TAX FOUNDATION

Due to the Blizzard of '96, this newsletter was a week late getting off the press. We apologize for any inconvenience this has caused our readers.

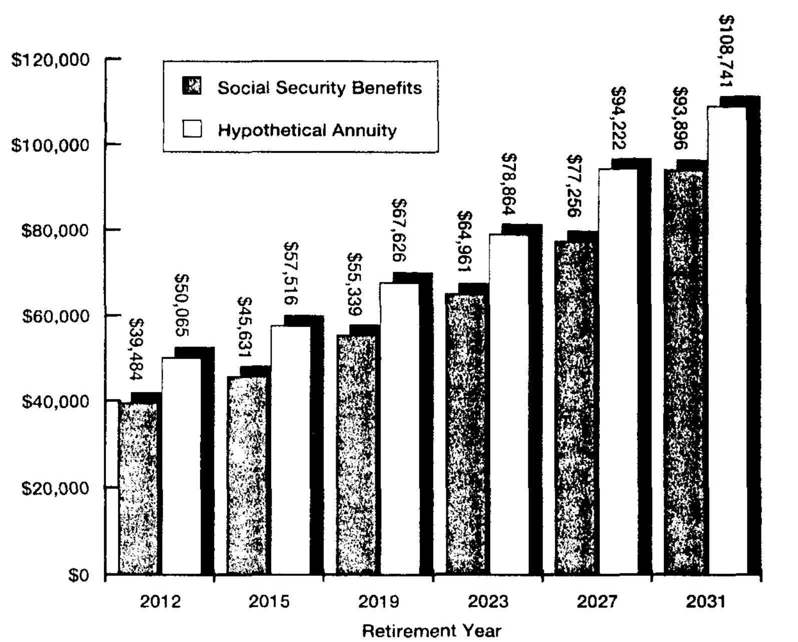
TAX FEATURES©

January 1996 Volume 40, Number 1

Social Security a Bad Deal for Baby Boomers
Chilean-Style Opt-Out Plan Would Enrich "Investors"

Most members of the baby-boom generation — those people born between 1946 and 1964 — can expect to lose money on Social Security when it is viewed as a retirement investment. In fact, says a newly published report by the Tax Foundation, the negative returns will almost certainly become worse if lawmakers enact traditional reforms to keep the Social Security system from going broke in the year 2029.

Chart 1: Annual Retirement Income for Average-Wage Couples: Social Security Program v. Hypothetical Private Annuity



Source: Tax Foundation.

In his *Special Report* titled "Social Security: A Bleak Outlook for Baby Boomers," Senior Economist Arthur P. Hall observes that policymakers wrestling over how to save the floundering Social Security trust fund must avoid traditional approaches, such as increased payroll taxes, reduced benefits, or postponing the eligible retirement age. "Such reforms will make Social Security an even worse deal for baby boomers—and the generations that follow them—because they each have the effect of raising the cost of Social Security benefits," notes Dr. Hall. The only productive alternative, he says, may be to break with tradition and implement some type of plan which permits taxpayers to opt out of Social Security.

One way to understand the quality of the baby-boom generation's Social Security investment 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. Dr. Hall concludes that low-, middle-, and high-income couple of that generation would have been much wealthier if their payroll

Social Security *continued on page 6*

FRONT & CENTER

A New Tax System and Kitchen Table Economics for America

Senator Phil Gramm (R-Texas)

4-5

Two Ways to Balance the Budget by Year 2002

With federal budget negotiations grinding to a halt again in Washington, and both Congress and the administration introducing budget plans that (by Congressional Budget Office estimates) balance by the year 2002, Americans may logically ask what separates the two sides. The Tax Foundation offers an overview, below, of each plan's annual spending and revenue totals. Numbers are in billions of dollars, and may not total due to rounding.

	1996	1997	1998	1999	2000	2001	2002
Discretionary Spending							
BBA of 1995	$534	$524	$518	$516	$520	$516	$515
Administration	540	547	542	542	542	531	514
Mandatory Spending (without net interest)							
BBA of 1995	791	838	878	922	975	1,021	1,081
Administration	874	933	984	1,039	1,099	1,156	1,216
Net Interest							
BBA of 1995	243	247	249	247	242	241	240
Administration	243	247	249	250	247	248	248
Total Spending (including net interest)							
BBA of 1995	1,568	1,609	1,644	1,685	1,738	1,779	1,836
Administration	1,576	1,648	1,695	1,750	1,804	1,847	1,886
Revenues							
BBA of 1995	1,417	1,450	1,518	1,588	1,666	1,745	1,839
Administration	1,423	1,481	1,546	1,619	1,693	1,781	1,887
Deficits							
BBA of 1995	151	159	127	97	73	34	–3
Administration	153	167	149	130	110	65	-1

Note: The Democratic plan assumes that the anticipated change in the CPI methodology used by the Bureau of Labor Statistics will reduce the rate of growth of the CPI by 0.3 percentage points a year. Both revenue and expenditure figures have been altered to reflect this assumption. Total spending includes deposit insurance and other offsetting receipts now shown.
Source: Tax Foundation; House Committee on the Budget.

Tax Reform at the Crossroads: An Overview of the Tax Foundation's 58th National Conference

While reform of the current federal tax system is a distinct possibility over the next few years, the kind of overhaul that might develop and the complexities involved in creating and operating such a system are in question. The Tax Foundation's 1995 national conference in New York City, "Tax Reform at the Crossroads," explored these issues in depth. Here are excerpts from some of the speakers.

Kenneth J Kies

Ken Kies, Chief of Staff, Joint Committee on Taxation: "Revenue neutrality is an extremely important objective. We generally have some degree of confidence, depending on the nature of the proposal, in our revenue projections. However, I have said publicly a number of places that when we're talking about these proposals to completely replace the current tax base, the Joint Committee's view is that if you could get within plus or minus 10 percent on the revenue estimates, you'd be doing very well. Let me point out what plus or minus 10 percent means. The total revenue take is $1.4 trillion per year, so plus or minus 10 percent is $140 billion either up or down. That's a fairly big swing when you're talking about the potential dollar impact. So, estimating capabilities really have to come a substantial distance in order to be able to rely on them for these complete restructuring proposals.

Paths of Fundamental Tax Restructuring

Andy Laperriere, Economic Analyst, Rep. Dick Armey (R-Texas): "Why do (Americans) like the flat tax...? The flat tax is designed to tax every dollar of income earned in the economy and subject it to one level of tax at the same rate....The Tax Foundation has estimated that our proposal would reduce compliance costs by 94 percent. So, the first benefit of the flat tax is simplic-

A second benefit is fairness....No matter what industry you're in, no matter whether you have a lobbyist in Washington or not, under the flat tax you're treated the same as everybody else. And I think that, more than any other reason, is why the flat tax enjoys such popular support in the country....Another benefit of the flat tax is visibility. We call it honesty. Under the current system, it's very difficult to determine what your share of the government is....With the flat tax, you know exactly what your share of government is for the federal income tax."

Walt Lukken

Walt Lukken, Legislative Assistant, Sen. Richard Lugar (R-Ind.): "The thing I like most about the national sales tax is that you sort of put Congress out of business. There's a lot of social engineering going on under the current income tax sytem, where special interests come in and want a certain deduction, and want a certain exemption. So the system becomes very complex, where the rest of the people are subsidizing these tax breaks. Under the national sales tax, deductions and exemptions would not be possible, just by its nature. There's always going to be some sort of tinkering by Congress, but the national sales tax eliminates a lot of the social engineering that the current sytem, or the flats tax, or the USA Tax, would have."

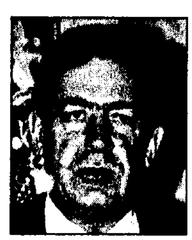
Ernest Christian

Ernest J. Christian, Chief Counsel, Center for Strategic Tax Reform: "The USA Tax, introduced by Senators Domenici and Nunn last April, includes three progressive tax rates on a transition basis, and two progressive tax rates on a permanent basis. But that very same structure of the USA Tax could easily have a single, flat tax rate. The flatness of the tax rate may or may not be what people in America want, but it's not the exclusive province of any particular tax structure. The flatness of the rate, or the single rate, has nothing really to do with simplification and a single flat tax rate in and of itself has nothing to do with relieving the bias against saving. The issue on the rate side is, of course, how high that rate is."

The Effects of the Tax Reform Proposals on Specific Industries

Peter R. Merrill, Partner, Price Waterhouse: "Under the present law, the average corporate tax liability paid by non-financial C corps over the 1988 to 1992 period was $73.6 billion. Under the USA tax, we found over the same five-year period tax payments by corporations would have been $81.7 billion on average. That is a tax increase of 11 percent. The flat tax at 17 percent rate resulted in a reduced tax liability of 10 percent....However, the Treasury Department is skeptical that a 17 percent rate is revenue neutral. At a 23-percent rate, which Treasury says would be revenue neutral, the flat tax would have meant a tax increase on average of 22 percent over the five-year period."

How to Model Consumption Taxes



John Wilkins

John Wilkins, Director of Tax Policy for Economic Analysis, Coopers & Lybrand: "A hybrid modeling of some sort is where we have to turn. Either you kind of link a macromodel with your micro-modeling in a sort of soft way,...or you can try a more hard link that will provide actual interactive feedback, so you would get both the household and corporate sectors as well as the macro sector working together more rigorously. As economists would

Conference *continued on page 8*

A New Tax System and Kitchen Table Economics for America

By Senator Phil Gramm (R-Texas)

Following are excerpts of remarks by Senator Gramm at the unveiling of his tax plan in mid-January 1996.

I know many Americans are focused on the debate over tax reform. It is an important piece to a more important puzzle, but is only one piece of that puzzle. What I want to do today is to present an outline of a new economic program for America—to lead America and the world into the new millennium—and in the process learn from our experience in the world in the last millennium and to learn from our experience in America in the previous 300 years.

The conclusion that I reach in looking at this is that there is no government program that can equal economic growth in providing jobs and growth and opportunity, in fulfilling the ability of people as guaranteed by the founders, not just to seek happiness but to find it.

So here I present an eight-year program to change America, to bring back the American dream, and to share that dream with people who missed it the first time around.

First of all, if one thing is clear of the century in which we live, it is that economic growth works, that it provides broad-based opportunity for ordinary people and that there is no government substitute for economic growth. Until roughly 1965, America experienced, except for the Great Depression, periods of very rapid sustained growth, and in those periods of rapid sustained growth, all boats in America were lifted.

Some rose higher on waves than others, but America just benefited, and Americans sitting around their kitchen tables at night dreaming the American Dream saw with hard work and family sacrifice, the ability of their children and their grandchildren and themselves to live that dream. For example, since 1960, in the years that economic growth equaled or exceeded 3 percent, let me tell you what happened:

On average in each and every one of those years since 1960 where real economic growth equaled or exceeded 3 percent, the average income of a family of four in America in current dollars adjusted for inflation has risen by $1,050 a family. In years where we have achieved a 3 percent growth rate since 1960, over a million Americans have escaped poverty in that year. Escaped it not through some government program where they fall back into poverty when the program is gone, but they have escaped it by having the ability to use their God-given talent with jobs and growth and opportunity so that the vast majority of them have never fallen back.

In years where we have had a 3 percent growth rate since 1960, American has created 2.3 million jobs. The conclusion that I reach in looking at this is that there is no government program—whether it's expanding an existing program or starting a new program or reinventing government or whatever the current cliché of the era is—that can equal economic growth in providing jobs and growth and opportunity, in fulfilling the ability of people as guaranteed by the founders, not just to seek happiness but to find it.

And so the basis of my plan to ignite an American renaissance through economic growth is to try to ignite growth by changing the environment in the country. Let me begin with a subject that everybody wants to talk about and then get to the other parts of the trouble as well. Let me talk about taxes.

First, I think it is imperative if we're to have an efficient tax system

that we eliminate taxation on inflation. I want to adjust capital gains for inflation, beginning it initially on a prospective basis. We are now looking at various simulation models of the potential for doing it retroactively. I want to adjust depreciation schedules for inflation so that we don't have either individuals or businesses paying taxes on inflationary gains.

The second change is, I want to repeal estate and gift taxes. I don't think it's right that Americans work a lifetime to build up a business or a family farm, every penny they put into that business or family farm being an after-tax dollar, and yet when they try to pass it on to their children or grandchildren, those children and grandchildren are forced into selling the business or selling the farm to pay what is a double taxation, often paying up to 55 percent of the farm or business's value to the government. I intend to end that tax because it is anti-family, anti-growth. It is dual taxation and it produces irrational and inefficient economic behavior as people try to avoid that tax.

I want to change the American tax system. I want to adopt a simple tax system that has one rate. I want the rate to apply to all income. We can achieve it by phasing in a 16 percent rate that will apply to all income no matter how you earn it.

We can preserve the ability of families to have a deduction beginning at $32,000 for a family of four and, over the eight-year period of this economic program, my goal would be—through onomic growth and setting up an economic growth dividend—to see that raised to roughly 72 percent of the income level of the average family, which is the same level that existed in 1950. As to how much income was totally protected from federal income taxes, that level in 1995 dollars will be an income of about $40,000 when fully implemented in our program—$40,000 that a family of four could earn without paying income taxes.

Inevitably people are going to ask, "What is the difference between this proposal and others?" Let me first say that there are few ideas in history that are any older than the idea of a single flat tax rate. What is different about my proposal from many of those that are being discussed is that it applies to all income. I reject the idea that income derived from labor should be taxed and that income derived from capital should not be taxed.

> ***What is different about my proposal from many of those that are being discussed is that it applies to all income.***

If we have the same father and he takes part of the family's capital and sends you to Stanford to become a physician, why should you pay taxes your whole life on your income, when if he gives me the funds as investment and I invest it and earn a capital gain, why should that be tax free? I believe the only efficient tax system, the only fair tax system, is a system which applies all income as part of the tax system, so that all income no matter how it is earned—after adjustment for inflation, after adjustment is made to eliminate dual taxation—is taxed and taxed at the same rate. Not only do you have a totally unfair, totally indefensible system if you do it another way, but you have a terribly inefficient system, because you induce people to invest in physical capital instead of human capital. You distort the investment patterns of the country, and you deny the country jobs, growth and opportunity that it could have.

In terms of the constraint on government required to make the American renaissance possible, one of the things that the Republican Party must come to grips with once and for all is the fundamental law of economics which is more powerful than supply side economics and demand side economics, and that is: In the long run, you can't let government spend it and let workers keep it. If all we do is adopt a flat tax with a single rate and we don't do something about spending, we will soon have the simplest tax system in history. It will have one line on it. We'll have 100 percent tax rate and you can fill out the one line and then send it in. That is not what we want.

The components of the program which I outline here which is indispensable in providing an American renaissance is less government and more freedom, and it begins by applying to the federal government the same kind of tough decision-making that families make every night around their kitchen table.

Every night parents sit down around their kitchen table, they get out their pencil, get out a piece of paper and they try to figure out how they are going to pay the mortgage or the rent, how they are going to buy braces for the 14-year-old in their family, how they are going to pay that spike in insurance rates when their son turns 16.

When families are making those tough decisions, is it asking too much for the government to make exactly the same kind of decisions? Why is there courage in making decisions around the kitchen table in the home of every working family in America every night and there is so little courage when our political leaders sit down around the cabinet table in the White House? I intend to change that. •

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

Social Security

Continued from page 1

taxes had been placed in an interest-bearing account rather than immediately paid out to Social Security recipients (see Chart 1).

For example, low-wage couples retiring in the year 2012 can expect to receive $26,835 in inflation-adjusted, after-tax Social Security benefits each year. An annuity purchased with lifetime payroll taxes compounded with interest would be $3,000 more valuable. (In addition, notes Dr. Hall, the full value of the hypothetical annuity 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.)

The annuity values that Dr. Hall's study reports are conservative estimates, 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 *Special Report* points out that, if the U.S. adopted a Chilean-style "opt-out" plan — which provides citizens an opportunity to out of its government-run social security system and into a (mandatory) system that is privately run — most couples of the baby-boom generation would choose such an option. Under current law, projects Dr. Hall, every low-wage couple retiring in the year 2025 (age 37 in 1996) or later would choose to opt out of Social Security; every average wage couple retiring in the year 2013 (age 49 in 1996) or later would opt out; and all high-wage couples would choose to opt out, no matter what their age. In fact, average-wage couples age 33 or

Social Security *continued on page 7*

Chart 2: Annual Social Security Benefits Versus Value of Annuities Under a Chilean-Style Opt-Out Program, Assuming Taxpayers Opt Out in 1996

Low-Wage Couple

Year of Retirement	Worker's Age in 1996	Annual After-Tax Value of Annuity Paid for With: Payroll Taxes Paid Through Opt-Out Date*	Private Savings in Lieu of Payroll Taxes	Total of After-Tax Opt-Out Annuities	After-Tax Soc. Sec. Benefits
2012	50	$15,105	$7,680	$22,785	$26,835
2015	47	16,617	10,686	27,304	31,017
2019	43	18,487	15,915	34,401	37,622
2023	39	19,236	24,304	43,539	44,164
2027	36	21,492	33,781	55,273	52,432
2031	32	21,780	46,884	68,664	63,779

Average-Wage Couple

Year of Retirement	Worker's Age in 1996	Annual After-Tax Value of Annuity Paid for With: Payroll Taxes Paid Through Opt-Out Date*	Private Savings in Lieu of Payroll Taxes	Total of After-Tax Opt-Out Annuities	After-Tax Soc. Sec. Benefits
2012	50	$25,301	$13,928	$39,229	$39,484
2015	47	27,416	19,386	46,802	45,631
2019	43	29,291	28,887	58,178	55,339
2023	39	29,597	44,115	73,712	64,961
2027	36	32,209	61,336	93,546	77,256
2031	32	29,912	85,015	114,928	93,896

High-Wage Couple

Year of Retirement	Worker's Age in 1996	Annual After-Tax Value of Annuity Paid for With: Payroll Taxes Paid Through Opt-Out Date*	Private Savings in Lieu of Payroll Taxes	Total of After-Tax Opt-Out Annuities	After-Tax Soc. Sec. Benefits
2012	50	$37,774	$23,478	$61,252	$53,217
2015	47	40,120	32,690	72,810	61,532
2019	43	41,869	48,712	90,582	74,649
2023	39	40,724	74,390	115,114	87,624
2027	36	41,096	103,326	144,422	104,014
2031	32	31,132	143,240	174,372	126,439

* Compunded with interest until retirement.
Note: Annuities reflect female life expectancies.
Source: Tax Foundation.

Social Security

Continued from page 6

younger in 1996 and high wage couples age 38 or younger in 1996 would choose to opt out of Social Security even if they lost *all* of the benefits associated with their previously-paid lifetime employer/employee payroll taxes upon opting out.

(In the spirit of the rules governing pension plan investments in the United States, interest rates used in this analysis when the couples' money is in the custody of a private company assumes the rate of return on a portfolio containing equal shares of A-, Aa-, and Aaa-rated corporate securities.)

The "Total of After-Tax Opt-Out Annuities" column under each couple profile in Chart 2 sums the two separate annuity streams to determine the total annual cashflow available to retiring couples if they opted out of Social Security in the year 1996. Comparing this sum with the couples' annual "After-Tax Social Security Benefits" in Chart 2 determines whether or not couples retiring in Dr. Hall's designated years would choose to opt out of the Social Security system.

Chart 2 also offers a fiscal perspective of a Chilean-style opt-out plan. For example, an average wage couple retiring in the year 2015 can expect to receive $45,631 in inflation-adjusted annual Social Security benefits. However, if this couple were to choose a Chilean-style opt-out plan, the federal government would have a liability (in annualized terms) of $27,416, a 40 percent reduction. The remainder of the couple's $46,802 annual cashflow would come from their privately funded annuity. Thus, says Dr. Hall, in addition to making future retirees wealthier, such an opt-out plan could help short-circuit the greatest potential fiscal policy crisis in U.S. history — the retirement of the baby-boom generation. •

FOUNDATION MESSAGE

Churchill's Past Wisdom Relevant to Current Battle

"They are decided only to be undecided, resolved to be irresolute, adamant for drift, all-powerful for impotence."

This quote from Winston Churchill about the 1936 British government probably describes rather well how most Americans see their own government as the budget drama plays out. This view is unfortunate, however, as it misses a great struggle for the proper role for the federal government.

In a reflective moment, I recently picked up a book of Churchill's maxims and reflections. As I juxtaposed his captured wisdom with the budget battles, I was impressed by the many parallels between war, on the one hand, and the budget on the other.

For example, like most wars, the budget battle did not occur by accident. Nor has it been staged. Instead, it results directly from the last two elections, when Democrat Bill Clinton was given control over one branch of government and, thereafter, when Republicans took control of another. At that point, "nothing in human power could break the fatal chain, once it began to unroll. A situation had been created in which hundreds of officials had only to do their prescribed duty . . . They did their duty." Churchill's words about the start of World War I seem strangely apt to today.

J.D. Foster
Executive Director and Chief Economist

Another parallel arose when, upon taking power, both the Democratic President with health care reform and the Republican Congress with the balanced budget amendment felt the truth of another Churchill observation: "The problems of victory are more agreeable than those of defeat, but they are no less difficult."

The Republicans, particularly the House freshmen, have been often criticized for their intransigence, even at times seeming to correct their leader, Newt Gingrich, when he wavered from the demands for a tax cut and a certain balanced budget. Adamant and resolute, they understand Churchill's maxim: "There is no place for compromise in war. That invaluable process only means that [legislative careers are squandered] because their leaders in council and camp are unable to resolve."

Politicians are often accused of making policy by the polls. They would do well to heed another Churchillian admonition: "Nothing is more dangerous in wartime than to live in the temperamental atmosphere of a Gallup poll....I see [it said that] leaders should keep their ears to the ground. All I can say is that (the American people) will find it very hard to look up to the leaders who are detected in that somewhat ungainly posture."

One reason it is so hard for anyone to get a real bead on what is happening with the budget is that it can be terribly complicated. There are appropriations and continuing resolutions, entitlement spending, simultaneous spending cuts and spending increases on the same program, debt limits, and competing revenue estimates and economic assumptions. And yet even so, "Out of intense complexities simplicities arise." Simplicities such as whether Medicare should be allowed to go bankrupt. Simplicities such as whether spending should be slowed enough to allow a tax cut. Simplicities such as whether a balanced budget is important enough to assure through concrete action, or little more than a paramour's promise.

The struggle for the direction of the nation is necessary and inevitable. If a victor eventually emerges, we must hope that the gains will be worth the price and that we avoid Churchill's sad epitaph on World War II: "We were so glutted with victory that in our folly we cast it away."

TAX FEATURES

Tax Features (ISSN 0883-1335) is published monthly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are $15.

Co-Chairman
Dominic A. Tarantino

Co-Chairman
The Honorable Jim Miller

Chairman, Program Committee
E. Noël Harwerth

Distinguished Fellow
The Honorable Bill Frenzel

Executive Director and Chief Economist
J.D. Foster

Administrator and Director, Foundation Development
C. Gaye Bennett

Adjunct Fellow
Charles E. McLure, Jr.

Tax Counsel
Lynda K. Walker

Director, Corporate Development
Reneé Nowland

Editor and Associate Director/ Communications Director
Stephen Gold

Tax Foundation
(202) 783-2760 Tel
(202) 942-7675 Fax

58th National Conference

Continued from page 3

like to think of this, we always like to have simultaneous solutions so everything fits together nicely. Either you get it by linking things tightly, or you get it by very rapid iterations, and either of those can be done, and I think will have to be done, if you want to get correct answers under tax reform."

Dr. Perry Quick

Dr. Perry D. Quick, National Director of Tax Analysis and Economics, Ernst & Young LLP: "There is a way that we can use some of the static models to at least get a better handle on where we are before we can go clear to the dynamic models. Let's take these various behavioral assumptions, and in a static world, make the other extreme assumption. Call that a new static world, where all the adjustment is going to take place to exchange rates, where all of the wage tax is going to be passed on to the employees. In that world, do we get results that just totally change around where we are in terms of winners and losers, in terms of incentive effects, in terms of economic efficiency? That is at least one way we can use the kind of analysis we can do today and not have to wait until we get all of our general equilibrium, all of our real dynamic models done."

Linden C. Smith, Managing Director of the Barents Group LLC, KPMG Peat Marwick: "I view this discussion so far as a little bit of vindication of the Joint Committee's traditional revenue-estimating methodology, which is basically static. You can see that some of the discussions about behavior are all over the map, and that indeed is one of the problems that the Joint Committee faces when it's trying to look at behavioral effects and how they should be taken into account in revenue estimates."

The Kemp Commission on Tax Reform

Alan Reynolds

Alan Reynolds, Research Director, National Commission on Economic Growth and Tax Reform: "I have developed a flawless technique for estimating the individual income tax receipts....We'll call it the Reynolds Law. The technique works like this: Regardless of what the tax rates are, regardless of deductions or any other loopholes, the individual income tax will collect 10 percent of personal income plus or minus one percentage point. It's been true every year since 1951. The only time it hit 11 was the surtax of 1969 and the bracket creep of 1981. Both were followed by economic collapse, and the revenues collapsed, too. At the present time, we're down at the lower end of the range, 9. The tax increases, so-called, of 1990 and 1993 had the virtue of reducing the ratio of income tax to personal income, or to GDP for that matter....Then the smoke cleared, and it turned out the individual income tax was yielding 8.2 percent of GDP in 1994, up from 8.6 percent in 1989. Oh, that's down, isn't it? Oh, gee, if they keep raising taxes like that, no wonder they're going broke." •