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UPCOMING SOCIAL SECURITY TAX HIKES CAN THREATEN RETIREMENT BENEFITS

INTRODUCTION

Thanks to Social Security legislation passed in 1977 and 1983, working Americans face payroll tax rate increases next year and in 1990. By 1990, the combined employer and employee payroll tax will be 15.3 percent. Yet the current combined 14.3 percent tax already is far too high. It destroys jobs, drives up labor costs, and imposes an unfair and untenable economic burden on workers, particularly those with lower incomes. America's international economic competitiveness is undermined as a result.

Some may argue that this is a price worth paying, for at least it ensures the solvency of Social Security a couple decades into the 21st century. If United States economic growth continues as projected under relatively cautious "intermediate" assumptions, then over the next twenty years the Social Security system as a whole will accumulate a healthy surplus in the program's trust funds.[1] This is because during this period the huge baby boom generation will be working and paying taxes, while the much smaller generation born during the low fertility years of the Great Depression and World War II will be in retirement drawing benefits.

Demographic Wind Shear. But these fat days for Social Security will be a financial calm in the eye of the storm. As the baby boomers begin retiring, Social Security will run into a demographic wind shear. Instead of paying into the system, the tens of millions of baby boomers will start drawing benefits. As the surplus quickly fades, the baby boomers' benefits will have to be paid by the relatively small generation born during the low fertility years since the mid-1960s, which will

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1. The term "trust fund" is really a misnomer, hiding some very creative accounting. There is in fact no actual fund or pool of money being set aside for Social Security. The money goes straight into general revenues, in return for Treasury bonds.

comprise most of the work force. Even including the 1988 and 1990 tax increases, under intermediate assumptions, the entire Social Security system will run short of funds by 2029. Payments to retired Americans will be running almost 50 percent greater than revenues by 2035.

To pay all promised benefits in that year would require raising total payroll tax rates to 23 percent. Under more pessimistic assumptions, which may in fact be more plausible over the long run because of fertility and life expectancy developments, the total payroll tax rate would have to jump to a crushing 35 percent by 2035.

$25 Billion Tax Hike. The planned payroll tax hikes for 1988 and 1990 will not solve the Social Security system's long-term problem. To the contrary, these hikes will clamp a heavy drag on U.S. economic activity, thus slowing the very growth necessary for the Social Security trust funds to build up reserves. These scheduled tax increases amount to a $25 billion per year tax hike by 1990, borne entirely by employment. This tax burden would reduce the creation of new jobs, particularly for low-skilled Americans, and could tip the whole economy into recession. The result: fulfillment of the pessimistic economic scenario under which the entire Social Security system runs short of funds soon after the turn of the century.

Since the 1988 and 1990 payroll tax increases will hurt, not aid, the long-term outlook for Social Security, the hikes must be canceled. Doing so will help America's international competitiveness, prevent the loss of jobs, and improve the chances for long-term economic growth. Canceling the scheduled tax hikes also will alleviate the rising payroll tax burdens on workers.

At the same time, stopping the tax hikes will not impede the Social Security system from paying its benefits for the next two or three decades. According to the Social Security Administration's own intermediate projections, the sustained economic growth made possible by eliminating these tax increases would yield sufficient tax revenue for payments to be made.

But without more fundamental reform, payroll taxes immediately thereafter would have to be raised, regardless of whether the 1988 and 1990 tax hikes became effective, to much higher levels than now scheduled, to pay all promised benefits to the baby boom generation. To make the cancellation of the 1988 and 1990 tax increases permanent and provide for actual payroll tax reduction, fundamental reforms must be adopted now to allow the baby boom generation to rely more on the private sector in their retirement years than on Social Security and Medicare.

THE INEXORABLE RISE OF PAYROLL TAXES

Every few years, Congress rushes to pass a law to "save" Social Security from insolvency. Each time the congressional solution consists almost entirely of raising tax rates. A few years after each effort, lawmakers find themselves confronting yet another Social Security solvency crisis. In 1977, for instance, Congress enacted a schedule of automatic payroll tax rate increases effective through 1990 to save Social

Security from bankruptcy. Automatic rate increases took effect in 1978, 1979, 1981, and 1982. It was clear by 1982, however, that the system faced another bankruptcy crisis. Amendments to Social Security passed in 1983 led to tax hikes in 1984, 1985, and 1986. Further payroll tax rate increases are scheduled for 1988 and 1990, boosting the total employee-employer payroll tax rate to 15.3 percent, up from 11.7 percent in 1977 and 14.3 percent today.

These increases impose an enormous payroll tax burden on U.S. workers. The maximum annual payroll tax for an individual worker, including both the employer and employee shares, is already over $6,200 and is projected to climb to $7,574 by 1990. For the great majority of workers, the combined employee and employer payroll tax is more than they pay in federal income taxes. For many lower paid workers, their share of the tax alone is far larger than the state and federal income taxes withheld from their paychecks. By FY 1990, the Social Security payroll tax is projected to collect $358 billion--eerily close to the $450.8 billion the Treasury will get from the individual income tax.

UNDERMINING COMPETITIVENESS AND DESTROYING JOBS

The payroll tax is a tax on employment. Thus at the margin, the tax discourages employers from hiring workers and discourages workers from accepting jobs. About this there is no dispute among respected economists. And because the payroll tax increases the general cost of U.S. labor, it reduces U.S. international competitiveness. Poor competitiveness means that American businesses lose sales to foreign firms and Americans lose jobs to foreign workers. The result: fewer jobs and reduced economic growth. And the higher the payroll tax, the greater the damage.

The burden of the tax is especially heavy on low-income Americans. A married worker with two children who this year earns $8,000, which is below the official poverty line for such a family, will pay $572 in Social Security payroll taxes. With the additional $572 paid by his or her employer, the total payroll tax burden for the worker will be $1,144. By 1990, this burden climbs to $1,224 for the same income. This severely limits employment opportunities for the unskilled and encourages welfare dependency.

For today's young workers of any income, moreover, the payroll tax is so high that, even if they were to receive all their promised Social Security benefits, they would be receiving below market returns (or effective interest rates) on the taxes paid into the program over their careers.[2] In other words, Social Security taxes have now climbed so high that they make the program a bad deal for today's young workers. For many of these workers, the Social Security return actually would be negative. Indeed, those who pay the most in taxes are destined to receive the most negative returns. The low returns expected for today's young workers contrast

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2. Peter J. Ferrara, *Social Security Rates of Return for Today's Young Workers* (Washington, D.C.: National Chamber Foundation, 1986); Peter J. Ferrara and John R. Lott, Jr., "Rates of Return Promised by Social Security to Today's Young Workers" in Ferrara, ed, *Social Security: Prospects for Real Reform* (Washington, D.C.: Cato Institute, 1985), chapter 1.

sharply with the happy experience of today's elderly, who in general receive an extremely high return in benefits on the much lower taxes paid over their careers.

THE FINANCIAL OUTLOOK OF SOCIAL SECURITY

Immediately after enactment of the emergency 1983 amendments designed to save Social Security from bankruptcy, the system was still in trouble, at least in the short term. Internal Social Security Administration documents recognized that, if another major recession occurred during the 1980s, then Social Security would face yet another financial crisis because falling payroll tax revenues would not cover the system's obligations.[3] Such a recession would have been consistent with the trends of the 1970s.

Only if the steady economic expansion of the Reagan years continues through this decade and into the 1990s will it be a relatively rosy time for Social Security. The huge baby boom generation will be entering its prime earning years, swelling Social Security tax payments. At the same time, the relatively small generation born during the low fertility years of the Great Depression and World War II will be entering retirement, claiming relatively small benefits from the system.

Reversing the Trends. These years will be the calm before the storm. Soon afterward, the trends reverse. As baby boomers retire, the demands on the Social Security system will soar. Paying for this will be the relatively small generation born during the low fertility years following the baby boom.

The official projections regarding Social Security's financial outlook reflect these trends. Under the most commonly used assumptions, technically called Alternative IIB by the Social Security Administration, Social Security under current law (with the 1988 and 1990 tax increases taking effect) is projected to accumulate substantial reserves in the 1990s. This would still be the case even if excess funds within Social Security were used to bail out the payroll tax-financed portion of Medicare (Hospital Insurance or HI), which is projected to run short of funds by 2002 under the same Alternative IIB assumptions.

Under Alternative IIB, the Social Security trust funds taken as a whole, including the HI trust fund, are expected to peak at about 21 percent of GNP in 2015. In today's terms, this would amount to about $900 billion.[4] Once the baby boom generation begins retiring, the trust fund reserves start to be consumed and

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3. Richard S. Foster, Deputy Chief Actuary, Social Security Administration, "Short-Range Financial Status of the Social Security Program Under the Social Security Amendments of 1983," Memorandum, April 6, 1983; see also Ferrara, *Social Security: Prospects for Real Reform*, pp. 49-58.

4. Calculated from Harry Ballantyne, Chief Actuary, Social Security Administration, "Long-Range Estimates of Social Security Trust Fund Operations in Dollars," Actuarial Note 127, April 1986; *1986 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*, Washington, D.C.. March 31, 1986 (hereinafter referred to as *1986 HI Trustees' Report.*) A trust fund of $900 billion today would still be only about 20 percent of the amount needed to fully fund Social Security and about half the amount held by private pensions and independent retirement accounts.

will be unable to pay promised benefits by 2029.[5] By 2035, according to Alternative IIB, the entire system's projected expenditures will be almost 50 percent greater than its revenue.[6]

Periodic Recessions. These Alternative IIB projections assume steady economic growth for the foreseeable future. The Alternative III projections offer a more pessimistic scenario. The assumptions under Alternative III more closely reflect the economic performance of the 1970s by anticipating periodic, major recessions.[7] Under these assumptions, Social Security develops only minor trust fund reserves in the mid-1990s after bailing out Medicare's HI, with the system as a whole running short of funds to pay promised benefits by 2007.[8] By 2035, the entire system's projected expenditures are more than 100 percent of projected revenues.[9]

Ironically, the 1988 and 1990 tax increases will themselves undermine the sustained economic growth assumed under the Social Security Administration's Alternative IIB projections by which a trust fund surplus will accumulate during the 1990s. These scheduled tax increases amount to a $25 billion per year tax hike by 1990 focused entirely on employment. This kind of increased tax burden could trigger the very recession that Alternative IIB assumes will not occur. This then would invalidate Alternative IIB and fulfill the gloomy projections of Alternative III under which the entire Social Security system runs short of funds soon after the start of the next century.

WHY THE PAYROLL TAX HIKES SHOULD BE CANCELED

Under the Alternative IIB assumptions, the 1988 and 1990 payroll tax rate increases could be eliminated without threatening the payment of benefits for the next 25 to 30 years. Canceling the scheduled tax hikes would avoid a further jump in U.S. labor costs that would impair U.S. global competitiveness and slow job creation. Even assuming that excess Social Security funds would be used to bail out Medicare's HI, the entire system still would have sufficient funds to pay promised benefits until about 2020--without need of the 1988 and 1990 tax hikes.[10] In this

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5. *Ibid.*

6. *Ibid.*; see also *1986 Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Washington, D.C., March 31, 1986 (hereinafter referred to as *1986 OASDI Trustees' Report*), Appendix E.

7. For a discussion of these alternative assumptions, see *1986 OASDI Trustees' Report*; Peter J. Ferrara, "For Social Security, the Crisis Continues," Heritage Foundation *Backgrounder* No. 467, November 4, 1985; Ferrara, *Social Security: Prospects for Real Reform*, pp. 49-56; Ferrara, *Social Security Rates of Return for Today's Young Workers*, pp. 19-21.

8. Calculated from the sources cited in footnote 4.

9. *Ibid.*; see also *1986 OASDI Trustees' Report*, Appendix E.

10. Calculated from the sources in footnote 4.

scenario, the Social Security trust funds, including HI, would peak at about 10 percent of GNP in 2010, the equivalent of about $440 billion today.[11]

A number of major policy changes, in fact, have been adopted in the past six years, which enhance and sustain steady economic growth and thus keep the Social Security system solvent. Marginal tax rates on income have been reduced dramatically, monetary policy has stabilized prices without undercutting economic growth, and many onerous regulatory burdens have been removed. If such pro-growth economic policies are maintained and if anti-growth policies such as scheduled payroll tax increases are avoided, then the expectation of more sustained, regular economic growth during the 1990s is reasonable.

Gloomy, Realistic Assumptions. But even under Alternative IIB assumptions, unless there is fundamental reform of Social Security, payroll taxes eventually would have to be raised to much higher levels than now scheduled in order to pay all promised benefits when the baby boom generation retires. Assuming no tax rate increases in 1988 and 1990, the total employee-employer payroll tax rate will have to be raised to 19 percent as early as 2021, and to 23 percent, by 2035.[12] Under the gloomier Alternative III assumptions, the total payroll tax rate would have to be raised to 35 percent by 2035.[13]

These Alternative III assumptions may be more realistic over the long run, when demographic factors will be most strongly felt. Alternative IIB assumes that fertility increases significantly and permanently from current levels, while the rate of increase in life expectancy slows.[14] Higher fertility means that there eventually will be more workers to pay taxes into the system, resulting in higher revenues, while a slower increase in life expectancy means that the elderly will not be living and collecting benefits as long, resulting in lower total benefit expenditures. Alternative III assumes that fertility stabilizes at a lower level and that life expectancy continues to increase steadily, which more closely reflects longstanding trends.[15]

TWO PROPOSALS TO ELIMINATE THE NEED FOR NEW TAXES

The only way to resolve the financial problems of Social Security and to avoid further payroll tax increases permanently is to continue pursuing policies that stimulate economic growth, while at the same time adopting fundamental reforms to encourage the baby boom generation to rely more on the private sector in retirement years than on Social Security and Medicare.

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11. *Ibid.*

12. See *1986 OASDI Trustees' Report*, Appendix E.

13. *Ibid.*

14. See the sources cited in footnote 7.

15. *Ibid.*

Legislation introduced by Representative French Slaughter, the Virginia Republican, for example, would allow workers and their employers to receive income tax credits for contributing to private savings and insurance accounts, which would substitute for part of their Medicare coverage in retirement.[16] This would help relieve the Medicare spending burden as workers turned to the private sector, reducing as well the need for future increases in the Medicare portion of the payroll tax. Indeed, the long-term Medicare financing gap could be eliminated entirely through this option, without cutting benefits or raising payroll taxes. The Slaughter plan has attracted over 40 co-sponsors, including liberals and conservatives, Democrats and Republicans.

The principle behind this proposal could be extended to other Social Security retirement benefits. Former Delaware governor Pete du Pont, for instance, proposes that workers and their employers be given income tax credits for their contributions to private savings and insurance accounts which would substitute for part of their Social Security benefits.[17] The du Pont Plan woud reduce the Social Security spending burden sufficiently to allow substantial reductions in payroll tax rates. Moreover, comparisons of Social Security with private savings plans indicate that today's young workers could expect to receive much higher returns and benefits through the private sector.

DECIPHERING THE TRUST FUNDS

The prospect of the Social Security trust funds accumulating surpluses is creating substantial confusion among lawmakers. What effect, for instance, will such a surplus have on the national debt? In anticipation of surpluses, many lawmakers already are thinking of ways to spend the money.

In truth, however, the money will not be available. This is because the ostensible trust funds are not trust funds at all. Revenues collected from Social Security payroll taxes are deposited into what are called Social Security trust funds. From there the money is used to pay the Social Security system's benefits. If revenues coming in exceed payments going out, a surplus in theory is created. But this surplus is not deposited in some fund earmarked for Social Security. Instead, the surplus cash is lent to the U.S. Treasury in return for specially issued, interest bearing bonds, and as long as there is no surplus in the entire federal budget, the funds are spent on other programs. (Social Security almost never buys existing government bonds on the open market. There is consequently no possibility that, as the trust funds grow, Social Security will end up buying most or all outstanding government bonds, as some have erroneously suggested.)

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16. For further discussion of this proposal see Representative D. French Slaughter, Jr. "Health Care Savings Accounts: A Plan for Self-Reliance," *Heritage Lectures* No. 59, Washington, D.C., June 10, 1986.

17. For further discussion of this proposal, see Peter J. Ferrara, "The Social Security System" in *Mandate for Leadership II* (Washington, D.C.: The Heritage Foundation, 1984).

No Cash Backing. The Social Security trust funds hold these government bonds until the Social Security system's revenues fall short of expenditures. Then the bonds are traded back to the Treasury for cash. The federal government holds no cash or other assets to back up these bonds. Thus when the Social Security system presents some of its bonds for redemption, the Treasury must raise the funds through increased taxes, reductions in other government expenditures, or increased borrowing. This means:

1) **There is no pool of cash** specifically belonging to the Social Security system.

2) **The Social Security trust funds** are not a cash reserve for the U.S. Treasury.

The Social Security trust funds already have been lent to the federal government and spent by it. The trust fund assets are simply paper claims against the U.S. Treasury, which have to be financed out of federal revenues or borrowing if they ever have to be cashed in to finance Social Security benefits. The dirty secret of the Social Security system is that its putative trust funds are nothing more than an internal federal bookkeeping entry indicating what one part of the federal government owes another part of the federal government. As a practical matter, the only real, substantive significance of the Social Security trust funds is that they are a statement of the legal authority which Social Security has to draw from general revenues in the future.

Overstating the Surplus. The total Social Security trust fund balance does not represent an offset to the national debt. This balance is in fact officially recognized as part of the gross national debt, and it is a potential addition to the net national debt held by the public to the extent it is ever cashed in to pay promised benefits. The national debt is only reduced when a surplus is run in the entire, unified, federal budget. Consequently, the projected growth in the Social Security trust funds does not indicate that the national debt will be reduced sharply from current levels or be paid off, as some lawmakers believe.

If one year's Social Security revenues exceed its expenses, the overall federal budget deficit for that year is reduced by the amount of the excess, just as when Social Security revenues fall below outlays, it increases the overall federal deficit for that year, regardless of the amount held by the trust funds. The potential reduction in the federal deficit from the annual surpluses in Social Security revenues over expenditures projected for the 1990s is often vastly overstated.

Analysts, for example, often fail to make the necessary adjustments to the Social Security annual surplus to calculate its impact on the overall federal deficit. Interest payments by the government on the Social Security trust fund bonds, payroll taxes paid by the federal government as an employer, and certain general revenue payments into Social Security must be subtracted from the annual surplus because these are expenditures by the federal government on one side of the ledger as well as receipts on the other. Consequently, they do not reduce the overall federal deficit.

Medicare Deficits. Miscalculations also are made by analysts who use nominal dollars when they talk about annual Social Security surpluses 30 or more years into the future. With inflation and real economic growth over time, a discussion in nominal dollars presents a grossly distorted picture of the annual surpluses. Expressing the surpluses as a percentage of GNP each year would provide a more valid statement of their true magnitude.

Finally, analysts often fail to subtract the annual Medicare HI deficits starting in the mid-1990s from the surpluses in the rest of Social Security. It is just sleight of hand to focus on surpluses in only one part of the trust fund system and ignore deficits in other parts.[18]

These factors reduce the annual surpluses in the Social Security system, including HI, under Alternative IIB assumptions to less than 1 percent of GNP throughout the Hurplus period starting in the 1990s.[19] Such annual surpluses would offset 10 to 15 percent of the federal deficit--assuming the red ink was about the same, as a percentage of GNP, as the deficits of recent years. While this would be a significant reduction, the annual Social Security surpluses do not hold the potential of eliminating continuing federal deficits, as some have suggested. Economic growth rates and federal spending patterns will be far more important as factors influencing the deficit.

Unrealistic Proposal. Misunderstanding the true nature of the Social Security trust funds has prompted proposals to "use" the trust fund "reserves" for various purposes. Such proposals mistakenly assume that the trust funds hold cash or other assets available for current use. One of the most unrealistic proposals is to invest the accumulating Social Security trust fund assets in the stock market to gain higher returns. To make such investments, the Social Security trust fund bonds would have to be sold back to the U.S. Treasury for cash. Treasury then would have to borrow this money to enable Social Security bureaucrats to speculate in the stock market.

A suggestion by former longtime Social Security Chief Actuary Robert Myers is to cut payroll taxes now but adopt an automatic trigger for payroll tax increases if the Social Security trust funds fall below a certain percentage of annual Social Security expenditures. This seems little more than a ploy to win enactment of the massive payroll tax increases that will be necessary to pay promised benefits to the baby boom generation and younger workers as things now stand. It could lead to total payroll tax rates of 23 percent to 35 percent of wages by the time today's young workers retire, an increase of 60 percent to 250 percent over current rates.

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18. For an example of an analysis that makes all three of these major errors, see Paul Blustein, "A Switch Back to Big Government," *The Wall Street Journal*, January 19, 1987, p. 1.

19. Calculated from the sources cited in footnote 4.

CONCLUSION

The U.S. economy cannot afford to suffer new blows as it attempts to become more competitive internationally. Nor can it afford job losses and reduced economic growth. Yet these would be the results of the Social Security payroll tax hikes scheduled for 1988 and 1990. At best, these new taxes would provide no more than temporary relief to a system that is plagued with structural financial problems. More likely, the hikes would reduce the moderate economic growth on which even the short-term health of the Social Security system depends.

To ensure continued U.S. economic growth, the creation of hundreds of thousands of new jobs, and the health of Social Security, the scheduled 1988 and 1990 tax hikes should be canceled. To give long-term financial stability to the Social Security system and to avoid permanently even larger payroll tax hikes, fundamental reforms are needed to allow the baby boom generation to rely more on the private sector for its retirement benefits than on Social Security and Medicare. Failure to take such action means that the Social Security system's problems will remain chronic and that today's young workers will face gloomy retirement prospects.

Prepared for The Heritage Foundation by
Peter J. Ferrara,
a Washington attorney,
formerly a member of the White House
Office of Policy Development