Institute For Policy Innovation IPI

Summary: *The solution to looming Social Security shortfalls is increased economic growth. Personal retirement accounts, owned by workers and invested in real assets, would prefund benefits and could provide new saving and investment critical to economic growth, provided that tax reform makes saving and investment in the U.S. more attractive. Thus the path to Social Security reform is through tax reform.*

THE ROAD MAP TO TAX REFORM™

SOCIAL SECURITY REFORM AND TAX REFORM:

Is One Possible without the Other?

By Aldona Robbins

INTRODUCTION

The mention of tax reform makes most people think of the personal income tax. But there is another tax—the payroll tax—that is just as important. Federal, state and local governments levy payroll taxes on wages and salaries to fund benefits for retirement, disability, and unemployment. As these social insurance programs have grown, so has the importance of payroll taxes.

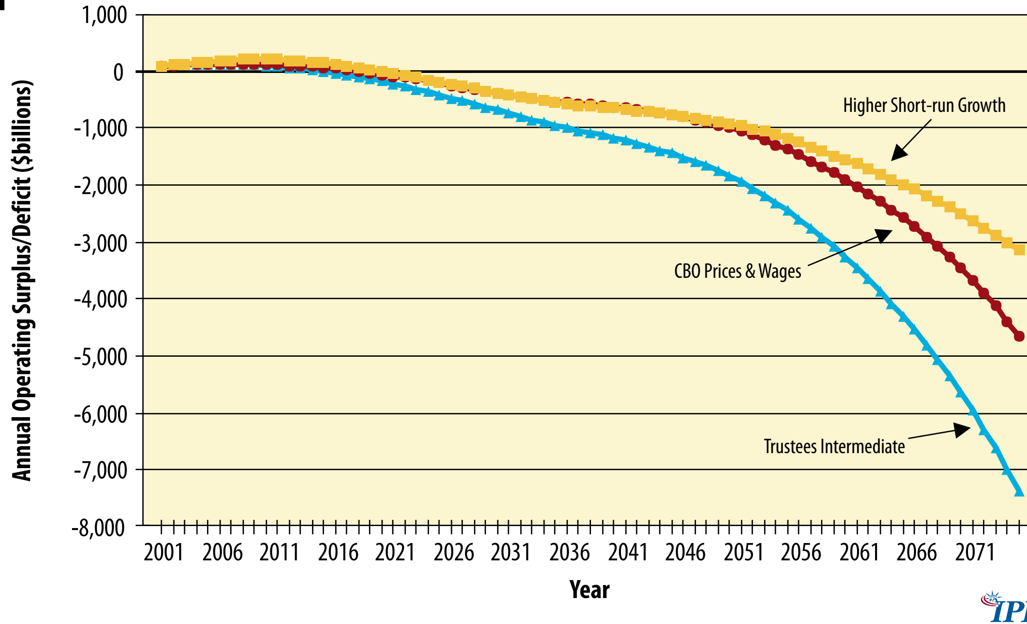
Social Security and Medicare operate on a *pay-as-you-go* basis. Benefits disbursed in any one year are paid from tax revenues collected in that same year. When more payroll tax revenue comes in than benefits go out, the government **borrows** the surplus Social Security or Medicare taxes, credits the appropriate *trust fund* with a government bond, and tallies the amount "borrowed" with a special accounting device called a *special issue bond.* In other words, Social Security's assets consist solely of federal debt.

THE FINANCIAL OUTLOOK OF SOCIAL SECURITY

According to the 2001 Trustees' annual report on the financial condition of the system, Social Security will take more in taxes than are needed to pay benefits in each of the next fifteen years. Treasury bonds held by the combined OASDI trust fund should climb from the little over $1 trillion at the end of last year to $4.9 trillion ($3.1 trillion after inflation) in 2015. Thereafter, however, the Trustees project payroll tax revenue coming into Social Security will fall short of money going out.

As growing numbers of baby boomers reach retirement age, the payroll taxes collected from workers along with the income taxes on Social Security benefits will no longer be enough to cover the checks sent to beneficiaries. The Trustees project these *annual operating deficits* to start out small—about $18 billion in today's dollars—but expand at a rate of 6.5 percent a year, after inflation.

Figure 1 **Higher Growth and Lower Inflation Reduce Social Security Deficits**



The economy and Social Security

In general, the stronger the economy, the better off is Social Security. Adopting the Congressional Budget Office's (CBO) growth and inflation assumptions (instead of the Trustees' assumptions) improves Social Security's financial outlook considerably. For instance, CBO growth and inflation assumptions cut the present value of Social Security deficits over the next 75 years in half, from $3.2 trillion to $1.5 trillion. A third scenario is that economic growth would average 4.4 percent over the next ten years before settling down to 3.1 percent. From 2012 on, the level of real GDP would be 15 percent higher than in the CBO scenario, reducing the present value of Social Security trust fund deficits over the next 75 years by 85 percent to $496 billion.

Figure 1 compares the resulting Social Security deficit of the three sets of assumptions: the Trustees,' the CBO's, and a higher short-run growth scenario. While a stronger economy definitely helps Social Security, the program still would run widening out-year deficits under both the CBO and higher-growth policy simulations. However, as Figure 1 shows, those deficits would begin somewhat later than in the Trustees' intermediate case and would be considerably smaller. *There is no question that a faster-growing, lower-inflation economy would lessen the financial strain imposed by Social Security.*

Social Security as "social" insurance

Social Security is commonly perceived as providing workers a return on their tax "contributions" when they retire. However, the relationship between return and lifetime contribution is not one-to-one because of the program's *social insurance* aspect, which falls into two broad categories. The progressive benefit formula of Social Security and the redistribution of benefits are two aspects that complicate reform.

A progressive benefit formula

To determine benefits for a retired worker, the worker's 35 highest-earning years are indexed and then averaged to come up with the Average Indexed Monthly Earnings (AIME). The retired worker's basic benefit, or primary insurance amount (PIA), is determined by the following formula:

PIA = 90% of the first $561 of AIME
plus 32% of AIME in excess of $561 but less than $3,381
plus 15% of AIME over $3,381.

Under a one-to-one correspondence between "contributions" and benefits, the PIA would be a flat percentage of the retiring worker's lifetime earnings. But, just like the income tax, Social Security's benefit formula is progressive. In other words, workers with higher lifetime earnings receive a lower return from Social Security.

Social Security benefits are assumed to reflect average lifetime earnings, but this is not the case. A little over half the workers retiring at age 65 had PIAs less than that of the hypothetical average-wage worker. These results suggest that lifetime earnings may be lower and the redistribution within Social Security higher for more retirees than generally recognized.

Transfers for Beneficiaries of Retired Workers and the Disabled

Dependents

Besides retired workers who paid payroll taxes all their working lives, Social Security also pays benefits to eligible dependents, including children under 18, spouses, and divorced spouses. Eligible dependents can receive a benefit equal to as much as half that of the retired worker. In 1999, benefits were paid to 2.8 million spouses and 442,000 children of retired workers. These dependents accounted for 7.3 percent of OASDI beneficiaries and 4.1 percent of benefits.

Survivors

Surviving spouses who are at least 60 years of age are the largest group of survivors receiving benefits from Social Security. At the end of 1999, the 4.7 million widows and widowers of deceased workers accounted for 10.6 percent of OASDI beneficiaries and 11.3 percent of benefits. Next largest were 1.9 million surviving children who were 4.2 percent of beneficiaries and received 3 percent of benefits.

Disabled workers and dependents

Since 1957, Social Security has insured against disability. At the end of 1999, disabled workers accounted for 14.6 percent of OASDI beneficiaries and 12.4 percent of benefits. Dependents of disabled workers made up 3.7 percent of OASDI beneficiaries and received 1.1 percent of benefits at the end of 1999.

Reforming Social Security

As discussed earlier, the Trustees' "best guess" is that today's 12.4 percent tax rate will not be enough to pay for benefits promised to future retirees. The status quo would attempt to keep Social Security financing pretty much as it is—pay-as-you-go. To handle projected deficits, it would advocate a mixture of tax increases and benefit reductions. Workers will supply less labor in the face of these higher tax rates, thereby leading to less output. The slower rate of economic growth will put Social Security even further into the red.

Modest reform

Reformers, on the other hand, look to *personalize and prefund* Social Security. Modest reformers advocate redirecting a portion of the Social Security payroll tax rate into individual accounts. Several bills put forth in the last Congress as well as President Bush's campaign proposal fall into this category. The accounts might operate much like an Individual Retirement Account (IRA) or 401(k) plan. Payroll taxes going into the accounts would be invested in assets such as stocks, bonds and mutual funds. The contributions and earnings from investments would accumulate, free of tax, until the worker is ready to retire.

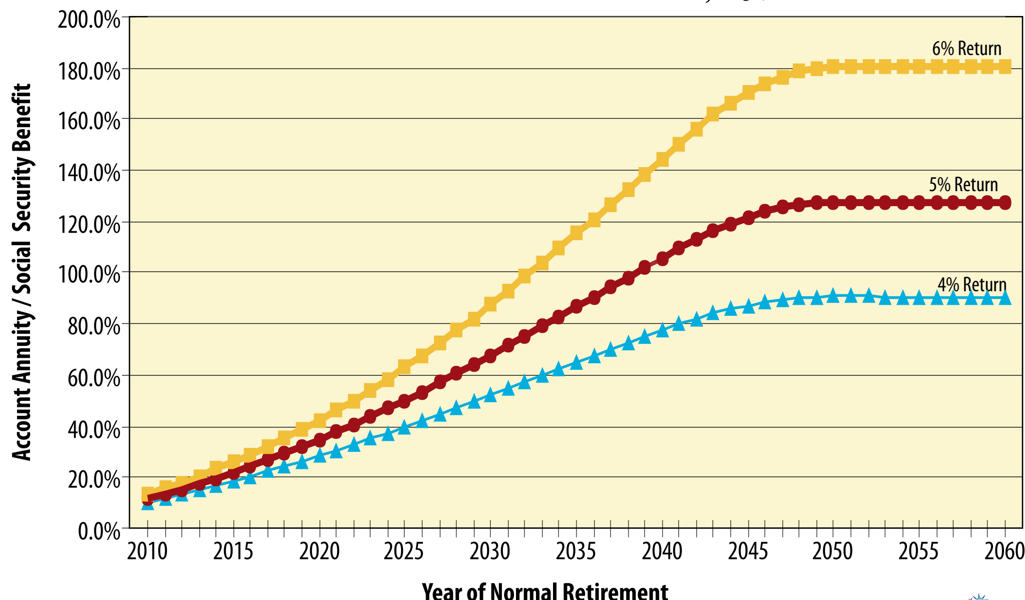
In general, these proposals contemplate using roughly two percentage points of the 12.4 percent OASDI tax rate to fund individual accounts. If 2 percentage points of payroll taxes (2 percent of wages) were saved each year starting in 2002, the asset build-up in individual accounts would be substantial: the annuity value of the average worker's account would eventually amount to more than a fourth of the Social Security retirement benefit assuming a very conservative return of 4 percent after inflation.

More sweeping reform

More sweeping reformers advocate a higher contribution rate for individual accounts. Currently, Social Security collects a payroll tax rate of 12.4 percent. Allowing for the progressive benefit formula and special categories of benefits leaves slightly more than half of the original OASDI payroll tax rate (6.3% of wages) to fund individual retirement accounts.

As Figure 2 shows, the annuity value of such an account for an average worker 33 years old today and retiring in 2033 would match the Social Security retirement benefit if the account earned an annual, inflation-adjusted return of 6 percent. Accounts for younger workers would do even better, with the annuity value eventually stabilizing at 180 percent of the Social Security benefit. Accounts earning 5 percent would take six more years (to 2039) to equal Social Security and would stabilize at 128 percent of the benefit level. At a return of only 4 percent, however, the annuity value would level off at 90 percent of the Social Security benefit.

Figure 2 Annuity compared to Social Security Average Worker; 6.3% Saved



Social Security reform and tax reform

Whatever their differences, the major approaches to tax reform aim to make the tax system more *neutral,* that is, to tax each dollar of income once, and only once, and at the same rate. In theory, payroll taxes can be neutral. A uniform rate on labor compensation would tax the next dollar of income the same as the first or average dollar. As for simplicity, the definition and measurement of labor income is straightforward, making a payroll tax easy to understand and administer. Visibility is achieved provided that wage statements given to workers delineate all the payroll taxes paid on their behalf.

In practice, payroll taxes have problems. As for neutrality, while the Social Security tax rate is not graduated, the benefits it determines are graduated. Because of the progressive benefit structure, the *net* payroll tax rate differs with the worker's wage. Also, payroll taxes are subject to double taxation: Under current law, payroll taxes attributed to the employee are subject to the income tax while those attributed to the employer are not. That is why the Kemp Commission report on tax reform recommended full deductibility of payroll taxes.

Can Social Security be reformed without tax reform?

Could putting some of the payroll taxes in individual accounts avert the gross deficits that are projected for Social Security while still providing similar levels of social insurance? Some claim unconditionally yes because the money going into individual accounts will increase savings. The problem with this assertion is that unless the return to saving goes up, households will simply rearrange their portfolios to offset the funds going into the individual accounts. The reason: People already save as much as they want given current rates of return. Without an added incentive to save more, they will not.

What is more, even if some of the funds in the accounts do represent new saving, there is another problem. In an open economy, this new saving will translate into U.S. investment *if* the rate of return to plant and equipment sited in the United States also goes up. Otherwise, new saving would flow into investment all around the world. While foreign investments would pay a return to U.S. savers, it would be only a fraction of the benefit to the U.S. economy if the investment had stayed at home.

For political viability of reform, the proceeds from private accounts earning the average return plus remaining Social Security benefits must leave beneficiaries at least as well off as they would be under current law. For this to happen, two things must occur. *The funds saved must represent new saving and that saving must translate into new U.S. investment.* To achieve both conditions the return to saving and the return to U.S. capital investment must increase. The best way to assure those outcomes is to reduce economic distortions caused by the U.S. tax system. In other words, the surest way to Social Security reform is through tax reform.

Conclusions

Avoiding potentially draconian tax increases or benefit cuts requires fundamental reform be undertaken as soon as possible. Therefore, 1) Social Security must begin to operate more like a private pension plan in which savings accumulated over a worker's career finance benefits in retirement, and 2) tax reform must reduce the bias against capital in the current tax system so that the return to U.S. saving will translate into domestic investment. The combination of new savings generated through Social Security reform and increased growth made possible through tax reform increases the likelihood that the economy will be able to produce sufficient output to satisfy workers and retirees.

©2002 Institute for Policy Innovation

Editor & Publisher . . . . Tom Giovanetti

IPI *Quick Study* is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.

NOTE: Nothing written here should be construed as an attempt to influence the passage of any legislation before Congress. The views expressed in this publication are the opinions of the authors, and do not necessarily reflect the views of the Institute for Policy Innovation or its directors.

Direct all inquiries to: **Institute for Policy Innovation**
250 South Stemmons, Suite 215
Lewisville, TX 75067

(972) 874-5139 (Voice)
(972) 874-5144 (FAX)
Email: ipi@ipi.org
Internet Website: www.ipi.org

This study is a summary of IPI Policy Report # 172, *Social Security Reform and Tax Reform: Is One Possible without the Other?,* by Aldona Robbins, IPI Senior Research Fellow.

Want More Info?

Copies of the full study are available from our Internet Website (**www.ipi.org**), in HTML and Adobe® Acrobat® format. Point your browser to our website, and follow the dialogs to the Policy Reports section.

Or contact IPI at the address at left, and we'll mail you a full copy.