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DATA IN TRUSTEES' REPORT SHOW SOCIAL SECURITY SHORTFALL IS LESS THAN HALF AS LARGE AS THE REVENUE LOSS FROM THE TAX CUT

by Richard Kogan and Robert Greenstein

The estimates in the Social Security Trustees' report issued March 26 of the size of the Social Security shortfall over the next 75 years — while substantial — equal less than half the cost that the tax cut enacted last year will have over the next 75 years if made permanent. These data indicate that scaling back a portion of the tax cuts for very wealthy individuals that are not yet in effect — and devoting the preserved revenue to Social Security — could dramatically reduce the Social Security shortfall.

The Trustees' report projects that the Social Security shortfall over the next 75 years will equal 1.87 percent of covered payroll, or 0.72 percent of the Gross Domestic Product over this period. (The Gross Domestic Product is the basic measure of the size of the economy.) The estimate that the shortfall equals 0.72 percent of GDP is found in table V1.E5 on page 164 of the Trustees' report.

The cost of the tax cut over 75 years equals an estimated 1.68 percent of GDP. In other words, the tax cut is more than twice as large as the entire Social Security shortfall. The long-term cost of the tax cut can be measured by taking the Congressional Budget Office's estimate of the cost of the tax cut in 2011 if all of its provisions are extended and assuming these costs remain constant as a share of GDP after 2011.[1] This is the standard approach that the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office use when preparing long-term fiscal projections. For a number of reasons, this estimate of the long-term cost of the tax cut is almost surely conservative.[2] A forthcoming

[1] This estimate also reflects Joint Tax Committee estimates of the cost of extending alternative minimum tax relief beyond 2004. A provision of last year's tax-cut legislation provides relief from the AMT through 2004 but is scheduled to expire at the end of that year. That provision holds the number of taxpayers subject to the AMT through 2004 to roughly the number that would have been subject to the AMT under the law in place prior to enactment of the tax-cut legislation. In preparing the estimates used in this analysis, the JCT assumed continuation of the AMT relief provision in such a manner that the number of taxpayers subject to the AMT would continue to track closely the number that would have been subject to the AMT under prior law. This still assumes a very large increase in the numbers of taxpayers subject to the AMT, from less than two million this year to more than 20 million by 2011. The Joint Tax Committee prepared these estimates at the request of Rep. Charles Rangel.

[2] The assumption that the tax cut will remain a constant share of GDP after 2011 is likely to be conservative. Before the tax cut was enacted, both income tax revenues and estate tax revenues were projected to grow somewhat faster than the economy. This growth was projected to occur primarily because national income is projected to grow faster than inflation (with the resulting income growth pushing some taxpayers into higher marginal tax brackets even though the brackets are indexed to inflation), and because the amount that was exempt from the estate tax was not indexed for inflation. In addition, some provisions of the tax legislation, such as the creation of Roth
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Brookings Institution analysis by Alan Auerbach, William Gale, and Peter Orszag estimates the long-term cost of the tax cut at 1.85 percent of GDP over 75 years.[3]

Another way to compare the relative sizes of the Social Security shortfall and the tax cut is to examine how much each amounts to in dollars and cents. From data in the Social Security Trustees' report, one can readily compute that the "present value" of the projected Social Security shortfall is $3.7 trillion. (The present value is the amount today that, with interest, would cover exactly the Social Security shortfall over the next 75 years. In other words, if Social Security currently held $4.9 trillion in assets instead of the $1.2 trillion it currently holds, then the combination of projected Social Security revenues and these expanded trust fund reserves, along with the interest the reserves would earn, would fully cover projected Social Security costs for the next 75 years.)

By contrast, the present value of the tax cut is $8.7 trillion. In other words, the revenue losses from the tax cut over the next 75 years would equal $8.7 trillion in today's dollars, plus the interest that would accrue on that amount over the 75-year period. Here, too, the revenue loss from the tax cut is seen to be more than twice as large as the projected Social Security shortfall.

Tax Cut Poses Problems for Social Security

The tax cut threatens the nation's ability to restore long-term solvency to the Social Security system. Nearly every major proposal that has been introduced in Congress to restore long-term solvency — as well as both of the proposals to restore solvency proposed by the President's Social Security Commission in December — rely on the transfer of large sums from the rest of the budget to Social Security, either on an ongoing basis or for a several-decade-long "transition period." Yet if the tax cut is made permanent, there will not be non-Social Security surpluses left to transfer, as the latest CBO and GAO budget projections demonstrate.

These projections of the size of the Social Security shortfall and the cost of the tax cut over the next 75 years do offer a ray of hope, however. From listening to various pundits and policymakers, many Americans may believe the tax cut is modest in size while the long-term Social Security shortfall is enormous. In fact, a comparison of the relative magnitudes of the Social Security shortfall and the tax cut shows that the tax cut is far more costly than its proponents generally acknowledge, while the Social Security shortfall — although a significant problem that must be addressed — is not as gargantuan as often portrayed by some who favor radical changes in Social Security.

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[2] (...continued)
401(k) accounts and the increase in the amount that can be contributed to a Roth IRA, are substantially more costly in the long run than in the short run.

[3] Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "The Budget Outlook and Fiscal Policy Options," Brookings Institution, forthcoming. The difference between the two estimates primarily reflects differences in estimating the costs of the interaction between the tax cut and the Alternative Minimum Tax.

This means that scaling back a portion of the tax cut not yet in effect and devoting the preserved revenue to Social Security could close a large portion of the Social Security shortfall. Indeed, if all portions of the tax cut now in effect were made permanent but the parts not yet in effect were cancelled — and the revenues they would have lost were devoted to Social Security instead — the entire Social Security shortfall for the next 75 years would be eliminated. (This is not a course we would recommend and is noted here for illustrative purposes; were the tax cuts not yet in effect to be deferred or cancelled, as budget experts such as former CBO director

The Administration's Response

When an earlier version of this analysis was first issued last August, the Administration responded by saying that the cost of the tax cut is only one percent of GDP while the Social Security shortfall is, likewise, close to one percent of GDP (rather than 0.72 percent). The Administration itself thus acknowledged that the revenue loss from the tax cut is fully as large as the Social Security shortfall.

The 1.0 percent of GDP figure that the Administration used for both estimates, however, was not valid. Its Social Security estimate differed from that which the Social Security Trustees have issued and overstated the size of the Social Security shortfall, while its tax cut estimate failed to include the cost of at least three provisions of the tax-cut law and thereby understated the tax cut's cost.

The new Trustees report projects that the Social Security shortfall equals 0.72 percent of GDP. The Administration derived its estimate of one percent of GDP by ignoring the assets of the Social Security Trust Fund, and thereby effectively assuming that the Trust Fund's $1.2 trillion of Treasury bonds will not be available to finance Social Security benefits. This contradicts the long-established practice of the Social Security actuaries and Trustees, who understand that these Treasury bonds are backed by the full faith and credit of the U.S. government and surely will be honored.

In terms of the tax cut, the Administration estimated its cost to be only 1.0 percent of GDP by looking solely at the cost of the tax cut, as enacted, *in 2010*, rather than the cost of the tax cut when fully phased in and with all provisions extended. Under the Administration's estimating approach, the provisions of the tax cut that are artificially slated to expire in 2004, 2005, and 2006 are assumed to die rather than to be extended — including a provision scheduled to expire in 2004 that protects millions of taxpayers from being subject to the mushrooming individual Alternative Minimum Tax. The Administration's estimate that the tax cut will cost 1.0 percent of GDP assumed that 35.5 million taxpayers will be subject to the AMT in 2010, as compared with less than 2 million today, and that the AMT will cancel out significant parts of the tax cut for many Americans. No credible observer believes Congress will allow this AMT-relief provision simply to expire in 2004. Similarly, the Administration's approach excludes the large cost of repealing the estate tax, which only shows up in years *after* 2010. Under the tax law, the estate tax is not repealed until 2010. As tax estimators know, the cost of repealing the estate tax shows up only a year or two *after* the year in which it is repealed, because there is normally a lag of a year or so between the time an individual dies and the time the estate is settled and tax is paid on it.

Other independent estimates of the cost of the tax cut when it is fully in effect also place the cost at more than twice the Social Security shortfall. A recent Brookings analysis estimates the cost at 1.85 percent of GDP over the next 75 years.

Robert Reischauer have recommended, it would be better to devote the preserved revenues to a number of purposes rather than solely to Social Security.)

Alternatively, if a modest portion of the tax cuts for upper-income Americans that are not yet in effect were cancelled and the preserved revenue devoted to Social Security, the Social Security shortfall could be reduced substantially in size. For example, if all reductions in the estate tax scheduled to take effect through 2008 were implemented — with the estate tax exemption raised to $2 million per individual (effectively $4 million per couple) and the estate tax rates lowered — but the estate tax was not repealed and the estate tax revenues that continued being collected were dedicated to the Social Security Trust Fund, about one-quarter of Social Security's long-term financing gap would be closed.

If this were done, fewer than one percent of estates would be subject to the estate tax. In addition, those estates that did owe the tax would receive very large estate-tax reductions, compared with what they would have owed under the estate-tax law in effect before last year's tax cut.

If one went further and coupled such a change in the estate tax with the cancellation of income tax rate reductions not yet in effect for the top three brackets, almost *half* of Social Security's long-term gap would be closed. Only the highest-income five percent of taxpayers would be affected by cancelling the scheduled rate reductions in the top three brackets, and they would still receive tax cuts substantially larger in dollar terms than the tax cuts received by those with less hefty incomes.

In short, policymakers concerned about the restoration of Social Security solvency and the nation's long-term fiscal health would do well to consider options for canceling some of the scheduled tax cuts before they take effect (particularly those targeted on households with the highest incomes) and using a portion of the resources preserved as a down payment toward restoring solvency to the Social Security system. Canceling part of the tax cut could provide the resources for transferring some general revenues to Social Security; such transfers are likely to be an essential ingredient of any Social Security reform package that can be enacted. The magnitude of the Social Security benefit cuts or payroll tax increases that would be needed as part of any solvency package that did *not* include such general-revenue transfers would likely doom any such plan politically.