

Cato Institute Policy Analysis No. 129: Cut the Social Security Payroll Tax

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Executive Summary

Sen. Daniel Patrick Moynihan (D-N.Y.) has dropped a bomb into the fiscal debate with his recent proposal to reduce Social Security payroll taxes. The immediate support he has received from individuals and groups representing all shades of the political spectrum is well deserved testimony to the merit of his idea. Social Security taxes have skyrocketed in recent years. Tax increases signed into law by former presidents Jimmy Carter and Ronald Reagan raised the total combined employee/employer payroll tax rate by more than 30 percent, from 11.70 percent in 1977 to 15.30 percent today. Moynihan's legislation would immediately repeal the 0.28 percent tax rate increase that went into effect January 1, 1990, and reduce it further, to 13.10 percent, on January 1, 1991.

Sens. Robert W. Kasten, Jr. (R-Wis.) and Steven D. Symms (R-Idaho) have also introduced separate pieces of legislation that would provide payroll tax relief to working Americans. While the publicity is new, cutting payroll taxes is an idea that has been discussed for several years. Peter Ferrara, one of the nation's foremost experts on Social Security, urged a payroll tax reduction in *An American Vision*, published in January 1989. The Heritage Foundation has also been in favor of lowering the payroll tax for quite some time.

Opponents of lower payroll taxes have branded the idea as irresponsible. They assert that discussing tax cuts while the government is still running yearly deficits is wrong. Furthermore, they argue that a large tax cut would wreak havoc with the Balanced Budget and Emergency Deficit Reduction Act of 1985 (commonly known as Gramm-Rudman) and undermine the only legislation that has had a positive impact on controlling federal spending. Critics also attack the idea of returning to a "pay-as-you-go" basis for Social Security. To them, the main reason for the large tax increases contained in the 1983 Social Security Reform Amendments was to build a reserve in the Social Security Trust Fund that could be used to pay benefits when the baby-boom generation retires early next century. They may agree that high payroll taxes are a burden on the economy, but they believe a payroll tax cut would inevitably result in a reduction in Social Security benefits. Others worry that cutting Social Security taxes this year would simply set the stage for economically destructive tax increases next year.

Although some of those concerns are legitimate, the tangible benefits of lower payroll taxes strongly outweigh the potential drawbacks of the proposal.

The Social Security Tax Burden

Rapidly rising payroll taxes are a burden on the productive sector of our economy. Even more so than the income tax, the payroll tax is a direct tax on jobs. At current levels, the payroll tax drives a 15.30 percent wedge between the cost of an additional worker to a business and the take-home pay the worker receives. For some workers, that means less income to spend on housing, clothing, education, food, and other consumer goods. For others, however, especially those with few skills and limited job experience, it means unemployment. The 15.30 percent wedge may be enough to

price them out of the job market.

Unlike income taxes, payroll taxes are levied on the first dollar of income. The government extracts 15.30 percent of every dollar of income up to \$51,300. (Since there is a relationship, however loose, between taxes paid and benefits received, there is a cap on both the amount of taxes one must pay and the retirement benefits one can receive.) For a worker making \$51,300 or more, the total payroll tax this year will be more than \$7,800, theoretically split between employer and employee. Total payroll taxes now exceed income taxes for nearly three-quarters of the workforce.

The division of payroll taxes between the employer and the worker is essentially an accounting gimmick designed to hide the true burden of payroll taxes from the individual taxpayer. The average employee is usually unaware that his employer is paying additional payroll taxes above and beyond the amount he sees deducted from his paycheck. Since the direct cost of an employee to a business includes wages, fringe benefits, and total taxes, a worker will not be hired unless the firm expects that his output will be at least equal to his direct cost. As a result, although half of the payroll tax is directly paid by the business, the full 15.30 percent is a tax on the employee's income (as Congress unofficially acknowledged when legislators raised payroll taxes for self-employed individuals to equal the combined employee/employer total of 15.30 percent).

Social Security Taxes Are Too High

The increasing burden of Social Security taxes is dramatically illustrated by the growth in Social Security tax receipts. As recently as 1977, total payroll tax receipts for Old-Age, Survivors, Disability, and Hospital Insurance amounted to \$106.5 billion. This year payroll tax collections are projected to total \$385.4 billion, nearly four times the level of just 13 years ago. Some growth in payroll tax revenue was the natural result of a growing economy; the 20 million new jobs generated by the current economic expansion have swelled the government's coffers.

Much of the increase in payroll tax revenues, however, is the result of deliberate tax increases by the federal government. There are three major ways the government can increase payroll receipts, and all three have been used since the Social Security system was created. The most obvious way to increase revenue is to increase the tax rate. Figure 1 illustrates the dramatic climb in the payroll tax rate since the Social Security system was created in the 1930s.

As Figure 1 indicates, payroll tax rates have increased approximately every other year since 1966, including seven times in the "tax-cutting" 1980s. The current level of 15.30 percent is more than double the level that was in effect less than 25 years ago.

The government increases payroll tax revenue in other ways as well. Increasing the cap on income subject to the tax can raise significant amounts of money. As recently as 1977, payroll taxes were assessed against only the first \$16,500 of income. Just 13 years later, however, payroll taxes are levied on the first \$51,300 of income, more than three times the 1977 level.

Figure 1 Payroll Tax Rates

Source: Board of Trustees of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund, Annual Report, 1989.
(Graph Omitted)

The final method the government uses to increase payroll tax revenue is to tax previously exempt forms of income. A recent increase of that type occurred when the law was changed to make the income of federal judges subject to the payroll tax. The amount of money that can be generated from that type of change in the future is quite limited compared with the amounts that can be raised by increasing tax rates or the maximum level of taxable income. The inclusion of employees of state and local governments as well as employees of nonprofit organizations in the 1980s brought the last significant sources of tax revenue into the government's social insurance net.

Payroll Taxes Have Become a Prominent Source of Tax Revenue

Another way of demonstrating the dramatic rise in payroll taxes is to examine how payroll taxes have increased as a percentage of total government tax receipts. For much of America's history, the bulk of government revenues came

from excise taxes and customs duties, mostly because income taxes were not a permanent part of the tax structure until the Sixteenth Amendment was ratified in 1913. Payroll taxes, of course, were trivial or nonexistent until the Social Security system was created in the 1930s.

In the 10-year period between 1945 and 1955, social insurance taxes (primarily Social Security but also other items, the largest of which was unemployment insurance taxes) averaged 9.48 percent of total government receipts. Between 1955 and 1965, that figure rose to 15.44 percent, and between 1965 and 1975, it climbed further to 23.3 percent. Between 1975 and 1985, social insurance taxes climbed to 31.48 percent of tax revenue, and in the last five years, social insurance taxes have risen to an all-time high of 36.53 percent of total tax revenue (see Figure 2).

Figure 2

Social Insurance Taxes as a Percentage of Receipts

Source: Based on Budget of the United States Government, FY 1991, historical tables.

(Graph Omitted)

Recognizing that social insurance taxes have climbed as a percentage of total tax revenue, of course, says little about the solution, if any, to that shift. Some would suggest that payroll taxes are not a significant issue and that the real problem is that corporate and personal income taxes have been allowed to decline as a percentage of total revenue, primarily because of the 1981 Economic Recovery Tax Act. The latter assertion is factually and analytically wrong. Personal income tax collections have stayed fairly constant, while corporate income tax collections have fallen as a percentage of total tax collections, as have excise taxes. That does not suggest, however, that the answer is higher excise and corporate taxes. The real problem is the rise in the overall tax burden, as measured by both actual tax collections and tax collections as a percentage of gross national product.

Total Taxation at Record High

Notwithstanding a public perception that President Reagan cut taxes, total federal tax collections as a percentage of GNP during the 1980s were the highest in U.S. history, averaging 19 percent of GNP. Much of that increase was due to greater payroll taxes, which, as is shown in Figure 3, have climbed steadily since World War II.

Figure 3

Social Insurance Taxes as a Percentage of GNP

Source: Based on Budget of the United States Government, FY 1991, historical tables.

(Graph Omitted)

Some would argue that the increase in payroll taxes was necessary to fund the rising level of benefits and that any talk of cutting the payroll tax is irresponsible. Although payroll tax revenues are used to fund Social Security and Medicare spending, and Social Security and Medicare spending have been two of the fastest growing parts of the budget, revenues from payroll taxes have grown even faster, which raises the issue of how to dispose of the "surplus." If the revenues flowing into the system were less than, equal to, or only slightly greater than the outlays, there would be an argument against reducing payroll taxes without a commensurate reduction in annual benefit increases.

That is not a relevant issue, however. Annual Social Security tax collections (OASDI) are considerably higher than needed to fund annual outlays. This year alone, the trust fund into which OASDI tax moneys flow will amass about \$65 billion more in revenues than will be expended. That \$65 billion "surplus" will rise to approximately \$100 billion in 1993 and to more than \$100 billion for several years thereafter.

Lower Payroll Taxes Would Spur Economic Growth

The Social Security surplus, as it is popularly known, offers a unique opportunity to lower the burden of payroll taxes. A reduction in payroll taxes would inevitably result in a stronger economy and creation of more jobs. Those are the major benefits of the Moynihan proposal or any other legislation to reduce Social Security taxes.

Predicting the exact magnitude of the economic growth associated with lower payroll taxes is difficult since there are many other factors--interest rates, other taxes, the level of regulation, and trade policy, to name but a few-- that also

affect economic growth. Scholarly studies differ on the burden payroll taxes impose upon the economy, but it is clear that higher taxes, all other things being equal, mean a weaker economy.

According to Aldona and Gary Robbins, both of whom served in the Treasury Department and are among the nation's leading experts on the economic effects of payroll taxes, the combined 1.0 percent increase in the payroll tax rate in 1988 and 1990 will cost workers one-half million jobs, reduce GNP by \$320 billion by the year 2000, and reduce the nation's capital stock by \$100 billion over the same period.[1]

If a 1.0 percent increase in the payroll tax rate can be expected to cost 500,000 jobs, what would be the economic impact of a payroll tax reduction of the magnitude Moynihan proposes? According to the model developed by the Robbinses, a 2.2 percent reduction in the payroll tax rate would lead to the creation of more than 1 million additional jobs. As employers hired additional workers and expanded their output of goods and services proportionately, the nation's GNP would grow by about \$35 billion more than it would otherwise, adding more than one-half of 1 percent to the economy's growth next year.

The Social Security Surplus Does Not Mask the True Size of the Deficit

The current debate over reducing payroll taxes has its origins in the growing perception that the Social Security surplus is being used to mask the true size of the deficit. Indeed, Senator Moynihan was just one of several senators who introduced legislation in the first session of the 101st Congress to remove Social Security from the budget calculations. Supporters of taking Social Security off-budget argue that the system's annual surpluses are being used to fund spending in what is called the "operating budget." The reason surplus Social Security revenues should not be included in the operating budget, according to proponents of the proposed legislation, is that those revenues are supposed to be saved to pay benefits to future retirees.

Unified Budget Is Proper Way to Measure Deficit

Economists and budget experts generally agree that Social Security revenues and outlays should be included when calculating the budget deficit. In other words, the fact that Social Security revenues exceed Social Security outlays really does mean that the deficit is smaller. The "surplus" is not masking the true size of the deficit. The deficit is the amount of money the government borrows from private credit markets in a given year, period. If the deficit is to be measured accurately, total federal government spending, including Social Security outlays, should be subtracted from total federal government revenue, including Social Security revenues. Table 1 shows major sources of revenue and major spending categories for the current fiscal year.

Table 1 Estimated 1990 Spending and Revenue by Major Category	
Category	(\$ Billions)
Major revenue sources	
Individual income tax	491
Corporate income tax	107
Social insurance	389
Other (excise, inheritance, etc.)	85
Total revenues	1,071
Major outlay categories	
National defense	301
Domestic discretionary	204
Entitlements	587
Net interest	180
Offsetting receipts	-60

Total outlays	1,212
Total deficit	141

Source: Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1989.

That approach, traditionally known as the unified budget approach, presents the most accurate picture of the economic impact of the government's fiscal policy. Taking part of the government off-budget, whether it be the savings-and-loan bailout or the Social Security system, simply hides the truth from the American people and creates uncertainty in financial markets.

Social Security Trust Fund Is Not a Cash Reserve

A large number of people believe that taking Social Security off-budget would prevent politicians from spending the surplus on other government programs. Presumably, the money would be saved in the trust fund and be used to pay future retirement benefits. Taking the Social Security system off-budget, however, would not accomplish those goals. Since the Social Security system is required to purchase U.S. government debt from the Treasury if there is an annual surplus, the system does not build up a cash reserve. The trust fund reserve is effectively nothing more than a collection of IOUs.

The large and growing balance in the Social Security Trust Fund has been the source of considerable confusion. Reports that the trust fund will have a maximum balance of \$12 trillion in 40 years have led some to believe the fund is a pot of money that can be spent. First of all, that \$12 trillion is not "current" dollars. Adjusted for projections of future inflation, the maximum value of the trust fund will be \$2.8 trillion in today's dollars, not the \$12 trillion commonly cited. Table 2 compares the trust fund's year-end assets in current and constant (inflation-adjusted) dollars under the most commonly used set of economic assumptions.

Table 2		
Current and Constant Trust Fund Assets (\$ Billions)		
Year	Current Dollars	Constant Dollars
1989	168.3	168.3
1990	237.3	227.2
1991	314.2	287.9
1992	400.7	351.8
1993	498.4	420.0
1994	609.4	493.5
1995	733.6	571.5
1996	872.3	653.4
1997	1,025.5	738.6
1998	1,025.5	827.1
2000	1,581.8	1,012.9
2005	2,892.5	1,522.3
2010	4,815.6	2,083.1
2015	7,196.1	2,558.5
2020	9,575.6	2,798.3
2025	11,355.6	2,727.5
2030	11,929.8	2,355.2
2035	10,832.4	1,757.7

2040	7,641.8	1,019.2
2045	1,446.1	158.5
2046	--a	--a

Source: Board of Trustees of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund, Annual Report, 1989.

a The trust fund will be exhausted in 2046.

The fact that \$12 trillion shrinks to \$2.8 trillion in constant dollars is not the biggest reason for concern. Even more important, the \$2.8 trillion is not money in the bank. The trust fund's assets will be U.S. government bonds, or debt, issued by the Treasury Department. In order to spend any of that money, the trust fund will have to cash the bonds. The relevant question, of course, is where will the Treasury get the money to redeem the bonds? The money will have to come from either that year's tax revenue or additional government borrowing.

Legislators could also reduce the amount of bonds the trust fund needs to cash in future years by reducing retirement benefits. Regardless of which option future policymakers choose, future years' benefits will be paid for by revenues raised in future years. The Social Security taxes paid today will not prevent that from happening. The Social Security Trust Funds are nothing more than a statement of the legal authority Social Security has to draw funds from general revenues.

Allowing the Trust Funds to Invest in the Private Sector Is Not the Answer

Since requiring that the trust fund invest in government bonds does not provide real savings for the baby boom's retirement, some have proposed that the answer is to allow the trust fund to invest in the productive sector of the economy. They are partially right. If some, or all, of the money that is currently going into the Social Security system were instead invested privately, the increase in the nation's capital stock would create additional wealth and generate a flow of income that could provide for the retirement needs of the population. This is the principle by which people are able to invest for their own retirement, a by-product of which would be future economic growth.

It is highly unlikely, however, that the present trust fund could achieve that goal. To secure an adequate rate of return, the trust fund would need the freedom to make investments on the basis of expected profit. A system under the control of politicians, such as the Social Security Trust Fund, is unlikely to have that freedom. Proposals have already surfaced that would require the trust fund to invest in roads, education, infrastructure, environmental cleanup, bank bailouts, and other politically favored undertakings.

Those causes may or may not require additional financial resources. Whatever their merit, however, they are not investments that would yield a profitable rate of return to the trust fund. There would also be a danger that politicians would force the trust fund to invest in certain politically favored industries, creating a back door industrial policy under which political power, rather than market forces, determined what investments were made. Because of the sheer magnitude of the Social Security surpluses, the trust fund would eventually wind up owning a large portion of the private sector.

Proposals that would solve the problem of political control over private investment by giving individuals varying degrees of control over their retirement funds have also been made. Those proposals will be addressed later.

Proper Measures of Social Security and the Budget Deficit

Not everyone has greeted Senator Moynihan's tax cut proposal with enthusiasm. An important concern in the minds of many is the legislation's effect on the deficit. Although the bill would save taxpayers \$7 billion this calendar year and an additional \$55 billion next year, in the absence of other changes, the savings to taxpayers would be matched by higher deficits.[2]

Moynihan's legislation does not address the deficit issue. Since it is not expected that a payroll tax cut would be

matched by increases in other taxes (though that may be what the senator has in mind), reducing payroll taxes would mean higher deficits in the short run. That has led some budget analysts to oppose lower payroll taxes. They argue that progress has been made on the deficit and that we should concentrate on balancing the budget before considering new tax cuts. A tax cut, they believe, would send the wrong signal to financial markets and result in higher interest rates.

Although a temporarily higher deficit would almost certainly put some upward pressure on interest rates, that increase is not likely to be significant. Economic theory supports the assertion that a higher deficit will cause interest rates to be higher than they would otherwise be, but scholarly studies have not found any evidence of a significant correlation between lower deficits and lower interest rates. A comparison of interest rates and the deficit in the 1980s (Table 3) indicates that there is not a strong relationship between interest rates and the deficit.

Table 3

Interest Rates and the Deficit

Source: Budget of the United States, FY 1991, historical tables; Joint Economic Committee, Economic Indicators, January 1990.

As the numbers clearly indicate, interest rates and the deficit do not always move in the same direction. Indeed, they moved in opposite directions in six of the past eight years. That trend is mainly due to the fact that interest rates are primarily influenced by short-run monetary policy. Increasing deficits probably resulted in interest rates being higher than they otherwise would have been, but the effect of the deficit is overwhelmed by other factors.

A \$55 Billion Tax Cut Would Not Necessarily Undermine Deficit Reduction

Even if they agree that interest rates are influenced by other economic variables in addition to the deficit, critics of Senator Moynihan's legislation contend that the loss of \$55 billion of revenue in 1991 would be enough to force interest rates higher. They are probably right. The question is whether the economic benefits of lower taxes would be sufficient to more than balance the economic costs of temporarily higher interest rates.

One way of estimating the impact of a \$55 billion tax cut on interest rates is to assess what a tax cut of that size would do to the deficit. That assessment, however, requires that the calendar year revenue loss estimates (\$7 billion and \$55 billion for 1990 and 1991, respectively) be replaced with fiscal year estimates. As noted earlier, the fiscal year revenue loss from Senator Moynihan's legislation would be \$5 billion in 1990 and \$42 billion in 1991, according to the Congressional Budget Office. Assuming that the revenue projections are accurate, a \$42 billion tax cut would mean that the deficit would be that much higher than it would have otherwise been, assuming no dynamic effects.

The Gramm-Rudman target for 1991 is \$64 billion. Since the conventional wisdom suggests that Congress will not be able to produce a budget that meets that target (unless the president permits sequestration, Gramm-Rudman's automatic budget control mechanism), it may not be realistic to simply add \$42 billion and \$64 billion to arrive at an estimate for the 1991 budget if Moynihan's rate reduction passes. Under a more pessimistic scenario, assume that the actual deficit will be over \$100 billion and that a payroll tax cut would raise the deficit to approximately \$150 billion. What would that mean for interest rates?

Because GNP in 1991 is expected to be about \$6 trillion, interest rates will probably not be greatly affected. A \$150 billion deficit will only be about 2.5 percent of GNP that year, which will probably mean a slight increase compared with the deficit as a percentage of GNP in 1990, which is estimated at 2.3 percent. However, the deficit will be smaller, relative to the economy's size, than it was every year during the 1980s (Table 3).

Dynamic Effects of Tax Cut Would Generate Some Offsetting Revenues

Finally, the economic models used to estimate revenue gains and losses from changes in the tax code are unable to capture dynamic changes. Thus, while Senator Moynihan's legislation would "lose" \$42 billion under a static model that does not incorporate changes in incentives, the actual revenue loss is likely to be considerably less because of the supply-side effect.

As discussed above, reputable estimates indicate that a 2.2 percent reduction in the payroll tax rate would result in an additional 1 million jobs and a six-tenths of 1 percent increase in GNP. Since federal tax revenues are projected to total 19.5 percent of GNP in 1991, a significant increase in total GNP (representing an additional \$35 billion of output) would result in about \$7 billion of additional tax revenue. As a result, the total revenue loss to the government would probably be closer to \$35 billion than \$42 billion.

Gramm-Rudman Should be Preserved

Though the law has its critics, the Gramm-Rudman Deficit Reduction Act has been a success. The deficit was \$230 billion when Gramm-Rudman was enacted in 1985; just five years later it is only about half that level. In the five years before passage of the law, federal spending was increasing by an average of 9.9 percent annually. In the five years since Gramm-Rudman was enacted, annual spending growth has fallen to an average of about 4.5 percent. Government spending as a percentage of GNP, which rose in four of the five years before passage of the Gramm-Rudman Act, has fallen every year since its passage.

Some would argue that government spending slowed down for reasons other than Gramm-Rudman. Others believe Gramm-Rudman is responsible for the slowdown in federal spending growth and oppose the law because they favor more government. Even the law's most ardent supporters admit Gramm-Rudman is imperfect, but until something better comes along, it should remain part of the budget process.

A significant tax cut would almost certainly necessitate some alteration of the law's deficit targets. Fortunately, that should not be a difficult exercise. Simply stated, federal revenues are now increasing by more than \$80 billion annually. Gramm-Rudman requires that about half of that revenue be applied to deficit reduction with the rest going to increased spending, primarily for entitlements. Even after a significant tax cut, the basic structure of Gramm-Rudman can be preserved by modifying and extending the deficit targets.

That approach is unlikely to satisfy those who believe in eliminating the deficit as quickly as possible regardless of the alternatives. Many supporters of a payroll tax cut, however, believe that it would be acceptable if the new deficit targets required a balanced budget sometime between 1995 and 2000, depending on how much deficit reduction was required each year. Indeed, many in Congress have proposed moving Social Security off-budget, which would increase the reported deficit even more than the Moynihan payroll tax cut. They would then extend the Gramm-Rudman targets, requiring a balanced budget in the late 1990s. Congress could just as easily adopt the payroll tax cut and adjust the targets in a similar fashion.

The important goal is the preservation of Gramm-Rudman. Many of the economic benefits associated with lower payroll taxes will not be realized if politicians are permitted to simply substitute deficit spending for spending that has been financed by taxes. To maximize the economy's long-term performance, policymakers need to minimize the amount of resources the government extracts from the productive sector of the economy, whether through taxes or borrowing.

Comparing Economic Benefits of Unified Budget Surplus and Tax Cuts Is Not Realistic

Many opponents of lower payroll taxes not only wish to preserve the current target of balancing the budget in 1993, they would also like to mandate budget surplus targets beginning in 1994. The most commonly cited method for accomplishing that goal is to take Social Security off-budget and require that the deficit in the remaining portion of the budget be eliminated. The actual effect of such legislation would be a growing unified budget surplus.

Supporters of that approach argue that a unified budget surplus would increase the amount of savings available for private-sector investment, which would lead to an increase in future economic growth. The additional wealth and income that would result from more investment in the productive sector of the economy would then make it possible to meet the retirement needs of future generations without having to resort to excessive levels of taxation. That approach, they argue, not payroll tax cuts, is the key to a stronger economy.

How a budget surplus is to be achieved is an important but unanswered question. If it is accomplished by restraining the growth of federal spending, the economy will be in stronger shape than it is today. On the other hand, if a surplus

is achieved by increasing the tax burden, there is little chance that the economy will benefit. Regardless of how a surplus is achieved, however, the question remains whether it would be better to reduce taxes and run a balanced budget. If there were some way to guarantee that Congress would enact budgets with real surpluses (and without higher taxes), an approach presently favored by the Bush administration, the economic benefits would be significant. Whether or not the benefits of a budget surplus are greater or less than the benefits that would follow a tax cut is a matter over which reasonable people can disagree. In both cases, as long as the president maintains his no-tax-increase pledge and Gramm-Rudman continues to exist, government spending as a percentage of GNP should decline.

Comparing the economic benefits of tax cuts and budget surpluses, however, is a theoretical exercise with little practical value. Simply stated, given the various demands of special interest groups, Congress is unlikely to have the fiscal discipline needed to maintain continuous and growing budget surpluses. Even today, years before a budget surplus might exist, politicians regularly call for additional spending on programs they believe were "neglected" during the 1980s. Those incentives are unlikely to change in the near future. At no time in the last 60 years has Congress demonstrated a consistent capacity to use tax revenue to reduce the national debt.

As a result, it seems more prudent for Congress to enact a tax cut, balance the budget as required by the newly modified Gramm-Rudman deficit targets, and then examine how realistic it would be to run budget surpluses. If Congress is genuinely willing to exercise the restraint needed to achieve a surplus, a delay of a few years will not matter. However, if it turns out that Congress is not capable of running a budget surplus, taking the tax cut first will preclude politicians from spending the money.

Would Payroll Tax Relief Undermine the Social Security System?

Some representatives of the Bush administration have charged that a reduction in payroll taxes would threaten future retirement benefits. The basis for that claim is that a payroll tax cut would limit the build-up of reserves in the trust fund. Since those reserves will theoretically be the source of revenue from which future retirement benefits are paid, any reduction in the trust fund could mean the Social Security system will run out of money.

As explained previously, however, the so-called trust fund is not a cash reserve. The assets in the fund are government bonds. The only way those bonds can be used to pay benefits is by cashing them at the Treasury Department. Since the Treasury can only redeem the bonds by raising cash from some other source, the money to pay for future years' retirement benefits will have to come from taxpayers in those years. That is true regardless of the balance in the trust fund. The payroll tax cut in no way diminishes the government's ability to pay retirement benefits.

Indeed, a strong case can be made that the payroll tax cut might actually make it easier to pay future retirement benefits. We know that future benefit payments will be borne by future taxpayers. If the economy is strong, funding retirement benefits will not be as heavy a burden for future taxpayers as it will be if the economy is sluggish. Therefore, it is increasingly important that legislators adopt policies that will enhance and maximize long-term economic growth in order to strengthen the Social Security system.

Payroll Tax Reduction: Opportunity for Reform?

The evidence strongly supports a reduction in the payroll tax. Several Social Security experts, however, have raised the question of whether it would be best to combine a cut in the payroll tax rate with Social Security reform proposals that would increase the retirement security of America's workers. Those proposals, such as the one by Rep. John Porter (R-Ill.), generally would institute some form of alternative private savings plan whereby each individual taxpayer would be able to put his portion of the Social Security surplus into a nongovernmental retirement account. Individuals who chose that option would forgo a portion of future Social Security retirement benefits, but the interest income they would earn from their private savings accounts would more than offset the loss.

The advantage of such an approach is that individuals would be able to develop alternative sources of retirement income. The burden on taxpayers in general would be lowered, especially after the baby boom retired. Moreover, compared with the results of the present formula for determining how much is received in Social Security retirement benefits, money put into private retirement accounts would earn a much higher rate of return for today's young workers. Not only would individuals be better off with the private retirement account option, the economy as a whole

would benefit. Although some people assert that Social Security is a retirement savings plan, money paid into Social Security is not saved. It is instead spent on other government programs. Private retirement accounts, however, would unambiguously increase the pool of private savings in the economy.

Given the political volatility of the Social Security issue, policymakers will undoubtedly wish to examine their options carefully before proceeding. To the extent that their decisions are based on what is best for the economy and the retirement security of America's workers, legislators should consider some of the carefully researched alternative private savings proposals that have been developed. However, payroll taxes could be cut now and a private alternative to part of Social Security could be phased in at some point in the future.[3] That would probably be the most attractive option politically.

Conclusion

Senator Moynihan has performed a valuable service by focusing attention on the excessively high level of Social Security payroll taxes. Reducing the payroll tax burden would provide the economy a shot in the arm, and if combined with an adjustment of the Gramm-Rudman deficit targets, could be done without sacrificing long-term deficit reduction.

Despite the scare tactics that have been employed in opposition to Senator Moynihan's legislation, a Social Security tax cut would not threaten future retirement benefits. Returning to an explicit pay-as-you-go system (as opposed to the pay-as-you-go system we have now) would prevent the government from taxing the economy twice to pay for future benefits.

Finally, a payroll tax reduction gives policymakers a rare opportunity to explore the possibilities for reforming the Social Security system and creating alternative and more financially secure sources of retirement income for workers.

Footnotes

[1] Aldona Robbins and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Economic Report no. 39, Institute for Research on the Economics of Taxation, February 3, 1988.

[2] The commonly cited savings to taxpayers of \$7 billion for 1990 and \$55 billion for 1991 refer to calendar year savings. Since fiscal years begin on October 1 of the previous calendar year and end September 30, the taxpayer savings will be different. Translated into fiscal years, the government would collect about \$5 billion less revenue in 1990 and \$42 billion less revenue in 1991 under the Moynihan proposal.

[3] See Peter Ferrara, "Social Security: A New Compact between the Generations," in *An American Vision: Policies for the '90s*, ed. Edward H. Crane and David Boaz (Washington: Cato Institute, 1989).