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## Social Security Reform (Part II)

*In Part I, we discussed Social Security's financial outlook. The ultimate problem is that when the baby boomers retire there simply will not be enough workers in relation to retirees to maintain the level of payments that Social Security's beneficiaries currently receive. We also discussed the implications of "privatization." Advocates hope that allowing workers to invest a portion of their payroll taxes in private savings accounts would allow the government eventually to reduce the guaranteed benefits that it has promised to pay future retirees under the current system. Problems abound with this idea, however. Among other things, it would create pressure for the government to influence the financial markets and to bail out individuals whose investments did poorly.*

*Here, we present our own proposal for Social Security reform.*

Social Security is an income transfer program, in which income is transferred from the current generation of workers to the current generation of retirees. Partial privatization would not eliminate this transfer. Workers would still pay large payroll taxes, and most of these taxes would still be used to pay benefits to the elderly.

Unless this income transfer is more widely recognized, efforts at reform are unlikely to address the real issues: what level of support do we want to guarantee to the elderly via transfers, what is to be the age and/or circumstance of those qualified for such support, how can we make such a system affordable, and what is the best way of financing it?

Should the government continue to operate a "pension plan" designed to provide substantial incomes (i.e., above a basic subsistence)? Should it continue to pay larger dollar benefits to relatively better-off retirees (i.e., those with histories of higher earnings)? Should it continue to rely on ever-higher payroll taxes to do so?

### *AIER's Proposal: Equalize Benefits, Repudiate Myths*

If the goal is to provide a basic level of subsistence to the elderly, Social Security's minimum payments are too low and the maximum benefits are excessive. We believe that the ultimate goal of a successful reform should be to make benefits equal for everyone.

To do this means scrapping the entire notion that the program bears any resemblance to savings or private insurance. This applies to both the revenue used to pay for the benefits as well as the benefits themselves. Beneficiaries, politicians, and reformers often say that benefits represent a return on the taxes one pays into the system. In economic terms, however, payroll taxes are just another source of Federal revenue, and benefits are just another Federal outlay.

Moving toward equal benefits for all Social Security recipients at a level that the productive members of society can afford cannot, in fairness, be accomplished quickly. Current retirees and those nearing retirement years have planned on specific levels of benefits that should not be markedly changed overnight.

How could benefits gradually be equalized? By changing the formula used to calculate them. Current recipients' benefits are based on their "PIA" (primary insurance amount), which is the monthly amount one would receive when retiring at the full retirement age *before* any adjustments for marital status, dependents, early retirement, etc. The PIA is calculated on the basis of your earnings history, indexed by changes in the national average wage. It is possible to calculate the PIA earned thus far by younger workers (in the same way that the benefits of disabled workers are calculated, based on their earnings history at the time of disability). One way to gradually equalize all PIAs would be to calculate all these amounts under current law as of a cutoff date. Thereafter, instead of computing increases in individuals' PIAs using the indexes of average wages and prices, they could all receive the same *dollar* increase.

This annual dollar increase could be computed in a variety of ways. One possibility would be to give everyone the same *dollar* cost-of-living adjustment, rather than the same *percentage* COLA.

The starting point might be the COLA given to individuals who get the maximum benefit payable to an individual under Supplementary Security Income (SSI), the general revenue-financed program for elderly and disabled Americans with no other income source. In 2005 this benefit is about $580 per month. Suppose that, to reflect any general increase in living standards, the annual increase in it were based on changes in the average wage. Under this regime, if the average wage rose 3.5 percent (reflecting, say, a 2.0 percent increase in the cost of living and a 1.5 percent increase in productivity), the increase in the maximum SSI benefit would be about $20 per month, raising the individual benefit from $580 to $600. This same dollar increase could be given to everyone owed Social Security benefits.

The experts and actuaries might conclude that some other arrangement would be preferable, but the objective should remain the same: to gradually decrease the purchasing power of the benefits of those entitled to high benefits under the current system, who have been and will continue to be those best able to provide for themselves, and to increase the purchasing power of the minimum payments that mainly go to the truly destitute. At some point, very few individuals would remain with benefits above the minimum. Eventually, everyone would get the same amount.

### *Abolish the Payroll Tax*

Our proposal should limit Social Security's future outlays. It would also eliminate vast amounts of bookkeeping

for employers and for the government itself, because, after the cutoff date, keeping track of earnings histories and Social Security tax payments would be unnecessary.

More significantly, if Social Security took its place as just another Federal spending program, there would be no need to maintain the fiction that it is a savings or insurance program "paid for by worker contributions," and the link to payroll taxes could be broken for good. If this were accomplished, the payroll tax could be examined on its own merits or, as we believe, lack thereof.

The payroll tax is regressive, i.e., poorer taxpayers pay a higher proportion of their incomes in payroll taxes. This is not only because there is a legal limit on earnings subject to the tax (currently $90,000) but also because property income (interest, rents, dividends) is not subject to Social Security taxes.

At its current level of 15.3 percent, the payroll tax is a significant barrier to employment. It is the largest part of the "wedge" between what it costs an employer to take on an employee and what that employee actually gets. Plant and equipment that can substitute for human labor are not subject to the payroll tax, nor, more to the point, is the capital used to finance them.

We believe that the appropriate course is to abolish the payroll tax. This would, of course, leave a gigantic void in Federal receipts. Something would be needed to replace it. Our candidate is a value-added tax.

### *A Value-Added Tax*

The value added by an enterprise is the difference between its revenues or sales and the cost of the goods and services purchased from other firms. A value-added tax (VAT) is essentially a sales or turnover tax, with the important difference that a specific enterprise gets, in effect, a credit for the taxes paid by its suppliers. This means that the tax base of a VAT includes the same base as payroll taxes (compensation of employees) *and* whatever is left over after suppliers and vendors have been paid, which is the return to capital (interest and profits).

A long-standing objection to a VAT is that it is regressive. Our suggestion is to replace one regressive tax with another. However, a VAT is a proportional (neither regressive nor progressive) tax on consumption: it is regressive only to the extent that lower-income people consume a higher proportion of their incomes. Savings are not taxed. If a family with an income of $20,000 somehow saved $1,000 in a year, the value-added tax on their consumption of $19,000 would be a lower proportion of their income than it would for a family with an income of $200,000 that spent it all. The current payroll tax claims a higher proportion of the income of the $20,000 per year family than it does from the $200,000 family, no matter what either family does with the money.

Because it is simple, and because enterprises have a strong incentive to declare their purchases from vendors, a VAT is comparatively easy to administer. Compliance and so-called "horizontal equity" (the principle that those in equal circumstances pay equal taxes) generally are better than for income taxes—there are far fewer gray areas subject to interpretation and dispute.

With the broadest base of any tax, the VAT is a very robust source of revenue. Thus it is with some trepidation that we suggest it. In some respects it makes about as much sense as, to quote a simile that P.J. O'Rourke used in another context, "giving whiskey and the car keys to teenage boys." We stress that we only advocate a VAT as a *replacement* for the payroll tax and, because it taxes income from capital as well as labor, *as a replacement for the corporate income tax* as well.

### *Abolish the Corporate Income Tax*

Congress imposed the corporate income tax four years before passage of the 16th Amendment to the Constitution permitting taxation of individual income. This reflects an early understanding that corporations do not pay taxes, they simply collect them on the Government's behalf. The notion at the time may have been that, with ownership of corporate equities concentrated among the wealthy, a corporate profits tax would fall disproportionately on the rich, and the tax may have been enacted as an "end run" around the constitutional prohibition on an income tax (Article I, Section 9 prohibited "a capitation or other direct tax, unless in proportion to the census.").

In any event, the corporate income tax was retained even after the 16th Amendment was ratified. Its significance for Federal revenues has varied greatly over the years. For some years during World War II it raised nearly half of Federal receipts, but after the war its share of revenue fell, and is now less than 10 percent of receipts.

The top *marginal* rate of Federal corporate profits taxation has varied from one percent (in 1909-1916) to 52.8 percent in 1968-1969. Many industries faced much higher rates on "excess profits" during World War II and the Korean War, as did many oil producers under the 1980-1991 "windfall profits tax." The current rate is 35 percent, but the decline in the significance of corporate profits taxes has not been simply a function of lower rates. The *effective* rate has usually been much lower than the marginal rate, because of various exemptions, credits, and methods of calculating profits (accelerated depreciation, in particular) designed to encourage corporations to behave in certain ways.

### *Who Pays*

To repeat, corporations are a way that people organize themselves – corporations do not pay taxes but collect them on behalf of the government. Although the corporate income tax may have been imposed in an attempt to tax the rich, the notion that profits taxes are paid by rich stockholders is questionable.

The evidence strongly suggests that profits taxes simply are shifted to and collected from customers in the aggregate and over the long term. The tax becomes another cost of doing business that becomes embedded in the selling price. The profits tax would thus appear to function as an equivalent to a sales or value-added tax. This is a major reason why profits taxes should be abolished if a VAT were levied.

However, unlike a straightforward VAT, the profits tax is capricious. It *will* affect the shareholders of a given firm, when that firm's profits fluctuate in the short term. For example, if the hula-hoop fad revives, a hula-hoop manufacturer's profits, and taxes, will soar. If profits subsequently become losses, say, because the new plant comes on line just as the fad ends, the firm may be able to claim a refund for taxes paid in prior years. Perhaps more significantly, a given corporation's taxes can vary enormously to the extent that it can use various loopholes ("tax incentives") that Congress has written into the law.

### *Political Mischief*

Thus the real mischief of a profits tax is that it enables politicians to grant favors. One reason why its effective rate has usually been far below the nominal rate has been that Congress often has permitted larger write-offs than are indicated by financial or economic accounting, thereby reducing taxable income and profits taxes. Moreover, Congress has allowed various tax credits and exclusions that further have reduced the tax. These have not been uniform over time or even across industries; some have been written so narrowly that they benefit only one company! Such "tax incentives" reflect a history of lobbying to obtain legislation favoring special interests. When campaign contributions are solicited, these interests no

doubt remember which politicians were "helpful."

Because the tax base would be enlarged, the VAT rate needed to replace the revenues now generated by the payroll tax and the corporate profits tax should be lower than the 15.3 percent payroll tax and much lower than the 35 percent nominal profits tax rate. A lower tax rate on capital and labor would reduce the employment disincentives of the current tax system. And because a VAT would not distinguish between the returns to equity and debt capital, it would remove the current system's bias in favor of debt financing.

Various transition rules no doubt would be needed to ensure the continuity of employees' take-home pay and employers' costs before and after the cutoff date. Other provisions would be needed to ensure that the value added of financial corporations, sole proprietorships, partnerships, nonprofit organizations, and governments (where the notions of revenues or sales and the nature of personal compensation can differ from nonfinancial corporations) would remain in the tax base.

### *Outlook*

Our long-time readers* may be aware that a tax on the site value of land is the only tax that we believe serves to facilitate rather than hinder the economic process. We make the above recommendation only because the best should not be the enemy of the good, i.e., a VAT would be better than what we now have, even if better alternatives can be imagined. In this regard, readers who object to our recommendations should rest assured that we rate as close to nil the chance that Congress would adopt them. Politicians of both parties have painted themselves into a corner on the question of curtailing benefits and have a huge vested interest in maintaining the myth that beneficiaries are "getting back" what they paid in. And given its decreasing contribution to Federal revenue, the corporate profits tax may exist mainly to keep the money flowing to "the best Congress money can buy."

The prospects for *any* meaningful reform of Social Security remain highly uncertain. Details of President Bush's plan remain sketchy, but he seems to be having trouble finding enough support for it even among Republicans. For politicians, the easiest way to solve a problem is to postpone dealing with it. However, a serious debate over the goals of Social Security and how we should pay for the program—the largest single component of the Federal budget and the largest social spending program in history—is long overdue. ❑

* We fully recognize that these may become fewer in number after they read these recommendations. Many of those now receiving Social Security checks may become especially alienated. As a fully independent research organization we have to call them as we see them.

## BEYOND MONEY-MARKET FUNDS*

*For those willing to take on slightly more risk than a money-market fund in order to receive a higher yield, there are a number of alternatives with limited potential for loss of principal in a rising rate environment.*

The average taxable money-market fund currently pays around 1.5 percent. This is better than the rates of less than one percent that prevailed on such funds during much of last year, but is still well below the historic norm.

Long-term bonds offer higher returns but carry a substantial risk that their value will decrease if interest rates continue to increase. There are other options, however, for investors looking to move out of money-market funds without significantly boosting their interest-rate risk. Short-term fixed-income securities that mature in one or two years, and mutual funds that invest in such securities, pay more than money-market funds but their prices will not be severely affected if interest rates continue to head higher. Other securities carry rates that are adjusted periodically to keep pace with prevailing rates. The options include certificates of deposit, short-term Treasury securities, and savings bonds.

### *Ultra-Short Bond Funds*

Ultra-short bond funds are less volatile than most other types of bond funds because they have very short durations that average one year or less, and some have durations that are significantly shorter. Duration takes into account a bond's cash flows from current interest payments, and is considered a far more accurate barometer of volatility due to interest rate changes than other measures, such as average maturity. You can multiply a fund's duration by a change in interest rates to get its price movement. Thus, a fund with a duration of one would lose one percent of its value if interest rates rose one percent, and two percent of its value if they rose two percent. Current yields are in the 2.5 percent range, about a percentage point higher than the average money-market fund.

Although most of the funds focus on high-quality corporate and government securities, a few drift into riskier bonds to help boost yields. To make sure a fund does not invest in lower-rated bonds, be sure to read the prospectus. Look for funds that invest in higher quality bonds and have low expense ratios of .60 percent or less, since these may offer higher yields without compromising credit quality.

Some fund managers have recently added tax-free ultra-short bond funds to their lineup. However, these may not necessarily be a better deal than the taxable version for investors who pay taxes on interest income at a Federal rate of 28 percent or less. Because the yield gap between taxable and tax-exempt securities is generally wider for bonds with short maturities than it is for longer-term bonds, investors usually need to be in a higher tax bracket to reap any benefit. Recently, a high-quality municipal note maturing in one year carried a yield that was about 70 percent of the yield available from a one-year Treasury bill.

### *Certificates of Deposit*

Currently, yields on CDs are significantly higher than money-market rates. The annual yield on three-month CDs averaged 2.61 percent in January (versus 1.06 percent a year ago). In early February, the average one-year CD paid 2.75 percent, and two- year CDs yielded 3.14 percent, according to a national survey of banks by bankrate.com.

At one time, CDs paid a fixed rate until maturity (with some penalty for early withdrawal) and you could only get them at a bank. Today, investors may choose among variable rate CDs, callable CDs, and CDs with other special features, and they are not always purchased directly from banks. "Brokered" CDs are sold through brokers, but they are issued by banks and are obligations of the banks. They generally have the features of bank CDs and are eligible for the same FDIC insurance as CDs purchased directly from banks (generally up to $100,000 for your total deposits at any one bank). The "CD trade confirmation" the broker is required to send will describe the availability of deposit insurance coverage, maturity, annual percentage yield, and other important considerations.

Regardless of whether you buy a CD

* This article is by Marla Brill, AIER Research Associate.

through a broker or a bank, be sure that you fully understand all its terms. Research any penalties for early withdrawal. If you need the funds on a CD purchased from a broker, the broker may have to sell your CD before maturity at a discount in the secondary market if interest rates have risen. Banks are not required to permit withdrawal of CD funds prior to maturity, and there are no strict guidelines governing the penalty a bank may impose.

Finally, keep in mind that some brokers have been using low rates of interest on CDs as a selling point for products with slightly higher yields and much higher commissions. For example, a startling number of ads in newspapers and on the Internet trumpet fixed-rate annuities as an alternative to low-yielding certificates of deposit to lure yield-starved investors. While annuities may be appropriate for some people, comparing them to CDs is misleading because they have different tax features, expenses, and withdrawal provisions. Annuities also are not covered by FDIC deposit insurance.

Despite these warnings, brokered CDs offer a number of advantages. Because brokerage firms work with banks from around the country, the certificates they sell often have a slightly higher rate of interest than you can get from a local bank. Unlike banks, securities brokers must provide an estimated market value of your CD, which reflects what you might receive if you sold your CD prior to maturity. This estimate appears on the same statement as other investment holdings, which can give you an idea of the certificate's value and help consolidate paperwork.

### *Short-Term Treasury Securities*

Treasury *bills* are short-term debt that matures in one year or less from the issue date. You buy them at a discount from their par (face) value, and when you redeem them for that par value, the difference between the two values represents your interest. Treasury *notes* pay a fixed rate of interest every six months, and mature in more than a year, but no more than ten years, from their issue date. In January, the yield on one-year Treasury bills averaged 2.86 percent and for two-year notes it was 3.22 percent.

Interest from Treasury securities is not subject to state taxes, and therefore should be compared with the *after-tax* yield on other fixed-income investments. Even if the Treasury's stated yield appears lower than other alternatives, it could be higher after taking state taxes into account. In California, which taxes interest income at a rate of 9.3 percent, a fully taxable certificate of deposit would have to yield 3.86 percent to equal a 3.5 percent yield on a Treasury note, which is exempt from the state tax. In Massachusetts, where the state tax rate is 5.3 percent, the CD would have to yield at least 3.7 percent to beat the Treasury note.

### *Savings Bonds*

Like other Treasury securities, savings bonds are not subject to state income taxes, and they also offer the opportunity to postpone Federal taxes, keep pace with rising rates, and sidestep state taxes on interest income. Series EE bonds are issued at half of the bond's face value, which may be anywhere from $50 to $10,000, and the difference between the original price and the redemption value is interest, which compounds semiannually. The rate of interest for bonds purchased today is 90 percent of the average five-year Treasury yield for the preceding six months, and the rate adjusts every six months. Newly-purchased Series EE bonds yield 3.25 percent. Although the increase in the bond's value can be reported annually for tax purposes, most people choose to pay income taxes when they cash their bonds.

In contrast to the EE bond, the I Bond is sold at face value. The interest calculation is based on a fixed rate of return established at the issue date and a price inflation rate, which changes semiannually. The combined fixed interest rate and inflation adjustment on I bonds is added to the value of the bond and, like the EE bond, does not have to be reported for tax purposes until redemption. The current rate for newly purchased I Bonds is 3.67 percent.

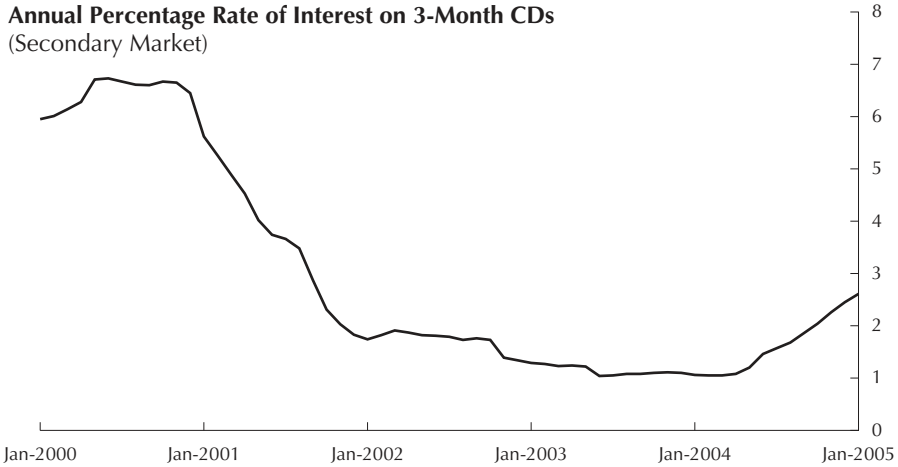
Both EE and I Bonds can be redeemed after one year, which makes them a viable short-term investment. However, a three-month interest penalty will apply to bonds redeemed during the first five years.

### *Staying Put*

For investors still on the fence about moving out of money-market funds, staying put for a while is a more palatable option than it was a year ago. At that time, some investors parked their cash in low-yielding money-market mutual funds or bank money-market deposit accounts because they expected rates to rise. Although the Federal Reserve raised the Federal funds rate five times in 2004, the first of those rate increases did not occur until June 30, when the average taxable money-market fund yielded a measly .50 percent.

This year, rates on taxable money-market funds could rise gradually because most analysts expect short-term interest rates to continue to increase. Such predictions are by no means certain, but they do conform to the Fed's pledge to raise interest rates at a "measured pace." If that occurs, investors this year can move into higher-yielding fixed-income securities gradually, while still earning a respectable yield on any amounts that remain in money-market funds. ❑

**Annual Percentage Rate of Interest on 3-Month CDs**
(Secondary Market)




Source: Federal Reserve Bank of St. Louis.

**PRICE OF GOLD**

| | *2003* | *2004* | *—— 2005 ——* | |
|---|---|---|---|---|
| | *Feb. 13* | *Feb. 12* | *Feb. 3* | *Feb. 10* |
| Final fixing in London | $352.80 | $411.60 | $419.80 | $415.50 |

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