Value-Added Tax and the Financing of Social Security

By Gerard Brannon

The issue of substituting a value-added tax (VAT) for part of present payroll taxes in financing social security is best thought of as two fundamental questions: (1) whether social security should be totally limited to a payroll tax; and, if so, how? (the linkage issue); and (2) whether we want a consumption tax, like VAT, in the Federal tax system (the consumption tax issue).

Linkage — What Case for a Payroll Tax?

There is, in the social security literature, much discussion of the connection between the system of benefits and the payroll tax, under the general rubric of the "contributory principle." To some extent the linkage is explained by a theory that the payroll tax constitutes an insurance contribution by the insured, but this patently does not explain the 100 percent linkage. Wilcox, in a somewhat philosophical review of the issues in the early 1950s, offers the theory that the cost of extra benefits for employees with low lifetime wage experience, the welfare component, was paid for by the employer tax, while the purely wage-related component of the benefit was paid for by the employer tax, while the purely wage-related component of the benefit was paid for by the premium-type contribution by employees who would be future beneficiaries. Wilcox offers no explanation why this particular tax — a tax on employers — was used to finance the non-insurance, welfare component.

Even Wilcox’s insurance premium analogy is not easy to justify as a long-run argument in the system that we have today. Burkhauser and Warlick have shown that, at best, only about a third of the benefit in Old Age and Survivors’ insurance is wage related. Inclusion of Medicare makes the wage-related component even smaller.

Two other recent developments add to confusion about the contributory principle. For some low-income workers, the payroll tax is effectively repealed or reduced by a tax credit on earned income, and the creation of Supplemental Security Income amounts to blanketing in many people with little or no payroll tax credits. Some workers get a social security benefit without really paying for it, and others pay for a benefit they would have gotten anyway.

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2Willcox, loc. cit.

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Presently, there is no well articulated theory of why social security should be linked to a payroll tax other than a rather vague notion that, to some extent, wage-related benefits are justified only by some tax (or compulsory contribution) on the wages that give rise to the benefit. I turn now to a rather theoretical discussion of the question to what extent should the benefit system be linked to wages.

Employer and Employee Taxes. I assume that the employer tax is shifted to workers and I will treat it as a tax paid in the short run by workers. This conclusion is reached by Brittain and is followed by most current writers in social security.4 . . .

To the extent that there is any controversy about the shifting of payroll taxes, it involves mostly issues of the long-run impact on labor supply of a charge on working. But these consequences are related to any charge on working. The point is that the payroll tax, whether on employers or employees, is a charge on working.

A Minimum Linkage System with Payroll Taxes. Payroll tax financing would be quite rational if it were part of a social security system in which: (a) benefits were roughly proportional to taxable wages at all wage levels (possibly up to a ceiling on wages for both tax and benefit purposes); and (b) the level of benefits and wage taxes were not changed in any significant way except through a referendum of young voters (which will be elaborated shortly). I refer to these as the proportionality condition and the political condition, respectively.

A strict proportionality between benefits and taxable wages would clearly justify calling social security an insurance system even though it does not involve a reserve. The analogy has been developed to a social contract in which the present working generation makes consumption loans to the present aged generation in return for the expectation of obtaining "repayment by drawing down such payments from the next generation" (when present workers are old).5

Clearly social insurance is different from private insurance, but these differences are matters of degree and the issue is so close that under our strict proportionality one could not assert a priori which workers would prefer. I will say more about this choice shortly when we discuss politics.6 If we have only a loose proportionality between benefits and wages, i.e., more benefits in relation to taxes paid for low-wage workers, the insurance analogy still has some merit but the case is more complicated. A private retirement or survivor insurance system, as well as a social insurance system with strict proportionality between benefits and wages, provides insurance against the eventualities of living a long time after retirement (and having one’s savings run out) or dying young, with surviving dependents, before accumulating savings. Generally these eventualities are unpredictable at young ages (there is little room for adverse selection); so we are dealing with an eventuality of the type handled by private insurance.

One can still make a strong case for payroll-tax-financing in a social security system in which the benefit structure is moderately biased in favor of workers with low lifetime wages. Our political discussion will throw more light on this.

Our argument to this point has been based on analogy and has been rather normative. We need to give more attention to some behavioral aspects of a payroll-tax-financed social security system such as exists now in the United States. This is the thrust of our political condition.

If a social insurance system is in being, it is possible to change the scale of benefits and taxes and thereby extend benefits to all of the already retired who never paid a dime of contribution toward the cost of this new insurance. Further, any 55-year-old worker will pay more tax for ten years and then enjoy a benefit that would ordinarily cost a lifetime of tax contributions. This is how we introduced Medicare.

The fact that social security involves a transfer between generations has received much attention in the literature.7 In an ongoing system of social security this transfer is of no great consequence — it can be the way our tribe cares for its aged. The problem is rather different when we are considering a basic change in the social security system, like extension of medical insurance for the aged or disability insurance. . . .

A broad political decision on changing social security, in which the retired and older workers, like me, vote, is an atrocious public choice mechanism. . . .

This atrocious public choice situation argues strongly against the heavy use of wage-tax-financing in the kind of social security system that we have today, in which system level changes are voted on by non-taxpayers and short-term taxpayers.

To be thoroughly justified as a device for social security financing, the payroll tax should serve as a device for making political decisions about social security more rational. If we provided that no basic

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Gerald M. Brannon is Professor of Economics at Georgetown University, where he has been a member of the faculty since 1951. He has also served as economist for the Joint Committee on Taxation and for the House Ways and Means Committee; director of the Office of Tax Analysis, U.S. Department of the Treasury; consultant to the U.S. Interior and Treasury Departments; and as a member of many policy organizations.

Dr. Brannon frequently presents testimony before the House Ways and Means Committee and the Senate Finance Committee. He received his Ph.D. from Harvard University and is the author of numerous scholarly publications on tax policy.

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4Even with strict proportionality of the benefit amount to tax-paid wages, there would be a bias against workers planning to stay single arising from the survivor benefit. It is my impression that such a bias is common in private pension plans.

change in social security would be enacted unless approved in a referendum in which only people below the age of 50 could vote, this test would be met. The trouble with the wage tax when coupled with universal voting on system changes as normal political issues is that it becomes too easy for oldsters to vote themselves windfall gains by voting for higher levels of social security.

The Income Tax and General Revenue Financing

A tentative conclusion of the argument to this point is that there ought to be substantial general revenue financing of social security. I propose to hold this in abeyance for a while and consider the question: "If we increase the expenditures that must be financed out of general revenues (and borrowing), should we increase income taxes or adopt a new tax, like VAT?"

We start with the obvious point that, excluding payroll taxes, the U.S. Federal government runs on income taxes. For a practical matter, it is possible to meet new expenditures by raising income tax rates. Further, still in the realm of possibilities, it is well known that the income tax yield could be increased without changing marginal tax rates on ordinary income by caging loopholes. It is also well known that, politically, loophole closing is very hard to do, about as hard as raising tax rates.

You are well aware that there is large support within the Congress for the Kemp-Roth bill to reduce income tax rates. I do not expect this to pass, but I cite it as a bloc of votes that would oppose substituting income tax for payroll tax. A further political point is that, for quite a few years, payroll tax rates have increased while income tax rates have been reduced. Much of the reduction in income tax rates has been merely removing the... increases associated with inflation, but I still draw on this historical evidence that a full reversal to raising income taxes in order to cut payroll taxes would face a tough political road.

I would not shirk from a political fight if the case for higher income taxes were pure. Unfortunately, I cannot report that this is the case. In the contemporary public finance literature, the income tax as it now exists (or even as it would exist if it were reformed toward a more comprehensive tax base) is taking considerable abuse. This academic attack on the income tax is made up of several charges.

A most serious attack centers on the argument that an income tax discriminates against savings. The "double-tax-on-savings" argument in economics goes back to John Stuart Mill and Irving Fisher. There is widespread public concern about this "savings" penalty of an income tax. One is the concern about "capital shortages." Another is the sort of welfare-economics evidence offered by Martin Feldstein that the marginal rate of substitution between capital and labor in production is greater than the marginal rate of substitution between future and current consumption; i.e., the productivity of capital is greater than the rate of time preference. Finally, our lawmakers, including "liberal" Democratic presidents, have enacted a large, but erratic, collection of "loopholes" in the double tax on savings — pension plans, investment credit, favorable treatment of equity in home ownership, IRA accounts, tax-exempt bonds, deferral of tax on capital appreciation, accelerated depreciation, and the like...

We are not here to bury the income tax but to note that it has severe health problems that stand in the way of expansion. From a logical basis, our system of taxing corporations is very unsatisfactory. The problem of the double tax on dividends is well known, but only in 1977 did the business community realize that merely removing the double tax on dividends leaves an undistributed profits tax, which wasn't popular either. More serious is the feature of an unintegrated corporate income tax to overtax earnings of low-income investors and undervat the retained earnings belonging to high-income investors.

It is well known that an income tax works badly in inflation, and we don't know how to correct this fully. Indexing the exemptions and rate brackets is relatively easy. Increasing the basis of assets would seem manageable (if not simple), but this overlooks all of the problems associated with inflationary distortions of debt, i.e., gains to borrowers and losses to lenders.

Finally, what to do about capital gains is a major structural problem. The source of the difficulty is that the Congress consistently refuses to deal with the problem of appreciation transferred at death. Estate building through unrealized capital appreciation promises avoidance of income tax. Given this way of avoiding tax on capital appreciation, it is not smart to realize gain during one's lifetime when reinvestment is planned. In these circumstances we will continue to see demonstrations that a heavy tax on realization causes some holders of appreciated property to put off realization. These demonstrations tend to hold down the capital gains rate (as they did last year), and a low capital gains rate generates all sorts of schemes to avoid tax on what should be ordinary income.

In summary, my conclusion about the state of the intellectual debate over the income tax leaves me with the same conclusion as my assessment of the politics. Increasing the income tax to provide a replacement for part of the payroll tax is a very poor prospect.

A Consumption Tax (VAT) and General Revenue Financing

We arrive finally at the subject of using the VAT as the general revenue tax to replace part of the payroll tax. My argument here will, I regret, still be moderately complicated.

In the first place, the clear implication of my previous remarks is that any addition to general revenue financing should be a consumption tax. The problems in the income tax center on the taxation of savings and wealth; so a Federal tax on wealth encounters the same difficulties.

*E.g., Barry Bosworth, James Duesenberry and Andrew Carron, Capital Needs in the Seventies, Washington, D.C., Brookings Institution, 1975. The authors are "optimistic" about the supply of savings assuming balanced Federal budgets.


In the second place, as a practical matter, the most efficient means of introducing a new Federal tax on consumption is the tax on value added (VAT). From an economic standpoint, however, a tax on wages has a broad similarity to a tax on consumption.

Finally, I will argue that the most significant difference between using a broad consumption tax like VAT to replace part of the payroll tax is that it could avoid some of the bad political consequences of the payroll tax.

The last two parts of the argument require some elaboration.

Our experience in this country with consumption taxation is in retail sales taxation. A Federal retail sales tax would, however, have a variety of exemptions. Even if the Feds hold the line on food and medicine exemptions, there would be a need for a variety of exemptions dealing with particular sales that are near the retail-wholesale border. A special set of Federal exemptions to be administered at the checkout counter, along with existing and different state tax exemptions, seems to me to create a serious administrative problem. A VAT, however, can be collected much as an income tax.

There are a variety of problems associated with applying VAT to various kinds of consumption, such as housing. My guess is that in an actual VAT some types of consumption would be unequally taxed, but I doubt that the outcome would amount to as much neutrality as is generated by the...income tax.

In the United States, the important argument, historically, against a Federal consumption tax has been that any such tax is regressive. As a substitute for a payroll tax, this argument is irrelevant since the payroll tax is also regressive. The Pechman-Okner study of the income distribution of the tax burden shows that the difference in the distribution of the burden is quite trivial when part of the employer payroll tax is treated like a sales tax. There are differences, however. Pechman and Okner indicate that, in 1966, backward shifting (i.e., assuming that the payroll tax really falls on wages) makes it slightly more progressive than a consumption tax. With the increase in the wage base provided by recent legislation, the wage tax would appear even more progressive.

The issue of tax progressivity or regressivity, however, is not really very important, since the government should care about the total distribution of after-tax income, not a single effect on this distribution. Under either payroll tax or VAT we could change the regressivity by making payments of cash, such as refundable credits. Browning has argued that our institutions for setting transfer payments and adjusting them for price-level changes does this fairly automatically, and he concludes that Pechman and Okner overstate the regressivity of a consumption tax.

My point about the irrelevance of the progressivity differences is closely matched when we look at the neutrality aspects of consumption vs. payroll taxation. The problem that I emphasized in the income tax was the overtaxation of savings. In principle, this "double-tax" problem could be eliminated by exempting income saved from tax, which is what a consumption tax does, or it could be eliminated by taxing savings and thereafter excluding the tax on investment income, which is what we do when we tax only wages and proprietor "earned" income, as in the payroll tax.

My conclusion to this point is that there would be little or noth different in the increasing effect of the U.S. tax system if we substituted a VAT for part of the payroll tax. This argument has not gone to the serious political problems identified with the payroll tax. It gives the older population an unwarranted opportunity to obtain a windfall gain by committing the young to excessive levels of social insurance. This would be avoided by my special voting proposal on social security issues, but without this form of voting, I see the payroll tax (in theory) as too easy to increase. The evidence of increasing payroll taxes here and abroad gives substance to this theory.

My theoretical point can be seen very clearly when it is recognized that even if consumption taxes and payroll taxes are equivalent with regard to the income size distribution of tax burden, they are not indifferent as to the age distribution of the tax burden. Payroll tax financing exempts the aged and tells those past the age of 50 that they will have to carry a heavier tax burden. It is an alternative, I part, to a selective system of scaling back benefits in the less meritorious cases as was proposed in the 1980 budget by President Carter.

Conclusion

If we knew that the scale of social security would not change, I don't think it would make much difference whether we financed the program by payroll taxes or in part by a VAT. We know, however, that the system will change over time. There will be continuous pressure to increase the benefit level, and, as the relative size of the aged population rises, there will be unavoidable choices between raising taxes or limiting benefits.

Assuming that we don't introduce a control in the form of a referendum limited to young workers, I would argue for a strategy of relying on general revenue financing, by way of VAT, to finance increases in the system. As a practical matter, I would regard the present transition that we are going through, namely the large increase in the wage base that will come into effect over the next few years, as a change decision. It is an alternative, in part, to a selective system of scaling back benefits in the less meritorious cases as was proposed in the 1980 budget by President Carter.

In the longer run, I would like to see the transition cost of new benefit scales financed by a VAT. Ideally the current payroll tax should also be increased at the same time, and it should be used to generate some reserve financing; but this is not crucial. It would be feasible to enact a long transition increase in payroll tax with the extra cost of full, immediate extension of benefits being paid by a VAT.