General Revenue Financing of Social Security

Testimony before the Senate Finance Committee

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Mr. Chairman and Members of the Committee:

As a member of the baby boom generation, I grew up with individuals who, whether conservative or liberal, considered themselves idealists when it came to the role of the federal government. They might have disagreed over the optimal size of government or the degree of taxation, but they did believe that government should serve its citizens well and should promote civil rights, defend against totalitarianism, and provide opportunity, especially to the poor. Today this cohort has come into full power as members of the labor force, of the business community, of the White House, and of Congress itself. *It is ironic that the legacy that baby boomers would now bequeath is one in which almost the sole purpose of the federal government would be to care for their own consumption needs in retirement.*

I do not believe this legacy is intended. Yet it would come about under current law, under the President's proposals, and under many of the Republican and Democratic budget alternatives now being considered in Congress. It is largely the consequence of laws written decades ago that are determining almost all of the spending priorities of future generations. In particular, it is the consequence of designing Social Security benefits (as well as health benefits for the elderly) so that they forever grow faster than the economy, without regard to changes in fertility and mortality rates that determine the numbers of taxpayers and beneficiaries (see figure). In the presence of such unsustainable growth, the greatest difficulty with today's budget policy is not whether either the surplus or revenues are too large or too small in the short or intermediate term, but that *the law itself would deny to posterity both the right and the privilege to decide for itself the priorities and needs facing the nation.*

The simple fact is that general revenue financing of benefits does not in any way change the scheduled growth in commitments to programs for the elderly and near-elderly. General revenue financing, standing by itself, can even detract attention from the more important issue of how the structure of Social Security benefits relates to the true needs of society.

Issues Raised by General Revenue Financing

In theory, general revenue financing is an issue more of political economy than pure economics. General revenue financing puts on the table several very important questions:

- First, would it add to real assets held by the government or simply to a pretense that Social Security holds onto real assets? Would it hide how obligations still must be covered by future taxpayers? Would that make reform easier or harder?

  My own assessment is an additional transfer from the government's left hand (Treasury) to its right hand (Social Security)—over and above any surplus accruing between taxes and benefits—tends to mask too much. The simple fact is that future taxpayers must cover the cost of the interest and principal on any gift of bonds from Treasury to Social Security.

- Second, do new sources of general revenue financing lay bare the fact that programs for the elderly, including Social Security, have always relied in part upon general revenue financing? If so, what does it mean when trust funds temporarily run surpluses?

  Programs for the elderly have often had general revenue fixes. These include: the financing of Part B of Medicare out of general revenues; the transfer at times of benefits from Medicare Part A to Part B so that Part A appears more solvent; the expansion of long-term care for the elderly within Medicaid (or, as the President proposes, with income tax credits) rather than as part of a broader reform of the health care benefit package offered as a whole to the elderly; the use of SSI to pay for some transfers to low-income retirees even though other large transfers occur within Social Security; the income tax exemption for one-half of Social Security taxes paid; and the simultaneous transfer to Social Security of income taxes paid on benefits on the basis of a very generous formula. Considered as a whole, programs for the elderly have always run substantial deficits if benefits were to be compared to Social Security taxes paid.

- Third, and closely related, did the tie between taxes and benefits, as reflected in the concept of trust fund balances, act as a constraint on the system and prevent deficit financing? Whether or not it acted as a break in the past, would severance of this break reduce or eliminate one of mechanisms that tends to force elected officials to deal with imbalances between benefits and taxes?

  In general the tie between taxes and benefits has acted as a modest past constraint on growth, sometimes forcing action, as in 1983. It has also kept taxes and benefits somewhat in balance. On the other hand, the expansion in general revenue financing of elderly programs as a whole probably has forced wage earners on average to pay something like 20 percent of wages to support elderly programs, rather than the supposed 15.3 percent Social Security tax rate. As for the future, it appears that the current willingness to tackle Social Security's problems is based in part on trust fund imbalances projected under current law; these imbalances would appear less severe with a general revenue transfer.

- Fourth, does general revenue financing break the relationship between benefits and taxes on earnings, so that the public comes to view Social Security more as a transfer program than a social insurance program? Would such a change invite means testing and would that be a good thing for elderly programs?

  The more formal introduction of general revenue financing could shift public sentiment toward viewing the system as a transfer program. Already the Administration is saying that some of the remaining imbalances in Social Security (and Medicare) could be met by further gifts of bonds from Treasury beyond what they have proposed. Hence it suggests that the general revenue financing door can be opened even further by this or later Congresses. Although I have written elsewhere that one might easily justify flattening the benefit structure in Social Security, especially in exchange for subsidies for saving, means testing is another matter. Means testing of a substantial portion of the elderly population could be considered degrading, and means testing is highly inaccurate given the ability to shift assets to children or simply hide them. Means testing also severely discourages saving for retirement.

- Fifth, would general revenue financing open up consideration of the appropriate tax base to support old age programs—wage taxes, income taxes, or consumption taxes? Would the outcome of that debate lead to a better or worse Social Security system? A better or worse tax system?

  This is an open question. Certainly a case can be made for consumption taxation vis-a-vis wage taxation if, as projected, we continue on a path where larger and larger portions of Social Security and Medicare recipients consume at higher rates than many of the workers who pay for those benefits. By the same token, it is doubtful as a matter of simplicity—yes, there are a few of us left who care about simplicity—that one would want to add yet another tax system onto the ones we already have.

- Sixth, would the transition to general revenue financing be done in a way that might encourage more short-run saving by government?

  This is the principal argument used by the Administration. In its own proposal, success depends upon the crafting of legislation that somehow would count transfers of bonds and interest to Social Security as an outflow for purposes of some new unified budget deficit accounting, but then turn around and not count the inflow of bonds to Social Security as income for the same set of books. I have serious doubts as a matter of accounting practice that this hoped-for constraint can be achieved, and, if achieved, that it can be made to constrain future politicians. Nothing stops someone from looking at the current unified budget deficit, which is useful for a variety of purposes, not the least of which is to understand the flow of demand for borrowing from the public.

  The confusion that reigns over the Administration proposal, however, does not mean that short-run saving still might not be enhanced. In fact, the Administration has made a good case not to deplete very much of the current surplus. Its proposal to subsidize USA accounts also attempts to encourage some saving relative to alternative budget uses.

  We must also distinguish between the short-run political fight over what this Congress might do with the longer-run issue of how future Presidents and Congresses might be constrained. The Administration really doesn't propose to save the non-Social Security surplus over the short-run, but rather somehow to put future Presidents and Congresses under a new pay-as-you-go rule where they have few choices as to how to spend the additional revenues that taxpayers will be paying and the temporary surpluses that they would see under today's unified budget accounts. In fairness, a number of tax cut proposals would also tend to lock in future elected representatives as well.

- Finally, would general revenue financing be used to finance the transition to a new system? That is, would it be one means of dealing with the political pain (not necessarily the economic pain) borne by those sometimes identified as the "transition" generation—the ones who would be called upon both the save more to cover their own benefits and to cover the benefits of those whose Social Security taxes have already been spent.

  The Administration does not really come up with a structural reform that might achieve this purpose. But it has thrown on the table the possibility of using general revenues to meet these ends. This is reflected partly in the amount of the non-Social Security surplus that it would try to make future Congresses save. It is also reflected partly in the USA account proposal, although no structural offset of any type is suggested—even a modest cutback in Social Security benefits for non-poor recipients in exchange for their new USA account subsidy.

Summary

In summary, we have only begun our journey toward a domestic policy in which our children are allowed some choice as to what their government will do to meet their own needs and those of their children. Getting our budget into surplus after years of large deficits has been a positive development. However, obligating the children of today to pay almost all of their future federal taxes as transfers to support the consumption of their parents is a recipe neither for citizen-led government nor for economic growth. The size of the deficit or surplus has never been more than a symptom of the disease from which we suffer, and excessive attention to that number has detracted from dealing with the longer-term direction of policy.

Done the right way, the infusion of some general revenues into a Social Security reform package might help deal with some of the political pain. Certainly more saving by government—or limited reduction in projected surpluses—is a prudent move. Development of the USA account, just like other individual account proposals, offers the prospect of addressing the very poor distribution of private pension wealth in society.

Nonetheless, direct general revenue financing of Social Security might reduce the willingness to deal with our long-term problems and could raise a whole series of other debates such as whether to means-test Social Security benefits. It is also unclear how an obscure form of budget accounting, even if it passed this Congress, could be placed off-bounds for re-consideration by future Presidents and Congresses.

APPENDIX 1

The Nature of Future Obligations

A few examples convey the extraordinary nature of our future obligations, whether financed out of Social Security taxes or general revenues.

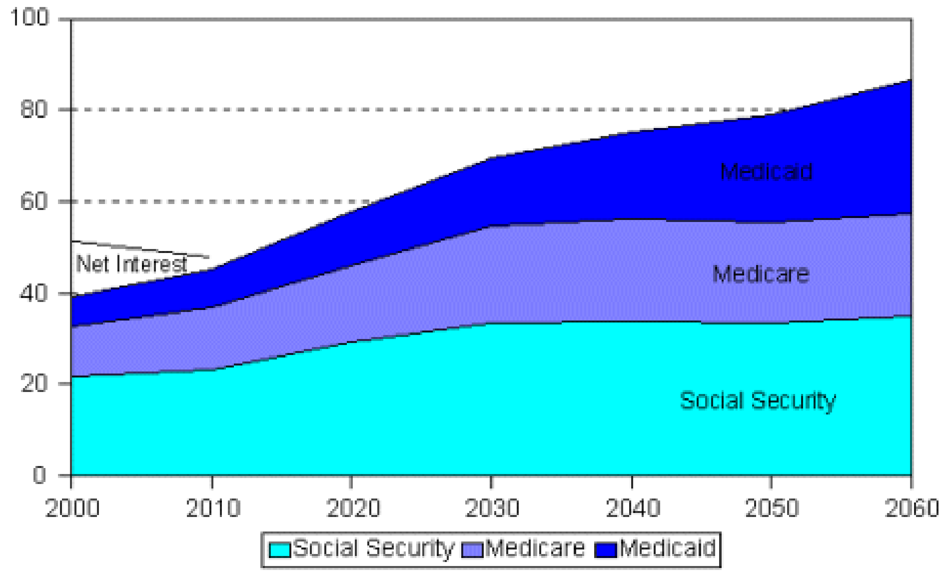
- Using today's prices, an average-income couple retiring in 1960 could expect at that time to receive about $100,000 in lifetime Social Security benefits. A typical couple retiring today would receive about $1/2 million in Social Security and Medicare benefits (about equal amounts of each). Average-income baby boomer couples, on the other hand, would receive around $3/4 million, and those who come later are scheduled to receive as much as $1 million (in today's dollars). General revenue financing does not change that level of obligation.

- If the number of workers per beneficiary drop from more than 3-to-1 to less than 2-to-1, as scheduled, the children of baby boomers must finance Social Security benefits one way or the other. Out of every dollar in cash wages, the government already requires workers to pay 15 cents in Social Security tax, plus several cents in general revenues, to support elderly and disability programs alone. In the future that rate of tax could increase substantially—5 to 6 percentage points alone due to Social Security. General revenue financing only changes what type of tax will support those elderly programs.
- One reason for these rising costs is that Social Security and Medicare dictate that successive generations should receive higher levels of real benefits than all previous generations. For example, baby boomers are told that, regardless of other needs of the population, they are entitled to receive higher levels of real benefits from their children than they, the baby boomers, transferred to their parents—that this is an entitlement. General revenue financing does not change these scheduled increases in benefits.
- Another reason that Social Security and other retirement programs take ever larger percentages of national income is that people are living longer and spending more years in retirement—almost a decade more than Social Security retirees in the early years of the program. *Today individuals claim an entitlement to retire on Social Security for about one-third of their adult lives*. More years of retirement also reduce the number of taxpayers for both Social Security and other purposes, thus raising tax rates on those still working. General revenue financing does not change this trend.
- Within a few decades, *close to one-third of the adult population will be receiving Social Security benefits under current law*. Add to those numbers the unemployed or unemployable, or those on other assistance programs, and a substantial portion of the adult population will be largely—in many cases, primarily—dependent upon the children of today to support them through their tax dollars. Of course, our children will need to support their own families, as well, but the share of the budget available to meet the educational, environmental, health research, urban, justice and other needs of our children and grandchildren would be drastically reduced. General revenue financing simply reinforces that pressure.

Figure

Federal Expenditures as a Percentage of Revenue

Long-Run Budget Projections of Clinton's 2000 Budget Policy



Source: The Urban Institute, 1999. Based on the Budget of the United States Government, FY 2000.
Note: Net interest not shown after 2010.

Other Publications by the Authors

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