenues without ever being entitled to benefits.

Until a recent change in federal policy, Social Security had long been fundamentally different from a welfare program. Though individual Social Security benefit totals did not necessarily correspond with individual tax contributions (because, among other things, individuals draw benefits for different lengths of time), certain connections between benefits and contributions had been preserved. All individuals, rich or poor, could earn an entitlement to old-age, survivors, and disability income “insurance,” with the magnitude of their monthly benefit entitlement essentially proportional to their contributions.<sup>1</sup> Though the rate of return on these contributions was higher for low-wage individuals than for high-wage individuals, all taxed earnings generated benefits for rich and poor alike.

In addition, while benefits and contributions would not necessarily balance for each specific individual, the total amount of the program's benefit payments was limited to the total amount of such worker contributions plus some revenue derived

1. Technically, the proportionality was to the amount of their wages subject to the Social Security tax. The benefit calculation begins by counting all of the worker's prior annual earnings subject to the Social Security payroll tax, then indexes those amounts by national wage growth to produce their updated wage equivalents and averages the worker's top 35 earnings years when so indexed. The resulting number for an individual's average indexed monthly earnings is then converted into a benefit (fully payable at the normal retirement age) using a formula that delivers higher returns for low earnings levels and lower returns for high earnings levels. All earnings subject to the payroll tax are included in the calculations, and all such earnings in one's top 35 earnings years accrue benefits. This meant that individual contributions and benefits remained linked—at least as long as payroll taxes remained the sole significant source of program income.

from the taxation of benefits and interest earnings thereon.<sup>2</sup> This was to ensure that workers as a group paid fully for their own benefits as a group (even if there were substantial intergenerational transfers within that broad group). All of this enforced an ethic of a self-financing system of benefits earned by worker contributions.<sup>3</sup>

This historical construct was a direct reflection of the insights of President Franklin D. Roosevelt (FDR) with respect to the financing basis that would enable his cherished Social Security program to long endure. FDR understood that a program financed from general taxes would be exposed to competition from other federal programs for budgetary resources, and thus to constant pressure to limit costs whether by constraining benefit levels or by limiting the number of those eligible to receive them. As FDR stated in his address to the Committee on Economic Security (CES) that developed recommendations for Social Security legislation:

We must not allow this type of insurance to become a dole through the mingling of insurance and relief. It is not charity. It must be financed by contributions, not taxes. . . . As Governor of New York, it was my pleasure to recommend the passage of the Old-Age Pension Act which, I am told, is still generally regarded as the most liberal in the country. In approving the bill, I expressed my opinion that full solution of this problem is possible only on insurance principles. It takes so very much money to provide even a moderate pension for everybody, that when the funds are raised from taxation only a “means test” must necessarily be made a condition of the grant of pensions.<sup>4</sup>

2. Historically there have been some modest general revenue transfers to the Social Security trust funds, but these had been extremely limited (less than \$40 billion out of a total Trust Fund balance of \$2.6 trillion through the end of 2010) and usually related to a localized rationale, such as financing specific benefits based on certain noncontributory military wage credits. See Social Security Online, *Actuarial Publications*, “Trust Fund Data,” last updated July 18, 2011, <http://www.ssa.gov/oact/STATS/table4a3.html>.
3. Under current law there is a substantial imbalance between scheduled benefits and tax revenues that must be resolved to maintain self-financing program solvency. While this issue is important for policymakers, this study does not focus on the specific policy options for maintaining solvency, about which this author has written extensively elsewhere. See Charles Blahous, *Social Security: The Unfinished Work* (Stanford, CA: Hoover Institution Press, 2010). This study instead focuses on a more fundamental binary choice—whether policymakers wish to restore or permanently abandon the self-financing principle—and on the potential implications of that choice.
4. Franklin D. Roosevelt, “Address to Advisory Council of the Committee on Economic Security on the Problems of Economic and Social Security” (speech, Washington, DC, November 14, 1934), <http://www.ssa.gov/history/fdrstmts.html#advise>. When Roosevelt refers at the start of the quotation to “this type of insurance,” he refers specifically to “unemployment insurance” (the original Social Security Act described old-age pensions as part of a general system of unemployment insurance). See, for example, the text of the final report of the CES, in which part of the rationale for old-age benefits is to compensate for unemployment among the elderly: “The depression has largely wiped out wage earners’ savings and has deprived millions of workers past middle life of their jobs, with but uncertain prospects of ever again returning to steady employment. For years there has been

A “means test” was exactly what FDR did not want. He anticipated that a program financed with general revenues would ultimately become a means-tested or welfare program for the poor only, not a broader system of old-age pensions.

When the CES delivered its report recommending the outlines of Social Security legislation, it generally followed FDR’s lead. As their report stated:

The satisfactory way of providing for the old age of those now young is a contributory system of old-age annuities. This will enable younger workers, with matching contributions from their employers, to build up a more adequate old-age protection than it is possible to achieve with non-contributory pensions based upon a means test.<sup>5</sup>

Although many changes were made to Social Security during the ensuing legislative process and over the subsequent decades, this philosophical core held firm. The program was financed with worker and employer contributions separate from general taxes, which were credited to a separate set of Social Security trust funds.<sup>6</sup> Workers received an accounting of their Federal Insurance Contributions Act (FICA) withholding tracked separately from their federal income taxes. Unlike income taxes, FICA taxes were assessed on the first dollar of wage earnings with no deductions of any kind, pursuant to an ethic whereby these contributions were not considered part of the shared tax burden of funding general government but rather as establishing the individual’s direct entitlement to Social Security benefits.

This common perception of Social Security as a benefit earned by separate contributions is reflected in statements routinely made by American citizens, including public officials. The following by then-OMB Director Jacob Lew is one typical example:

Social Security benefits are entirely self-financing. They are paid for with payroll taxes collected from workers and their employers throughout their careers. These taxes are placed in a trust

some tendency toward a decrease in the percentage of old people gainfully employed. Employment difficulties for middle-aged and older workers have been increasing, and there is little possibility that there will be a reversal of this trend in the near future.” Social Security Online, “Reports and Studies: Report of the Committee on Economic Security; Need for Security,” 1935, <http://www.ssa.gov/history/reports/ces/ces5.html>.

5. Social Security Online, “Reports and Studies: Report of the Committee on Economic Security.”
6. Social Security has two trust funds: the Old-Age and Survivors Insurance Trust Fund, and the Disability Insurance Trust Fund. Though each must remain solvent on its own for full benefit payments to be permitted, popular discussion of Social Security often refers to the combined balances of the two trust funds. This paper observes that convention by referring to balances for the trust funds in combination.

fund dedicated to paying benefits owed to current and future beneficiaries.<sup>7</sup>

This is how millions of Americans continue to think of Social Security today.

Historian Arthur Schlesinger Jr. recorded perhaps the defining quotation on this subject from President Roosevelt himself: “We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program.”<sup>8</sup> In this statement FDR asserts that the philosophical foundation of the Social Security program rests primarily on the fact of its being financed with separate worker payroll taxes distinct from general taxes. From this vantage point, the day Social Security ceases to be a self-financed program is the day its political foundation threatens to collapse.

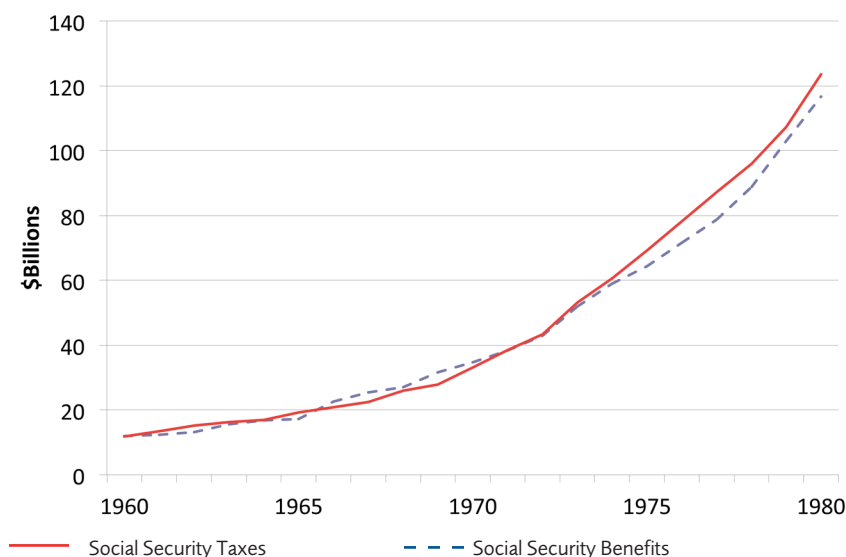
#### AFTER THE 1983 SOCIAL SECURITY REFORMS: STILL SELF-FINANCING?

BIPARTISAN COMMITMENT TO the ethic of Social Security as a self-financed, earned benefit program has remained very strong for most of its history. Landmark program reforms in 1983 did not destroy conceptual support for this principle, though they did bring into question whether self-financing would continue to be observed in practice, as this section will explain.

Through most of Social Security’s history the program was operated essentially on a pay-as-you-go basis. Instead of requiring each generation to put aside sufficient advance savings to finance their own eventual benefits, each generation’s benefits were paid directly from tax contributions made contemporaneously by individuals then in the workforce. The program operated such that each year tax collections and benefit expenditures were approximately balanced. See figure 1.

7. Jacob Lew, “Opposing View: Social Security Isn’t the Problem,” *USA Today*, February 21, 2011.
8. Arthur M. Schlesinger Jr., *The Age of Roosevelt: The Coming of the New Deal*, American Heritage Library edition (Boston, MA: Houghton Mifflin, 1988), 308–309.



**FIGURE 1. HISTORICAL PAY-AS-YOU-GO FINANCING: ANNUAL BALANCING OF TAXES/BENEFITS**

Source: Social Security Administration, <http://www.socialsecurity.gov/OACT/STATS/table4a3.html>.

Thus before the mid-1980s, though Social Security maintained separate trust funds, the residual balances of these funds were kept relatively small as a matter of deliberate federal policy.<sup>9</sup> The primary purpose of a Social Security Trust Fund was then to provide a contingency reserve of spending authority for protection against economic downturns; it was not to amass a significant storehouse of savings for financing future benefits. When evaluating whether the program was successfully self-financing, the principal revenue source was understood to be incoming payroll taxes contributed by workers with any interest earnings on trust fund balances playing an essentially negligible role.

9. The historical reasons pay-as-you-go financing was observed through most of Social Security's early history are beyond the scope of this paper. In essence, the reasons lay with concerns about the federal government having the power to control and direct the investment of massive amounts of financial resources. For a fuller discussion of this history, see Sylvester Schieber, *The Predictable Surprise* (Oxford, UK: Oxford University Press, 2012). On page 45, for example, Senator Arthur Vandenberg is quoted to the effect that the build-up of a trust fund balance sufficient to meaningfully advance-fund future benefits would be a "positive menace to free institutions and to sound finance." In his appendix to the 1983 report of the Greenspan Social Security Commission, commission executive director Robert Myers described the prevailing financing ethic as understood at the time: "Gradually, the funding basis shifted, in practice, to what might be called a current-cost or pay-as-you-go basis. The intent under such a basis is that income and outgo should be approximately equal each year and that a fund balance should be maintained within the year and also over economic cycles which have durations of several years. There is no established rule as to the desirable size of a contingency fund, although the general view is that it should be an amount equal to between 6 and 12 months' outgo." See Greenspan Commission, "Report of the National Commission on Social Security Reform," January 1983, Appendix J, "Financial Status of the Social Security Program."

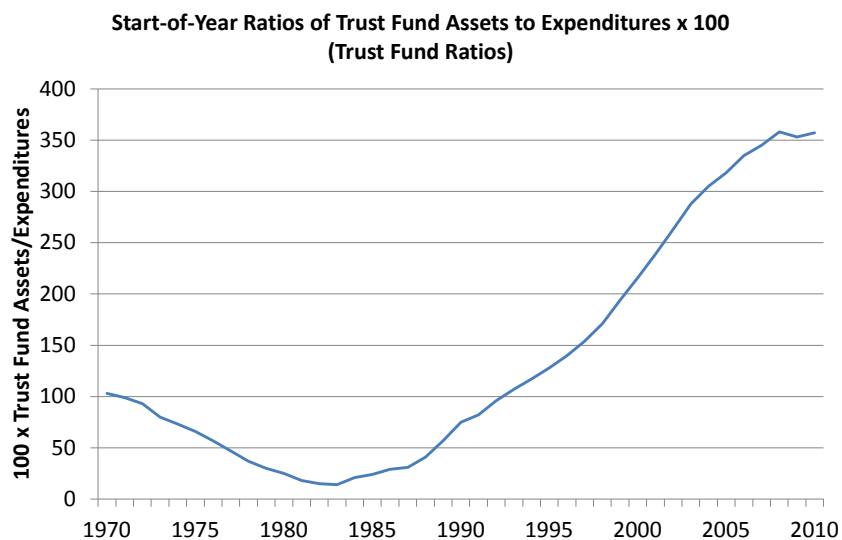
In the early 1980s, Social Security faced a financing crisis that produced a landmark bipartisan agreement: legislation ensuring program solvency for decades into the future. Beginning in the mid-1980s and lasting until 2010, Social Security ran substantial annual operating surpluses of tax collections over expenditures causing its trust fund balances to explode—growing from equaling less than two months' worth of benefit payments in 1983 to more than three years' worth of benefit payments by 2010 as shown in figure 2.

The surpluses and trust fund buildup that followed the 1983 reforms are among the most widely misunderstood phenomena in Social Security history. Many mistakenly believe that the 1983 reforms embodied a deliberate change in Social Security financing policy from pay-as-you-go to partial advance-funding, the purpose being to accumulate savings resources to prefund the Social Security benefits of Baby Boomers who would enter retirement a generation later. Contemporary documentation, however, establishes that there was no such intent.<sup>10</sup>

Intentional or not, the creation of significant Social Security surpluses from 1984 to 2009 eventually resulted in multitrillion-dollar Social Security Trust Fund

10. A full explanation of the actual intent of the 1983 reforms is beyond the scope of this paper. Blahous, *Social Security: The Unfinished Work*, chapter 2 is devoted to the history of the 1983 reforms, including several quotations of key legislative players to the effect that they did not intend to depart from Social Security's historical pay-as-you-go financing basis. See also Charles Blahous, "The Social Security Challenge," Policy Review, Hoover Institution, December 1, 2010. For example, neither the Greenspan Commission nor Congressional legislators counted trust fund balances or interest earnings in their calculations of the reforms' effects on the program's actuarial balance, instead using a methodology inconsistent with intent to prefund future benefits by amassing a significant trust fund. Indeed, most of the surpluses that arose in the 1990s and 2000s were actually created by legislative changes effected in the 1977 Social Security amendments rather than in 1983. Although the popular memory of the 1983 Social Security reforms has become somewhat hazy over time, it was understood during the 1980s that the attainment of a long-term actuarial balance composed of large annual imbalances (that is, large surpluses in the 1980s–2000s followed by large deficits afterwards) was inadvertent. Greenspan Commission member Senator Daniel P. Moynihan asserted that the large surplus "has come upon us almost unawares" (Congressional Record, 1990, S14755–6) while then-assistant comptroller General David Thompson noted that that the buildup of Social Security reserves "was not planned" (Lawrence Thompson, "The Financing Debate: A Scorecard" [speech to the National Academy of Social Insurance, Washington, DC, 1989]). The Social Security Advisory Council's own briefing materials in 1989 noted that the "buildup and subsequent draw-down of the trust funds is largely an inadvertent result of the 1983 Amendments" (Social Security Administration, "Economics of the Trust Fund Buildup: Analysis and Issues" [background paper prepared for the Advisory Council on Social Security, November 27, 1989]). Chairman of the Social Security Subcommittee of the House Ways and Means Committee Jake Pickle, a key contributor to the 1983 legislation, even went so far as to argue at the time that a significant Trust Fund buildup was "not likely to be tolerated by the public" (Jake Pickle, Letter to the *Wall Street Journal*, May 17, 1983). An excellent summary of the historical intent of the 1983 reforms is a 1997 Congressional Research Service report, which notes: "Various misperceptions of their intent have developed over the years, among them being that Congress wanted to create surpluses to 'advance fund' the benefits of post-World War II baby boomers. . . . There is, however, little evidence to support the view that the surpluses were intended to pay for the baby boomers' retirement." (Congressional Research Service, "Social Security Financing Reform: Lessons from the 1983 Amendments," 1997.)

FIGURE 2. SIGNIFICANT TRUST FUND RESERVES BEGAN BUILDING IN THE 1980s



Source: Board of Trustees Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2012 Annual Report* (Washington, DC: Government Printing Office, April 25, 2012), <http://www.ssa.gov/oact/tr/2012/tr2012.pdf>; and Greenspan Commission, "Report of the National Commission on Social Security Reform."

balances with annual interest earnings exceeding \$100 billion. This complicated the picture of whether Social Security would actually remain self-financing when expenses later began to significantly exceed annual tax collections.

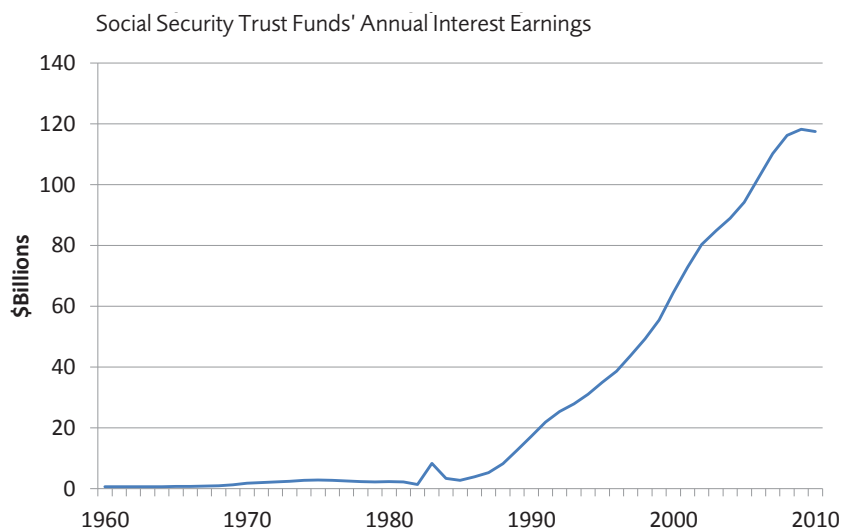
To understand how the picture has been complicated, one must understand the factors that determine the balances of the Social Security trust funds. These balances reflect prior surpluses of tax income over expenditures, plus any (until recently, relatively small) transfers of general government funds. Both of these income categories result in Treasury bonds being issued to the trust funds. These bonds earn interest, which is a further source of trust fund income.

This process produced relatively uncomplicated program financing prior to the 1980s. Before then, the overwhelming majority of Social Security revenues derived from payroll taxes. The trust funds' interest earnings were small enough that they did not interfere with the predominant impression of benefits financed primarily by incoming worker contributions.

After the mid-1980s, however, interest credits to the Social Security trust funds became far more significant as figure 3 shows. By the end of 2010, for example, nearly \$1.5 trillion of the trust funds' total balance was attributable to interest earned on the Treasury bonds they contained.

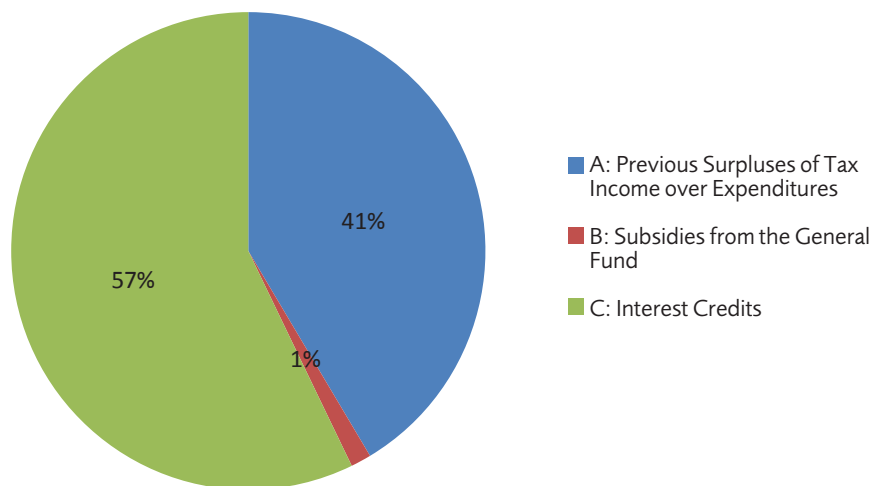
As shown in figure 4, it is largely due to these interest credits, paid not by participating workers but from the general fund of the U.S. Treasury, that the combined Social Security trust funds will remain solvent through 2033.

**FIGURE 3. AFTER THE 1980s, INTEREST PAYMENTS FROM THE GENERAL GOVERNMENT FUND BECAME A GREATER CONTRIBUTOR TO SOCIAL SECURITY INCOME**



Source: Social Security Administration, <http://www.socialsecurity.gov/OACT/STATS/table4a3.html>.

**FIGURE 4. COMPONENTS OF SOCIAL SECURITY TRUST FUNDS BALANCE, END OF YEAR 2010**

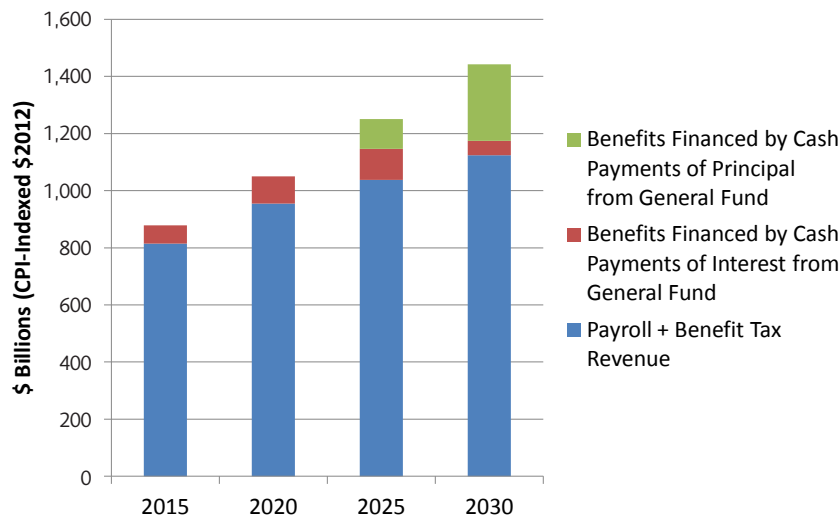


Source: Author's calculations based on Social Security Administration data published at <http://www.socialsecurity.gov/OACT/STATS/table4a3.html>.

Note: Percentages do not sum to 100 percent due to rounding.

Through 2033 as shown on figure 5, Social Security effectively will receive substantial direct financing from the general fund of the Treasury to maintain benefit payments well beyond those that can be financed from payroll tax contributions.<sup>11</sup> It can be argued that this is no longer true self-financing.<sup>12</sup>

**FIGURE 5. IN FUTURE YEARS SOCIAL SECURITY PAYMENTS WILL BE FINANCED INCREASINGLY BY CASH PAYMENTS FROM THE GENERAL FUND**



Source: Board of Trustees' *Annual Report*, 2012.

11. An interesting suggestion is that Social Security, by relying so heavily on interest payments from the general fund, is in fact now subject to the sort of competition for funding within the general budget that self-financing was designed to avoid. There is some truth in this, though it should also be recognized that interest payments have a higher-priority claim on federal funds than do other forms of discretionary spending.
12. If Social Security had actually operated as a savings program, in that its annual surpluses were banked and thereby reduced other debt service of the federal government, there would be no reason to suggest that the trust funds' drawing upon these interest credits might violate the ethic of self-financing. In that instance, the interest credits would simply recognize the present value of savings put aside by workers through Social Security to finance their own future benefits. Most empirical analysis, however, has found by contrast that the federal government has operated such that Social Security's surplus revenues were not used to reduce federal debt but instead to increase other federal government consumption. See Sita Nataraj and John B. Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds?" (NBER working paper 10953, National Bureau of Economic Research, Cambridge, MA, December 2004); and Kent Smetters, "Is the Social Security Trust Fund Worth Anything?" (NBER working paper 9845, National Bureau of Economic Research, Cambridge, MA, July 2003). These studies have generally found that the generations that produced the annual operating Social Security surpluses used them simultaneously to increase their own consumption of other government services. Another paper similarly concluded that the main historical effect of Social Security surpluses was to reduce pressure to constrain other federal

The role of the trust funds in program financing has become intensely controversial, especially since Social Security began to operate substantial surpluses in the 1980s. One could take either of two perspectives. On the one hand, one could argue that despite the program's large current deficits of tax income relative to expenditures, the program will still remain self-financing into the 2030s because it is fully entitled to the principal and interest payments on the bonds in its trust funds. On the other hand, one could argue that, entitled or not, the payments of interest represent a de facto subsidy provided by income tax payers to Social Security, delivering additional income to the program without any corresponding reduction in the interest payments these taxpayers must finance on behalf of the general treasury.

A fair summary of the political environment surrounding Social Security from the 1980s to the late 1990s was that there remained strong bipartisan commitment to the ethic of Social Security self-financing, even as the waters had been muddied with respect to whether it would actually be observed in practice after the 1983 reforms. It was only more recently that the bipartisan commitment to self-financing as a fundamental conceptual principle began to unravel.

#### THE ENDURING STRENGTH OF THE SELF-FINANCING CONCEPT THROUGH THE MID-1990s

DESPITE THE ANALYTICAL complexities introduced by the 1983 amendments, the foundational principle that Social Security should be an earned benefit, self-financed through participant contributions and tracked in separate trust funds, retained enduring bipartisan support until recent years, even among experts who were otherwise sharply divided in their Social Security policy preferences.

A particularly telling example of this enduring consensus was the set of unanimous opinions authored by the 1994–96 Social Security Advisory Council appointed by Donna Shalala, Secretary of Health and Human Services during the Clinton administration. That council was unable to secure internal agreement upon specific

consumption, though they also considered that this phenomenon might then be in the process of changing. See Douglas W. Elmendorf, Jeffrey B. Lieberman, Matthew D. Shapiro, and Stephen P. Zeldes, "Social Security Reform and National Saving in an Era of Budget Surpluses," *Brookings Papers on Economic Activity* 2000, no. 2 (2000): 1–71. The implication of these various studies is that interest credited to the Social Security Trust Fund is not associated with additional income to the U.S. Treasury (for example, in the form of reduced federal debt service payments). The ongoing payments of interest from the general fund to the Social Security trust funds are thus a direct transfer of resources from those who provide general revenues (such as income tax payers) to Social Security beneficiaries. The direct financing of these transfers could also come from additional borrowing from the public, but general revenue providers (such as income tax payers) are ultimately responsible for repaying this as well.

policy recommendations to shore up the long-term finances of Social Security.<sup>13</sup> Despite their intense policy differences, there were nevertheless certain general principles that received unanimous support from council members. One of them was that:

Social Security should be financed by taxes on workers' earnings, along with taxes paid by employers, earmarked taxes on benefits, and interest earnings on accumulated reserves, *without other payments from the general revenue of the Treasury*.<sup>14</sup> (Italics added.)

This opinion of the council encapsulated how Social Security's "earned benefit" construct embodied an enduring arrangement between the political left and the political right. By maintaining self-financing, the right was assured that program cost obligations would not exceed the tax income it generated while the left received an additional political protection for benefit payments. This political protection was based on the perception that benefits had been earned by beneficiaries, thereby insulating them from competition for funding within the larger federal budget. These respective virtues were referenced in the council's statement:

Many foreign systems have contributions from general revenues to their social security systems, either to pay for administrative costs or for part of the benefits. The Council recommends against that procedure.

The method of financing Social Security entirely by dedicated taxes has given the system considerable protection from having to compete against other programs in the general budget. The fiscal discipline in Social Security arises from the need to ensure that income earmarked for Social Security is sufficient to meet the entire cost of the program, both in the short run and long run, rather than from competition with other programs in the general budget.

13. *Report of the 1994–96 Advisory Council on Social Security* (Washington, DC: 1996), <http://www.ssa.gov/history/reports/adCouncil/report/toc.htm>. The council split into three camps over different approaches to incorporating advance-funding into the program. Seven of its thirteen members favored establishing Social Security personal accounts, with five of these favoring privately administered accounts and two favoring publicly held accounts. The remaining six members of the council opposed personal accounts and instead urged the consideration of collective investment of the trust funds in the stock market. Though all three camps agreed that the current-law method of financing Social Security did not embody effective advance funding and they further agreed that partial advance funding was desirable, they were unable to agree on how such funding should be accomplished. In this, the council replicated a broader policy divide that has made it difficult for Congress to produce a bipartisan plan for sound financing of Social Security over the long term.
14. *Ibid.*, vol. I, "Findings and Recommendations."

Unless a program is especially protected as, for instance, by dedicated taxes, the Federal budget results are inevitably determined by competition in allocating spending during the budget cycle, depending on the revenue generally available. Social Security, on the other hand, is a very long-range program—people pay dedicated taxes today toward benefits that may not be received for 30 or 40 years—and should not be part of an annual budgetary allocation process. There would be less security in a retirement system that changed benefits—those being paid now or those payable many years hence—because of short-term budgetary considerations. Social Security’s obligations and contributions can certainly be changed and have been. But the process of doing so requires a long lead time and consistency with internal principles of the program.<sup>15</sup>

This statement is noteworthy for a number of reasons. One is that it was a unanimous statement by experts who otherwise occupied a wide expanse of the policy spectrum. Substantively, it reflected a longstanding view that the foundational ethic of Social Security required that it be managed separate and apart from general federal budget policy—that neither Social Security’s tax income nor its benefit obligations should be at risk of sudden changes due to near-term pressures arising elsewhere in the federal budget or as a result of other economic policy goals.

The Advisory Council also spoke unanimously to the importance of maintaining Social Security’s contribution-benefit link, opining that the program would be weakened if individual workers did not receive benefits that directly reflected the contributions they had made:

Conventional means-testing of Social Security is unwise. . . . The Council rejects the further proposition that Social Security should also condition benefits on assets or other income at retirement—conventionally known as ‘means-testing.’ The fact that benefits are paid without regard to a beneficiary’s current income and assets is the crucial principle that allows—in fact encourages—people to add savings to their Social security benefits and makes it feasible for employers and employees to establish supplementary pension plans.<sup>16</sup>

The council’s opposition to means testing did not mean that Social Security’s benefit formula could not be progressive; indeed the current benefit formula functions somewhat analogously to a progressive system of tax brackets in that it treats individuals with high lifetime incomes less generously. All tax contributions,

15. Ibid.

16. Ibid.



however, have earned benefits under the formula and historically there has been no withholding of benefits based on income earned outside of Social Security.<sup>17</sup>

To further accentuate this point the council embraced another unanimous principle that “Social Security should provide benefits to each generation of workers that bear a reasonable relationship to total taxes paid, plus interest.”<sup>18</sup> Requiring high-income Americans to subsidize Social Security finances with income taxes or other taxes, while receiving no additional benefit credits for those tax contributions, violates this principle.

All of these statements of the council reflected a firm, enduring philosophical conception of Social Security held throughout most of the American political spectrum up through the mid-1990s. While some on the far right might have wished to abolish the program altogether, and some on the far left might have wished to finance it entirely with taxes paid only by high-income Americans, the predominant consensus was that Social Security should be separately self-financing and that all Americans rich and poor should receive benefits from it that reflected their own individual contributions.

There is an ample documentary record of the strength of this longstanding bipartisan opposition to general-revenue financing. Previous Social Security advisory council reports contain many examples. The 1957-59 advisory council opined, “We believe that the experience of the past 22 years has shown the advantages of contributory social insurance over grants from general tax funds.”<sup>19</sup> Similarly, the 1981 National Social Security Commission asserted, The primary source of funds to pay Social Security benefits has been, and the Commission believes should remain, the payroll tax. The link between payroll taxes and benefits is important both to the acceptance and strength of the system.”<sup>20</sup>

The 1981 Social Security Commission’s view that the “link between payroll taxes and benefits” was vital is in turn reflected in the statements of many policy advocates over the years, conveying both a policy ideal as well as the prevailing perception of Social Security’s existing financing method. Consider for example emblematic public statements of AARP (“Social Security is a self-financed program. . . . Older Americans earned these benefits after a life time of hard work”<sup>21</sup>) and of public

17. A portion of Social Security benefits are subject to income taxation, where tax rates reflect income outside of Social Security. Less than 3 percent of program revenues have derived from this source.
18. *Report of the 1994–96 Advisory Council on Social Security* (Washington, DC: 1996), vol. I, “Findings and Recommendations.”
19. 1957–59 Advisory Council, “1957–59 Advisory Council on Financing,” *Social Security Online Reports and Studies*, <http://www.ssa.gov/history/reports/58advisegen.html>.
20. National Commission on Social Security, “Financing Social Security and Medicare,” in *Social Security in America’s Future: Final Report of the National Commission on Social Security* (Washington, DC: National Commission on Social Security, March 1981), 52–119, <http://www.ssa.gov/history/pdf/80chap4.pdf>.
21. AARP letter to U.S. Senate, July 22, 2011, <http://www.aarp.org/about-aarp/press-center/info-07-2011/aarp-sends-letter-to-senate-outlining-opposition-to-cuts-to-social-security-medicare-and-medicaid.html>.

officials: (but one typical example: “[T]hey seem to dismiss the tax contributions hard working Americans have deposited into the Trust Fund . . . Americans have built up a \$2.6 trillion dollar surplus in their Trust Fund.”)<sup>22</sup> Severing the link between payroll taxes and benefits, whether by turning to general-revenue financing of Social Security or by establishing supplemental Social Security tax assessments not credited toward benefits, is thus a policy shift of enormous significance relative to what Americans have long understood Social Security to be.

### CRACKS IN THE CONSENSUS: PROPOSALS TO BREAK SOCIAL SECURITY'S CONTRIBUTION-BENEFIT LINK

THE FIRST POINT at which departing from Social Security's historical self-financing structure entered the mainstream political discussion was in 1999 with the introduction of President William Clinton's "Save Social Security First" proposal.

The context of President Clinton's proposal was a broader debate over federal budget policy. In the late 1990s, a surge in government revenues fueled by the dot-com stock bubble resulted in the first federal budget surpluses in decades. The Clinton administration opposed Republican proposals to return the surplus revenues through income tax relief, arguing instead that they should be used to extend the solvency of the financially troubled Social Security program. The Clinton proposal specifically was for a series of transfers of general budget revenues to the Social Security Trust Fund.<sup>23</sup> In effect the plan would have ended the era of Social Security self-financing and begun a new chapter in which the program was substantially subsidized from the general government fund.

The Clinton Social Security proposal was derailed by impeachment proceedings and subsumed by a cross-party debate over the broad direction of federal fiscal policy. It was thus never seriously considered by the Congress, nor were its dramatic implications for Social Security ever fully aired in the press. Social Security experts, however, understood at the time that the proposal would have fundamentally changed the nature of the program. Comptroller General David Walker said the following during testimony before the U.S. Senate Committee on Finance:

This proposal represents a fundamental shift in the way the Social Security program is financed. It moves away from payroll tax financing toward a formal commitment of future general fund resources for the program. This is unprecedented.<sup>24</sup>

Under the Clinton proposal Social Security would have been given a new claim

22. Xavier Becerra, "Opening Statement at Social Security Subcommittee Hearing," June 23, 2011.

23. President William J. Clinton, "Budget of the United States Government," FY 2000.

24. Senate Committee on Finance, "What the President's Proposal Does and Does Not Do," 106th Cong., 1st sess., February 9, 1999.

on general tax revenues. The taxpayers who provided these revenues would not be given additional benefit credits based on these contributions, nor would these additional contributions be separately tracked on W-2 forms in the historical manner of other FICA contributions. Social Security would be given the authority to spend substantially more on benefits than it had generated in taxes.

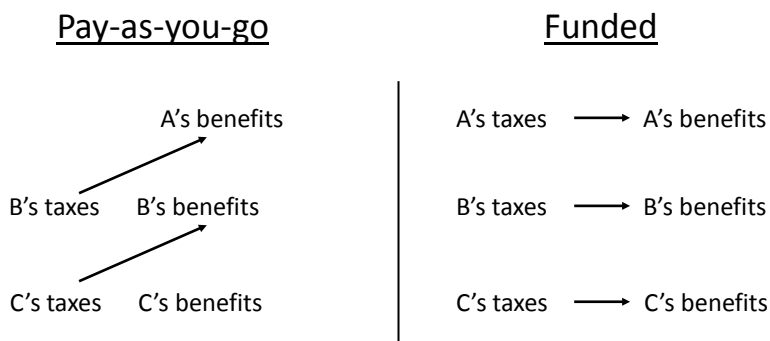
Though the Clinton proposal faded without serious legislative consideration, the following decade saw many other similar proposals to break Social Security's contribution-benefit link and to subsidize the program with taxes levied on higher-income taxpayers.<sup>25</sup> A seminal proposal in this regard was that of two noted economists, Peter Diamond (later a Nobel Prize winner) and Peter Orszag (later the director of the Congressional Budget Office and then of the Office of Management and Budget).

The Diamond-Orszag comprehensive proposal for Social Security solvency contained a provision to establish a "legacy charge" or "legacy tax" of 3 percent on the earnings of workers above the maximum Social Security taxable amount. No benefit credits would be earned based on this extra contribution.<sup>26</sup> In effect the proposal would have broken Social Security's contribution-benefit link by requiring higher-income earners to directly subsidize benefits paid to other workers with no incremental returns to themselves.

The rationale provided by Diamond and Orszag for this 3 percent surcharge was that it would help to discharge what they termed as Social Security's "legacy debt." This concept is visually depicted in figure 6.<sup>27</sup>

25. Some Republican proposals implicitly accepted President Clinton's position on transferring general (surplus) revenues to Social Security, one example being the Archer-Shaw proposal. The main presentational difference in these Republican proposals was that the new revenues would have been invested in individually owned Social Security accounts. Under some of these proposals (but not Archer-Shaw), the Social Security system would have been required to ultimately repay any general revenues borrowed.
26. Stephen C. Goss, "Estimates of Financial Effects for a Proposal to Restore Solvency to the Social Security Program," memorandum, October 8, 2003. See Provision 5: "Apply a 3 percent tax rate . . . to all OASDI covered earnings above the OASDI taxable maximum amount, as modified above. Benefit levels would not reflect the additional earnings subject to taxation."
27. "The benefits paid to almost all current and past cohorts of beneficiaries exceeded what could have been financed with the revenue they contributed, including interest. This history imposes a 'legacy debt' on the Social Security system. That is, if earlier cohorts had received only the benefits that could be financed by their contributions plus interest, the trust fund's assets would be much greater today." Peter Diamond and Peter Orszag, "Saving Social Security," *Boston Review*, April/May 2004. Diamond and Orszag connected the legacy debt concept to the proposed new surcharge as follows: "We would impose a legacy tax on earnings above the maximum taxable earnings base, thereby ensuring that very high earners contribute to financing the legacy debt in proportion to their full earnings." The Diamond-Orszag proposal contained other provisions also aimed at addressing the program's legacy debt, but the particular provision most relevant to this paper is the one to require a subsidy from higher-income taxpayers equal to 3 percent of their income above the Social Security tax cap. There are some methodological imperfections with the legacy tax concept. Though it is true that the first generations who drew Social Security benefits received far more than they contributed

FIGURE 6. THE "LEGACY DEBT" IS A MANIFESTATION OF PAY-AS-YOU-GO FINANCING



Note: "A" represents the first generation of beneficiaries, members of which received benefits well in excess of their contributions. "B" and "C" represent subsequent generations.

Though the windfall for earlier generations that figure 6 depicts was real, it did not necessarily lead to a systemic financial imbalance under pay-as-you-go financing. To understand why, note that the finances of a pay-as-you-go system are essentially governed by the following equation:

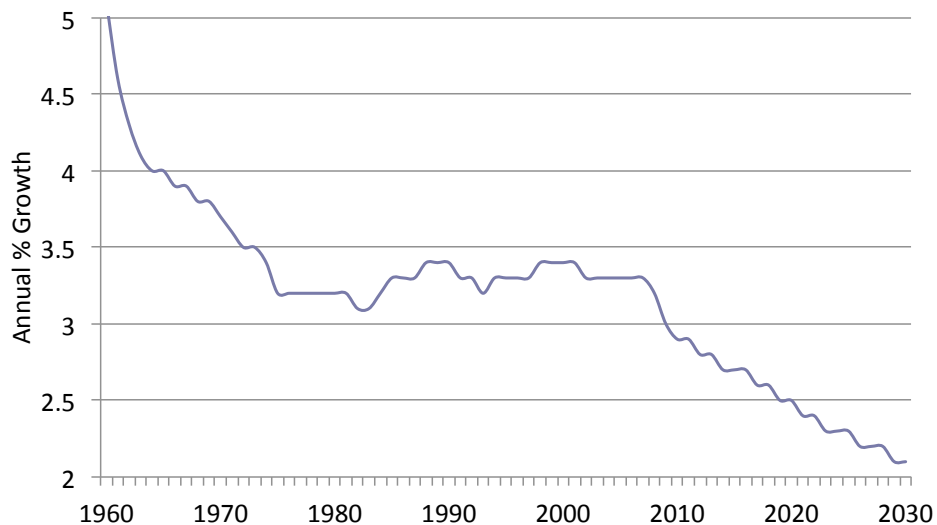
$$\frac{\text{Benefits as a percentage of current worker wages}}{\text{Ratio of workers to beneficiaries}} = \text{Tax rate as a percentage of current worker wages}$$

Social Security's current financial imbalance arose because key factors in this equation have changed over time. For one, the ratio of workers to beneficiaries is declining as shown in figure 7, a consequence of rising longevity and changing fertility patterns (i.e., members of the large Baby Boom generation not having borne as many children as did their own parents).

At the same time, legislative changes over the years and especially in the 1970s increased Social Security benefit levels relative to contributing-worker wages, as shown in figure 8. This subsequent legislation increased benefits not only in absolute terms but even relative to the higher earnings levels of later generations.

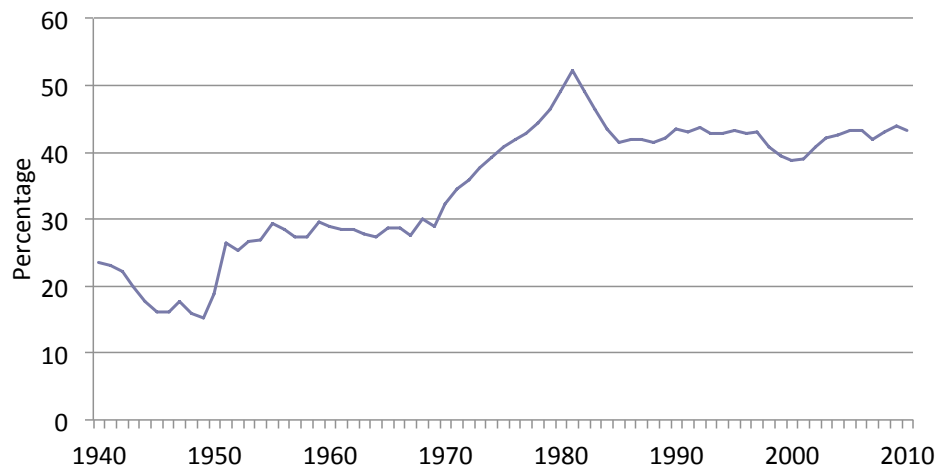
to the system, it is not strictly correct to suggest that this is a primary cause of the program's currently projected financing shortfall. The windfall received by the first generation of recipients was a consequence of its pay-as-you-go financing structure, in which each generation's benefits are financed from the contributions of the working generation that follows. This does not necessarily lead to a financial imbalance, nor is it a phenomenon that can be eradicated by addressing the imbalance, as explained in the main text.

FIGURE 7. SOCIAL SECURITY WORKER-BENEFICIARY RATIOS, 1960–2030 (PAST AND PROJECTED)



Source: Board of Trustees' *Annual Report*, 2012.

FIGURE 8. SOCIAL SECURITY FINANCES HAVE BEEN STRAINED BY REPEATED BENEFIT INCREASES  
Medium-Wage Worker Benefits at NRA, as % of Wages



Source: Board of Trustees' *Annual Report*, 2012.

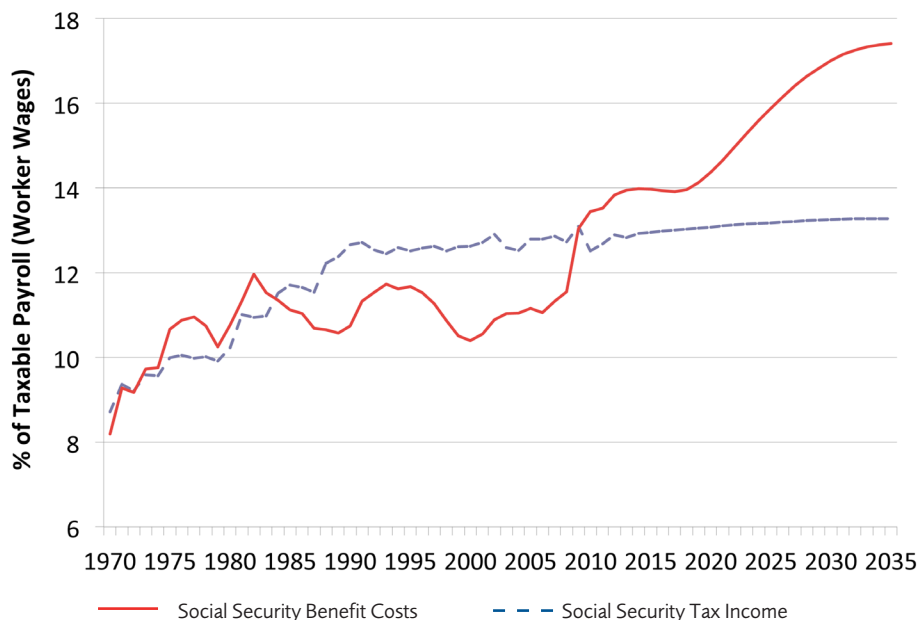
Note: "Wages" are measured with indexation for national wage growth per Social Security Administration conventions. Social Security replacement rates as a percentage of nominal preretirement earnings are substantially higher.

Social Security's imbalance has arisen primarily because of interactions between three factors: (a) pay-as-you-go financing, (b) demographic changes, and (c) legislated benefit expansions.<sup>28</sup> The resulting deficits that compose Social Security's

28. For a fuller discussion of these factors, as well as behavioral incentives that have exacerbated them, see Blahous, *Social Security: The Unfinished Work*; and Charles Blahous and Jason J. Fichtner, "Social Security Reform and Economic Growth," in *The 4% Solution: Unleashing the Economic Growth America Needs*, ed. Brendan Miniter (New York: Crown Business, 2012), 204–225.

currently projected shortfall began to be manifested only after 2010, as shown in figure 9.

**FIGURE 9. SOCIAL SECURITY'S PROJECTED IMBALANCE CONSISTS OF DEFICITS EMERGING LONG AFTER SOCIAL SECURITY'S INITIAL "LEGACY COSTS"**



Source: Board of Trustees' *Annual Report*, 2012.

Had birth rates not declined after the Baby Boom and had benefit levels not been expanded in the 1970s, Social Security would actually be in financial balance today despite its legacy debt. So while the legacy debt is an informative historical concept, it does not explain the causes of the current shortfall nor does it clarify the measures most appropriate to address it.<sup>29</sup>

Analytical issues aside, the 2003 Diamond-Orszag proposal gave a new impetus to an idea that had long been conceptually taboo among Social Security advocates: namely, breaking Social Security's contribution-benefit link. This momentum was created by offering a new rationale for doing so: specifically, that higher-income taxpayers should pay to discharge the initial start-up costs of the Social Security

29. It is particularly problematic to invoke the legacy debt concept to justify breaking Social Security's contribution-benefit link by introducing continuing surcharges on higher earners. To the extent that the legacy debt is a valid concept, it describes an intergenerational phenomenon, that is, a transfer of income resources from younger generations to older ones. This can be addressed only by a solution that mitigates intergenerational income transfers, for example by transitioning from pay-as-you-go financing to whole or partial advance-funding. An intergenerational income transfer cannot be mitigated simply by shifting resources between income classes while continuing with a pay-as-you-go financing structure. To be effective in remedying a legacy debt, a surcharge would need to embody a method of financing a new funded component within Social Security. One possible means of achieving this would be a personal account funded with the new surcharge.

system. For example, a “Social Security Fix-It Book” published by the Center for Retirement Research at Boston College suggested as one policy option that

in the early years of Social Security, retirees got benefits worth far more than they put in. The cost of these start-up benefits is now built into the program’s ongoing cost. We could transfer these start-up costs to general government revenues. Then the payroll taxes paid by each generation would closely reflect the benefits it gets.<sup>30</sup>

President Clinton had earlier attempted to head off momentum for income tax relief by giving the Social Security Trust Fund a prior claim on general government revenues. After President George W. Bush was elected and income tax relief enacted in 2001, the Diamond-Orszag proposal would have effectuated a version of President Clinton’s policy after the fact, undoing much of the recently enacted income tax relief by reclaiming 3 percent of the earnings of higher-wage Americans for the Social Security Trust Fund.

After the Diamond-Orszag proposal, efforts accelerated among some left-of-center thinkers to find the most acceptable means of subsidizing Social Security with progressive taxes. In 2005, former Social Security commissioner Robert Ball proposed that higher estate taxes be reinstated and the revenues transferred to Social Security.<sup>31</sup> This proposal was particularly notable in coming from Ball, who had been one of the members of the 1994–96 Advisory Council expressing unanimous opposition to such transfers of general revenues. Ball’s reversal was indicative of a growing comfort among some advocates with the idea of replacing Social Security self-financing with a progressive tax subsidy.

The remainder of that decade saw various additional proposals for requiring higher-income taxpayers to subsidize others’ Social Security benefits. During the presidential campaign of 2008, then-Senator Barack Obama proposed that Americans with earnings over \$250,000 be assessed an additional Social Security tax.<sup>32</sup> In 2009, Congressman Robert Wexler proposed that those with earnings above the Social Security maximum taxable amount be assessed a 6 percent surcharge with no credit toward benefits.<sup>33</sup> In 2011, U.S. Congressman Peter DeFazio

30. Steven Sass, Alicia H. Munnell, and Andrew Eschtruth, *The Social Security Fix-It Book* (Boston: Center for Retirement Research at Boston College, 2009 ed.), 20. It should be noted for precision that the only reason a general revenue subsidy to Social Security would stabilize the future return on payroll taxes is that it would transfer affected workers’ income losses under Social Security to the income tax side. Shifting the tax burden from payroll taxes to income taxes does not ameliorate declining returns for younger generations as a whole; it simply further concentrates the losses on higher-income taxpayers.
31. Memorandum, Social Security Chief Actuary Stephen C. Goss, April 14, 2005.
32. Associated Press, “Obama: Tax Incomes above \$250,000,” MSNBC, June 13, 2008, [http://www.msnbc.msn.com/id/25143640/ns/politics-decision\\_08/t/obama-tax-incomes-above](http://www.msnbc.msn.com/id/25143640/ns/politics-decision_08/t/obama-tax-incomes-above).
33. Memorandum, Stephen C. Goss, July 2, 2009.

and Senator Bernie Sanders each proposed that a 12.4 percent tax be assessed on earnings over \$250,000, again, with no Social Security benefit credits for the added contributions.<sup>34</sup>

In 2010, driven primarily by the influx of Baby Boomers onto the retirement and disability rolls, and accelerated by economic recession, Social Security ran a deficit of expenditures over tax income for the first time since 1983. These fiscal strains arose after a decade of acclimation of some influential left-of-center thinkers to the idea of breaking Social Security's contribution-benefit link and subsidizing benefit payments with progressively assessed taxes.

The era of bipartisan commitment to the principle of Social Security as an earned benefit financed predominantly through a separate payroll tax was drawing to a close.

## THE LURE OF PAYROLL TAX RELIEF

AS BIPARTISAN COMMITMENT to maintaining Social Security's contribution-benefit link has eroded, the attraction of payroll tax relief has risen for many policy advocates. At least four trends of opinion have lent further momentum to the idea of relieving payroll tax burdens and allowing Social Security to rely partially on general tax income.

The first of these trends involves rising expressed concerns about income inequality, especially on the left end of the American political spectrum. These concerns have focused attention on whether the Social Security payroll tax is undesirably regressive. This perception of the payroll tax is rooted in its design as a flat tax rate with no deductions, collected on income only up to a cap (currently \$110,100).<sup>35</sup> Individuals with income above the cap thus have a smaller percentage of their total income subjected to the payroll tax than do lower earners.

The perception that the payroll tax is regressive is incomplete at best. There are two self-consistent ways to think about the distributional impact of the Social Security payroll tax. Social Security is either separate from the general budget or it is not. The payroll tax is either tied directly to one's Social Security benefit entitlement or it is not. Either view, if employed consistently, would conclude that lower-income individuals are not subject to regressive payroll taxation.

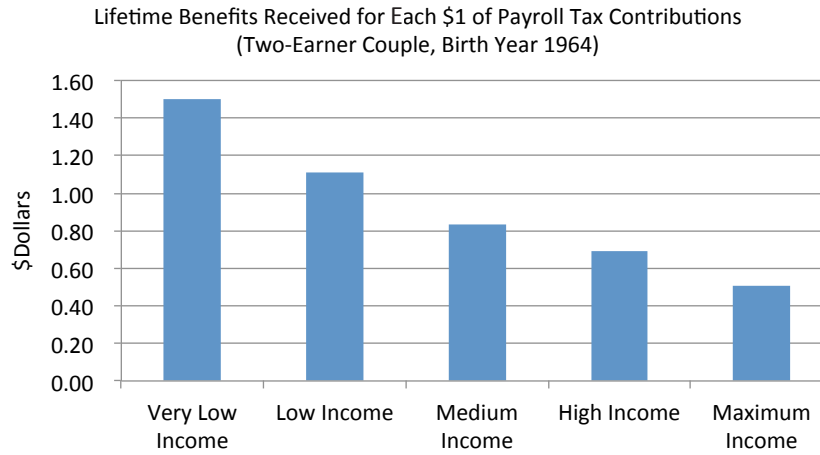
If on the one hand the payroll tax is truly a separate financing mechanism that establishes (in FDR's words), one's "legal, moral and political right" to Social Security benefits, then it is clearly not regressive in its overall effects. Low-income Americans receive a systematically higher return on their payroll tax contributions than do higher-income Americans, as shown in figure 10.

34. Memorandum, Stephen C. Goss, March 3, 2011.

35. The cap is automatically indexed to rise annually with the national average wage index under typical circumstances.



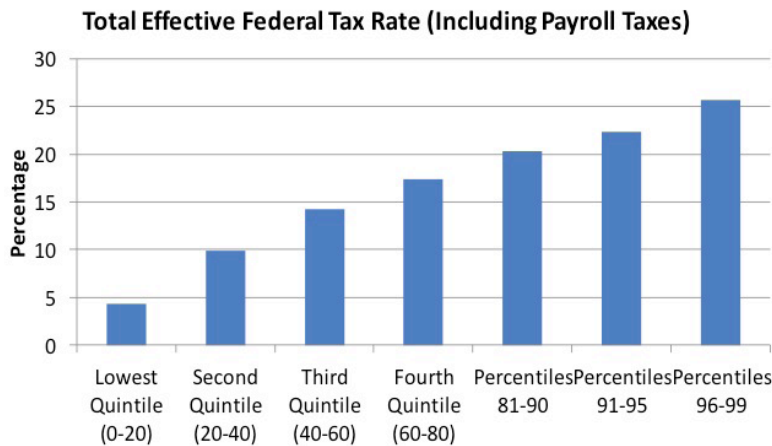
**FIGURE 10. PAYROLL TAXES BUY SOCIAL SECURITY BENEFITS IN A SUBSTANTIALLY PROGRESSIVE WAY**



Source: Michael Clingman, Kyle Burkhalter, Alice Wade, and Chris Chaplain, "Money's Worth Ratios under the OASDI Program for Hypothetical Workers" (*Actuarial Note No. 2011.7*, Social Security Administration, Office of the Actuary, Baltimore, MD, May 2012), <http://www.ssa.gov/OACT/NOTES/ran7/an2011-7.pdf>, table 3.

If, on the other hand, the payroll tax is simply a component of the broader tax burden of financing general services provided by the federal government, that general tax structure (even including the payroll tax) is also substantially progressive, as seen in figure 11.

**FIGURE 11. THE TOTAL FEDERAL TAX BURDEN IS SUBSTANTIALLY PROGRESSIVE**



Source: Congressional Budget Office, "Historical Effective Tax Rates, 1979 to 2005: Supplement with Additional Data on Sources of Income and High-Income Households," December 23, 2008.

The payroll tax appears to be regressive only if one considers merely one side of the equation, that is, if considering the tax—but not the Social Security benefit entitlement that it creates—as separable from other federal revenues and expenditures. Because it is implausible that a separate Social Security payroll tax would ever have

been established without Social Security benefits, this is an inherently problematic view of the distributional effects of the payroll tax.

Problematic or not, the perception that the payroll tax is regressive and should be relieved to ameliorate broader income inequality has nevertheless acquired an allure for some policy advocates.

The second important factor contributing momentum to payroll tax relief is that Social Security benefit costs have now risen above the levels that lawmakers are willing to require workers to finance under FDR's traditional contributory insurance structure. Generally, as program costs have risen so too have concerns about the tax burdens Social Security imposes on working Americans.<sup>36</sup> Lawmakers have thus looked for and found creative ways to relieve low-income Americans of the costs of financing benefits without cutting the benefits themselves. Though they have sought to do this without weakening the public perception of Social Security as an earned benefit, they have nevertheless weakened the contribution-benefit link in substantive practice.

For example, the 1983 Social Security amendments contained tax increases to help avert program insolvency, yet lawmakers moved simultaneously to cushion workers against their practical effects. Both the 1983 amendments and subsequent legislation established refundable income tax credits to shield wage earners and the self-employed from experiencing a net tax increase to support Social Security benefit payments.<sup>37</sup> Thus, while the link between contributions and benefits remained superficially intact after the 1983 reforms, lawmakers had adopted a deliberate policy of refunding payroll tax increases via the income tax code. Another example of this policy trend was the repeated expansion of the earned income tax credit (EITC), a refundable income tax credit designed in part to offset rising payroll tax

36. For historical rate increases, see OASDI Trustees' Report, table V.C6, "Contribution and Benefit Base and Payroll Tax Contribution Rates," 2012, [http://www.ssa.gov/OACT/TR/2012/V\\_C\\_prog.html#284997](http://www.ssa.gov/OACT/TR/2012/V_C_prog.html#284997).

37. The 1983 legislation raised payroll tax rates from 10.8 percent to 12.4 percent on an accelerated schedule relative to previous law. The Greenspan Social Security Commission recommended that the first step in this increase—from 10.8 percent to 11.4 percent—be accompanied by a provision to offset the employee share of the increase (0.3 points) with a refundable income tax credit. See Report of the National Commission on Social Security Reform, January 1983, Findings and Recommendations: "For 1984, a refundable income tax credit would be provided against the individual's Federal income-tax liability in the amount of the increase in the employee's taxes over what would have been payable under present law." Economist Alan Viard describes the dynamic that unfolded after the 1983 amendments: "The trust fund received implicit, but undisguised, general revenue financing in 1984 through 1989 in the form of income tax credits to offset Social Security tax increases. An income tax credit equal to 0.3 percent of taxable wages was granted in 1984 to offset an increase in the payroll tax rate. Income tax credits equal to 2.7 percent of taxable self-employment earnings in 1984, 2.3 percent in 1985, and 2 percent in 1986 through 1989 were granted to offset increases in the self-employment tax rate." See Alan D. Viard, "Social Security and the General Treasury: Who's Raiding Whom?" *Tax Notes*, February 21, 2011.

burdens, in the years after 1983.<sup>38</sup> Lawmakers' decision to accomplish this financing relief through programs separate from Social Security reflected the continued political importance attached to maintaining the appearance of self-financing.

In sum, Social Security benefits and costs already exceed what lawmakers are willing to assess low-income workers to finance. The simultaneous unwillingness to cut these workers' benefits or to charge workers for the full costs of them inevitably erodes commitment to maintaining the program's contribution-benefit link.

A third important factor involves declines in the percentage of Americans paying income taxes. A widely cited study by the Tax Policy Center found recently that fully 47 percent of American households now have no federal income tax liability at all.<sup>39</sup> This situation has precipitated a number of economic policy debates. On the one side, many are concerned about the political economy effects of so many Americans receiving government services without shouldering any of their associated costs. On the other side, it is often observed that roughly two-thirds of those who lack an income tax liability nevertheless do pay Social Security and/or Medicare payroll taxes (though this rejoinder often neglects the higher benefit returns low-income Americans receive for these contributions).<sup>40</sup>

The large number of Americans lacking income tax liability can become an especial issue whenever tax-relief legislation is debated, whether the purpose of the tax relief is to spur long-term growth or to provide short-term stimulus. Lawmakers often wish to deliver an income boost to low-income Americans who lack income-tax liability. At the same time, lawmakers may wish to characterize this income boost as "tax relief" rather than government spending.

The rhetorical answer to this conundrum has often come in the form of refundable income tax credits. The Congressional Budget Office appropriately treats such payments as outlay spending when they involve sending a payment from the federal Treasury to someone who does not pay income taxes. But as many of these individuals do pay Social Security payroll taxes, these payments are sometimes depicted by their advocates as tax relief. The Obama administration, for example, referred to its refundable "Making Work Pay" tax credit as a "tax cut" and structured it as a credit equal to up to 6.2 percent of earned income so that it could be represented as

38. See for example, Center on Budget and Policy Priorities, "Policy Basics: The Earned Income Tax Credit," updated February 22, 2012, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2505>. "The Earned Income Tax Credit (EITC) is a federal tax credit for low- and moderate-income working people. It is designed to encourage and reward work as well as offset federal payroll and income taxes." See also, Results.org, "Earned Income Tax Credit," [http://www.results.org/issues/us\\_poverty\\_campaigns/economic\\_opportunity\\_for\\_all/earned\\_income\\_tax\\_credit](http://www.results.org/issues/us_poverty_campaigns/economic_opportunity_for_all/earned_income_tax_credit) (accessed March 20, 2012). "Congress originally created the tax credit legislation in 1975, in part to offset the burden of social security payroll taxes."
39. Tax Policy Center, "T11-0176. Baseline Distribution of Tax Units with No Income Tax Liability by Cash Income Percentile; Current Law, 2011," *The Numbers*, July 13, 2011, <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3057> (accessed March 20, 2012).
40. Tax Policy Center, "Who Doesn't Pay Federal Taxes?" *Tax Topics*, <http://www.taxpolicycenter.org/taxtopics/federal-taxes-households.cfm>.

a refund against the Social Security payroll tax (of which the employee share is 6.2 percent).<sup>41</sup> These portrayals were substantively problematic in that policymakers did not actually intend to reduce Social Security program income or to cut Social Security benefits, both of which would have resulted under a program of actual payroll tax relief.<sup>42</sup>

The fourth important factor trending toward payroll tax relief is rising confidence in the assumed political strength of Social Security, particularly among younger left-of-center thinkers. As this paper has reviewed, for decades the ideological descendants of FDR saw Social Security's separate payroll tax, its self-financing structure, and its contribution-benefit link as the critical ingredients that would protect the program from the vulnerable political position of being thought of as a dole. The perception that workers had paid for their benefits assured FDR that "no damn politician can ever scrap my Social Security program."

In recent years, however, a view has arisen among some left-of-center thinkers that Social Security need not pay its own way to retain its political support. To the contrary, some have opined that it would do actual substantive harm to require Social Security to finance itself. Columnist Ezra Klein argued in a 2010 column:

If Social Security is proving a drag on the federal budget, then one option is make changes to Social Security, but another option is to make offsetting changes elsewhere in the federal budget. And increasingly, that's my preference. It's a testament to Social Security's efficiency that every option for balancing its books is a bad option. Raising the retirement age hurts real people. Raising taxes also hurts real people. Cutting benefits hurts—well, you get the point. Social Security is adding value. Any change you make will either increase how much we're spending for that value or decrease the total value we're getting from the program.<sup>43</sup>

41. Office of Management and Budget, *A New Era of Responsibility: Renewing America's Promise* (Washington, DC: Government Printing Office, 2009), <http://www.gpo.gov/fdsys/pkg/BUDGET-2010-BUD/pdf/BUDGET-2010-BUD.pdf>.
42. William McGurn, "Obama Talks Nonsense on Tax Cuts," *Wall Street Journal*, October 21, 2008, <http://online.wsj.com/article/SB122455061443852529.html>. The eventual policy of cutting the payroll tax and substituting general revenues is economically similar to a refundable income tax credit. Under both policies, workers are refunded a portion of their payroll tax contributions while Social Security is held harmless for the government's revenue loss. The 2011–12 payroll tax cut was ultimately enacted after it became clear Congress would not extend the Making Work Pay tax credit further.
43. Ezra Klein, "The Case against Reforming Social Security," *Washington Post Voices*, August 30, 2010, [http://voices.washingtonpost.com/ezra-klein/2010/08/the\\_case\\_against\\_reforming\\_soc.html](http://voices.washingtonpost.com/ezra-klein/2010/08/the_case_against_reforming_soc.html).

There are substantive inaccuracies in the paragraph above that involve analytical issues extending beyond the scope of this paper.<sup>44</sup> These aside, the passage is remarkable for another reason: it represents a reversal from how left-of-center thinkers had for decades typically thought about Social Security. Instead of seeing self-financing as the key to Social Security's enduring strength, this new view holds that upholding self-financing actually undercuts Social Security's potential to offer its greatest societal value. Unlike earlier generations of left-of-center thinkers, significant numbers of younger advocates now believe Social Security's political strength can not only endure but perhaps even be optimized if the self-financing construct is abandoned altogether.

This study's mention of the rise of such sentiments should not be misinterpreted as attributing this viewpoint to all left-of-center advocates. Other influential advocates, such as Nancy Altman, continue to support the principle of self-financing as indispensable to Social Security's future viability.<sup>45</sup>

Nevertheless, four crucial political factors were simultaneously present by 2010: perceptions that the payroll tax was regressive, discomfort with charging workers for the full cost of their Social Security benefits, a desire to offer tax relief to the nearly half of American households that owe no income tax, and fading commitment among certain left-of-center advocates to maintaining Social Security self-financing. These and other factors combined to create an environment conducive to cutting the payroll tax, financing the program in part from general revenues, and abandoning Social Security's historical design as a self-financing program.

#### THE ABANDONMENT OF SELF-FINANCING: THE 2011–12 PAYROLL TAX CUT

IN DECEMBER 2010, Congress passed and President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The core of the legislation was the extension of current income tax rates through the end of 2012. The law also contained a provision sought by the president to temporarily

44. One overriding analytical problem with the cited paragraph is that it implicitly assumes that Social Security adds a positive value if its expenses exceed its tax collections and that there are inherently fewer adverse consequences if income tax payers rather than payroll tax payers are required to finance its shortfall. This is incorrect; the costs of financing Social Security do not become smaller by virtue of being financed from general revenues. They simply become less transparent.
45. See, for example, Nancy Altman, "The End of Social Security," *My Fire Dog Lake*, December 7, 2010, <http://my.firedoglake.com/nancyaltman/2010/12/07/the-end-of-social-security>, in which Altman writes, "The innocent-sounding payroll tax holiday . . . will lead inexorably to killing Social Security."

reduce the Social Security payroll tax by two percentage points (from 12.40 percent to 10.40 percent).<sup>46</sup>

Reducing the Social Security payroll tax rate to its lowest level in decades was a significant policy change yet not the most significant from the vantage point of general Social Security policy. Even more significant was the law's taking the unprecedented step of beginning substantial funding of Social Security from general government revenues. This occurred under a provision of the law stipulating that to the extent that the legislation reduced payroll tax collections general revenues would be transferred to the Social Security Trust Fund to compensate:

There are hereby appropriated to the Federal Old-Age and Survivors Trust Fund and the Federal Disability Insurance Trust Fund established under section 201 of the Social Security Act (42 U.S.C. 401) amounts equal to the reduction in revenues to the Treasury by reason of the application of subsection (a). Amounts appropriated by the preceding sentence shall be transferred from the general fund at such times and in such manner as to replicate to the extent possible the transfers which would have occurred to such Trust Fund had such amendments not been enacted.<sup>47</sup>

In 2011 this provision resulted in an unprecedented amount of general government revenues—\$103 billion the first year alone—being transferred to subsidize Social Security benefit payments. This general revenue transfer fundamentally transformed the nature of Social Security financing. It was more than fifteen times the size of the largest single transfer in any previous year and roughly three times the total net transfers in all years from Social Security's inception through 2010 inclusive.<sup>48</sup>

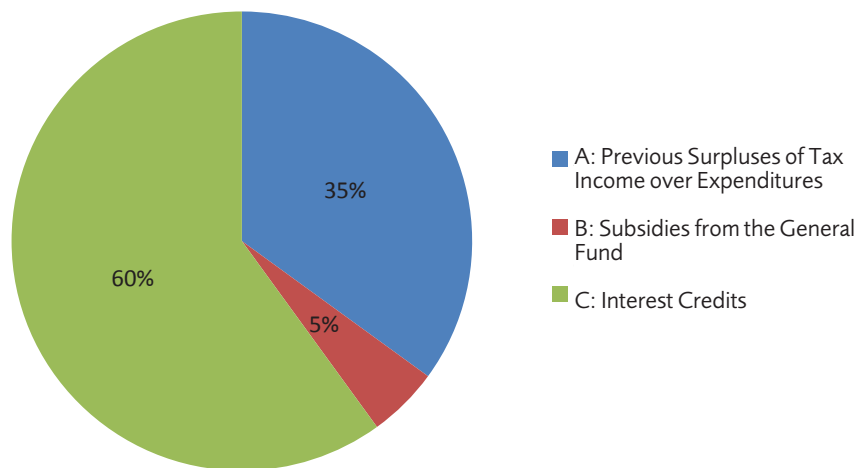
Prior to this policy change, the Social Security trust funds' balance had consisted almost entirely of the nets of prior surplus tax collections over expenditures plus interest earned on those operating surpluses, as previously shown in figure 4. With the new law as shown in figure 12, general revenue subsidies began for the first time to represent a more significant portion of Social Security Trust Fund assets.

46. Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010), §601. The standard 12.4 percent payroll tax rate is nominally split evenly between employer and employee, with each contributing 6.2 points of the 12.4 point total. Economists generally agree that both the employee and employer halves of the tax subtract from the worker's total compensation. The self-employed pay both halves of the 12.4 percent tax rate. The two point payroll tax cut in 2011–12 was made effective on the employee side so that the employee share is nominally 4.2 percent in these years.

47. *Ibid.*

48. See Social Security Online, "Old-Age, Survivors and Disability Insurance Trust Funds Receipts," Actuarial Publications: Trust Fund Data, second table, <http://www.socialsecurity.gov/OACT/STATS/table4a3.html>.

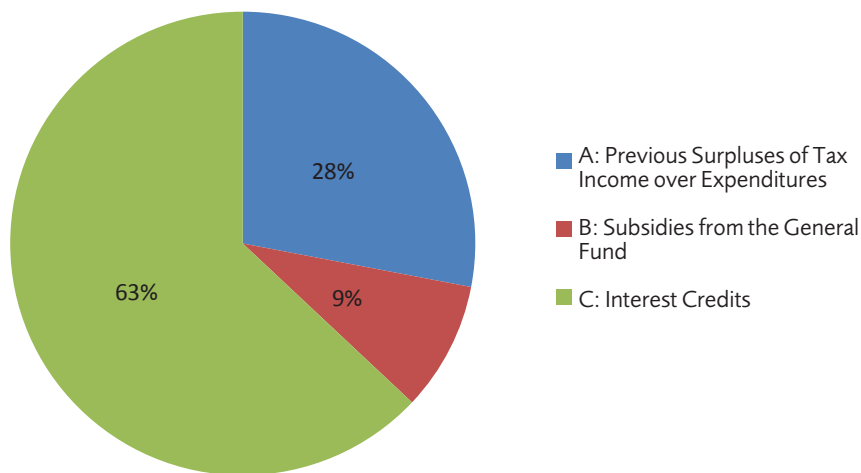
FIGURE 12. COMPONENTS OF SOCIAL SECURITY TRUST FUNDS BALANCE, END OF YEAR 2011



Source: Author's calculations based on Social Security Administration data published in the 2012 Social Security Trustees' Annual Report and at <http://www.socialsecurity.gov/OACT/STATS/table4a3.html>.

In December 2011, Congress and President Obama agreed to extend the payroll tax cut, initially for two months and then for the remainder of 2012. This further increased the reliance of Social Security on subsidies from the general fund (see figure 13).

FIGURE 13. COMPONENTS OF SOCIAL SECURITY TRUST FUNDS BALANCE, END OF YEAR 2012



Source: Author's calculations based on Social Security Administration data published in the 2012 Social Security Trustees' Annual Report and at <http://www.socialsecurity.gov/OACT/STATS/table4a3.html>.

As of this writing it is unknown whether the current policy of replacing payroll tax assessments with general revenue subsidies will be extended further. If it were extended for just a few more years, Social Security's Trust Funds' balance would soon be attributable entirely to direct subsidies and interest payments from the general government fund.<sup>49</sup> Even if not, the transfers have already caused a fundamental change in Social Security finances. As a result of current policy, Social Security will in the future be permitted to spend roughly \$217 billion—plus future interest credits in the hundreds of billions—more on benefits than it has ever generated in tax collections. This is a sharp break with longstanding practices. It represents, in effect, the end of the era of Social Security self-financing.

### IMPLICATIONS FOR TAXPAYERS AND THE FEDERAL BUDGET

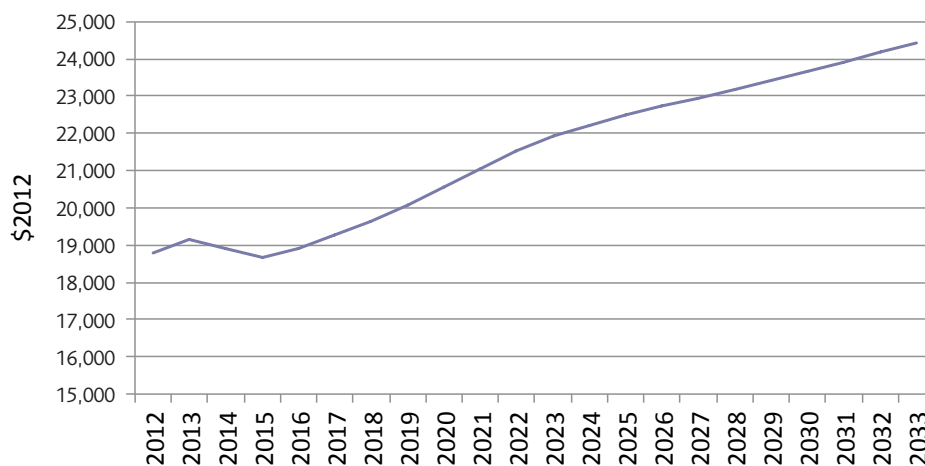
IN ADDITION TO its implications for the philosophical basis of Social Security financing, subsidizing Social Security from the general fund has direct financial implications for taxpayers and the federal budget.

The first direct financial effect is to formally commit providers of general fund revenues (for example, income tax payers) to financing Social Security benefits at higher levels and for a longer period of time than would be the case in the absence of such subsidies. Social Security's trustees now project the program to remain solvent until 2033, meaning that it has a legal claim on financial resources sufficient to pay full benefits through that date. Specifically, without a further change in law Social Security will be authorized to pay the rising benefit levels depicted in figure 14. As shown in figures earlier in this paper, these obligations will place sharply rising pressure on the federal budget.

49. Author's calculations based on data published at <http://www.socialsecurity.gov/OACT/STATS/table4a3.html> and [http://www.ssa.gov/OACT/TR/2012/IV\\_A\\_SRest.html#382302](http://www.ssa.gov/OACT/TR/2012/IV_A_SRest.html#382302). See footnote 54 for additional information.



**FIGURE 14. SCHEDULED INITIAL RETIREMENT BENEFITS FOR MEDIUM-WAGE EARNERS**  
(At Normal Retirement Age, in \$2012)



Source: 2012 Social Security Trustees Report.

Starting in 2033 incoming program taxes would be inadequate to fund these obligations to previous beneficiaries even if payments to new claimants were entirely eliminated—an implausible scenario. If lawmakers thus wish to protect previous and low-income retirees from sudden benefit reductions while also sparing workers from unprecedented payroll tax increases, new legislation will be required very soon.

Were it not for current general revenue subsidies, the apparent urgency of such reforms would be greater. The \$217 billion in general revenues now being committed to Social Security will earn interest in the coming decades and add over \$600 billion to trust fund assets by the 2030s. Without this substantial additional revenue commitment, Social Security would be projected to be insolvent a year earlier, by early 2032.<sup>50</sup>

The provision of substantial general fund resources to Social Security commits the federal budget—and the income tax payers standing behind it—to supporting rising benefit costs for a longer period of time. This by itself directly transfers economic resources from income tax payers to program beneficiaries. Beyond this, however, the transfers have the more subtle but equally important effect of postponing Social Security’s projected insolvency date, diminishing the apparent urgency of legislative action, postponing needed reforms, and ensuring more beneficiaries will be on the rolls by the time a legislated solution is finally negotiated.<sup>51</sup>

Because lawmakers are always reluctant to cut benefits for those already

50. Author’s calculation based on SSA OACT estimates for trust fund operations and interest rates as published with the 2012 trustees’ report.

51. The currently reported Social Security shortfall over the next 75 years is \$8.6 trillion in present value. This shortfall would be roughly 2.6 percent higher were it not for current general revenue transfers.

receiving them, this dynamic could lead to a higher proportion of the remaining shortfall being addressed via tax increases as opposed to cost reductions. Under current law, the entirety of projected future program cost growth relative to GDP will occur prior to 2035. Whether this cost growth can be meaningfully checked depends primarily on legislative choices made in the next few years. Even a small diminution of apparent urgency reduces the vanishing chances that the program's financing shortfall can be resolved without large tax increases.<sup>52</sup>

Both legally and politically, therefore, the infusion of general revenue funds into Social Security exacerbates the rising cost burdens income tax payers face. As will be discussed in the next section, this could lead to political outcomes in which income tax payers demand and receive a more prominent seat at the Social Security policy bargaining table and once seated, argue for more aggressive cost reductions.

The use of general fund revenues to subsidize Social Security also undermines transparency and accountability to taxpayers. Currently, each taxpayer receives an annual accounting on his W-2 form of the FICA tax revenues he is supposedly paying to Social Security. The new policy of shifting general revenues to the program renders this accounting misleading. In 2011, only 70 percent of Social Security program revenues came from payroll taxes.<sup>53</sup> Over the next two decades Social Security benefit payments will rely on income tax revenues to an even greater extent.

In part because of recent financing changes, the "Social Security taxes" line on each worker's tax forms now fails to fully account for what each individual is now paying to support Social Security and is becoming especially misleading for those with significant income tax liability.

52. To take but one example of how a reduced sense of urgency increases the tax cost of an eventual solution, consider the diminishing savings that would arise under proposals to shift the program's initial benefit formula from wage indexing to price indexing. In 2005 it was projected that across-the-board price indexing would more than balance system finances even if those over 55 remained unaffected, with significant additional funds left over to provide for benefit growth above price inflation for lower-income participants. By 2009, however, it was projected that exempting those over 55 from price indexing would lead to eventual depletion of the Social Security trust funds unless taxes were raised. In effect, one cost of just a few years' delay is that it is no longer possible without a significant tax increase to provide for future real benefit growth while exempting those near retirement from benefit changes. Soon it will no longer be possible to provide for future real benefit growth while exempting those already in retirement without a significant tax increase.
53. *2012 Report of the Social Security and Medicare Trustees.*

## THE FUTURE OF SOCIAL SECURITY IN THE ERA OF GENERAL REVENUE SUBSIDIES

THERE ARE ESSENTIALLY four possible future courses for Social Security policy in the context of the recent incorporation of substantial general revenue subsidies.

1. *Continuation.* In this scenario Social Security continues to receive substantial subsidies from the general fund while its historical ethic of self-financing is tacitly abandoned.
2. *Recurrence.* In this scenario the current general revenue subsidies are allowed to terminate on schedule, but a precedent is established whereby lawmakers feel few inhibitions about resuming such subsidies whenever they believe other policy considerations warrant doing so.
3. *Termination with Lasting Policy Effects.* In this scenario the general revenue subsidies terminate on their current schedule and are not revived, but public perceptions of Social Security's role are significantly affected by awareness that benefit payments have been subsidized from the general fund.
4. *Termination with No Lasting Policy Effects.* In this scenario the general revenue subsidies terminate on their current schedule, public awareness of the subsidies remains limited, and lawmakers henceforth treat the 2011–12 practice as a one-time exception to longstanding policy and otherwise enforce self-financing in the future.

Scenario 4 could transpire only if it ultimately proves possible for Social Security to be “a little bit pregnant” with respect to the recent departures from self-financing. This scenario would play out if lawmakers re-adopt the historical requirement that Social Security tax collections be sufficient to fund its benefit payments—excepting the \$217 billion in general fund subsidies provided during 2011–12. Under this hypothetical scenario, the policy value judgments otherwise made by lawmakers in restoring the program to financial balance would be unaffected by the 2011–12 subsidies.

Under the other three scenarios, Social Security's future is substantially different because of general-revenue financing. As of this writing it is impossible to know whether and when continued general fund subsidization would so alter public perceptions of Social Security as an earned benefit as to precipitate other transformative changes to Social Security policy. This could, however, happen within the next few years as general revenue subsidies replace net tax surpluses in the importance of their contributions to the balance of the Social Security trust funds.<sup>54</sup>

54. If for example the current two-percentage point payroll tax reduction is continued (along with its accompanying general revenue infusion), then by the end of 2016 Social Security's \$2.9 trillion trust fund balance would be entirely attributable to general revenue deposits and interest credits from the general fund, with the net value of past tax collections over expenditures having dropped below zero. It is far from certain that the public would continue to regard Social Security benefits

For the past few decades of Social Security’s history, the following policy principles have generally been observed:

1. Funding Social Security via a payroll tax assessed as a flat contribution rate without exemptions or deductions, increased periodically as necessary to finance program benefits.
2. Broad benefit eligibility without income limits; no formal means testing.
3. Wage indexation of the initial benefit formula so that benefits grow rapidly enough to remain a constant share of preretirement income for similarly situated beneficiaries across time.
4. Linkage of individual benefit levels to tax contributions.
5. Eligibility ages set so benefits are received by the vast majority of contributing workers.

There has yet been little public attention to the potential implications for these historical policy principles of ending Social Security’s longstanding self-financing framework. Each of these principles, however, is fairly likely to be overwritten if Social Security continues to be subsidized from the general fund.<sup>55</sup> Exploring each principle in turn:

**Social Security Taxes.** Historically, Social Security taxes have been raised repeatedly to maintain program finances.<sup>56</sup> The original combined employee-employer payroll tax rate of 2.0 percent rose gradually to 12.4 percent by 1990 due to periodic legislation.<sup>57</sup> The wage base subject to the tax was also repeatedly raised.

Looking forward, many have suggested that further increases in payroll tax assessments, particularly in the wage base subject to the tax, might be a reasonable

as “earned” once such a milestone is reached. Even if the payroll tax cut is terminated on schedule at the end of 2012, a similar point would still be reached by the end of 2021, at which time the trust funds’ combined balance of \$3.05 trillion would be entirely attributable to past general revenue deposits and interest credits from the general fund. Under current law Social Security will place substantial accumulated pressure on the federal budget and therefore on income tax payers through 2021 and beyond. In this context, a simultaneous change in perceptions that Social Security beneficiaries have not paid for their benefits carries the potential to alter the dynamics that historically have determined Social Security policies. Author’s calculations based on data provided on Table IV.A3 of the *2012 Social Security Trustees Report*.

55. This section of the paper focuses on the policy implications of ending self-financing. Mechanically such a change in financing is almost trivially simple to accomplish; for example, by reenacting the text of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 with respect to transfers from the general fund to the Social Security trust funds, altering the amounts transferred as lawmakers decide.
56. OASDI Trustees’ Report, table VI.C6, “Operations of the Combined OASI and DI Trust Funds, Fiscal Years 2007–21,” 2012, <http://www.ssa.gov/OACT/TR/2012/VI.C.SRfyproj.html#287447>.
57. For historical rate increases, see *OASDI Trustees’ Report*, table V.C6.

way to address projected financing shortfalls. Such a provision has appeared in the proposals of many left-of-center advocates as well as bipartisan commissions such as the Simpson-Bowles commission and from the Bipartisan Policy Center.<sup>58</sup> Survey data consistently has shown this option among the more popular choices for improving Social Security solvency, especially among Democrats and self-identified progressives.<sup>59</sup>

It becomes much less likely, however, that lawmakers will choose to raise the cap on Social Security taxable wages if current general fund subsidies to Social Security continue. The recent adoption of such subsidies thus undercuts a central element of the progressive program for maintaining Social Security solvency. This is true for several reasons.

First, past payroll tax increases have been driven by the perceived obligation to require that Social Security pay its own way. Once it is instead deemed acceptable to collect payroll taxes in amounts substantially lower than required to finance program benefits, this historical force compelling higher payroll tax assessments is eliminated.

The degree to which this financing change might liberate policymakers from longstanding financing discipline should not be underestimated. Once payroll tax rates are to be determined by factors other than Social Security's own revenue needs, there is no longer an obvious rationale for raising program revenue collections to the levels necessary to finance benefits. For example, Orszag recently advocated unlinking taxes and benefits as a permanent feature of federal economic policy, writing that "rather than simply extend the payroll-tax holiday through the rest of the year, Congress should link it to the unemployment rate."<sup>60</sup> That is, whenever the unemployment rate rises the payroll tax rate should fall, regardless of Social Security's own financing needs. Social Security would need to draw from the general budget while the payroll tax rate is automatically lowered as an "economic stabilizer."

Acceptance of using general revenue subsidies to cover for lower payroll taxes would greatly depress the incentives for opposite sides of the political spectrum to agree to increase Social Security's payroll tax base. In such an environment

58. See Social Security Online, "Proposals Addressing Trust Fund Solvency," *Actuarial Publications*, last updated May 9, 2012, <http://www.ssa.gov/OACT/solvency/index.html>, in particular the proposals from Senator Tom Harkin, Senator Bernard Sanders, Congressman Peter DeFazio, the Bipartisan Policy Center, and the National Commission on Fiscal Responsibility.

59. There are multiple examples, but one is a survey published by the National Committee to Preserve Social Security and Medicare, which found that the most popular option for restoring solvency was "raising the wage base on which Americans pay payroll taxes." See National Committee to Preserve Social Security and Medicare, "Americans Support Protecting Social Security Benefits: Findings of NCPSSM Survey," survey conducted March 12–15, 2009, [http://www.ncpssm.org/pdf/poll\\_results\\_33109.pdf](http://www.ncpssm.org/pdf/poll_results_33109.pdf).

60. Peter Orszag, "Tie U.S. Recovery Program to Other Indicators," *Bloomberg.com*, February 7, 2012, <http://www.bloomberg.com/news/2012-02-08/tie-u-s-recovery-program-to-economic-indicators-peter-orszag.html>.

conservatives would have even greater reason to resist an increase in the base considering that general revenue funding already represents a substantial shift in financing burdens to higher-income taxpayers. Progressives meanwhile would already have accomplished a substantial increase in the progressivity of Social Security financing without carrying the political burden of having subjected critical constituencies (for example, small business owners) to a transparent increase in their payroll tax burdens. Both sides might regard it as political overkill to increase Social Security's payroll tax base while also further shifting program financing burdens to income tax payers through the general fund.

The use of general fund subsidies to support Social Security therefore guts much of the force of recurrent arguments to balance Social Security finances by raising either the payroll tax rate or the base. Once it is accepted that Social Security tax collections need not be adequate to finance its benefit payments, there are fewer strong reasons to consider further increasing Social Security taxes.

**Means Testing.** As previously described, there is strong historical resistance to means testing Social Security benefits. The 1994–96 Social Security Advisory Council's unanimous opinion against means testing is but one of countless examples of a historically predominant bipartisan consensus that no individual should be denied Social Security benefits based on non-Social Security income.<sup>61</sup>

Financing Social Security from the general fund removes a significant philosophical barrier to means testing. To the extent that general funds finance Social Security benefits, the providers of those funds (many of them income tax payers) are providing tax revenues to support Social Security without any additional benefit accruals for themselves. These revenues derive in turn from the taxation of individual income earned outside of the Social Security system. In terms of its net effect on these individual taxpayers, general-revenue financing has much in common with a means test of Social Security benefit payments. Whether achieved by denying a Social Security benefit payment or by assessing additional taxes, the essential effect of either policy is to require certain individuals to provide a subsidy to Social Security based on income earned outside of it.

General-revenue financing erodes political barriers to Social Security means testing in another way. Knowing that Social Security benefits would not have been fully earned by the pool of beneficiaries, income tax payers as a class may demand a seat at the bargaining table where Social Security benefit levels are determined. In the past, Social Security has escaped much of the ongoing political negotiation to constrain eligibility requirements, benefit levels, and total costs to which general revenue–financed programs are typically subjected. Financing Social Security from general revenues has the potential to change that dynamic and thereby force a more skeptical review of rising program costs.

61. Some have argued that the income taxation of some Social Security benefits under current law is effectively a “back-door means test” because the tax can be triggered by non-Social Security income.

Many other federal “welfare” programs financed from general funds are subject to various forms of means tests. Medicare Part B, financed largely from the general fund, is also subject to a means test. Financing Social Security from the general fund increases the likelihood that it ultimately would be as well.

**Wage Indexing.** Since the 1970s, the initial benefit levels individuals receive upon reaching retirement age have been calculated by a formula that rises in proportion to the average wage index, which generally exceeds price inflation. Of Social Security’s future cost growth, roughly half has been estimated to arise from the aging of the population and roughly half from growth in real benefit levels arising under this formula (see figure 14).<sup>62</sup>

The historical rationale for this benefit formula is to maintain “wage replacement”—that is, to ensure that a typical retiree of the future gets a benefit that is just as high a percentage of his preretirement income as does a typical retiree today. Some advocates believe that the continuation of wage indexing remains the appropriate basis for calculating benefit growth.<sup>63</sup> Part of the rationale for the current formula is that contributions to Social Security are based on worker wages and thus benefit growth should be as well.

Problematic policy issues are associated with wage indexing. One is that it causes program costs to rise faster than the underlying tax base whenever the ratio of workers to beneficiaries declines with population aging. Because of this, wage indexing does not create intergenerational equity but rather exposes younger generations to continually higher tax rates.<sup>64</sup> Nevertheless, the form of wage indexing in use since the 1970s remains the default scenario (in more ways than one) and continues to have many defenders.

It is quite likely, however, that further financing of Social Security from the general fund would fatally undercut the policy argument that Social Security benefits should rise with worker wages. In the first and most obvious place, it would no longer be the case that worker wages were the sole source of program financing. Just as importantly, a government program financed from general funds in an era of fiscal strains must be operated with greater attention to controlling the growth of costs. If lawmakers are unwilling to collect payroll taxes at the levels required to finance

62. Congressional Budget Office, “The Future Growth of Social Security: It’s Not Just Society’s Aging,” *Long-Range Fiscal Policy Brief*, no. 9 (July 1, 2003), <http://www.cbo.gov/sites/default/files/cbo-files/ftpdocs/43xx/doc4380/07-01-socsecaging.pdf>.

63. See, for example, Robert Greenstein, “So-Called ‘Price Indexing’ Proposal Would Result in Deep Reductions over Time in Social Security Benefits,” Center on Budget and Policy Priorities, January 28, 2005, <http://www.cbpp.org/cms/index.cfm?fa=view&id=1461>; and Virginia P. Reno, “Are Social Security Benefits Adequate?” National Academy of Social Insurance, May 15, 2009, <https://www.nasi.org/civicism/file?reset=1&id=38&eid=13&type=pdf>.

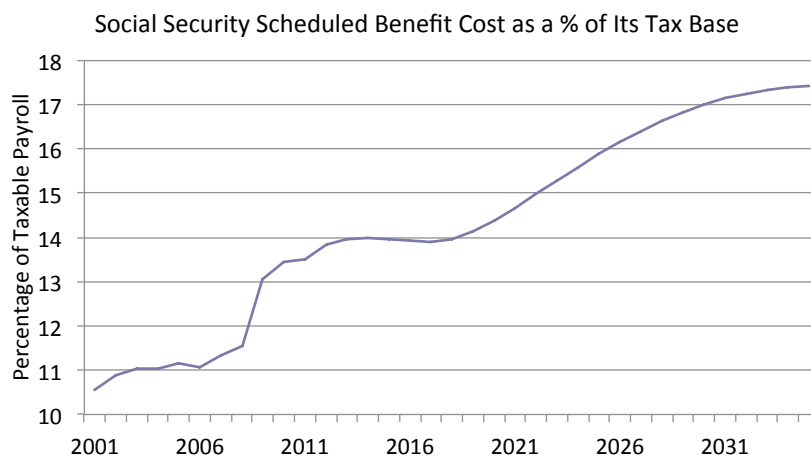
64. See Charles Blahous, “Nobody Is Proposing to ‘Slash’ Social Security Benefits,” *Wall Street Journal*, February 3, 2011. “Current wage-indexing doesn’t create benefit equity across generations. Rather, it ensures that each successive generation must pay higher taxes to get the same replacement rate.”



scheduled benefits, they are more likely to consider redrawing the benefit schedule.

Historically, programs financed from the general fund have usually been indexed to grow more slowly than Social Security now does. To date, Social Security has escaped such cost constraints largely because of the argument that it is financing itself. If it were instead financed permanently from the general fund, it is far less likely that the rising cost burdens of financing Social Security's wage-indexed benefits (shown in figure 15) would be deemed acceptable.

FIGURE 15. THE RISING COST OF WAGE-INDEXED BENEFITS



Source: 2012 Social Security Trustees Report.

Evidence of this lies in how federal lawmakers have indexed general revenue-financed programs in the past. The Supplementary Security Income program's benefits are indexed to grow with price inflation.<sup>65</sup> The EITC and the refundable child care tax credit are also indexed to price inflation.<sup>66</sup> Other analyses find that total benefits of Temporary Assistance for Needy Families have failed to keep pace with price inflation on a per-capita basis.<sup>67</sup> In sum, when federal programs are financed from within the general budget they are usually subject to much tighter constraints on per-capita benefit growth than Social Security has through most of its recent history.

65. U.S. Social Security Administration Office of Policy, "Changes in Incentives Influencing Program Size," Trends in the Social Security and Supplementary Security Income Disability Programs, [http://www.ssa.gov/policy/docs/chartbooks/disability\\_trends/sect05.html](http://www.ssa.gov/policy/docs/chartbooks/disability_trends/sect05.html).

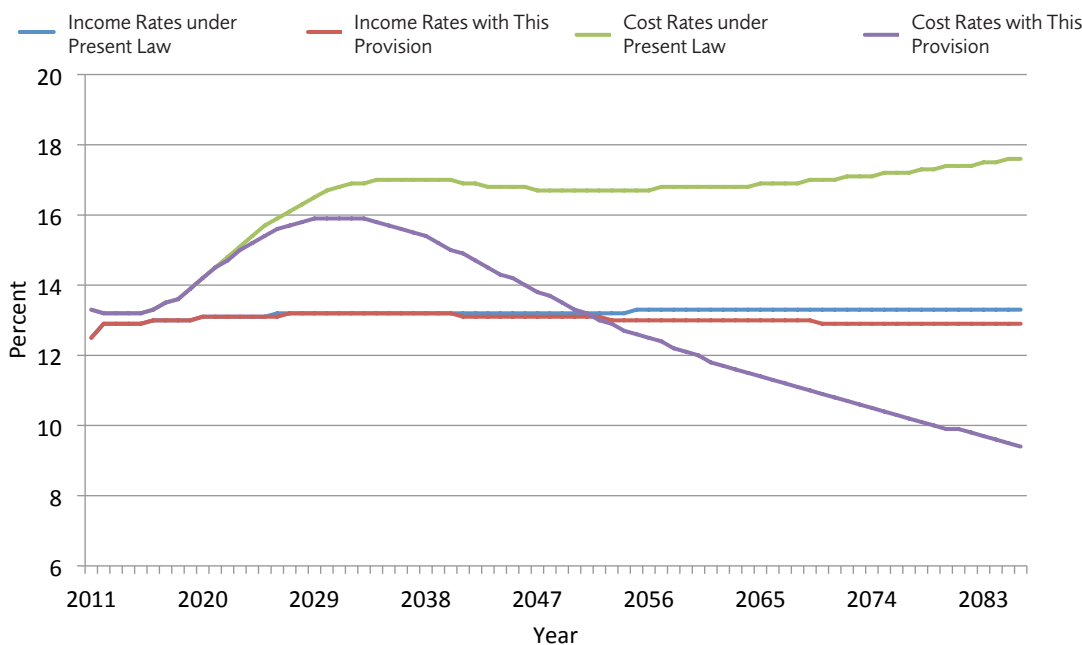
66. Robert S. McIntyre, "Earned Income Tax Credit," in *Tax Expenditures: The Hidden Entitlements* (Washington, DC: Citizens for Tax Justice, May 1996), [http://www.ctj.org/hid\\_ent/part-3/part3-3.htm](http://www.ctj.org/hid_ent/part-3/part3-3.htm); and Aviva Aron-Dine, "Improving the Refundable Child Tax Credit: An Important Step toward Reducing Child Poverty," Center on Budget and Policy Priorities, May 19, 2008, <http://www.cbpp.org/cms/?fa=view&id=766>.

67. Ife Finch and Liz Schott, "TANF Benefits Fell Further in 2011 and Are Worth Much Less Than in 1996 in Most States," Center on Budget and Policy Priorities, November 21, 2011, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3625>.



The Social Security Administration Office of the Chief Actuary has found that if Social Security’s initial benefit formula were tied to price inflation rather than wage growth, its long-term actuarial imbalance would be eliminated (though, if those over 55 were held harmless from the change, the program’s trust funds would still be depleted before annual operations again become tenable). Program costs would rise relative to the tax base for a time due to population aging and later become more affordable (see figure 16).

FIGURE 16. OASDI COST RATES AND INCOME RATES UNDER PRICE INDEXING



Source: Reproduced from Social Security Online, "Summary Measures and Graphs," *Actuarial Publications*, last updated December 21, 2011, [http://www.ssa.gov/OACT/solvency/provisions/charts/chart\\_run388.html](http://www.ssa.gov/OACT/solvency/provisions/charts/chart_run388.html).

Though a change to price indexation was fiercely resisted by many advocates during the program’s historical period of self-financing, it becomes a more feasible basis for benefit payments if Social Security is permanently financed from the general fund.

**The Contribution-Benefit Link.** Historically, Social Security’s individual benefit levels have been a reasonably direct function of individual tax contributions.<sup>68</sup> The greater one’s wages subject to taxation, the greater one’s Social Security benefit entitlement.

Subsidizing Social Security with general revenues (without crediting toward

68. Technically, they have been a function of wages subject to tax, ensuring the link as long as payroll taxes remained the primary source of program funds.

benefit accruals) breaks this historical link. Once this link is broken, the door is open to rewriting Social Security benefit formulas to avoid referencing tax contributions.<sup>69</sup>

In the past there has been resistance to proposals to have Social Security pay only for “safety net” protections against poverty rather than continuing to pay higher benefits to individuals who do not need them. Under some such proposals, the same basic flat benefit would be made available to all eligible individuals, the size of the benefit based on a judgment of income adequacy rather than the individual’s past contributions. Resistance to this suggestion has historically been based on the perceived imperative of preserving the contribution-benefit link to ensure continued broad public support.

Breaking the historical link between contributions and benefits could give additional impetus to the idea that Social Security’s primary function should be only to protect vulnerable individuals from poverty to the extent that general budget resources allow. This could mean redrawing Social Security’s benefit formula to instead provide a flat, defined floor of protection for those who need it most instead of a benefit that rises with a worker’s taxable income.<sup>70</sup>

**Eligibility Ages.** It is unclear what effect continued general-revenue financing would have on the ongoing debate over the appropriate ages of eligibility for Social Security retirement benefits. To date, eligibility ages have been set increasingly with an eye toward enabling the vast majority of Americans to collect old-age benefits if they live for a reasonably typical span. Since the 1961 program amendments, individuals of both sexes have been permitted to collect old-age benefits starting at age

69. Such a change could also affect individual workers’ labor and savings decisions. See Jeffrey B. Liebman and Erzo F. P. Luttmer, “The Perception of Social Security Incentives for Labor Supply and Retirement: The Median Voter Knows More Than You’d Think” (NBER working paper no. NB08-01, National Bureau of Economic Research, Cambridge, MA, September 24, 2008), <http://www.nber.org/programs/ag/rrc/08-01%20Liebman,%20Luttmer%20FINAL.pdf>. In this paper Liebman and Luttmer substantiate that workers perceive a link between tax contributions and Social Security benefits and behave accordingly. Liebman, Luttmer, and Seif also found that workers are more likely to continue their paid employment when marginal Social Security benefit returns are higher. See Jeffrey B. Liebman, Erzo F. P. Luttmer, and David G. Seif, “Labor Supply Responses to Marginal Social Security Benefits: Evidence from Discontinuities” (NBER working paper no. 14540, National Bureau of Economic Research, Cambridge, MA, December 2, 2008), <http://www.nber.org/papers/w14540>. Overtly severing the link between contributions and benefits through general-revenue financing is thus likely to reduce incentives for employment and savings.
70. Some have argued for putting the question of need first and then building the program’s financing arrangements around those value judgments. For example, see Robert J. Samuelson, “Would Roosevelt Recognize Today’s Social Security?” *Washington Post*, April 8, 2012, [http://www.washingtonpost.com/opinions/would-roosevelt-recognize-todays-social-security/2012/04/08/gIQAL-Chd4S\\_story.html?hpid=z5](http://www.washingtonpost.com/opinions/would-roosevelt-recognize-todays-social-security/2012/04/08/gIQAL-Chd4S_story.html?hpid=z5). He states that if the program were straightforwardly described as welfare, these value judgments would be easier to make: “By all rights, we should ask: Who among the elderly need benefits? How much? At what age? If Social Security and Medicare were considered ‘welfare’—something the nation does for its collective good—these questions would be easier.”
71. Geoffrey Kollmann, *Social Security: Summary of Major Changes in the Cash Benefits Program* (Washington, DC: Congressional Research Service, May 18, 2000).

62 (three years earlier than at Social Security’s inception).<sup>71</sup> The rapidly increasing numbers of those collecting Social Security benefits are the single biggest factor driving program cost growth.

Surveys of economists return the recommendation that raising Social Security’s age of eligibility for old-age benefits be one mechanism for restoring the program to financial balance.<sup>72</sup> The idea, however, remains politically controversial. As a result, the age of earliest eligibility for claims (62) has not changed since 1961; the current normal retirement age (NRA) (66) has only increased by one year since the program’s inception despite life expectancy at age 65 having grown by six years since then.<sup>73</sup>

Attitudes toward eligibility ages could change if Social Security evolves from a program in which the vast majority of participants expect to receive benefits for their individual payroll tax contributions into an income tax–financed program with benefits based primarily on economic need. In the latter circumstance the primary policy goal could become one of protecting against downside risk of poverty with less attention to providing a generally available pension benefit. In such a view the NRA could be raised to target benefits on those at greatest risk of outliving their other retirement savings—perhaps, for example, those in their mid-70s and beyond. This model would likely increase the relative share of total Social Security expenditures paid from its disability program, thereby benefiting those physically unable to work and to save for retirement in the manner of other workers.

In sum, continuation of general-revenue financing could precipitate a reassessment of several value judgments of Social Security policymaking, concerning payroll tax base increases, wage indexation of the benefit formula, the contribution-benefit link, eligibility ages, and formal means testing as summarized in Table 1. This could mean that the next round of major Social Security financing reforms is unlikely to resemble the comparative tinkering that took place in 1983. Though it is not possible to precisely predict how public attitudes would change on these questions, it is very unlikely that they would remain wholly unchanged if Social Security permanently loses its perceived status as an earned benefit.

72. Greg Mankiw, “The Consensus of Economists,” *Greg Mankiw’s Blog*, November 30, 2006, <http://gregmankiw.blogspot.com/2006/11/consensus-of-economists.html>. Mankiw cites Robert Whaples’s survey of Ph.D. economists. 77.2 percent of those surveyed agreed that “the best way to deal with Social Security’s long-term funding gap is to increase the normal retirement age.”

73. *OASDI Trustees’ Report*, table V.A4, “Cohort Life Expectancy,” 2012, [http://www.ssa.gov/OACT/TR/2012/V\\_A\\_demo.html#221776](http://www.ssa.gov/OACT/TR/2012/V_A_demo.html#221776).

**TABLE 1. POSSIBLE CHANGES TO HISTORICAL SOCIAL SECURITY POLICY PRINCIPLES UNDER GENERAL-FUND FINANCING**

<b>Policy Factor</b>	<b>Historical Principle</b>	<b>Possible Change</b>
Payroll taxes	Raise periodically as necessary to finance scheduled benefit obligations.	Argument for future payroll tax increases weakened; acceptable for aggregate payroll tax collections to fall short of benefit obligations.
Means testing	Full benefit eligibility for all contributors regardless of non-Social Security income.	Eligibility based in part on need in the manner of other general revenue-financed programs.
Wage indexing of initial benefit formula	Benefits funded with taxes on wages, indexed to remain a constant share of preretirement wages.	Benefits grow with price inflation in the manner of other general revenue-financed programs.
Contribution-benefit link	Benefit entitlement a reasonably direct function of individual payroll tax contributions.	Formula redrawn to provide limited safety-net benefit for all, irrespective of individual tax contributions.
Eligibility ages	Set to ensure that vast majority can withdraw old-age benefits.	Raised to target benefits on those most at risk of outliving preretirement savings.

## CONCLUSION

THE RECENTLY ADOPTED policy of reducing the Social Security payroll tax and replacing the revenue forgone with general government funds represents a fundamental departure from longstanding Social Security financing principles. Though the validity of the program's self-financing status had been increasingly debated since the 1983 program amendments, there had nevertheless been an enduring bipartisan consensus that Social Security should pay its own way as an earned benefit program in which total expenditures were limited to incoming tax collections. The new policy represents the first formal departure from this longstanding policy ethic.

The future policy implications of ending program self-financing are not yet clear and may be a function of whether lawmakers treat 2011–12 as a one-time exception to normal Social Security financing, never again to be repeated. To the extent, however, that the current general-fund subsidies are either precedential or permanently undermine prior public perceptions of Social Security as an earned benefit, there could be substantial ramifications for future Social Security policy. Income tax payers, now called on to subsidize Social Security benefit payments without additional benefit accruals for themselves, may demand greater representation at the negotiating table and argue for tighter cost controls. The end of the requirement that payroll tax assessments be sufficient to finance benefit payments could undercut the strength of recent arguments for future increases in the

program's payroll tax base. The introduction of subsidies from the general fund may influence other value judgments of Social Security policymaking concerning continued wage indexation of the benefit formula, whether a contribution-benefit link is maintained, how eligibility ages are set, and formal means testing, among others. In sum, the end of self-financing could mean an end to policy dynamics that historically have rendered Social Security unique and thereby prompt consideration of policy options that have traditionally been applied only to what have been popularly thought of as welfare programs.