817

March 15, 1991

THE FACTS ABOUT CUTTING SOCIAL SECURITY TAXES

Daniel J. Mitchell
John M. Olin Fellow

INTRODUCTION

Last year's record increases in federal spending and taxes, along with the imposition of expensive new regulations, have plunged the American economy into a recession. The return of Washington politicians to the failed policies of the 1970s has caused inflation and unemployment to climb, family incomes to fall, and has put America's economic future in doubt.

To spur economic growth and bring back the prosperity of the Reagan years, policy makers must undo the damage caused by Congress and the Bush Administration. A prompt reduction in Social Security payroll taxes would be an important first step in that direction. Lower Social Security taxes would spur economic growth by returning billions of dollars to workers, thereby offsetting partially the massive tax increase enacted last fall. Workers would receive an immediate increase in their take-home pay.

Million New Jobs. Further, since payroll taxes directly increase the cost of labor, lower Social Security taxes would create as many as one million new jobs – depending on how much the tax is reduced. In addition to creating these new jobs, businesses would be able to purchase additional new plant and equipment and increase rewards for investors with savings from lower labor costs.

Social Security taxes will take an estimated $329 billion out of the economy this year and the Social Security system will pay out $266 billion in benefits, according to the Congressional Budget Office. This will leave the Treasury with $63 billion in surplus Social Security revenues that are not needed to finance current retirement spending. Several pieces of legislation have been introduced to return part of this surplus to the American people. A bill (S. 11) introduced by Senators Daniel Patrick Moynihan, the New York Democrat, and Robert Kasten, the Wisconsin Republican, would lower the tax rates by one percentage point for both employer and employee. Meanwhile, Senator Malcolm Wallop, the Wyoming Republican, has sponsored economic growth legislation in the Senate (S.381), with a companion House bill (H.R. 960) cosponsored by Representatives Tom DeLay, the Texas Republican, and Robin Tallon, the South Carolina Democrat, which includes a similar reduction in the payroll tax rate.

Misleading Claims. As lawmakers debate this legislation, they will encounter claims that reducing Social Security taxes would have damaging effects on the retirement program and on the federal deficit. These claims are based on misunderstandings about the nature of Social Security, and policy makers should not be misled by them. Congress instead should take swift action on these bills, so that the payroll tax cut can begin to stimulate the economy and create new jobs.

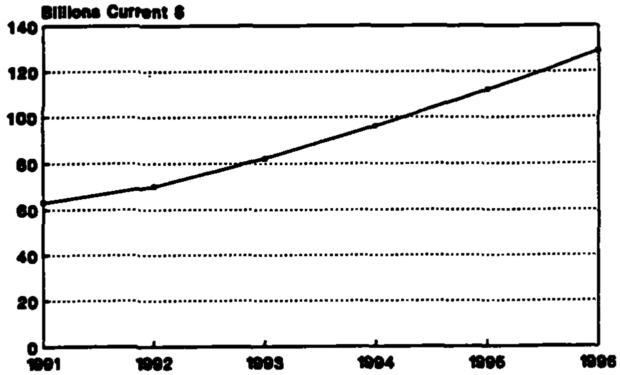
THE FAULTY CASE AGAINST CUTTING SOCIAL SECURITY TAXES

While the economic benefits of lowering Social Security taxes are clear, several lawmakers strongly oppose a cut. These lawmakers usually are unwilling to confess openly that they oppose the tax cut because they want to spend more of the taxpayers' money. Instead, they couch their opposition in false and misleading arguments about the effects of Social Security tax rate reduction. In considering a reduction in Social Security taxes, lawmakers thus must be careful not to be misled by these plausible but erroneous claims. Among them:

FICTION #1: A cutback in the payroll tax would undermine the Social Security system.

FACT: Excessively high payroll taxes currently are generating $63 billion more than is needed to pay retirement benefits. This annual surplus is expected to rise to more than $100 billion in just four years. Under current law, any annual surplus is turned over to the Treasury in exchange for federal government debt.

Projected Social Security Surplus



Source: Congressional Budget Office, *The Economic and Budget Outlook, FY 1992-1996*

Heritage DataChart

The Social Security system thus is being undermined by legislators who are spending surplus Social Security tax revenues on other government programs, leaving federal IOUs in the Social Security Trust Fund coffers. Reducing the payroll tax burden and returning to an honest pay-as-you-go system is the only feasible way to keep politicians from spending the surplus on other programs.

FICTION #2: A payroll tax cut would reduce retirement benefits and soon bankrupt the system.

FACT: There is more than enough Social Security tax revenue to pay full benefits. All the proposals to reduce the Social Security payroll tax burden are designed only to lower the annual surplus, not to create deficits. A smaller surplus will have no effect on current retirement benefits. Nor will lower payroll taxes have any effect on the size of future monthly retirement benefits, since each individual's Social Security payments are based on his earnings history and not on the amount of taxes paid.

Under the most commonly used assumptions about future economic performance, the Social Security Board of Trustees estimates that annual retirement benefits will begin to exceed annual Social Security tax revenues in 2017. Reducing the tax rate today, assuming no stimulative impact on the economy, would mean that the system would move into an operating deficit a few years earlier. But one of the main reasons to reduce the payroll tax now is to boost future economic performance to prolong the Social Security system's solvency. If the economy grows faster, and if more jobs are created, the system will be able to pay benefits longer without running into deficit.

Whatever changes are made today in payroll taxes, America will have to face the underlying imbalance in Social Security early next century when the baby boom retires and annual deficits begin. Difficult policy choices will be necessary before that time, regardless of whether annual deficits begin in 2015, 2017, or 2020. Maintaining unnecessarily high payroll taxes today, however, will only exacerbate the problem.

FICTION #3: The Social Security surplus is needed to accumulate reserves to finance the baby boom's retirement benefits.

FACT: The amount of IOUs collected in the Social Security Trust Fund has nothing to do with the actual financing of future retirement benefits. Opponents of payroll tax relief assert that today's large surpluses are required to build up the Trust Fund. But they fail to explain how these "reserves" of government bonds can be used to pay future benefits.

According to advocates of a big Trust Fund reserve, these government bonds can be cashed in when Social Security benefits begin to exceed payroll tax collections in approximately 25 years. This implies that spending cuts, tax increases, or more government borrowing will not be needed to ensure benefits are fully paid, as could be the case under a pay-as-you-go system.

Conveniently overlooked, however, is the question of where the government obtains the money to redeem the bonds. In fact, the only way that the government can provide funds to redeem Social Security IOUs is to cut spending, raise taxes, or increase borrowing. The IOUs are claims on government funds, not money ready to be passed out. In every meaningful sense, the current system is a pay-as-you-go system already – except that the payroll tax is unnecessarily high.

FICTION #4: Raising the amount of income subject to Social Security taxes would make the system "fairer" and help poorer Americans.

FACT: Turning Social Security into a welfare program will do nothing to help the poor. Under current law, Social Security taxes are paid on income up to $53,400, a figure that already is scheduled to increase to nearly $70,000 by 1996. Advocates of a higher limit on taxable income maintain that somehow the rich do not pay their "fair" share to Social Security. Yet, the reason for this "wage base cap" is that Social Security benefits are directly related to the amount of taxable earnings an individual has received during his working career. The only effect of increasing the wage base cap would be to increase future monthly retirement benefits for individuals earning high incomes today.

Increasing the amount of income subject to Social Security taxes thus will not increase retirement benefits for lower- or middle-income workers nor increase monthly benefits for current retirees. Some supporters of a cut in the Social Security tax rate do argue that the wage base cap should be raised in order to generate new tax revenues that could be used to offset the effect of the rate cut. The Moynihan legislation, for instance, increases the amount of income subject to Social Security taxes. This would be unwise and would reduce the economic stimulus of lower rates. In addition to turning the system into a welfare program, an increase in the wage base undermines one of the reasons for reducing the payroll tax in the first place: to avoid a huge surplus that politicians can, and currently do, spend on other government programs.

FICTION #5: Because of the budget deficit, taxes should be increased, not reduced.

FACT: Every single tax increase in recent history has resulted in higher, not lower, budget deficits. Deficit spending is at an all-time high this year because of last year's record tax increase. While simple math suggests lower taxes cause higher deficits and higher taxes lead to lower deficits, this approach completely fails to incorporate political and economic reality.

Politicians like higher taxes and fight tax cuts precisely because they want higher spending. Raising taxes makes more spending possible while reducing taxes puts downward pressure on spending. This helps explain why the deficit rose in the years following tax increases in 1982, 1984, 1987, 1989, and 1990.[1]

More taxes also lead to higher deficits because tax hikes slow economic growth. A weaker economy means lower payroll tax collections because fewer Americans are working, lower income tax collections because income levels fall, lower excise tax collections because people purchase less, and lower corporate income tax receipts because of depressed profits. The Congressional Budget Office estimated this January that tax revenues will be $206 billion lower over the 1991-1995 period compared to their estimate from last July because of a weaker economy.[2] This wipes out the alleged deficit reduction impact of the $170 billion tax hike enacted in October 1990.

FICTION #6: Reducing payroll taxes will lead to higher interest rates.

FACT: Critics maintain that a Social Security tax rollback will mean fewer funds for the Treasury, forcing the government to borrow more funds from private credit markets. This, it is alleged, will cause interest rates to increase. Yet even if a payroll tax reduction meant more government borrowing, there is no strong relationship between the size of the budget deficit and interest rates. Since higher taxes consistently have resulted in higher deficits, it is by no means clear that a reduction in payroll taxes will lead to an increase in

Table 1
Interest Rates and the Federal Deficit

Year	Prime Rate	Change	Deficit as % of GNP	Change
1981	18.87	–	2.6	–
1982	14.86	↓Down	4.1	↑ Up
1983	10.79	↓Down	6.3	↑ Up
1984	12.04	↑ Up	5.0	↓Down
1985	9.93	↓Down	5.4	↑ Up
1986	8.33	↓Down	5.3	↓Down
1987	8.21	↓Down	3.4	↓Down
1988	9.32	↑ Up	3.2	Down
1989	10.87	↑ Up	3.0	Down
1990	10.01	↓Down	4.1	↑ Up
1991*	9.50	↓Down	5.7	↑ Up

* Estimates

Source: *Budget of the United States Government, FY1992*, historical tables; Joint Economic Committee, *Economic Indicators*, January 1991.

[1] Daniel J. Mitchell, "Eleven Conditions for a Budget Summit," Heritage Foundation *Backgrounder* No. 779, July 23, 1990.

[2] Congressional Budget Office, *The Economic and Budget Outlook, 1992-1996*.

the budget deficit. The actual change in the deficit would depend on how much of a boost the tax cut gave to the economy and the degree to which lower taxes helped restrain the growth of federal spending.

Even assuming a payroll tax cut increases the deficit, interest rates will not necessarily climb. The contention that higher levels of government borrowing should lead to higher interest rates has never been proved. Scholarly studies have not found a strong relationship between deficits and interest rates, and a comparison of changes in the magnitude of the deficit and changes in interest rates shows that interest rates and the deficit actually moved in opposite directions eight out of the last ten years (See Table 1).

The deficit probably does have some effect on interest rates, but the effect is relatively small. American interest rates are affected by many factors that overwhelm the effect of the deficit, such as activity in world capital markets and changes in monetary policy. As a result, lower payroll taxes are unlikely to have any significant impact on interest rates, and any small change that might occur would be outweighed by the economic benefit of lower taxes.

FICTION #7: The Social Security surplus is better used for new spending programs than for a tax cut.

FACT: Politicians already are spending the surplus on other government programs. And the last thing America needs is more federal spending. Federal spending has jumped nearly $250 billion in just the last two years and now is consuming more than 25 percent of America's output, up nearly three percentage points since Ronald Reagan left office.

This does not mean, however, that special interests are satisfied or that politicians will not figure out a new way to spend money. Moreover, a change in the budget process rules has created a loophole that could lead to massive new spending. Last year some lawmakers charged that the Social Security surplus was "masking" the true size of the deficit and argued that taking the system off-budget was the only way to guarantee the surplus was actually saved to pay future benefits. Other policy makers pointed out that the true budget deficit — how much money the federal government is borrowing from private credit markets —should include all government spending and taxes, including Social Security. But many lawmakers worried this position would somehow be construed as "anti-elderly." As a result, Congress decided that Social Security should no longer counted in official deficit calculations.

Notwithstanding this cosmetic bookkeeping change, the system operates exactly the same way it did when it was part of the overall budget. Social Security taxes collected this year still are used to finance current retirement benefits and the annual surplus still is exchanged for government bonds, with the money spent on other government programs.

Because Social Security now is off-budget, however, the surplus officially no longer exists for purposes of calculating the deficit. So politicians have created the perfect ruse: They can increase spending without technically increasing the deficit if that spending occurs off-budget. The most attractive form of such spending might be new entitlements within the off-budget Social Security system itself. Because of the danger that legislators will use the Social Security surplus to further expand the size of government in this way, the real choice for policy makers may not in fact be between current law and a payroll tax cut. Instead, the choice may boil down to using the surplus either to "finance" a tax cut or allowing Congress to use it to increase federal spending.

FICTION #8: A Social Security payroll tax cut inevitably will cause other taxes to be increased.

FACT: No provision of last year's budget agreement or any other budget law requires that a payroll tax cut be offset by increases in other taxes. Nor is it likely that reducing the burden of payroll taxes would increase, beyond existing levels, the pressure to raise other taxes.

Some policy makers understandably are concerned that a debate over Social Security taxes will reignite the "tax fairness" issue and provide politicians an opportunity to introduce economically destructive "tax-the-rich" proposals. This indeed would be a serious threat to the economy. If some members of Congress however, want to set one segment of the population against another, there is nothing responsible lawmakers can do to stifle that debate. Rather than engaging in futile efforts to avoid the issue, pro-growth policy makers should present a positive agenda and ask the American people to choose what they feel is more important: growth or income re-distribution.

FICTION #9: Reducing the Social Security payroll tax burden will undermine the 1990 budget agreement.

FACT: Critics maintain that by undermining last year's budget agreement with a proposal to cut Social Security taxes, the door will be opened for other changes and fiscal responsibility will evaporate. But this is unlikely. Last year's agreement resulted in the largest single year increase in federal spending, the biggest first year tax increase, and the largest deficit in America's history. Moreover, it was a major cause of the first recession since 1979-1982. A budget agreement so fatally flawed should not be preserved.

Unfortunately, a payroll tax cut by itself will not reverse the huge spending increases built into the budget agreement. Nor will it remove the new regulatory burdens that helped push the economy into the recession. Lower Social Security taxes, however, will reduce a tax burden that is at an all time high. If enacted quickly, a payroll tax cut will help restore economic growth. In the long term, lower payroll taxes will increase the potential growth rate of the economy, helping to increase family incomes and boost living standards for all Americans.

FICTION #10:The current Social Security tax rates are not a burden.

FACT: Social Security tax rates have more than doubled in the last thirty years. The amount of income subject to the Social Security payroll tax has soared nearly 600 percent in the last twenty years alone (See Table 2). Actual Social Security tax collections, $116.7 billion as recently as 1980, are expected to exceed $300 billion this year.

The maximum level of tax any worker paid to Social Security, including the portion "paid" by the employer, was $288 in 1960. By 1970, it had climbed to $655.20, an increase of more than 127 percent. In 1980, the maximum tax liability jumped to $2,631.44, a 300 percent boost. By 1990, this figure had risen another 142 percent, with Social Security payroll taxes consuming as much as $6,361.20 of a worker's income. For 1991, the burden has climbed by another $261.

Table 2
The Growing Social Security Payroll Tax Burden

Year	% Tax Rate*	Income Subject to Tax ($)	Maximum Tax ($)
1950	3.0	3,000	90
1955	4.0	4,200	168
1960	6.0	4,800	288
1965**	7.2	4,800	348
1970	8.4	7,800	655
1975	9.9	14,100	1,396
1980	10.2	25,900	2,631
1985	11.4	39,600	4,514
1990	12.4	51,300	6,361
1991	12.4	53,400	6,622

* Combined employer/employee tax.
** Payroll taxes to finance Medicare began in 1966 and now consume and additional 2.9 percent of taxable income.
Source: *1990 Annual Report of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, The Board of Trustees.

The Social Security tax discourages employment and hampers job creation. The payroll tax is levied against the first dollar of income earned, so even workers who do not earn enough to pay income taxes must pay Social Security taxes. Because of the rising burden of payroll taxes, approximately 74 percent of workers pay more Social Security taxes than income taxes.

FICTION #11: A payroll tax cut will reduce the savings rate.

FACT: Reducing Social Security taxes will increase total savings. Allowing taxpayers to keep more of their income will lead them to increase their saving, not reduce it. Higher taxes reduce individual income and savings. Lower taxes, conversely, put money back in the pockets of taxpayers, some of which will be spent and some of which will be saved.

Proponents of high levels of taxation argue that a tax cut will increase the deficit. This, they claim, will mean more government borrowing and thus a reduction in the amount of savings available to be invested in the productive sector of the economy. To be sure, if government spending continues to grow as fast as it has in the first two years of the Bush Presidency, a payroll tax cut could result in a marginally higher deficit, but the solution to this problem is to control government spending, not to maintain unacceptably high levels of taxation.

FICTION #12: A payroll tax cut will be inflationary.

FACT: Monetary policy, not tax policy, determines inflation. Critics charged that Ronald Reagan's Economic Recovery Tax Act of 1981, which cut taxes, would increase inflation. But instead of climbing, inflation fell from 13 percent to 4 percent. Despite this clear refutation of the argument that lower taxes cause inflation, opponents of payroll tax relief are making the same argument today.

Inflation is caused when the Federal Reserve Board creates more money than the economic system requires for stable prices at a certain level of production. When too much money chases too few goods, prices in general are bid up to a higher level. Lowering the tax burden does not have this effect. Indeed, to the extent that lower taxes increase the production of goods and services, inflation may fall as a result of a tax cut, as it did after the Reagan tax cuts.

CONCLUSION

Policy makers have helped steer the economy into a recession by increasing government spending, taxes, and regulation. Hundreds of thousands of jobs already have been lost. Family incomes have stagnated and likely will decline this year. Equally disturbing is the long-term economic outlook. Government forecasters are predicting the economy's annual long-term growth rate will average only 2-3 percent. Anemic growth is unacceptable; America is capable of so much more.

Powerful Economic Stimulus. The only way to achieve that growth, however, is to remove the shackles excessive government imposes upon the economy. Lowering the Social Security payroll tax burden would allow Americans to keep more of their own money in their pockets and thus would be an important step toward this goal. Many lawmakers recognize that lowering the payroll tax would provide a powerful stimulus to the economy, but others are reluctant to support the move because they are unsure of the impact of such a cut on the Social Security system itself. The facts show that these reservations are misplaced.

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.