The 2016 Disability Insurance Time Bomb

In June, 11 million Americans collected benefits, up from 2.7 million in 1970. The 75-year unfunded liability: $40 trillion.

By Michael J. Boskin
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Social Security for retirement and Medicare are the best known of the major entitlement programs with looming financial disasters. While some argue about when they will run out of money, their projected 75-year unfunded liabilities grow larger every year and now total $40 trillion, much worse thereafter.

But the ticking time bomb of entitlement reform is Social Security's Disability Insurance Fund. According to the Social Security trustees, the bomb is due to go off—when the fund, running out of money, will need to make steep cuts in benefits—just in time for the 2016 election.

Without reform of this and other programs, beneficiaries aren't the only ones who will suffer. The primary driver of surging costs in every entitlement program is not demography but rising real benefits per beneficiary. If entitlement cost growth isn't slowed soon, standard estimates imply that taxes to pay for them will eventually rise to crushing levels, sharply lowering incomes within a generation.

With luck, the looming implosion of the Disability Insurance Fund will focus attention on other entitlements (and may dampen some of the happy talk now heard in Washington about the health of Social Security and Medicare). Coming to grips with the disability program also may provide a guide to reform of the larger programs.

The number of people collecting disability benefits has soared, especially in recent years, to almost 11 million in June, up from 2.7 million in 1970. The 2012 price tag was $140 billion, up eightfold, adjusted for inflation, from 1970. The quadrupling of beneficiaries over a few decades is far beyond what would be expected from demographic trends and elevated unemployment. So what else has been going on?

Government figures show that over that period the share of workers employed in manufacturing, mining and agriculture—where jobs are more physically demanding—has declined by between one-third and three-fourths since 1970. Meanwhile, employment in services has surged—including health, education and finance.

In the past, the Government Accountability Office routinely criticized the Disability Insurance Fund for not reviewing claims more often to make sure its beneficiaries were still eligible. In 1980, Congress increased the frequency of eligibility reviews. But that created a backlash and in 1984

Congress actually broadened eligibility, based on subjective criteria such as back pain and arthritis. The range of mental illnesses covered was also widened.

The complaints added by the broadened eligibility now exceed the formerly predominant and easier-to-identify ones such as cancer, blood disorders, heart disease and major musculoskeletal problems—and they now draw the majority of monetary awards.

Disability benefits also pay more than they used to relative to wages, weakening work incentives. And aging population and the increase in women with sufficient work history to qualify have also contributed to the astounding growth of the disability rolls.

Even so, the rising share of 45- to 64-year-olds (the group most at risk for disability and early retirement), due to the aging of the baby boomers, explains only a small part of the disability increases. Disability insurance has clearly become, in part, a form of extended unemployment insurance and early retirement, with Medicare benefits.

More than 20 states today try to shift people from their welfare and Medicaid rolls onto disability insurance and Medicare, which are fully paid for by the federal government. Some unions help their members obtain disability insurance—for instance, when companies are downsizing and laying off workers.

One fundamental lesson of the past decades is that the many overlapping benefit programs have become permeable. People figure out how to move from program to program, stretch boundaries and take the best option. When government is offering benefits—or green-energy corporate welfare, too-big-to-fail bank subsidies and tax breaks—people will find a way to take them.

The best alternative, as with so many government programs, is to slow spending. In this instance, that would mean targeting benefits far more effectively to those in real need and limiting payments for those who can reasonably be expected to work.

Disability insurance helps many with serious ailments, but it needs to better balance work incentives with legitimate insurance. My own reading of research by prominent labor economists—such as MIT's David Autor, Penn's Mark Duggan, the San Francisco Fed's Mary Daly and my Stanford colleague Luigi Pistaferri —suggests starting with a more sensible definition of disability, and more frequent re-evaluation.

Eligibility should emphasize objective medical—as opposed to more subjective and vocational—criteria, with a more rigorous appeals process for potential false rejections of meritorious but difficult-to-verify claims. About 40% of disability awards now follow appeals, of which a large majority are successful.

Next, offer better incentives to return to work for those who can. This means early intervention and providing information about job options—before people lose any attachment to the labor market and their skills deteriorate. Today, the disability-insurance program hardly focuses on the return to work. It is a Hotel California—you check in with a disability and don't leave unless you die or convert to Social Security retirement at age 66. In 2009 only a tiny percentage of those on disability, 0.8%, returned to work or gave up the benefits for other reasons.

Another useful reform would base disability-insurance employer taxes on disability experience—higher taxes for employers with a higher incidence of disability among their employees. Such a policy, also called experience rating, would give companies a better incentive to help workers prevent debilitating problems and manage their return to work. The prevalence of workers claiming disability declined substantially in the Netherlands after experience rating was gradually adopted between 1998-2003.

The surge in U.S. disability enrollments has far greater financial implications than the $140 billion spent in 2012 suggests. A new 50-year-old enrollee—the mean age of those who go on disability—will collect to age 66, at which time he or she will transfer to regular Social Security. The present value of disability-insurance benefits, plus Medicare costs, per new disabled worker is more than $300,000. The almost one million new disabled-worker awards in the past 12 months—there were also half a million awards for spouses and children—will cost about $300 billion.

Whether triggered by a disability-insurance blowup in 2016 or not, entitlement reform can't wait. It will determine whether the U.S. can resume its path as a flexible, dynamic market society, or slide further into an economically stagnant European-style social-welfare state.

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