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Implications of the Payroll Tax Holiday for Social Security:

Social Security Now Has Four Dedicated Income Sources The Tax Holiday Needs an Exit Strategy

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The contributions that workers pay for Social Security insurance protection have been temporarily reduced from 6.2% of earnings to 4.2% in 2011 and 2012. Employers continue to pay the 6.2% rate. This "payroll tax holiday" – enacted under the Tax Relief and Job Creation Act of 2010 and extended in December 2011 and February 2012 – is scheduled to end on December 31, 2012.

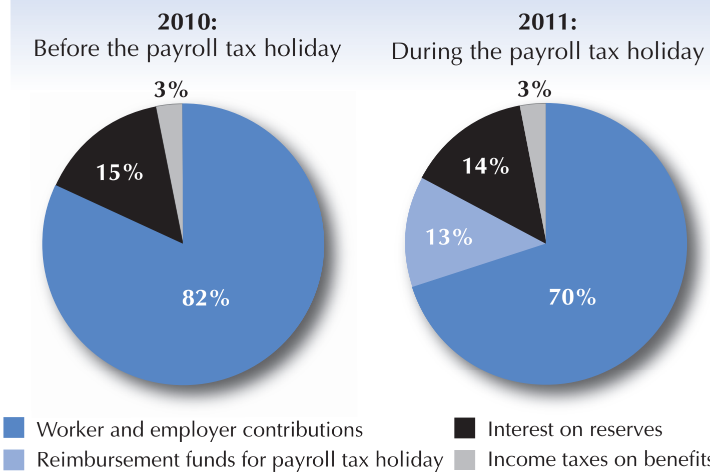
The purpose of the payroll tax holiday was to get money quickly into the hands of workers so they could spend it to help the nation out of the Great Recession. This purpose has nothing to do with financing Social Security. The legislation was expressly designed to avoid harming Social Security's finances by requiring that the lost revenues from payroll taxes be made up from general revenues. Stephen C. Goss, Chief Actuary of the Social Security Administration, estimated that because of this provision the projected level of Social Security's trust funds would be unaffected by the payroll tax holiday.[1]

Social Security Now Has Four Sources of Dedicated Income

For the duration of the payroll tax holiday, Social Security has four dedicated sources of income:

- *Contributions* that workers and employers pay in the form of payroll taxes, levied on earnings up to a cap ($110,100 in 2012). Workers pay 4.2% of their earnings – a temporary reduction from 6.2% – while employers pay 6.2%.
- *Dedicated reimbursement funds from the federal government* as a dollar-for-dollar replacement for the revenue lost because of the temporary reduction in payroll taxes.
- *Income taxes on benefits* that some beneficiaries pay.
- *Interest on the reserves* held by Social Security's trust funds.

Shares of Income to the Social Security Trust Funds



Source: Social Security Administration (SSA), 2012. Trust Fund Data. http://www.socialsecurity.gov/OACT/ProgData/allOps.html

Each of these dedicated income sources is required by law and each is credited to the Social Security trust funds to pay for future benefits. The dedicated reimbursement funds are a legally binding revenue source for Social Security, replacing dollar-for-dollar all of the reduction in funds caused by the payroll tax holiday. In 2011, the reimbursement funds made up 13% of Social Security's income that otherwise would have come from workers' contributions (see figure).

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Toward an Exit Strategy and Beyond

The contribution rate reduction for workers is set to expire on December 31, 2012. The payroll tax holiday needs an exit strategy that can help strengthen Social Security for the long run and that can attract broad public support. The prospects for such a strategy will likely be influenced by the outcome of the November elections and the condition of the economy.

If the economic recovery continues, the case can be made that the payroll tax holiday will have served its purpose. That could lay the groundwork for an exit strategy that addresses the immediate need to restore Social Security's contribution rate to 6.2% for workers, matching the rate paid by employers. One such strategy would gradually restore the rate to 6.2% over several years to smooth the transition period and avoid a sudden impact on the still-fragile economy.

Gradually raising the contribution rate beyond 6.2%, for workers and employers alike, would address the program's projected long-term revenue shortfall and help keep the program in balance throughout the retirement of the baby boomers and beyond. There is ample precedent for scheduling such future rate increases: between 1950 and 1983, contribution rate increases were scheduled 11 times in anticipation of increased outlays for benefits, with the understanding that an economy in long-term health can afford gradual, scheduled increases (even if short-term economic downturns may justify temporary adjustments). And across age groups and party lines, large majorities of Americans consistently agree that they want to "preserve Social Security for future generations even if it means increasing working Americans' contributions" to the program.[2]

An exit strategy and gradual contribution rate increase is outlined in a recent, unpublished paper[3] by National Academy of Social Insurance member Joseph White, director of the Center for Policy Studies at Case Western Reserve University. He suggests structuring an exit strategy along the following lines:

Social Security Contribution Rates for Workers, 2010-2023

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
6.2%	4.2%	4.2%	4.6%	5.0%	5.6%	6.2%	6.3%	6.4%	6.5%	6.6%	6.7%	6.8%	7.0%

Beginning in 2017, the employer rate would be raised to match the rate for workers. Although this rate schedule alone would not entirely eliminate Social Security's projected shortfall, it could – in combination with other changes such as lifting the cap on taxable earnings – keep the program in balance for the entire 75-year projection period used to assess the program's finances.

Regardless of the pros and cons of the payroll tax holiday, coupling it with an exit strategy based on gradual contribution rate increases could, as White notes, serve both the goals of boosting the economy during a short-term crisis and making Social Security's finances more secure for the long run.

Endnotes

1 Goss, Stephen C. 2010. Letter to Treasury Secretary Timothy Geithner and Office of Management and Budget Director Jacob Lew. Baltimore, MD: Social Security Administration. December 10, 2010.

2 Gregory, Janice M., Thomas N. Bethell, Virginia P. Reno, and Benjamin W. Veghte. 2010. "Strengthening Social Security for the Long Run." Social Security Brief No. 35. Washington, DC: National Academy of Social Insurance.

3 White, Joseph. 2012. "Social Security's Effects on the Federal Budget Deficit: Economics and Politics." Unpublished draft, January 23, 2012.

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