Hard Times for Social Security Lovers

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MarketWatch Blog by Alicia H. Munnell

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This is a hard time for someone who thinks that Social Security is one of the nation's most important programs. Republicans and Democrats, who can't agree on anything, recently agreed that the payroll tax cut should be extended. And the President put out another budget without any proposals to restore long-run solvency to the program. I know it's an election year, but last year wasn't and the President proposed nothing for Social Security then either. Undermining the revenue flow and failing to offer fixes for the financing hole puts the program at risk.

Social Security makes us do what we would not do on our own – save for retirement. And it provides insurance for us in the event that we become disabled and for our dependents should we die early. The retirement benefits are modest. The average worker who retires at 65 in 2012 gets 41 percent of pre-retirement earnings or about $1,400 per month. The program replaces more for lower earners and less for high earners. People can claim benefits at any age between 62 and 70, but Social Security adjusts the annual amount to keep lifetime benefits the same. Annual benefits are thus much lower if claimed at 62 and much higher if claimed at 70. Social Security benefits are adjusted for inflation, and they keep coming as long as we live.

Social Security is a terrific program. The problem is that projected benefits exceed scheduled taxes over the next 75 years. The good news is that – at least until people started fooling around with the payroll tax – the magnitude of the shortfall is totally manageable. And proposals abound for either reducing benefits or increasing revenues. Yes, those are the options. There is no magic bullet.

Before the 2011 payroll tax cut, the Social Security financing story was one where the average cost rate for the next 75 years was 16.2 percent and the scheduled income rate was 14.0 percent, producing a deficit of 2.2 percent. That figure means that if the payroll tax were raised immediately by 2.2 percentage points – 1.1 percentage point each for the employer and employee – the government would be able to pay the current package of benefits for everyone who reaches retirement age through 2085.

A 2-percentage point cut in the employee payroll tax changes the story. The deficit becomes 4.2 percent of payrolls. Yes, general revenues are being credited to the trust funds to make up for foregone revenues in the short run, but restoring balance to Social Security, which in 2010 looked trivial, now appears daunting. The expiration of any reduction in a tax is now characterized as a tax increase, and the resistance to tax increases is ferocious.

At the same time that policymakers are making the hole bigger, they are kicking the can down the road in terms of fixing the system. This lack of initiative is particularly annoying given that two recent commissions – The National Commission on Fiscal Responsibility and Reform (co-chaired by Erskine Bowles and Senator Alan Simpson) and The Bipartisan Policy Center's Debt Reduction Task Force (co-chaired by Senator Pete Domenici and Alice

Rivlin) – have presented comprehensive proposals to restore balance to the program.

The key question is how much of Social Security's financing gap should be closed by cutting benefits vs. raising taxes. My view is that retirements are at risk. The need for retirement income is increasing as people live longer, health care costs are soaring, and two-thirds will need some long-term care. At the same time, the retirement system is contracting. Therefore, my preference is to make more adjustments on the revenue side than on the benefit side.

In any event, restoring solvency to Social Security is long overdue. We have known since the early 1990s that promised benefits exceed scheduled taxes. The longer we wait, the bigger will be the required changes. It takes some political will and some mechanism to reclaim the payroll tax as the economy recovers. But preserving Social Security is the key to secure retirements in years to come.