GOKHALE: Democrats' Social Security policy dilemma

Excluding benefits from deficit reduction now will prove costly later

By Jagadeesh Gokhale

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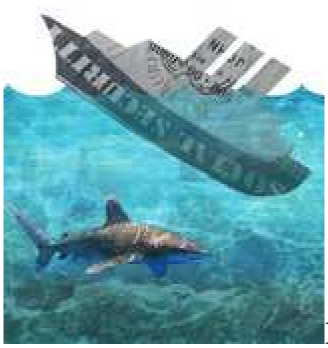
Illustration: Social Security sinks by Greg Groesch for The Washington Times

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Democratic policymakers appear divided on Social Security policy - whether changes to Social Security benefits should be among budget policies to reduce federal deficits. Despite Senate Majority Leader Harry Reid's recent emphatic rejection of that idea, the sizable decline in payroll taxes during the last recession has liberal-leaning policy mavens wondering whether their unconditional defense of the status quo on Social Security might backfire.

According to the Social Security trustees' 2010 annual report, the program is overpromising future benefits compared with its future revenues. The Social Security trust funds' Treasury securities, nominally valued at $2.5 trillion, will enable scheduled benefit payments without congressional legislation through 2037. But drawing down the trust funds means Social Security will add to future federal deficits - by $100 billion during 2020 and increasingly thereafter until the trust funds are exhausted in 2037. Status-quo supporters argue that Social Security did not contribute to past federal deficits and should not be changed to help reduce future ones. But Social Security will contribute to future federal deficits - those that fiscal adjustments being contemplated today are intended to reduce.

Even the claim that Social Security contributed nothing to past deficits is debatable. It depends on how one views the program's past operations. When the program was started during the 1930s, early retirees received more benefits than their payroll taxes, thus contributing a deficit to the program. As the program's benefits and taxes were increased, subsequent generations also received more benefits during retirement than their payroll taxes while working. The Social Security trustees report that under current payroll tax and benefit rules, the system's total shortfall equals $16.1 trillion. Of this, the legacy from past and current generations is a debt of $17.4 trillion ($20 trillion worth of gross debt offset by $2.5 trillion of trust fund Treasury securities) and a net projected contribution by future generations of $1.3 trillion.

But if past and current generations contributed a "legacy debt" of $17.4 trillion, why did it not result in high federal deficits? The answer lies in Social Security's pay-as-you-go financing, which directly transfers dollars from workers to retirees. As each past generation received more benefits than it had paid in, workers' payroll taxes were increased to fully cover those "excess" benefit awards so that the system's annual cash flow remained balanced or in surplus. As a result, each generation's "legacy debt" grew larger but remained hidden from public view because the government did not begin reporting the legacy debt until 2003.

Social Security's debt from the past is yet to be levied on any generation. Although the 1983 Social Security amendments increased payroll taxes, subjected Social Security benefits to income taxes and scheduled a gradual increase in Social Security's retirement age, those changes did not fully amortize the legacy debt. In the future, as the baby boomers retire and total Social Security benefits begin to exceed scheduled payroll taxes, the legacy debt will gradually re-emerge as explicit federal deficits. Instead of touting the trust fund of $2.5 trillion as a huge bulwark of security for the system's finances, its puny size relative to the gross legacy debt of $20 trillion needs to be acknowledged.

Now with excess benefits scheduled even for many among today's generations, shielding Social Security from policies to reduce federal deficits could be risky: It is intended to bide the time until aging boomers reinforce retirees' political clout toward preserving those scheduled benefits. Status-quo supporters hope that the 2010 Obamacare health care law will reduce Medicare and Medicaid costs and create fiscal space for the additional payroll taxes needed to preserve Social Security benefits. But the new health care law is unlikely to deliver cost savings given that it expands health coverage and subsidies and that those programs involve myriad pressure groups with conflicting interests.

If the excessive benefit commitments of entitlement programs are not reduced soon through sufficient cutbacks in benefits, then investors, entrepreneurs and high-skilled workers will develop expectations of steeper tax increases on incomes, payrolls and corporate earnings, and gradually reduce productive activities or shift them abroad. That would depress government revenues and force broader declines in public services.

All of this means that Social Security's funding is intimately connected to federal fiscal policies overall. Excluding it from budget policies to reduce federal deficits in order to secure greater political support for Social Security might seem politically expedient today, but it is economically unwarranted and appears unlikely to achieve the Democrats' long-term objective of preserving Social Security.

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