SOCIAL SECURITY:
IS THE ERA OF SELF-FINANCED, ‘EARNED BENEFITS’ OVER?

The recent policy of reducing the Social Security payroll tax and replacing the foregone revenue with general government funds represents a fundamental departure from Social Security’s historic self-financing principle.

The implications of severing the program’s contribution-benefit link are not yet clear. To the extent that it is either precedent-setting or permanently undermines previous public perceptions of Social Security as an earned benefit, the change could pose substantial ramifications for future Social Security policy.

In a new Mercatus Center study, Charles Blahous, senior research fellow at the Mercatus Center at George Mason University and public trustee for Social Security and Medicare, reviews the philosophical basis for Social Security’s unique financing structure; considers what the movement toward general-revenue financing may mean for the future of the program; and discusses what, if anything, can be done to restore the program to its self-financed, earned-benefit roots.

BACKGROUND

For most of Social Security’s history, there has been a strong bipartisan commitment to preserve the program’s self-financing principle. As President Franklin D. Roosevelt designed it, its benefits would be financed by workers’ contributions, not by general revenues. This earned-benefit structure was intended to distinguish Social Security from welfare; to impose fiscal discipline within the program; and, notably, to ensure program benefits enjoyed special political protection from competition elsewhere in the budget. As FDR explained:

“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.”

But over the past several years, commitment to this principle has weakened, as lawmakers have become less willing to tax workers at the level required to finance rising benefit costs. The trend culminated in the 2010 decision to reduce Social Security’s principal financing stream, the payroll tax, for economic stimulus and to turn formally to general revenues to subsidize the program. This shift threatens to fundamentally alter Social Security’s intended designation as an earned benefit as well as the long-standing protections that status has provided.

Below is a brief summary. To read “The End of Social Security Self-Financing: What Does It Portend for Social Security’s Future?” in its entirety and learn more about its author, please click here.
KEY POINTS

• FDR designed Social Security as a self-financed program to distinguish it from welfare, to impose fiscal discipline within the program, and to ensure all working people had a sense of having earned their benefits—all of which worked together to protect benefits from political pressure and budgetary competition.
• Since its inception, Social Security has been premised on this self-financing principle. Despite relatively minor shifts, there remained a strong bipartisan consensus through the mid 1990s to preserve this structure.
• Over the past several years, however, commitment to this practice has progressively weakened as lawmakers have become less willing to tax workers, particularly lower-income workers, at the level required to finance rising benefit costs.
• While several policies had already been enacted to shift Social Security financing burdens from individual payroll tax payers to the general government fund, the self-financing link remained formally intact until the 2010 payroll tax cut.
• In 2010, President Obama and Congress formally broke the Social Security program’s contribution-benefit link with the enactment of the payroll tax cut, which reduced the payroll tax for economic stimulus and required that general revenues be used to subsidize Social Security benefits.
• If Social Security’s contribution-benefit link continues to deteriorate, it could transform public perceptions of the program into something more akin to welfare.

SUMMARY

Introduction: Franklin D. Roosevelt and the Ethic of an Earned Benefit
From its inception, Social Security was intended to be, and has since been perceived to be, distinguished from a welfare program, in which recipients collect benefits based on need while others provide revenues based on their ability to pay.

President Franklin D. Roosevelt 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, either by constraining benefit levels or by limiting the number of those eligible to receive them. As FDR insisted:

“We must not allow this type of insurance to become a dole through the mingling of insurance and relief. [Social Security] is not charity. It must be financed by contributions, not taxes.”

After the 1983 Social Security Reforms: Still Self-Financing or Not?
Through most its history, Social Security was operated essentially on a “pay as you go” basis. Each year, tax collections and benefit expenditures were approximately balanced. Before the mid-1980s, while Social Security maintained separate trust funds, the residual balances of these funds were kept relatively small as a matter of deliberate federal policy.

In the early 1980s, however, Social Security’s financing crisis resulted in a landmark bipartisan agreement to ensure program solvency for decades to come. One result was that, from the mid-1980s until 2010, Social Security ran substantial annual operating surpluses, causing its trust fund balances and interest earnings to explode. It is largely owing 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.

So, while the landmark 1983 program reforms did not destroy conceptual support for Social Security’s self-financing principle, they did bring into question whether self-financing would continue to be observed in practice.
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 through the mid 1990s, even among experts who were otherwise sharply divided in their Social Security policy preferences.

As one example, President Clinton’s 1994–96 Social Security Advisory Council unanimously opined: “Social Security should be financed by taxes on workers’ earnings, earmarked taxes on benefits, and interest earnings on accumulated reserves, without other payments from the general revenue of the Treasury.”

Cracks in the Consensus: Proposals to Break Social Security’s Contribution-Benefit Link
1999. The introduction of President Clinton’s “Save Social Security First” proposal marked the first point at which discussions of departing from Social Security’s self-financing structure entered the political mainstream.

Under the proposal, Social Security would have had a new claim on general tax revenues and be given the authority to spend substantially more on benefits than it had generated in taxes. The taxpayers who provided these revenues would not, however, be given additional benefit credits, nor would their additional contributions be tracked separately on W-2 forms in the historic manner of other FICA contributions.

Although the Clinton proposal was never seriously considered, Social Security experts at the time understood that it would have fundamentally changed the nature of the program. Over the following decade, a number of other proposals were introduced to require higher-income taxpayers to subsidize Social Security with progressively assessed taxes that would not earn benefit credits.

2010. The influx of Baby Boomers onto the retirement and disability rolls, combined with an economic recession, caused Social Security to run a deficit of expenditures over tax income for the first time since 1983. These fiscal strains arose following a decade of changing opinions among some influential thinkers in favor of breaking Social Security’s contribution-benefit link and subsidizing benefit payments through progressively assessed taxes, drawing the era of Social Security as a self-financed, earned benefit nearer to a close.

The Lure of Payroll Tax Relief
As bipartisan commitment to preserving Social Security’s contribution-benefit link has eroded, the attraction of payroll tax relief has risen. By 2010, four crucial political factors were present: misperceptions that the payroll tax was regressive; discomfort among lawmakers 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 who owe no federal income tax; and fading commitment among some advocates to maintaining Social Security self-financing. These and other factors combined to create an environment conducive to cutting the payroll tax, subsidizing the program with general revenues, and abandoning Social Security’s historic design as a self-financing program.

The Abandonment of Self-Financing: The 2011–12 Payroll Tax Cut
The current administration and Congress formally broke the Social Security program’s contribution-benefit link with the enactment of the 2010 payroll tax holiday. With a desire for short-term stimulus but unwilling to reduce benefit payments, lawmakers decided to reduce the Social Security payroll tax and to subsidize the program from the general fund.

Congress and the President must soon decide whether to allow the existing payroll tax cut and accompanying general revenue transfer to expire or be continued beyond the end of 2012. But even if the full payroll tax is restored, the policy implications of the recent payroll tax cut are potentially substantial.

Implications for Taxpayers and for the Federal Budget
The provision of substantial general revenue 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. The effect of the transfers also postpone the program’s projected insolvency date, diminish the apparent urgency of legislative
action, postpone needed reforms, cause more beneficiaries to be on the rolls by the time a legislative solution is finally negotiated, and constrain the policy options available to maintain self-financing.

**The Future of Social Security in the Era of General-Revenue Subsidization**

There are essentially four possible future courses for Social Security policy:

1. **Continuation.** Social Security continues to receive substantial subsidies from the general fund while its historic ethic of self-financing is tacitly abandoned.
2. **Recurrence.** Current general-revenue subsidies terminate on schedule, but a precedent is established whereby lawmakers feel free to resume such subsidies whenever they believe other policy considerations warrant their use.
3. **Termination with lasting policy effects.** Current general-revenue subsidies terminate on schedule and are not revived, but the public’s perception of Social Security’s role is significantly altered by the awareness that benefit payments are subsidized from the general fund.
4. **Termination with no lasting policy effects.** General revenue subsidies are terminated on schedule, public awareness of the subsidies remains limited, and lawmakers henceforth treat the 2011–12 practice as a one-time exception to long-standing policy and strictly enforce self-financing in the future.

The fourth scenario could only transpire if lawmakers re-adopt the historic requirement that Social Security tax collections be sufficient to fund its benefit payments, solely excepting the $217 billion in general-fund subsidies provided during 2011–12.

Under the other scenarios, Social Security’s future is substantially different because of general-revenue financing. It is impossible to know when continued general-fund subsidization would so alter public perception of Social Security as an earned benefit as to precipitate other transformative changes in 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.

For most of its history, Social Security benefits have been treated differently from programs financed from the general government fund. Benefits in general-fund-financed programs have historically grown more slowly than Social Security’s—for example, by being indexed for price inflation rather than the faster wage-growth index that is used to calculate Social Security benefits.

General-fund-financed programs are also more likely to be subjected to means testing and to sudden changes in eligibility criteria. These differences reflect a dynamic in which lawmakers value the interests of income taxpayers who support programs through the general fund on a par with those of beneficiaries. It is therefore possible that the policy change to finance Social Security from the general fund will bring with it a number of other potential policy changes.

**Conclusion**

The end of the requirement that payroll tax assessments be sufficient to finance Social Security 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 well 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 have historically 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.

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