



Tax Reform Converges Fortuitously with Social Security Modernization

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The president's proposal to modernize Social Security with "personal retirement accounts" has much in common with his effort to reform the tax code. So much, in fact, that it is hard to think about one without the other.

Personal accounts and tax reform both enable more Americans to gain that special freedom that comes with ownership. Tax reform stimulates the GDP (and stock market) growth that personal accounts need for maximum success. Personal accounts offset a double tax on wage income, and tax reform seeks to eliminate double taxation of all income. Both reforms help preserve retirement security for the future.

Because of too few workers and too many retirees, beginning in 2018 and continuing each year thereafter, FICA payroll tax receipts will fall short of covering the scheduled annual payments to retirees.

To make up for these continuing annual shortfalls, the government will have to start repaying the "debt" it owes to the trust fund for the trillions of dollars of payroll taxes it has in past years spent for other purposes.

By 2042, the cumulative shortfall will have used up the entire amount (plus interest) owed to the trust fund. At that point, with no more intragovernmental debt to cash in and with outflows continuing to exceed payroll tax inflows, the trust fund will be insolvent - unable to meet its obligations as they become due.

Hidden Taxes

Because the government has already spent the money borrowed from the trust fund, in order to repay it and thereby keep the trust fund afloat until 2042, the government must cut other spending, borrow more money in the public debt market, or raise taxes - in large amounts.

For example, income tax hikes designed to match the debt repayment schedule would start in 2018, quickly rise to \$500 billion per year and, by 2042, total more than \$7 trillion in today's dollars (or roughly twice that amount in future dollars devalued by predicted inflation).

The Ponzi scheme nature of traditional Social Security financing thus far has hidden from public view impending tax increases of very large proportions. It has also misled the American people about the taxes they are already paying.

Social Security "trust fund" mythology aside, the 6.2% OASDI payroll tax extracted from the wage income of working Americans is fundamentally no different from the income tax they also pay on that same wage income at progressive rates that currently range from 10% to 35%. The only real differences are that the payroll tax is imposed at a flat rate, applies only to the first \$90,000 of wages, and is concentrated on low- and middle-income people who work.

Something Of Their Own

There once was the mythology that our payroll taxes were going into a trust fund where they would be held for us until our old age and then paid back to us as a Social Security retirement annuity. Of course, as we all now know, that was not true.

The only thing in the trust fund is a stack of government IOUs to itself. Except for a two step bookkeeping transaction, payroll taxes go into the Treasury's general fund just like income taxes and are used to pay the overall costs of government, ranging from congressional salaries to national defense to annuities for current retirees.

When understood in this way, which is especially powerful from the perspective of younger earners, it is obvious that the president's personal retirement account proposal is primarily a young American's tax cut combined with a government-sponsored payroll savings plan.

People who opt into the personal account system will still have to pay the OASDI payroll tax - but they will, in fact, be buying something that is their own. They will have a portfolio, albeit small in the beginning, of stocks and securities that they can use for retirement or pass on to their heirs.

Outside the Beltway, Social Security and tax reform are different issues, more readily explained separately than together, and are likely to remain so while the president builds a grass-roots constituency for change that is sufficient to overcome congressional timidity.

But when the legislative battle actually gets going, it is almost inevitable that these two historic initiatives will converge in what promises to be a transformational debate about fundamentals, including the relative roles of markets and governments in bettering the human condition. And out of that debate there is likely to emerge a new social compact based on economic growth that enables more Americans to climb the ladder of success.

Personal retirement accounts are a good idea that will make Social Security both more secure for retirees and more transparent in accounting to the public for the amount of debt and taxes involved.

If America had had private accounts for the last 50 years or so, our government either would have had to run greater on-the-books deficits, openly raised taxes or held down spending. Everyone would have known what was going on, could have voted accordingly and there would not now be future "crises" in the form of potentially massive tax increases after 2018 and trust fund bankruptcy in 2043.

President Bush's personal retirement accounts do not alone eliminate either crisis. He has, however, taken the right step in the right direction. And to his everlasting credit, he has launched a national debate in which the Congress and the American people, reluctant though they both may be, must confront and solve the real problems of the "unfunded" and perhaps "unfundable" entitlement liabilities that haunt America's future.

Not only will the basic payroll tax soon fall trillions of dollars short of funding OASDI obligations, the additional 1.45% HI (hospital insurance) payroll tax paid by both employees and employers is already patently incapable of paying for the burgeoning costs of Medicare. By 2024 Medicare is projected to cost more than Social Security, but the separate HI trust fund is expected to remain solvent only until 2019.

Three Jobs

These and other gargantuan charges against the nation's resources have already been legislated and will, like mortgage payments, inexorably fall due unless Congress intervenes. But the costs are obviously far too large to be paid for by government taking an ever-increasing share of GDP in taxes. (Taxes that high would stifle the economy in a hurry.)

Therefore, at this point in history this Congress must do three things for the nation's future. It must modernize and secure Social Security; it must drastically slow the growth of middle-class entitlement spending; and it must reform the tax code in a way that accelerates GDP growth and maximizes personal savings for all Americans.

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