Why Social Security Cuts Are Unavoidable

On May 16th, Moody's Ratings sent a shock wave through the financial world by downgrading U.S. credit from its Aaa rating to a rating of Aa1, following Standard & Poor's lead back in 2011 and Fitch Ratings in 2023, due to concerns over the government's ability to manage its debt. If the U.S. desires to maintain a high credit rating, then the GOP tax bill under consideration is entirely counterproductive to that goal.

The tax bill that just passed the House and now stands before the Senate will renew the 2017 tax cuts in tandem with increased outlays for border security and the military. It is estimated that, on net balance, this would contribute over $3 trillion to the national debt over the coming decade, according to the Committee for a Responsible Federal Budget (CRFB). This sends a signal to credit rating agencies and investors that only exacerbates their apprehensions about the current state of U.S. sovereign debt. A country that wants to boost confidence in its debt management would typically raise taxes and cut spending significantly, but this bill does the opposite. At the very least it should cut spending to a degree that offsets any tax cuts.

The erosion of confidence in U.S. debt worldwide will have the net effect of increasing yields on U.S. Treasuries. CRFB and Congressional Budget Office projections show that this alone will add $1.8 trillion to interest costs by the end of 2034, further eroding market sentiment. This creates a vicious cycle that, if not dealt with, will prompt agencies like Moody's to further downgrade the U.S. credit rating, making it increasingly difficult for the U.S. to attract capital.

The government faces few politically viable options in terms of what it can do to bring down spending. Social Security alone is the single largest government program at 21% of outlays, so any serious solution will address it. This creates a dilemma: dramatically reducing expenditure on Social Security will incite tremendous political backlash, yet it seems inescapable that this program must be restructured. With baby boomers entering retirement, the government will need to either increase payroll taxes or cut benefits to prevent the program from becoming insolvent. Given the tendency of tax hikes to perpetuate spending problems rather than to resolve them, the only long-term remedy to this issue is cutting benefits.

Introducing means-testing would be a politically feasible route. Means-testing for couples earning over $120,000 per year would trim $210 billion in spending over ten years (CRFB). Another promising option would be to use the Chained CPI measure of inflation (a more accurate measure of inflation than what is currently used), which would save $350 billion by 2035. Less feasible, but highly cost-effective, would be to flatten Social Security benefits. This would entitle all beneficiaries to payments that are 150% of the federal poverty line. The savings would amount to $860 billion in ten years. These are among the most politically palatable options for restructuring Social Security proposed by the CRFB, yet they generate only modest savings. Inevitably, something will have to be done that will be both painful and unpopular.

The effects of subordinating fiscal policy to approval ratings were experienced by Greece in 2009. When Athens admitted that its debt was larger than previously reported, a debt crisis ensued and Greece was forced to implement extreme austerity measures, which included spending cuts on pensions and social services. Recession became unavoidable. Unemployment surged to over 20% by 2011 and generated a massive public outcry. Greece's Real GDP still hasn't recovered to pre-2009 levels.

If the U.S. is to avoid such economic hardship, then prioritizing budgetary concerns must take precedence, even if it's at the expense of political popularity. Keeping the campaign promise to cut taxes will be popular among many, but absent any shadow of a plan to simultaneously make offsetting spending cuts, market sentiment will become more pessimistic. Cutbacks in Social Security benefits, while repugnant, are unavoidable. Given the current trajectory of U.S. debt, it is not a matter of if, but a matter of when a breaking point will be reached. When this happens, the government will have even fewer options than it has now and those options will prove far more painful than the changes that the U.S. could have instituted today.