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Payroll-Tax Reallocation Would Rob Social Security and Prevent Necessary Disability Insurance Reforms

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Abstract

Social Security and Disability Insurance (DI) are two separate programs, serving two distinct purposes and beneficiary populations, and are financed by two separate payroll taxes with two legally separate trust funds. Social Security provides income support to older Americans, while DI provides income to working-age individuals who become disabled. Although Social Security's 75-year shortfall is nearly 10 times as large as that of the DI program, the DI Trust Fund is projected to be exhausted much sooner. The DI program's impending insolvency has caused many to suggest that a portion of the Social Security payroll tax should be "reallocated" to the DI program. A reallocation, however, would not only evade necessary DI program reforms, but would raid Social Security—and risk significant benefit cuts for millions of current and future retirees, or substantial tax increases for current and future workers.

Although Social Security's 75-year shortfall is nearly 10 times as large as that of the Disability Insurance (DI) program, the DI Trust Fund is projected to be exhausted much sooner. According to the Social Security trustees' 2014 projections, the Social Security (Old-Age and Survivors Insurance—OASI) Trust Fund will be exhausted in 2034, but the DI Trust Fund will run dry in 2016—just two years from now.

The DI program's impending insolvency has caused many to suggest that a portion of the Social Security payroll tax should be "reallocated" to the DI program. A reallocation, however, would not only evade necessary DI program reforms, but would raid Social Security—a program with even larger deficits—and risk significant ben-

Key Points

- Although Social Security's 75-year shortfall is nearly 10 times as large as that of the Disability Insurance (DI) program, the DI Trust Fund is projected to be exhausted much sooner.
- The DI program's impending insolvency has caused many to suggest that a portion of the Social Security payroll tax should be "reallocated" to the DI program.
- A reallocation would not only evade necessary DI program reforms, but would raid Social Security—a program with even larger deficits—and risk significant benefit cuts for millions of current and future retirees, or substantial tax increases for current and future workers.
- The Disability Insurance program is broken and in need of reform. A reallocation of payroll tax revenues from Social Security to Disability Insurance would allow the DI program's problems to grow unchecked.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2940**

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efit cuts for millions of current and future retirees, or substantial tax increases for current and future workers. To avoid a nearly 20 percent cut in benefits to all DI recipients, it may be necessary to allow the DI program to borrow from the OASI Trust Fund. But just as a bank would not lend to a business without a credible plan for repayment, the OASI Trust Fund should not lend to the DI Trust Fund without a plan to improve the integrity and solvency of the DI program.

Two Programs, Two Trust Funds

Social Security and Disability Insurance are two separate programs, serving two distinct purposes and beneficiary populations, and financed by two separate payroll taxes with two legally separate trust funds. Social Security provides income support to older Americans, while DI provides income to working-age individuals who become disabled.

A recent report by the Center on Budget and Policy Priorities included the claim that the payroll tax has traditionally been divided "between OASI and DI according to the programs' respective needs." This is not true: When the DI program was enacted in 1956, Congress intentionally created a separate trust fund, with a separate payroll tax to finance the DI program. If Congress had intended the DI program to be a part of the Social Security program, it would have combined it with Social Security when it was first established.

Currently, workers pay a 10.6 percent payroll tax into the Social Security Trust Fund (up to a payroll tax cap of $117,000 in earnings for 2014) and a 1.8 percent payroll tax into the DI Trust Fund.[1]

DI Program: In Need of Substantial Reforms

The Social Security trustees have been warning for years that the DI program faces imminent insolvency. It has been taking in less tax revenue than it pays out in benefits for eight years now, recording a $32 billion shortfall in 2013.[2] The only way the DI program is able to pay full benefits today is through repayment of principal and interest from general revenues to the DI Trust Fund as a result of past borrowing (to finance general revenue spending). But these payments will run out in 2016, leaving the DI program with significantly less incoming tax revenues than promised benefits.

Recent and projected shortfalls in the DI program are largely the result of a massive increase in DI beneficiaries over the past decades. Since 1990, the share of the working-age population (ages 16–64) receiving DI benefits has more than doubled, from 2.3 percent to 5.0 percent.[3] This rise in DI beneficiaries has occurred despite an increase in life expectancy and a decline in the physical demands of most jobs that would otherwise suggest there should be a decline in the share of the adult population receiving DI.

A recent study by the Federal Reserve found that less than half of the rise in DI recipients since 1980 can be explained by factors such as the aging of the population and women's increased labor force participation.[4] The rest of the increase likely stems from economic factors that have made it more difficult to find jobs, a relative increase in DI benefit levels for low-income workers, and more subjective qualification standards that have increased access to DI benefits.[5]

1. Payment of the payroll tax is split equally between employees and employers, with each paying 5.3 percent into the OASI Trust Fund, and 0.9 percent into the DI Trust Fund. Self-employed workers directly pay the full combined payroll tax shares of 10.6 percent and 1.8 percent. While employers formally write the checks for half of these benefits, economists find that employees bear the cost of the overwhelming majority of this employer share through lower wages.
2. U.S. Social Security Administration, *2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, July 28, 2014, http://www.socialsecurity.gov/OACT/TR/2014/index.html (accessed July 28, 2014).
3. Author's calculations using data from the U.S. Census Bureau Population Estimates and Social Security Administration data on disability beneficiaries. The recipient rate equals the percent of the population ages 16–64 that receives worker, widower, or adult-children disability insurance benefits.
4. Mary C. Daly, Brian Lucking, and Jonathan A. Schwabish, "The Future of Social Security Disability Insurance," Federal Reserve Bank of San Francisco *Economic Letter*, June 24, 2013, http://www.frbsf.org/economic-research/publications/economic-letter/2013/june/future-social-security-disability-insurance-ssdi/ (accessed June 2, 2014).
5. According to the Social Security Administration's 2012 Annual Statistical Report (the most recent), 53.4 percent of all disability awards in 2012 went to individuals with arguably more subjective claims classified as musculoskeletal and mental disorders. This marks a roughly 40 percent increase in the share of musculoskeletal and mental disorder benefits over the past two decades. See Social Security Administration, *Annual Statistical Report on the Social Security Disability Program, 2012*, November 2013, http://www.ssa.gov/policy/docs/statcomps/di_asr/ (accessed August 6, 2014).

Marc Goldwein of the nonpartisan Center for a Responsible Federal Budget provides a long list of problems in the DI program that necessitate significant reform:

> Not only is the program financial [*sic*] insolvent, but the system is wrought with fraud, needlessly complex, difficult to navigate, inconsistent and unfair in determining eligibility, inflexible to changes in the structure of the workforce, administratively overburdened, almost completely uncoordinated with other government policies, and unable to help or reward those who are interested in reentering the workforce.[6]

The DI program is crucial to millions of disabled individuals who cannot work and would face severe hardship or destitution without DI benefits. These beneficiaries' well-being is threatened by inefficiencies and unintended growth in the DI program that are unnecessarily depleting its finances. The DI program must be reformed so that it can continue to provide for individuals who are truly unable to work, without subsidizing early retirement and long-term unemployment.

Reallocation Is *Not* Business as Usual

A reallocation of payroll tax revenues, from Social Security to Disability Insurance, has been suggested to push back the DI program's projected trust fund exhaustion in 2016. A reallocation would take a portion of the 10.6 percent Social Security payroll tax and add it to the existing 1.8 percent DI payroll tax.

Despite the assertion by groups such as the Center for Budget and Policy Priorities that a "Payroll Tax Reallocation Is Nothing New,"[7] reallocation of tax revenues from one program to another is not part of the program's design or intent, and it is not a regular occurrence.

As the Social Security trustees' 2014 annual report summary points out:

> The combined trust funds, and expenditures that can be financed in the context of the combined trust funds, are theoretical constructs because there is no legal authority to finance one program's expenditures with the other program's taxes or reserves.[8]

Over time, the amount of payroll taxes collected by the OASI and DI programs has varied, with payroll tax rates almost always rising. In 1983, payroll taxes were temporarily reallocated from the DI program to the OASI program, but this was part of a comprehensive reform to Social Security that eventually returned the DI tax rate back to its previously scheduled level.

In 1969, 1980, and 1994, payroll taxes were reallocated in the opposite direction, from the OASI Trust Fund to the DI Trust Fund. The most recent reallocation, in 1994, amounted to a 50 percent increase in the DI tax rate. Despite that increase, however, the DI Trust Fund is still insolvent. As recently as 2004, the DI Trust Fund was projected to remain solvent through 2029.[9] And now, 10 years later, the DI Trust Fund is projected to become insolvent 13 years sooner, in 2016.

A payroll tax reallocation would not solve the DI program's broken nature, but would instead allow the program to continue to grow unchecked with the presumption that it can repeatedly turn to the Social Security Trust Fund for future bailouts.

Reallocation Would Raid Social Security, Encourage Moral Hazard. A reallocation of OASI benefits to the DI program would rob Social Security of its necessary financing, causing its trust fund to be depleted earlier than currently scheduled. The trustees' most recent projections show that the

6. Marc Goldwein, "Social Security Disability System Is Broken," *The Hill*, May 1, 2012, http://thehill.com/blogs/congress-blog/economy-a-budget/224795-social-security-disability-system-is-broken (accessed July 17, 2014).
7. Kathy Ruffing and Paul N. Van de Water, "Congress Needs to Boost Disability Insurance Share of Payroll Tax by 2016," Center on Budget and Policy Priorities, July 31, 2014, http://www.cbpp.org/cms/index.cfm?fa=view&id=4168 (accessed August 4, 2014).
8. Social Security Administration, *2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*.
9. Social Security Administration, *2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, March 23, 2004, http://www.ssa.gov/OACT/TR/TR04/tr04.pdf (accessed July 23, 2014).

OASI Trust Fund would be depleted one year earlier—in 2033, instead of 2034—if its revenues were reallocated to the DI program.

When the OASI Trust Fund is exhausted, benefits would have to be cut by 23 percent across the board, absent other policy changes. For anyone who retires before 2035—that is, anyone who is 41 or older today—a reallocation could mean lower lifetime benefits. These earlier benefit cuts would be most harmful to low-income individuals who rely on Social Security as their only source of income in retirement.

The Social Security Trust Fund may be projected to be solvent for a longer period of time, yet its shortfall, at $12.0 trillion, is nearly 10 times that of the DI program's roughly $1.3 trillion shortfall.[10] It makes little sense to take money from a program with larger deficits and give it to one with smaller deficits simply because the latter will run out of money first. Yet, this is precisely what a payroll tax reallocation would achieve.

What is more, a reallocation—particularly one that does not tie reallocation to substantial reforms—would lead to moral hazard between the Social Security and DI programs. Moral hazard arises when an individual—or a program in this case—does not bear the full consequences of his actions and therefore acts less prudently than he otherwise would because he can push the costs of his negligence on to others. If it becomes clear that reallocation will be used whenever one of the programs faces imminent insolvency, both programs will have less incentive to implement reforms that preserve integrity and prolong solvency. Such reforms would leave more money on the table to be potentially taken, through reallocation, by the other program. Additionally, the programs would have an increased incentive to push for more generous benefits, as higher costs could cause that program to gain a larger share of payroll tax revenues.

Borrowing, Contingent on Reform. The imminent insolvency of the DI Trust Fund means that it will be very difficult to reap the benefits of potential reforms before the Trust Fund runs dry. To avoid immediate and indiscriminate benefit cuts, it may be necessary to allow the DI Trust Fund to temporarily borrow money. This was done in 1983 when the OASI Trust Fund was given temporary authority to borrow from the DI Trust Fund.

Allowing the DI Trust Fund to temporarily borrow from the OASI Trust Fund could provide the DI program time to implement necessary reforms and realize the savings from those reforms. But, just as a bank would not lend to a business without a credible plan for that business to repay the bank, the OASI Trust Fund should not lend to the DI program without a credible plan for repayment.

Reforming the DI program is more complex than reforming Social Security because the eligibility criteria are more subjective and the application and award process is far more complicated. However, there are certainly reforms that can be made to preserve the program for the truly disabled while limiting unnecessary awards. Policymakers should carefully examine the program's eligibility criteria and pathways to recovery to better focus program benefits on those who are truly unable to support themselves through work. This could include fostering accommodations to keep workers with less severe disabilities employed, encouraging beneficiaries to return to work as they are able, and reforms to the judicial process and continuing disability reviews to preserve the integrity of the program.

Reform, Not Reallocation

The Disability Insurance program is broken and in need of reform. A reallocation of payroll tax revenues from Social Security to Disability Insurance would allow the DI program's problems to grow unchecked. Additionally, reallocation would rob Social Security—an even more financially strapped program—and potentially lead to earlier and indiscriminate benefit cuts.

Social Security and Disability Insurance serve two separate purposes. Merging their finances through reallocation would encourage moral hazard, as both programs would have the incentive to push for more generous benefits and would have less incentive to implement reforms as changes in costs would be spread across both programs.

10. According to the Social Security trustees' 2014 annual report, the 75-year unfunded liability for the OASI program is $9.363 trillion, and the unfunded liability for the DI program is $1.202 trillion. However, the OASI Trust Fund also contains $2.674 trillion worth of IOUs that will add, dollar for dollar, to future deficits as the IOUs are repaid. The DI Trust Fund contains $90.4 billion in IOUs. Adding the IOUs to the unfunded liabilities amounts to combined shortfalls of $12.0 trillion for Social Security, and $1.3 trillion for Disability Insurance.

It may be necessary to allow the DI program to temporarily borrow from the OASI Trust Fund, but that borrowing must be contingent on the DI program's establishing reforms that will preserve its solvency and protect its integrity for the millions of disabled Americans who rely on Disability Insurance.

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