



The Concord Coalition's Series On Social Security Reform

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A “One Percent” Tax Increase Will Not Fix Social Security’s Problems

The Social Security payroll tax, better known to workers as FICA (or SECA for the self employed), is now levied at a rate of 12.4 percent on workers’ earnings up to \$90,000 a year. Employees and employers split the tax, meaning that they nominally pay 6.2 percent each. The Social Security trustees now project that the program has a deficit over the next 75 years equal to 1.89 percent of the payrolls on which the tax is levied (taxable payroll). Various commentators have thus pointed out that, in theory, the entire shortfall could be eliminated by levying a tax increase of a little less than 1 percentage point on employees and employers each (bringing the combined tax rate up from 12.4 percent to 14. 29 percent).¹

What then is all the fuss about? If employees and employers each simply paid one percent more, the problem goes away... Right?

Wrong. The 1.89 percent deficit figure is a highly misleading measure of Social Security’s funding shortfall. Ultimately, a tax hike at least three times as large would be required to pay scheduled benefits.

Trust fund solvency doesn’t solve much

The proposition that Social Security solvency could be achieved with a 1.89 percent hike in the payroll tax is based on a technical estimating concept called “actuarial balance,” which averages past and projected trust-fund surpluses against trust-fund deficits emerging over the next 75 years. Under that concept, Social Security appears to be solvent until 2042 — meaning that, until then, its trust funds would possess sufficient “assets” to cover current law benefit promises. And if Congress raised payroll taxes or cut benefits by 1.89 percent of taxable payroll, starting immediately, Social Security’s trust funds would be deemed “solvent” for 75 years

¹ All projections cited in this brief are based on the so-called “Intermediate” or central estimates of the 2004 Social Security and Medicare trustees’ reports.

The problem with the actuarial balance measure is that it equates trust fund solvency, which simply summarizes 75-years' worth of governmental bookkeeping entries, with genuine funding. It assumes that projected surpluses recorded to the trust funds in the early years will offset deficits later, i.e., that they will be saved. The government, however, is not in the business of saving surplus Social Security taxes. It invests them in federal securities, which means it lends the money to itself. Then, like all other federal receipts, the money is used to pay whatever expenses the government has on hand at any given time... and sometimes even to offset cuts in other taxes. In other words, Congress is free to spend the money it is supposedly saving.

For the 1.89 percent solution to ease Social Security's burden on future workers and taxpayers, the new money would have to be saved. That is, politicians would have to allow the program's extra interest-earning assets to accumulate unspent for decades — a proposition that seems highly unlikely and in any event cannot be guaranteed.

Because in practice the surplus Social Security dollars are not saved, there is no real reserve to cover future deficits, and there is no real interest earned on that reserve. The Social Security trust funds are credited with interest from the government's general fund, but this is simply a matter of bookkeeping between the government's own accounts. Both the reserve — now recorded to the trust funds at \$1.7 trillion — and the interest, however, are included in the calculation of the program's 75-year actuarial balance. Thus, by assuming that those large sums are real assets available to meet future benefits, the actuarial balance measure greatly understates the resources that will have to be taken out of the future earnings of employees and employers or levied in the form of some other tax.

What matters to the economy and the budget is not some summary measure of "trust fund solvency" but the annual difference between Social Security's outlays and its earmarked tax revenues. Under current law, this difference is due to turn negative in 2018 and widen to an annual deficit of \$370 billion, or 4.5 percent of payroll, by 2041, the last year the trust funds are technically "solvent." Even if the 1.89 percent solution were enacted, Social Security would still face large and steadily growing cash deficits starting in 2023.

Still, let's suppose for a moment that future Congresses will save the extra trust-fund surpluses generated by the 1.89 percent solution even though past Congresses haven't saved the surpluses of earlier years. There is a further problem—namely, that the solution isn't permanent. As the Government Accountability Office has explained:

While a 75-year actuarial balance has generally been used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program's solvency after the 75th year. For example, under the Trustees' intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately.²

² *Social Security Reform: Early Action Would be Prudent*, Statement of U.S. Comptroller General David M. Walker before the House Committee on Ways and Means, March 9 2005, GAO-05-397T p.9.

In other words, the “actuarial balance” concept assumes that while we would require the trust funds to be in balance over a full 75 years, our children will be satisfied with balance for 40 years and our grandchildren will be satisfied with an empty cupboard. To keep Social Security in balance permanently, an extra tax hike above and beyond the 1.89 percent solution would be required in each and every future year.

Not a minimal tax increase

Although proponents describe it as a relatively minimal “tweak,” a 1.89 percent of payroll tax hike is a significant tax increase. Less than 2 percent of anything sounds rather minimal, but if enacted this year, a 1.89 percent hike in the payroll tax would amount to a \$1.2 trillion tax increase over the next decade.

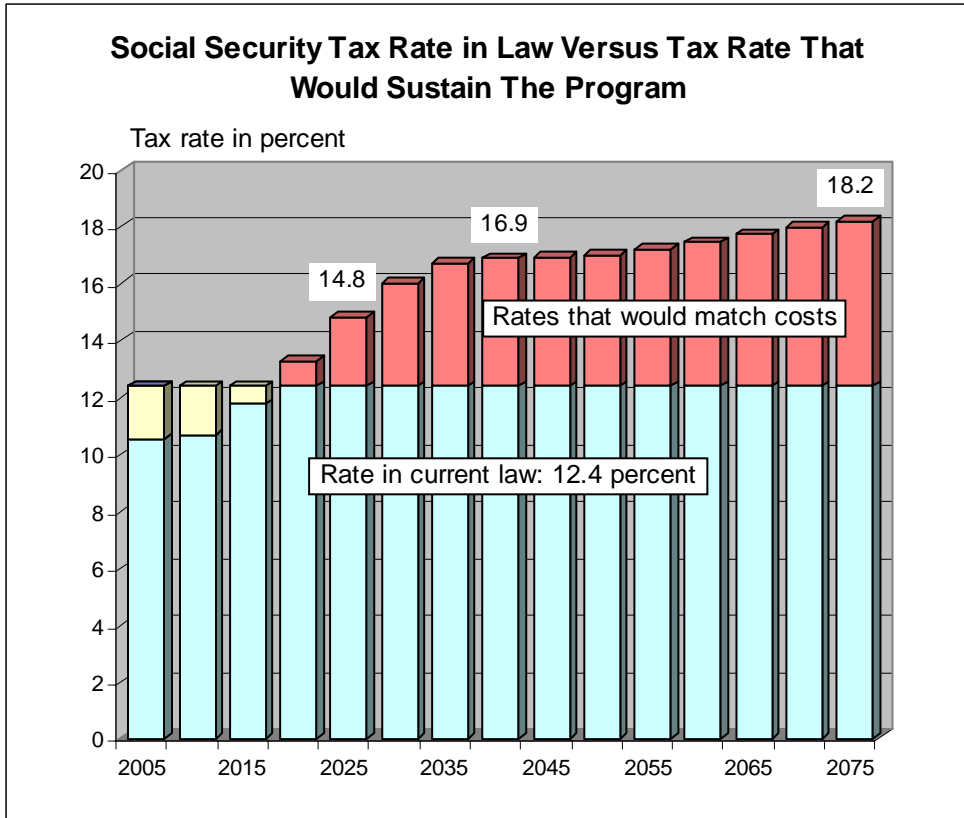
At the individual level, a one-percentage point rise in the payroll tax means a tax rate on employees and employers each of 7.2 percent instead of 6.2 percent. That translates into an increase in actual taxes to be paid of 16 percent. The average earning two-worker household will make about \$73,000 this year. A one-percentage point rise in the tax rate means they would have to pay \$730 in additional Social Security taxes—on top of the \$4,526 they already must pay. That increase is equivalent to seven weeks worth of groceries, thirty fill-ups at the gas pumps, one weekly vacation rental, and so on. If both workers in the household are self-employed, the tax increase would be in the range of \$1,200. That one-percentage point extra tax would be required year after year, and would subtract from each household’s ability to save. Moreover, none of this reflects what employers might do in reaction to their higher taxes: will they take it out of future wage hikes? ... Will they raise prices on their goods and services?

And keep in mind, the actual tax increases would ultimately have to be much larger than the 75-year actuarial imbalance figure suggests. Since the trust fund reserves are only IOUs between government accounts, other funds would have to be obtained to cover the shortfall—either by raising taxes, cutting other spending, or borrowing.

As noted earlier, if the combined 12.4 percent tax rate were raised by 1.89 percent, it would only keep the program’s cash flow positive through 2023, or for five additional years. If the payroll tax were hiked to cover the subsequent shortfalls, by 2025, it would have to be 14.8 percent; by 2040, it would have to be 16.9 percent; and by 2075, 18.2 percent. Those rates reflect increases that are a long way from what the 75-year actuarial balance measure implies.

- a 14.8 percent tax rate translates into a 20 percent increase in taxes;
- a 16.9 percent rate translates into a 36 percent increase, and;
- an 18.2 percent rate translates into a 47 percent increase.

Alternatively, if benefits were to be cut to close Social Security’s long-term deficits, the promised levels would have to fall by 16 percent in 2025, 25 percent in 2040, and 30 percent in 2075.



A growing tax burden

Those figures are only for Social Security, which is just one part of the looming cost burden future taxpayers will face. If Medicare’s projected deficits are taken into account, the implied tax rate would be much higher still. The Hospital Insurance (HI) portion of Medicare is also financed with a payroll tax and its shortfalls alone are higher than Social Security’s.³ Moreover, 75 percent of the cost of Medicare’s Supplementary Medical Insurance (SMI) program is paid for out of the general fund, with enrollee premiums covering only 25 percent.

The total resources needed to close the projected funding gap in the two parts of Medicare greatly exceed those projected for Social Security. This can be illustrated by showing the total cost of both programs as a percentage of taxable payroll. The SMI program is not currently funded with a payroll tax, and while Congress could choose other means to finance the portion to be derived from the general fund, if both the HI shortfall and the general fund portion of SMI were to be financed by a payroll tax hike, the tax rate for Medicare would have to rise from 2.9 percent today (1.45 percent on employee and employer each) to 15 percent in 2040 and 25 percent in 2075.

³ Workers and their employers pay a tax at the rate of 2.9 percent on all earnings (there is no maximum) to help finance the Hospital Insurance portion of Medicare, or 1.45 percent each. This is in addition to the taxes paid to support Social Security.

If added to the rates needed for Social Security, the implied payroll tax rate necessary to cover the future costs of both Social Security and Medicare would be 32 percent in 2040 and 44 percent in 2075.

The magnitude of the future fiscal challenge is minimized by the trust-fund accounting framework underlying the official Social Security (and Medicare) solvency measures. Actuarial balance greatly understates Social Security's true burden on our future. This indicator not only misleads the public about the magnitude of the future fiscal burden posed by Social Security, it says nothing about the program's impact on national savings and generational equity. The trustees could do a great service to the debate over reform by abandoning it altogether and instead focusing on what really matters—the system's deficits as they are projected to emerge and grow..

Implied Tax Rates That Would Cover Future Costs of Social Security and Medicare				
	Rates now scheduled in law	Rates implied by future costs		
		2025	2040	2075
(as percent of worker earnings)				
Social Security	12.4	15	17	18
Medicare	2.9	10	15	25
Combined	15.3	25	32	44

Source: Figures calculated based on the 2004 trustees' report intermediate projections.
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