Social Security will need more revenues — where should that money come from?

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MarketWatch Blog by Alicia H. Munnell

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Should today's workers have to bear the full burden?

Social Security is unlikely to appear on the political docket until 2021. (2018 is a congressional election year; 2019 is the lead-up to the next presidential campaign; and 2020 is a presidential election year.) But it is not too early to start thinking about how to solve Social Security's long-run financing shortfall.

As policy makers consider restoring financial balance to the program, one question is how to structure any tax increases. Understanding why – for a given level of benefits – Social Security requires a higher payroll tax than a funded retirement program is a crucial first step in informing this discussion. A **recent study** shows that if the program were financed as a funded 401(k) plan, the current employee/employer payroll tax contribution would be roughly sufficient to pay promised benefits. But because Social Security is financed on a pay-as-you-go basis, the required employee/employer tax is 3.7 percentage points higher.

The reason that Social Security is financed on a pay-as-you-go rather than a funded basis is the decision made by policy makers in the late 1930s. The

1935 Social Security Act set up a plan that bore a much stronger resemblance to a private insurance plan than to the system we know today. The legislation called for the accumulation of a trust fund and stressed the principle of a fair return. The 1939 amendments, however, fundamentally changed the nature of the program. They tied benefits to average earnings over a minimum period of coverage, and thus broke the link between lifetime contributions and benefits. As a result, early cohorts received windfall returns on their contributions.

Virtually all observers agree that the decision to provide full benefits to early cohorts was a wise one. Many of these people had fought in World War I and had endured the economic devastation of the Great Depression. Poverty rates among older people were at unacceptably high levels. Moreover, the recession of 1937 followed rapidly after the introduction of the Social Security system, making the accumulation of a substantial surplus undesirable on fiscal policy grounds.

The benefits paid to the early retirees did not come for free, however. If earlier cohorts had received only the benefits that could have been financed by their contributions plus interest, we would have a large trust fund today. That large trust fund would earn interest, and that interest would cover a substantial part of the cost of benefits for today's workers. Without it, payroll taxes must be substantially higher. That is, the payroll tax must cover not only the required contribution but also the missing interest.

The policy question is the fairness of asking today's workers to pay higher taxes because of the historical decision to give away the trust fund — a decision that benefited our parents and grandparents. One could argue that the burden should be shared more broadly than through a regressive tax on today's workers.

A couple of options exist.

One option is to have the missing interest from the missing trust fund be paid through the income tax – raising the average federal income-tax rate by 2.3 percentage points. (The calculation assumes that all the shortfall is covered by an increase in revenues.)

An alternative is to apply the current combined employee/employer rate to earnings above the cap ($127,200 in 2018), with the tax paid solely by the employer — thereby avoiding the need to provide additional benefits in return for the additional contributions.

Social Security will need more revenues, and the shortfall is roughly equivalent to revenues lost from giving away the trust fund. Should today's workers be required to ante up? Or should we consider other sources?