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Social Security, Tax Reform And Capital Accumulation

By Martin Feldstein

The reform of social security could be a powerful remedy for America's inadequate rate of capital accumulation. It is unfortunate, therefore, that the recent criticisms of social security have been largely misdirected and that the alarmed cries of an impending capital shortage have misconstrued the case for a greater rate of capital accumulation. As a result of this confusion, the Treasury's proposal for corporate tax integration has been inappropriately advocated as a method of increasing the nation's rate of saving. As I will explain in a moment, corporate tax integration would be a desirable reform for other reasons but cannot be predicted to increase capital accumulation.

During the past year, the press has frequently discussed the possible financial bankruptcy of the social security system. These criticisms focus on the fact that social security now has, according to official estimates, liabilities of more than \$2.4 trillion. This means that current workers and retirees are expected to receive \$2.4 trillion more than they are expected to pay in future taxes. If social security were a private pension program, it would require assets of \$2.4 trillion to be financially solvent, i.e., to guarantee its ability to meet its future obligations. Since the program has a trust fund of only \$55 billion, or some 2 percent of its obligations, social security is bankrupt by the conventional standards used to determine the actuarial soundness of private pension programs.

This analogy of social security to private pensions is totally misleading. A private pension must have sufficient assets to meet all prior commitments because it cannot be certain that any future contributions will be made. In contrast, the government can compel future generations of workers to pay social

security taxes. As long as the voters support the social security program, it will be able to pay the benefits that it promises.

The acrimonious debate about financial insolvency has obscured the more important issue of social security's adverse impact on the nation's rate of saving and therefore on our rate of capital accumulation. For most American families, the social security program is the major form of saving. In 1974, total social security contributions were \$89 billion, or 9 percent of total disposable personal income. At the same time, total private savings—including private pensions and corporate retained earnings—were \$130 billion. If individuals think of the social security contributions

This Issue in Brief

Public alarm over the impending bankruptcy of the social security system and cries of alarm about the "capital shortage" are misguided and divert attention from the main point: the need for a higher rate of U.S. capital accumulation, both now and in the future.

"A dollar invested today would yield society two dollars of consumption, measured in 1975 prices, after only 5 or 6 years. This high reward for current sacrifices is the reason to increase our national saving rate."

Professor Feldstein holds that corporate tax integration, while highly desirable for other reasons, would not predictably increase the rate of savings and capital formation, but he sees reform of the social security system as a potent method of doing so.

as equivalent to savings and reduce their private savings accordingly, the total potential private savings of \$219 billion are reduced by \$89 billion or about 40 percent.

This assumption that individuals reduce private saving by the exact amount of social security contributions is only illustrative. But in a recent econometric study of U.S. savings behavior since 1929, I found evidence that confirms that social security does substantially lower private saving. More specifically, the statistical estimates imply that social security now reduces private saving by about 35 percent. Because of our current pay-as-you-go method of financing, i.e., because social security tax receipts are paid out as concurrent benefits, there is no public saving to offset this fall in private saving. In the long run, the 35 percent reduction in private saving implies that the U.S. capital stock will also be more than 35 percent smaller than it otherwise would be.

This brings me to the general issue of the "capital shortage" about which so much has recently been written. Although these cries of alarm have been useful in directing attention at the low rate of saving in the U.S., the magnitude of the "shortage" has been overstated and the real reason for more saving has been ignored.

In May of last year, Treasury Secretary Simon testified before the Senate Finance Committee that "investment needs between 1974 and 1985 will range from \$4 trillion to \$4.5 trillion," estimates that are now a familiar part of the capital shortage litany. He then compared this with the \$1.5 trillion capital investment during the period from 1962 through

1973 and concluded that "our capital investment needs in the coming years are approximately three times the level of the recent past."

The short fall of \$2.5 trillion implied by these figures is both alarming and misleading. The capital requirements of more than \$4 trillion are projected in the prices of future years, based on a 5 percent rate of inflation. It makes no sense to compare future capital requirements measured in these depreciated dollars with actual past capital spending when the price level was lower than it is now.

If we do the calculations with constant 1974 dollars instead, the Treasury's \$4.2 trillion estimate implies only \$3.15 trillion in 1974 prices. The \$1.5 trillion of gross investment in the period from 1962 through 1973 represented annual rates that were about 14 percent of GNP. If this rate continues, actual investment from 1974 through 1985 would, on the Treasury's assumptions, total \$2.94 trillion in 1974 prices. The net short fall would be only \$210 billion, a far cry from the common figure of \$2.5 trillion. This gap could be closed by an increase in gross savings of less than one-tenth, i.e., from 14 percent of GNP to about 15 percent.

Capital Gap Is Exaggerated

The real potential gap may be larger than this suggests. The Treasury's estimate of future capital demands for housing, transportation, energy and capital modernization may be too low. But the government's current projections, when examined in terms of comparable prices, simply do not imply the great shortage that is now so widely bewailed.

There is another sense in which the projections of a capital shortage are misleading. As an economist, I am puzzled that experts appear to be predicting that the demand for capital will continually exceed its supply. Usually when there is excess demand for some good, its price rises until demand and supply are equal. In the capital market, the interest rate and the cost of equity capital should increase until they are high enough to force firms to tailor their aggregate investment demands to the available supply. There will be no short fall of investment funds because the demand for funds will shrink to the available supply.

The real problem therefore is not that there will be a gap between available saving and desired investment. The real problem is that the U.S. rate of capital accumulation is too low now and can be predicted to remain too low in the future. The additional future consumption that would result from more investment now would more than compensate for the current sacrifices. Economists estimate that



Martin S. Feldstein is professor of economics at Harvard University, where he has taught for the past eight years. He is also managing editor of *Studies in Public Economics*, and serves on the editorial boards of *the American Economic Review*, *Quarterly Journal of Economics*, and *Review of Economics and Statistics*.

A native New Yorker, Dr. Feldstein received the B.A. in economics from Harvard College, summa cum laude. From Oxford University he received, successively, the B.Litt., M.A. and D.Phil. While at Oxford from 1962 to 1967 he was Research Fellow then Official Fellow, lecturing in public finance.

In 1971 he was a Fellow of the Econometric Society; in 1975 he was Ford Research Professor at the University of California's Berkeley campus.

additional private investment would produce a total real yield to society of between 12 percent and 15 percent. A dollar invested today would yield society two dollars of consumption, measured in 1975 prices after only 5 or 6 years. This high reward for current sacrifice is the reason to increase our national saving rate.

To stimulate such an increase in saving, the Treasury has recently proposed integration of the corporation tax and the personal tax through a system of deductions and credits for dividends paid and received.¹ This has been an unfortunate source of confusion. In fact, integration is desirable even if it does not increase the rate of saving. Moreover, I believe that there is no way to know at this time whether integration is more likely to increase or to decrease aggregate capital accumulation.

Corporate tax integration would affect savings in two quite different ways. First, corporate savings are likely to fall if the Treasury proposal is enacted. Under current law, a corporation chooses between keeping an extra dollar of retained earnings and increasing the shareholder's *after tax* income by substantially less, i.e., by one dollar minus the shareholder's marginal tax rate. The Treasury's proposal (for a deduction for half of dividends paid and a non-rebatable credit for half of dividends received) would raise the "cost" of retained earnings, measured in terms of foregone dividends, by about 65 percent. This higher cost of retained earnings would induce a substantial switch from retained earnings to dividends. Since the increase in dividends that is likely to result would exceed the fall in corporate taxes, retained earnings would actually decrease. Although this reduction in corporate saving would be substantially offset by an increase in personal saving, the net effect would be a reduction in total private saving.

The second way in which integration would affect saving would be by reducing the total tax burden on corporate source income. This in turn would increase the *after tax* return that savers receive on all forms of capital income. But an increase in the net rate of return does not imply that there would be an increase in the rate of saving. Since so many discussions assert that a higher net yield would induce more saving, it is worthwhile to examine why this may not be true.

Consider for example a man now age 40 who wishes to save for his retirement at age 65. He now obtains a real *after tax* return of 4 percent; for every \$100 a year that he saves during the next 25 years, he will be able to dissave \$357 per year from the time he is 65 until he is 80. Given this opportunity, he

decides to save \$1,400 per year and thus dissave \$5,000 per year when he is retired.

Now consider what happens if his net-of-tax rate of return rises from 4 percent to 5 percent. Every dollar of preretirement saving would "buy" substantially more retirement consumption. More specifically, for each \$100 per year of preretirement saving, our man could later dissave \$422 (instead of the \$357 obtained at 4 percent). Faced with this lower "price" of retirement consumption, the individual is very likely to increase the level of planned retirement consumption. *But unless the new level of retirement consumption increases sufficiently, current saving will actually fall.* For example, if he decides to increase his annual retirement dissaving from \$5,000 to \$5,500, he can actually lower his current saving from \$1,400 to \$1,303. Only if planned retirement dissaving increases to at least \$5,900 would current saving increase.

Although this example was developed in terms of retirement saving, the same type of ambiguity applies to other motives for saving. We simply do not know how a rise in the net rate of return would affect the amounts that individuals save, not only for their retirement, but also for such things as their children's education, bequests, the future purchase of a home, or funds for emergencies.

Tax Integration A Valuable Reform

Although tax integration cannot be predicted to increase the rate of capital accumulation, I believe that some type of integration would be a very valuable tax reform. Corporate tax integration—either the complete partnership method or the Treasury's partial method of dividend credits—would increase the efficiency of the capital market and raise real national income in four different ways:

- (1) Capital would move from less productive uses in the unincorporated sector to more productive uses in the corporate sector.
- (2) The higher net rate of return to all capital income would raise individual well-being by reducing the current tax bias against future consumption.
- (3) An increase in the dividend payout rate would encourage investment by new companies and improve the allocation of capital within the corporate sector.
- (4) Removing the bias in favor of debt finance would reduce the capital market risks caused by high ratios of debt to equity.

These are, I believe, compelling reasons to move toward corporate tax integration even though it can-

¹This was the thrust of Secretary Simon's testimony of July 31, 1975, when he introduced the Treasury's proposal.

not be expected to increase capital accumulation.²

This brings me back to the reform of social security as a potent method of increasing capital accumulation. Although the social security program has long seemed to be beyond critical examination, stresses are developing within the social security program that will require serious political attention.

First, the method of adjusting benefits for inflation must be revised. The "double indexing" that was inadvertently enacted in 1972 makes both the value of benefits and the required tax rate hypersensitive to the rate of inflation. The current system is designed to provide benefits that will eventually replace 63 percent of a typical worker's gross earnings just before retirement. This will be achieved if the inflation rate is 2 percent. In contrast, a sustained 4 percent rate of inflation would increase the gross replacement rate from 63 percent to 95 percent. It is not surprising that everyone agrees that the benefit formula must be revised.

Social Security Taxes Must Rise

But even with a proper method of adjusting for inflation, the social security tax rate will have to rise substantially over time to maintain the current ratio of benefits to previous earnings. This is because the changing demographic structure of the population will result in a higher ratio of retirees to workers. Even if the fertility rate were to rise immediately to the value required for a stable population, the social security tax rate would have to rise eventually to 18.4 percent. With plausible but less favorable demographic conditions or productivity growth, the tax rate could exceed 22 percent.

In short, because of the long-run demographic trends, we are now asking the next generation to pay about twice the rate of social security tax that we are paying. It is, of course, unfair for us to impose this tax increase on them. Moreover, trying to do so runs the risk that future voters will reject the higher tax, leaving future retirees with an unexpected fall in benefits.

There are only two ways to avoid this problem. Fortunately, both of them have the added virtue of

²These ideas are elaborated in my statement for the Senate Budget Committee hearings on September 19, 1975.

substantially increasing the nation's rate of capital accumulation. I have developed elsewhere³ a proposal for a social security capital fund. The social security program, by collecting more in taxes each year than it paid in benefits, would add to the national rate of saving and would thus partially offset the reduction that it causes in the private savings rate. The income earned by this capital fund could eventually be used to pay part of the cost of future benefits. By raising the tax rate now, the eventual total increase can be reduced. For example, increasing the tax now by 4 percentage points would yield an investible surplus of nearly \$30 billion in the first year. Although a detailed study remains to be done, the accumulating fund that results from such an increase might be sufficient to eliminate the need for any future payroll tax increases.

The other way to mitigate the projected increase in social security tax rates is to reduce the rate at which benefits are now scheduled to grow. The anticipated 63 percent ratio of benefits to gross pre-retirement earnings for the typical worker implies little or no loss of *net* income upon retirement. Even with a proper adjustment for inflation, the current law evasions that the typical retiree 75 years from now will receive annual benefits of more than \$25,000 in 1974 prices!

These real benefit levels go well beyond social security's primary purpose: protecting the aged against the discomfort of inadequate income without the stigma of a means test. Moreover, with such high rates of replacement of net earnings, there is no need for any private retirement saving. Limiting the rate of growth of social security benefits would therefore both contain the payroll tax rate and provide a valuable opportunity for additional saving.

The increasing awareness of the problems inherent in the current social security law and the growing interest in capital accumulation should overcome the natural resistance to consider any change in social security. The inability of our tax system to provide a predictable stimulus to savings should lead to a search for some new approach. The reform of social security will therefore deserve very careful attention.

³See my testimony to the Social Security Subcommittee of the House Ways and Means Committee, May 15, 1975, and my "Toward a Reform of Social Security," *The Public Interest*, Summer 1975.