



Time for a “Holiday” from Accounting Gimmicks

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For many years, there has been a robust debate about whether the Social Security and Medicare Trust Fund balances actually mean anything if the payroll taxes collected for them were spent rather than saved (as seems intuitive in a trust fund). Today, unfortunately, there appears to be a bipartisan embrace of an even more problematic concept: persistently crediting the Trust Funds with tax revenue that has never even been collected.

The latest example of this is the so-called “jobs bill” that just passed both chambers in Congress. A centerpiece of that legislation is the Schumer-Hatch “Hire Now Tax Cut,” known colloquially as a “payroll tax holiday.” Under the plan, businesses that hire an unemployed person will receive a full tax credit for the employer’s share of Social Security taxes. Basically, they’ll experience the equivalent of not paying those taxes at all.

Less payroll tax revenue collected means less revenue collected and saved for the Social Security Trust Fund, right? Not under the jobs bill. As the Schumer-Hatch summary helpfully notes, “Lost Social Security Trust Fund revenues will be supplemented by the General Fund.”

Such crediting of uncollected revenues to the Social Security Trust Fund is no longer an isolated event. It’s becoming a trend. The previous week, when the Obama Administration released their revised health care plan, they included a provision to ensure that, “if necessary, funds will be transferred to the Social Security Trust Funds to ensure that they are held harmless by the proposal.” In other words: if it turns out that the plan results in less payroll tax

revenue, no problem: we’ll simply credit the Trust Fund as though the money had been collected.

The Administration’s “Making Work Pay” tax credit used the same gimmick. Individuals were refunded the amount of their Social Security payroll taxes, but the Trust Fund – and equally important, their Social Security benefit credits – continued to accumulate just as if those taxes had been collected.

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Throughout the health care debate, reform proponents have been rightly criticized for double-counting Medicare Trust Fund money – that is, spending the money generated by difficult measures and still claiming that the same money will be used to extend the solvency of Medicare. But while spending Trust Fund money is bad enough, still more blatant is applying credits on the government’s books for money never even collected.

It’s important to understand that this is not simply an inconsequential inside-the-beltway accounting gimmick. It will have real effects for future taxpayers. As the rising bills for Social Security and Medicare come due, general taxpayers will be asked to pay for Social Security and Medicare benefits supposedly earned by beneficiaries through contributions that were never made. The total amount that each program will be allowed to spend (defined by its Trust Fund balance) will have risen in proportion to these “general revenue transfers,” with interest, but no additional money will have ever come in.



This issue has become particularly relevant as bipartisan interest in reducing payroll tax burdens has grown in response to our current economic difficulties. Conservative economists from Greg Mankiw to Lawrence Lindsey have noted that payroll tax relief reduces both the cost of employment and barriers to hiring; like many others, they argue that it would spur economic growth efficiently and with a minimum of economic distortion.

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Some others have advocated payroll tax relief to go after bigger game than near-term growth; legislation has been introduced in Congress to impose a carbon tax, using the proceeds to reduce Social Security and Medicare payroll taxes. The basic idea is to tax something that we want to limit (carbon emissions), and to reduce the burden associated with something we want to encourage (the earning of wages).

There is nothing unsound about the basic premises behind many of these proposals if viewed solely from the vantage point of tax policy. But can the political system be trusted to carry their logic through in its connected spending commitments, in a way that doesn't worsen the government's deteriorating fiscal position?

Politicians notoriously adopt inconsistent postures towards the Social Security payroll tax. When we debate the progressivity of the tax code, we are told that the payroll tax is a regressive burden on working Americans and their employers. But when we debate Social Security and Medicare, we are told that these are inviolate benefit obligations that workers have earned with their payroll tax contributions.

It can't be both; either the payroll tax is but one component of a progressively redistributive transaction, or it is not; either the payroll tax establishes one's entitlement to Social Security benefits, or it does not. We can't logically treat the payroll tax simultaneously as the basis for subsequent Social Security benefit payments at the same time that we seek to eliminate it.

And therein lies the problem. Many of these proposals may be substantively meritorious. A payroll tax cut and a general revenue transfer, after all, is economically indistinguishable from stimulus spending financed directly from general revenues, and might be an especially efficient means of administering it. If that it is so, however, we should dispense with the rhetoric of payroll tax relief, especially in the context of proposals that would allow continued accrual of full Social Security and Medicare benefits.

This is probably best understood by extrapolating such proposals to their logical extremes. Suppose that we wholly eliminated the Social Security payroll tax – not just temporarily, but permanently – and that we restored the revenue to Social Security through countless trillions in general revenues, stretched over perpetuity. Even if this is a meritorious economic policy, it clearly destroys the rationale for maintaining a separate Social Security Trust Fund. A version of this problem exists regardless of the size and duration of the general revenue transfers.

Some advocates of a payroll tax reduction have sought to wave away these policy concerns. In a typical example, John Makin stated, “Opponents (of a payroll tax reduction) will claim that it constitutes a threat to maintaining Social Security and Medicare benefits. That claim would be unfortunate and untrue. The federal government is obligated to pay



retirement and medical benefits whether it finances them out of a payroll tax, an income tax, or by additional borrowing, which would be the case in current circumstances.”

[N]o payroll taxes should be credited to the Social Security and Medicare Trust Funds, or towards benefits, if that money has been returned via a tax credit, or never collected at all.”

This argument, however, misses something important. What is the amount of these obligations? Currently, an individual’s Social Security benefit entitlement is proportional to his payroll taxes contributed. Further, the total amount of benefits obligated by the Social Security system is constrained by the total amount of payroll taxes collected. If these payroll taxes are cut, then these entitlement benefits should (if honest accounting is used) be cut as well.

If instead the intent is to sever the relationship between taxes and benefits, then honest accounting demands that we do away with the misleading fiction of the Trust Funds and instead merge these programs into the general fund that is actually financing them. That’s a valid policy choice, but it must be carefully considered and acknowledged before the nation goes down the road of piecemeal general revenue financing of Social Security and Medicare.

If carbon taxes are offset with a payroll tax reduction, will Social Security benefits then be cut proportionally? Or will carbon taxes determine the amount of one’s benefit entitlement? If someone lives a purely green lifestyle, enjoying both reduced payroll taxes and low carbon taxes, what basis would they have for a claim to a full Social Security benefit? If carbon taxes exceed or lag behind projections, will Social Security benefits rise and fall accordingly? Will benefit formulas continue to be based on fictional

payroll tax contributions – contributions that would have been made if the payroll tax hadn’t been cut? Is it even possible to find a sensible resolution to all of these issues within Social Security and Medicare’s current financing frameworks?

Given the size of current payroll tax burdens, our sluggish economy, and the persistent interest in taxing carbon emissions, it’s likely that these debates will continue for some time. That discussion will be sounder and better informed, however, if Congress would first establish an important principle of accounting integrity: stop allowing the corruption of the Social Security and Medicare Trust Funds through general revenue transfers.

Recently, Congress and the Obama Administration made a public ballyhoo about the restoration of “paygo” requirements (which they are simultaneously violating, though that’s a subject for another essay). We suggest another budget accounting principle to restore a modicum of fiscal prudence going forward: no payroll taxes should be credited to the Social Security and Medicare Trust Funds, or towards benefits, if that money has been returned via a tax credit, or never collected at all.

If followed, this principle would establish a threshold for integrity in our national debate over Social Security, Medicare, and the payroll taxes that support them.