

# SPECIAL REPORT

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## A Primer on Social Security Reform

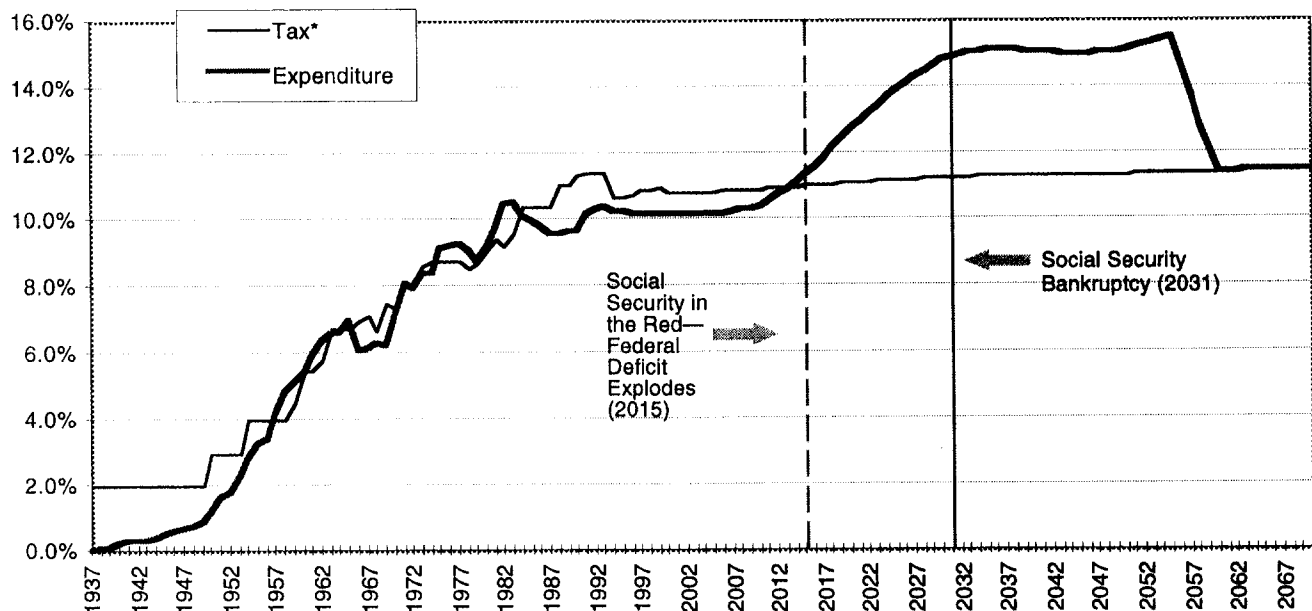
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The Social Security system once again faces financial trouble, despite the fact that payroll tax increases were enacted in 1983 to keep the system solvent. This time around, the Social Security Administration projects that the system will become bankrupt in the year 2031. Yet, the financial implications of this bankruptcy will confront taxpayers 16 years sooner, in the year 2015.

*Figure 1* tells one-half of the story. It provides a snapshot of the fiscal history and the projected fiscal future of the Social Security

system (Old-Age and Survivors Insurance only). The historical and projected growth path of expenditures and tax collections are expressed as a percentage of taxable payroll. The tax collections consist of dedicated payroll taxes and, since 1985, the revenue dedicated to the Social Security Trust Fund derived from the income taxation of Social Security benefits. As *Figure 1* clearly reveals, a major mismatch between Social Security expenditures and tax collections confronts U.S. taxpayers and Social Security recipients.

*Figure 1*  
OASI Tax Collections v. OASI Expenditures (as a Percent of Taxable Payroll)



Note: Historical data stops at 1995. Intermediate projection assumptions.

\* Includes dedicated payroll taxes and income taxation of Social Security benefits. The income taxation of Social Security benefits began in 1985 and accounts for about 2 percent of OASI tax revenue, increasing to about 5 percent in 2050.

Source: Social Security Administration.

However, the pending insolvency of the Social Security system is only one-half of the story. The other half is that most future retirees can expect to lose money on Social Security when it is evaluated as an investment program for retirement.

Consequently, the challenge — and urgency — of reforming Social Security is not simply to restore solvency to the system, because, as *Figure 3* helps illustrate, any reforms (like payroll tax increases) undertaken with solvency as the sole goal will make Social Security an even worse retirement program for future retirees. The challenge is to devise a reform program that simultaneously honors the promises made to current (and near-term) retirees and offers today's working population a better financial future.

## How Social Security Works

To understand how the federal government has placed taxpayers in a terrible position, one must understand how the Social Security system works. Social Security (OASDI) in no way represents an actual insurance system.

*Table 1*  
History and Projections of Male and Female Life Expectancies

Year	At Birth		At Age 65	
	Male	Female	Male	Female
1940	61.4	65.7	11.9	13.4
1955	66.7	72.8	13.1	15.6
1970	67.1	74.9	13.1	17.1
1985	71.1	78.2	14.4	18.6
2000	73.0	79.7	15.6	19.4
2015	74.9	80.9	16.3	19.9
2030	76.0	81.8	16.9	20.5
2045	76.9	82.7	17.5	21.2
2060	77.8	83.6	18.0	21.8

Source: Social Security Administration.

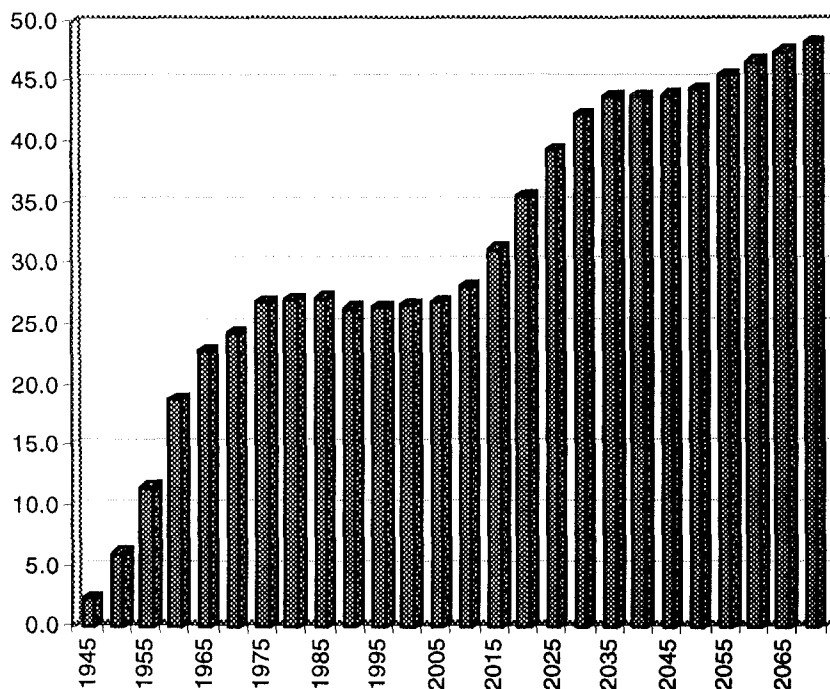
It is an intergenerational transfer program with a built-in welfare component. No certain or clear-cut link exists between the Social Security benefits one receives and the Social Security "contributions" one must pay, because the benefit formula considers a person's wage history only. (This discussion focuses on OASI, because that is the retirement portion of the larger Social Security program. The two other major portions of the program are Disability Insurance (DI) and Hospital Insurance (HI) — the major component of Medicare. The entire Social Security program is often referred to as OASDHI.)

### Social Security as a Transfer Scheme

The original idea of Social Security, enacted in August of 1935, was to create a fully-funded, government-run pension plan. To set up an Old-Age Reserve Account, the original Act provided that a two percent payroll tax be imposed starting in 1937, with the rate gradually increasing to six percent by 1946. To assure that a reserve existed, the original Act provided for no benefit payments before 1942 (although some assistance payments made from the federal government's general revenues began in 1937). However, a 1939 amendment replaced many provisions of the original law. The amendment delayed the scheduled payroll tax rate increases, made the benefit formula more generous, and initiated benefit payments in 1940 instead of 1942. Ever since that time, Social Security has evolved as a "pay-as-you-go" transfer program.

The implication of Social Security's pay-as-you-go structure is that the so-called contributions paid into the system do not represent the retirement savings of the contributor. Instead, they represent taxes that the federal govern-

*Figure 2*  
OASI Beneficiaries per 100 Workers  
(Intermediate Projection Assumptions)



Note: Historical data stops at 1995.  
Source: Social Security Administration.

ment immediately pays out to Social Security recipients. This procedure is clearly illustrated in *Figure 1*. After the initial build up of reserves initiated by the original Social Security Act, Old-Age and Survivors Insurance expenditures begin to track almost perfectly with payroll tax collections.

The pay-as-you-go financial history illustrated in *Figure 1* demonstrates that the Social Security "Trust Fund" represents an accounting fiction that merely tracks the periodic mismatches between taxes collected and transfers paid out. When payroll tax collections exceed Social Security benefit expenditures, the excess is used to purchase federal government bonds, which can be liquidated (at taxpayer expense) when the funds are required to make benefit expenditures. When Social Security benefit expenditures exceed payroll tax collections, the shortfall must be obtained from the general revenues of the federal government (which may include liquidating previously purchased federal government bonds) or from a transfer of funds from the Disability Insurance or Medicare "Trust Funds."

### How Social Security Benefits are Determined

Unlike a defined-contribution private pension plan in which payments into a fund (compounded with interest) dictate payments out of the fund, Social Security benefits are determined by a formula based on a person's wage history. This formula has, and was always intended to have, a built-in income redistribution component. People with a history of lower wage earnings receive relatively higher benefits relative to their lifetime earnings than do people with higher wage earnings. (To be eligible for Social Security benefits, a person must have paid payroll taxes on a minimum amount of wages for 40 quarters. The required quarterly earnings increase each year and are relatively small — about \$670 in 1997.)

The benefit formula has changed several times since the inception of the Social Security program. The way it would work today for Mr. Smith, who plans to retire in 1997 at age 65, is as follows:

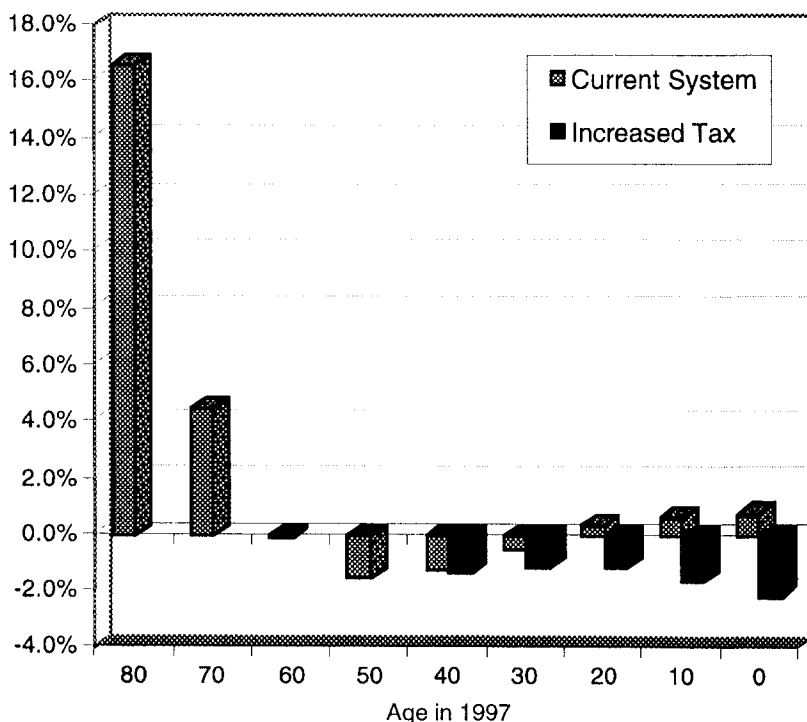
A) The Social Security Administration (SSA) would first calculate Mr. Smith's average indexed monthly earnings (AIME) to derive his primary insurance amount (PIA), that is, his monthly Social Security benefits. (Note on eligible age: Age 62 is the first year of eligibility. However, benefit levels are reduced on a formulaic basis if benefits are taken before 65 years of age, the minimum age for full benefits. Beginning in the year 2003, the minimum age is scheduled to gradually increase from 65 to 67 over a 22-year period.)

B) To calculate Mr. Smith's AIME, the highest 35 years of his wage earnings are averaged. This average has two components: (1) wages earned between 1950 (or the year in which Mr. Smith turned age 21, whichever is the earlier date) and the year in which Mr. Smith turned the age of 60 and (2) wages Mr. Smith earned after the age of 60. Wages earned up to the age of 60 are indexed by the nominal growth of the average wage earned in the overall economy. Wages earned after the age of 60 are not indexed; they are counted at their nominal values.

The indexation procedure places Mr. Smith's wage levels earned before the age of 60 on a par with the wages he earned during the year he was 60 (the year 1992). The procedure accomplishes this goal by multiplying Mr. Smith's wages in any given year (before age 60) by the ratio composed of the economy's average wage in 1992 divided by the economy's average wage in the given year.

After the indexation procedure, the SSA

*Figure 3*  
Rate of Return on Social Security for Average-Wage Couple  
(Current Payroll Tax v. Increased Payroll Tax)



Source: Tax Foundation.

averages the highest 35 years of wage earnings. The resulting average is divided by 12 to obtain Mr. Smith's AIME. The AIME is used to determine his PIA, his monthly Social Security benefits.

C) The PIA formula is where Social Security's built-in welfare component resides. Lower AIME levels receive higher replacement rates. The formula for Mr. Smith would be:

90 percent of the first \$422 of AIME, plus  
32 percent of the next \$2,123 of AIME, plus  
15 percent of the AIME over \$2,545.

The dollar figures in the PIA formula (known as "bend points") are those for 1994, the year in which Mr. Smith turned 62 and first became eligible for Social Security benefits. The bend points in the formula change each year based upon the growth in the economy's average wage.

There is one more step in the calculation. The PIA is based on the bend points when Mr. Smith turned 62. However, he will retire at age 65, so his PIA must be updated to 1997. The SSA makes this adjustment by increasing Mr. Smith's PIA amount by the annual rates of inflation for each year from 1994 to 1997. The

SSA uses the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Benefits are adjusted for inflation each year thereafter. (If Mr. Smith had a dependent spouse, he would receive 150 percent of his inflation-adjusted PIA until either he or his spouse dies, at which time the benefit levels revert to 100 percent of Mr. Smith's PIA level.)

## The Causes of Social Security's Looming Bankruptcy

Trends in both demographics and life expectancies, combined with the pay-as-you-go nature of the Social Security program, provide a general explanation for the system's pending insolvency under current law. *Figure 2* illustrates the history and the projections of the number of Social Security recipients being supported by the active workforce. The number of beneficiaries per worker has increased substantially since the inception of Social Security. The baby-boom generation will start to become Social Security recipients in 2012. At that time, the number of beneficiaries per worker will surge again.

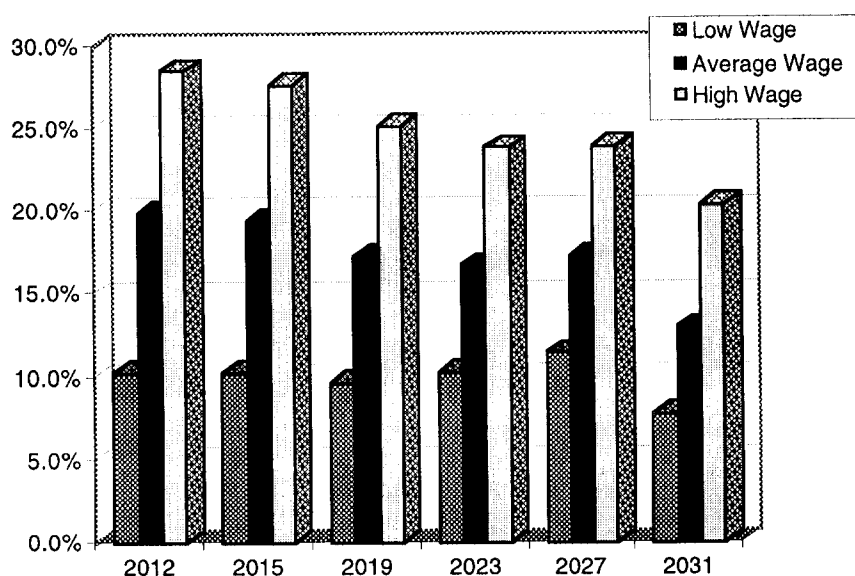
*Table 1* reports the increasing life expectancy of the population. From the start of Social Security in 1935 up until 1956, the minimum age of eligibility was 65 for both males and females. In 1956, females became eligible at age 62; in 1961, males became eligible at 62. *Table 1* shows that when Social Security was enacted, the life expectancy of the average male was 3.6 years less than the age of eligibility; the average female could expect less than one year of benefits. However, if a person had the good fortune to reach age 65 in 1940, a male could expect 11.9 years of benefits and a female could expect 13.4 years of benefits.

Contrast the first generation of Social Security recipients with the baby-boom generation. When baby boomers begin to retire (e.g., year 2015 with an eligible age of 66), the *average* male can expect 15.3 years of benefits and the *average* female can expect 18.9 years.

As *Figure 1* shows, current estimates of changing demographics and increasing life expectancies indicate that the bankruptcy of the Social Security (OASDI) Trust Fund will occur in the year 2031. (The broader definition of Social Security that includes Disability Insurance, OASDI, is projected to go bankrupt in 2029.) The consequences of these trends for taxpayers, however, begins in the year 2015. In 2015, annual expenditures begin to exceed current-law tax collections and the Social Security Administration will begin drawing down the surpluses the system has generated since 1984.

Surpluses in the Social Security Trust Fund

Figure 4  
Excess Payroll Taxes Paid by Baby-Boom Couples



Source: Tax Foundation.

*Table 2  
After-Tax Annual Social Security Benefit Compared with After-Tax Annual Annuity that could have been Purchased with Lifetime Employer/Employee Payroll Taxes Compounded with Interest — Current Law Payroll Taxes*

Year of Retirement	Worker's Age in 1997	Low Wage Couple		Average Wage Couple		High Wage Couple	
		Annual After-Tax S.S. Benefits	Hypothetical Annual After-Tax Annuity	Annual After-Tax S.S. Benefits	Hypothetical Annual After-Tax Annuity	Annual After-Tax S.S. Benefits	Hypothetical Annual After-Tax Annuity
2012	51	\$27,370	\$30,504	\$37,153	\$46,367	\$50,103	\$70,082
2015	48	31,666	35,267	42,978	53,357	57,981	80,222
2019	44	38,402	42,488	52,118	63,030	70,333	93,975
2023	40	45,081	50,225	64,663	77,636	87,250	114,580
2027	37	53,522	60,432	76,879	92,872	103,550	136,040
2031	33	65,107	70,638	93,439	107,379	125,872	158,121

Source: Tax Foundation.

are used to purchase special-issue federal government bonds. The interest generated from this bond portfolio counts as revenue to the Social Security Trust Fund. By investing in federal government bonds, however, the Social Security surplus finances current federal government (deficit) expenditures. Unlike the income-producing assets held by private retirement trust funds, both the interest and principal of the government bonds held in the Social Security Trust Fund represent nothing more than a government liability underwritten by U.S. taxpayers.

Because the Social Security Trust Fund only represents government debt, the real fiscal problem for taxpayers arises in 2015, not 2031. In 2015, the Social Security Administration must begin using the Trust Fund surplus to meet current obligations, meaning that the federal government will have no choice but to increase deficit spending, raise taxes, or reduce other expenditures.

### **Social Security is a Bad “Investment” for Most Future Retirees**

The pay-as-you-go nature of the Social Security transfer program helps explain its political popularity (to date) as well as its looming bankruptcy. The weak link between “contributions” and benefit formulas provided workers retiring before the early 1980s with substantial inflation-adjusted rates of return on their employer/employee payroll tax payments. These retirees generally received Social Security benefits based on their highest lifetime wage levels but faced relatively low lifetime payroll tax rates and, in many in-

stances, paid no payroll taxes for a large fraction of their working life.

The high rates of return on Social Security began to fade away in the early 1980s for two reasons. First, the Social Security system was maturing, meaning that most retirees (and their employers) had paid escalating payroll taxes for most of their working life. Second, policy changes in the early 1970s put the Social Security system on a path toward impending bankruptcy.

A comparison of *Figures 1* and *2* shows that the payroll tax rate essentially grew in lock-step with the number of beneficiaries per worker up until the mid-1970s. The growth of the payroll tax rate accelerated past the growth of beneficiaries per worker in the 1970s because of a 1972 reform measure that instituted automatic adjustments in the Social Security benefit formula based upon the growth of both wages and price levels. This reform dramatically (and unexpectedly) increased the growth rate of Social Security expenditures. Benefit levels were also indexed for inflation beginning in 1975. The resulting deficits (shown in *Figure 1*) forced Congress to revise the 1972 reform in a 1977 enactment, which became effective in 1982.

The deficits also resulted in the 1983 recommendations of the National Commission on Social Security Reform. The recommendations led to a temporary freeze in the inflation adjustment of benefits, higher payroll tax rates, a phased-in increase of the eligible age for full benefits beginning in the year 2003, and the income taxation of Social Security benefits. The result of these reforms led to the real and projected surpluses shown in *Figure 1*.

Since the enactment of these reforms, So-

cial Security has become an increasingly bad retirement program for almost all Americans. *Figure 3* provides one illustration of the fact that virtually any reforms designed to repair the solvency of the Social Security program — like payroll tax increases — will make Social Security an even worse retirement program for current workers than it is already. *Figure 3* reports the inflation-adjusted rates of return on Social Security payroll taxes (Old Age and Survivors Benefits only), under two scenarios, for an average-wage earning couple (see *Table 3*) at different stages of life in the year 1997.

The first scenario reports rates of return given current-law payroll tax rates and current-law taxation of Social Security benefits. A couple that retired in 1982 (age 80 in 1997) received a 16.58 percent return on their employer/employee payroll taxes (after compounding these tax payments with interest to reflect the opportunity cost of foregone private investments). In contrast, a couple at age 50 in 1997 (retiring in the year 2013) can expect to receive a return of -1.55 percent on the payroll taxes they and their employer(s) paid. The returns remain negative for most of the baby-boom generation couples that fit the average-wage earner profile.

The rate of return turns positive again for the hypothetical average-wage couple that is age 25 or younger in 1997. This result occurs because of the interaction of constant (current-law) payroll tax rates, growing wage levels, and longer life spans. However, as *Figure 1* illustrates, the Social Security system is not financially viable with the combination of current-law payroll tax rates and the current benefit structure. The second scenario in *Figure 3* shows that when payroll tax rates are increased sufficiently to keep Social Security solvent (according to the 1996 intermediate “cost basis” actuarial assumptions of Social Security’s Board of Trustees), the rate of return on Social Security payroll taxes turns negative for all couples age 60 or less in 1997.

The baby-boom generation — those people born between 1946 and 1964 — is the demographic trigger for Social Security’s looming bankruptcy. Since most baby boomers can already expect to lose money on Social Security when it is viewed as an investment for retirement, they, and the generations that follow, also stand to lose the most from traditional approaches of repairing the solvency of the Social Security trust fund: increased payroll taxes, reduced benefits, or postponing the eligible retirement age. Such reforms will make many baby boomers and the generations that follow them lose even more money on Social Security,

*Table 3*  
*Description of Taxpayer Types\**

Taxpayer Profiles	Age Entered Labor Force	Starting Wage**
Low Wage Earner		
Male	18	50% of Avg. Wage
Female	18	40% of Avg. Wage
Average Wage Earner		
Male	22	100% of Avg. Wage
Female	22	62% of Avg. Wage
High Wage Earner		
Male	26	175% of Avg. Wage
Female	26	109% of Avg. Wage

\* Couple’s composed of like males and females.

\*\* The economy-wide average wage is reported (and future years estimated) by Social Security’s Board of Trustees. Each type of wage earner is assumed to experience wage growth until age 50 equal to the growth of average wages plus one percentage point. After age 50, wages grow at the rate of inflation until the taxpayer retires at the legal retirement age for full Social Security eligibility. Historically, the median income of females has grown at a rate similar to that of males, but is, on average, 62% of the median income for males. An adjustment was made for low-wage females to conform with current minimum wage laws.

Source: Tax Foundation.

because each reform has the effect of raising the cost of Social Security benefits.

Another way to understand how bad an investment Social Security will be for baby boomers is to compare baby-boom couples’ expected annual after-tax Social Security benefits with a hypothetical after-tax annuity that they could have purchased with their lifetime employer/employee payroll taxes. The figures in *Table 2* demonstrate that every couple of the baby-boom generation would have been much wealthier if their (current law) payroll taxes had been placed in an interest-bearing account rather than immediately paid out to Social Security recipients.

For example, low-wage couples retiring in the year 2012 can expect to receive \$27,370 in inflation-adjusted, after-tax Social Security benefits each year. Their hypothetical annual annuity, however, would have amounted to \$30,504, a \$3,134 per-year increase. More importantly, under the hypothetical annuity arrangement, the full value of the annuity (and its underlying principal) would remain in the couples’ estate in the event of an untimely death, or deaths. Under Social Security, the cashflow simply stops for the deceased and the survivors have no claim to any amount of principal. In addition, the annuity values in *Table*

2 are based on the relatively low interest rates earned on Social Security Administration special-issue bonds. With market rates of interest on private securities, the hypothetical annuities would be substantially larger than those reported. The annual annuity values reflect female life expectancies. (Note that the couples presented are two-earner couples. The calculation for couples with only one earner and a dependent spouse differ, because of the Social Security rules that allow the worker to receive 150 percent of their formula benefits to cover their dependent spouse. For couples with a male worker and a female dependent spouse, only high-wage baby-boom couples would be better off with the hypothetical annuity.)

The essence of the results reported in *Table 2* is that most boomers will pay too much for their Social Security benefits. *Figure 4* provides calculations showing in a lifetime context how much taxpayers in the middle of the baby-boom generation, as represented in the couple profiles, will be forced to overpay, given current-law payroll tax rates.

The percentages presented in *Figure 4* result from calculating the percentage change in lifetime payroll tax rates such that these taxes (compounded with interest) would buy an inflation-adjusted annual after-tax annuity equal in value to annual after-tax Social Security benefits. Evaluating the current-law situation for average-wage couples retiring in the year 2015 will illustrate the point. These couples will pay \$178,651 too much for their expected Social Security benefits because the 13 different employer/employee payroll tax rates they face over their lifetimes (current law) will have been, on average, 19.45 percent too high. For example, the scheduled 1997 rate of 10.7 percent “should” be 8.62 percent.

The excessive payroll tax rates will result in lifetime employer/employee payroll taxes (compounded with interest and adjusted for inflation) of \$918,443. Yet the price of an after-tax annual annuity equal in value to this couple’s expected after-tax Social Security benefits amounts to only \$739,792. The \$178,651 excess is eliminated by decreasing the couples’ various lifetime payroll tax rates by 19.45 percent.

## The Opt-Out Solution to the Competing Problems of Social Security

Solutions to the competing problems of the current Social Security system seem intractable. The Social Security system will start to run deficits in the year 2015. At the same

time, Social Security will remain a terrible “investment” for most people still active in the workforce. Traditional solutions to the solvency problem — increased payroll taxes, increased eligible age requirements, or increased taxation of benefits — will only make Social Security a worse retirement program for the current workforce.

The only productive alternative to the current situation may be to break with tradition and implement an alternative that permits taxpayers to opt out of the current Social Security system. Those people who choose to opt out of Social Security would be permitted (or mandated) to dedicate to a private investment account some or all of the money represented by their employer/employee payroll taxes. By allowing people to opt out and invest in real, income-producing assets, the federal government can simultaneously reduce its future liabilities (thereby addressing the insolvency problem) and improve the financial position of most future retirees.

One must evaluate the details of implementing an opt-out plan within the context of the potential benefits such a plan offers to the overall economy. An improvement in the long-run performance of the overall economy may be crucial to reforming Social Security without necessarily making any particular generation of taxpayers worse off. If no improvements to the overall economy can be expected from moving from the current pay-as-you-go system to a fully-funded system, then the stage will be set for intergenerational conflict: Some generations will gain only at the expense of other generations.

Generally speaking, the economic promise of initiating an opt-out plan flows from the possibility that the U.S. saving rate will increase dramatically. The result over time will be a larger stock of wealth, an increase in productivity-enhancing investments and, therefore, a substantially increased standard of living for people residing in the United States.

### *Recognizing Past Social Security Taxes*

The challenge of instituting an ideal opt-out policy resides in making future retirees better off financially without making current and near-term retirees worse off. In this regard, a successful opt-out plan may require some mechanism by which taxpayers can recoup what they and their employer(s) have paid in payroll taxes. However, it is noteworthy that not all taxpayers would necessarily require such a mechanism. Tax Foundation research suggests that, depending upon lifetime wage profiles, many taxpayers would

gladly opt out of the current-law Social Security system, even if none of their past payroll taxes was recognized by the federal government and they were exempt from any future payroll taxes. For example, based on current-law payroll taxes and the wage profiles in *Table 3*, low-wage couples working less than five years, average-wage couples working less than eight years, and high-wage couples working less than 11 years would all walk away from Social Security if given that option in 1997. Nevertheless, for many people, some mechanism for recognizing payroll taxes paid will probably be required in order to make opting out of the Social Security system financially viable.

Generally speaking, two design options present themselves for recognizing past payroll taxes. First, lawmakers could develop a formula to calculate the degree to which a taxpayer is vested in the Social Security system based on the current-law benefit formula, detailed above. Second, lawmakers could define the degree to which a taxpayer is vested based on the inflation-adjusted value of all past employer/employee payroll taxes paid. Regardless of which option lawmakers choose, the government could then recognize taxpayers' taxes paid by issuing each taxpayer a bond (preferably transferable) equal to the present value dollar amount of the taxpayer's legally-determined vestment. These bonds would earn interest from the date of opt-out until the legally-determined date of retirement. The rate of interest would be the market rate of the government's long-term debt instruments prevailing on the date of opt-out.

#### *Financing the Transition of an Opt-Out Plan*

Implementing an opt-out plan would substantially reduce future government liabilities. However, government liabilities would remain in the form of benefits to those people currently receiving Social Security, those that choose not to opt out, and those that opt out but have a claim on the taxes they have already paid into the system. The four basic options for paying off such liabilities are debt issue, government asset sales, government spending reductions, and tax increases. These options can be combined in many different ways. The array of financing options for an opt-out plan and their interrelated implications for the long-run performance of the economy have different intergenerational and intragenerational economic effects.

#### A. Debt Finance

Borrowing money to finance an opt-out transition may increase the flexibility of the

government's financing operations, but it will merely delay the necessity of making a choice among the remaining three options: asset sales, spending cuts, and tax increases. Furthermore, because the government must borrow from the pool of private savings, debt financing will suppress the increase in saving (and therefore the enhanced economic growth opportunities) that will likely result from initiating an opt-out policy.

#### B. Asset Sales

The Social Security insolvency problem is a federal government balance sheet problem. The government has established policies that have produced large, unfunded liabilities. The most economically constructive approach to financing an opt-out plan would be for the government to pay down its future liabilities by liquidating a portion of its enormous pool of assets. Examples of such assets include massive land holdings (not including national parks), substantial gold reserves, and a variety of government-run enterprises that could be auctioned to the private sector.

To the extent that it is possible, selling assets to finance an opt-out transition would allow those who opt out to be made better off without making those that remain in the system worse off. Asset sales would have no foreseeable negative economic consequences. Indeed, by placing scarce resources in the hands of the private sector, this financing approach would likely improve the economy's growth potential. It would also expand the tax base so that current tax laws could better fund whatever parts of the transition could not be financed by asset sales and spending reductions.

#### C. Spending Reductions

The benefit of spending reductions (including Social Security spending reductions) is that they allow existing tax revenue to be redirected toward financing the transition to an opt-out plan. In this way, an opt-out plan and spending cuts mutually reinforce progress to the long-term economic goal of the opt-out plan. The opt-out plan will reduce the future spending levels that the government must make and, if executed properly, will expand the tax base by fostering economic-growth-promoting wealth accumulation. The combination of these two outcomes will allow the government to finance the opt-out transition more easily at constant or reduced levels of taxation.

A familiar opt-out strategy provides a straightforward example of liberating current tax payments for alternative uses by cutting



spending. Future Social Security expenditures (or the growth of such expenditures) can be reduced so that current workers can begin to dedicate a portion of their current payroll taxes to an opt-out retirement program. As people started to redirect their payroll tax payments to an opt-out account, they would forfeit their claim to a commensurate portion of the Social Security benefits they would have received. As this process evolved, it would accelerate the opt-out transition, because the more people were allowed to dedicate their payroll taxes to an opt-out account, the more quickly the government's liabilities would decline, which, in turn, would allow for an ever-greater share of payroll taxes to be dedicated to opt-out accounts.

#### D. Increased Taxation

From an economic viewpoint, increasing taxes may be the least desirable way to finance the transition to an opt-out plan. Increased taxation obstructs the goals of implementing an opt-out plan in two ways. First, increasing taxes either implicitly or explicitly makes Social Security a worse financial arrangement for some or all generations. Taxes that reduce the current value of Social Security benefits make the current elderly worse off. Taxes that effectively raise the cost of receiving Social Security benefits make the current working population worse off. Furthermore, any tax increase that effectively result in paying for the privilege of opting out reduces the incentive to opt out (particularly for those people closer to retirement) and thereby keeps the government's future liabilities higher than they would have been otherwise. Second, increasing taxes obstructs the economic growth process, and therefore the economic benefits that will likely result from implementing an opt-out plan. Different types of taxes will affect taxpayers and the economy in different ways.

##### 1. Payroll Tax Increase

The payroll tax suppresses the long-run growth potential of the U.S. economy to the extent that it provides a disincentive for people to work and employers to hire. The degree to which the current payroll tax induces such economic distortions in the labor market depends upon the "linkage" that people perceive between the levy and their future Social Security benefits. The more remote people perceive the linkage to be, the greater is the labor market distortion caused by the payroll tax, and vice versa. This principle implies that the labor market distortion caused by the payroll tax can differ

intergenerationally and intragenerationally.

In this context, the economic effects of increasing the current payroll tax to finance an opt-out transition depends upon (1) the share of the total payroll tax that continues to fund both current and future government liabilities and (2) the share of the total dedicated to the opt-out retirement plans. If, on balance, the share of the total levy that goes to fund government liabilities exceeds the current payroll tax rate, then the financing arrangement will distort the labor market more than it is already distorted. The negative economic implications will detract from the overall success of the opt-out plan. If a net reduction in the current level of payroll tax rates results from the final opt-out financing arrangement, then the labor market distortions in the economy will become less severe, the tax base will likely increase, and the arrangement will enhance the success of the opt-out plan.

##### 2. Income Tax Increase

If the government financed the transition to an opt-out plan by increasing the tax rates of the current income tax, it implies that the Social Security (OASDI) payroll tax would become transformed into real, dollar-for-dollar contributions to an opt-out retirement account. Such a financing arrangement has several noteworthy implications:

a) Because the income tax is biased against saving and investment, higher rates of income taxation would further suppress these key elements of the economic growth process. This outcome would perpetuate the need for higher income tax rates and reduce the long-run economic benefits, particularly for lower-income people, of initiating an opt-out plan. However, as the government's Social Security liabilities begin to shrink, income tax rates could be lowered to the benefit of future economic growth.

b) Because the income tax imposes a relatively heavy burden on the income from investments, higher rates of income tax would place a relatively heavy burden on current (and near-term) retirees, because they receive such a large share of their income from investments.

c) A mitigating factor to points (a) and (b) results from converting the payroll tax to a dollar-for-dollar contribution to a retirement fund. This conversion would eliminate the economic distortion of the labor market caused by the payroll tax. Eliminating the distorting effect of the payroll tax would likely increase the paid

labor pool and, therefore, the tax base. A larger tax base would allow for lower income tax rates and therefore more rapid accumulations of investment capital. In addition, lower-income groups within each generation would benefit relatively more from the accelerated growth of the economy because the regressive nature of the payroll tax would be eliminated.

d) The implications of increasing the income tax also has important implications for senior citizens and the economy because of the current rules relating to the income taxation of Social Security benefits. The damaging economic-growth consequences that result from the income taxation of Social Security benefits occurs not from the Social Security rules alone, but from the affect of these rules in combination with the concentrated wealth of the elderly. Based on 1993 data, taxpayers subject to the taxation of Social Security benefits represented only about 5 percent of all taxpayers with taxable income and received 2.3 percent of all wage and salary income. Yet, these people received a concentrated share of all investment income: 14 percent of business income; 31 percent of interest income; and 34 percent of dividend income.

A simplified explanation of the Social Security tax rules that generate high effective marginal income tax rates on senior citizens is as follows. Whenever a Social Security recipient's total income, plus one-half of his Social Security benefits, exceeds a designated threshold (\$25,000 for single filers and \$32,000 for joint filers) then one-half the amount over the threshold is added to the taxpayer's taxable income. For example, a single filer with \$24,000 in dividend income and \$8,000 in Social Security benefits would exceed the threshold by \$3,000. Therefore, he would have to pay income tax on \$1,500 of his Social Security benefits in addition to the tax on his dividend income.

This procedure amounts to a tax on other income (primarily investment income, in the case of senior citizens) because the tax on benefits only occurs if a Social Security recipient surpasses the income threshold. This person incurs higher effective marginal tax rates because he must pay tax on \$1.50 of his income for each dollar he earns over the threshold. In effect, this taxpayer's marginal income tax rate increases by 50 percent. A person in the 15 percent statutory tax bracket therefore incurs a marginal income tax rate of 22.5.

In 1994, the percentage of Social Security benefits subject to taxation increased from 50 percent to 85 percent for single taxpayers

with incomes over \$34,000 and joint filers with income over \$44,000. As a result, for each additional dollar they earn over the threshold, many Social Security recipients will have to pay tax on \$1.85, raising the top federal statutory tax rate of 39.6 percent to an effective marginal income tax rate of 73.3 percent. Because taxpayers subject to these rules have such a large concentration of the countries wealth, the high effective marginal tax rates that the rules generate contribute significantly to the high cost of investment capital and therefore the suppression of economic growth.

### 3. Consumption-Type Tax

Financing an opt-out transition using a consumption tax (again assuming that the payroll tax was converted into a dollar-for-dollar contribution to a retirement program) would not have the suppressing effect on saving and investment that an income tax rate increase would have. The full economic growth benefits would therefore accrue to current and future generations. In the context of financing an opt-out transition, a consumption tax would likely impose a burden on the elderly similar to that imposed by an increase in income tax rates. Instead of taxing the income generated by the wealth owned by the elderly, a consumption tax would tax that wealth as the elderly used it to sustain themselves in retirement.

Although it is possible, depending upon the type of levy implemented, that a consumption tax would impose a relatively greater burden on lower-income taxpayers, many of the downsides to using a consumption tax to finance an opt-out plan can be mitigated or eliminated if such a strategy is combined with overall tax reform. The prototype tax system known as the Universal Savings Allowance Tax System offers a ready example. The USA Tax System was originally designed to both replace the current income tax and fully rebate taxpayers for payroll taxes paid. These two features seem almost tailor-made for maximizing the economic success of implementing an opt-out plan. In addition, transition rules have been worked out that would largely exempt past savings from the new tax system, thereby imposing a lighter burden on the wealth of the current elderly than an income tax rate increase. The fact that the USA Tax System retains exemptions, deductions, and graduated tax rates similar to the current income tax also means that it has the flexibility to accommodate any policy goals seeking to control the tax burden on lower-income citizens.

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