DON'T REFORM IT, REPLACE IT
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Sunday,November 21, 2004
Edition: THIRD, Section: Op-Ed, Page K12

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After a long campaign season of spin, smear, and slogan, we're finally having a serious debate over domestic policy. President Bush has set the agenda - Social Security's privatization and tax reform. The president wants to cut Social Security's payroll tax and have workers invest their tax cut in stocks and bonds within private accounts. And he wants to replace the federal income tax with a tax on consumption.

Both proposals drive Democrats nuts. In their view, Social Security and the income tax are the only things keeping the elderly out of the poor house and the rich from gaining all the spoils. But Social Security is broke, and the income tax is a mess. So the Democrats must engage and stop treating these institutions like sacred cows.

In his quest to privatize Social Security, the president is poised to support one of three plans developed by his 2001 Commission to Strengthen Social Security. The plans differ in important ways, but each diverts payroll taxes to private accounts. Obviously, this limits Social Security's ability to meet its benefit obligations.

The trillion-dollar question is, thus, how to finance this tax cut, particularly given Social Security's dire financial position. As things now stand, Social Security doesn't need an immediate and permanent tax cut ranging, depending on the plan, from 16 to 33 percent. Instead, it needs an immediate and permanent 28 per cent tax hike to cover its short- and long-term benefit commitments.

One way to make up for the loss in revenue from privatization as well as cover the existing revenue shortfall is dramatically but gradually to cut Social Security benefits. Such cuts are part of each of the commission's plans. The commission's report uses artful language to hide this fact. But the proposed cuts are huge. The second plan, for example, indexes the initial receipt of retirement benefits to prices, rather than wages, as is currently the case. Over time, this means that Social Security benefits would replace an ever smaller share of workers' pre-tax wages. In the long run, Social Security would protect those in abject poverty, but that's it.

Because they cut long-run benefits so deeply, the plans are actually fiscally quite conservative. But in the short run, their adoption would significantly raise the already massive federal deficit. This could drive up interest rates and trigger a recession.

Another concern is transactions costs. On a per person basis, the proposed accounts are small. Indeed, they're so modest as to suggest that the commission's real goal is eliminating not just the existing Social Security system, but compulsory saving in general. Take a household with $50,000 in income. The maximum annual contribution under all three plans would be only 2 percent or $1,000. This is hardly worthwhile when you consider how much Wall Street will charge to "help" workers keep track of and manage this money.

Moreover, many workers won't properly invest their account balances and end up at retirement with little to show for years of contributing. Those workers who invest well will find themselves at the mercy of rapacious insurance companies when they try to convert their balances into retirement annuities (pensions).

Finally, the plans are generationally inequitable. Social Security has a $10.4 trillion unfunded liability, and well-heeled current and near-term retirees should be asked to help pay it. But the commission's plans force today's young and future generations to bear essentially the entire burden. The method is simple - eliminate most of their future Social Security benefits while maintaining most of their future Social Security taxes.

The president's second initiative, tax reform, has lots to recommend it. The income tax is enormously complex, engendering major compliance and collection costs. But fixing the income tax doesn't require shifting the tax base or reducing progressivity - the requirement that the rich pay proportionately more than the poor. We can and should keep the income tax, but also broaden its base and lower its rates, while maintaining the share of taxes paid by the rich.

Rather than substitute consumption for income taxation, I favor substituting consumption for payroll taxation. We should do this as one of nine steps needed to properly reform Social Security, albeit in ways that are very different from those the commission proposes. My plan, which has been endorsed by 150 of the nation's leading economists, is called the Personal Security System.

* Step 1 shuts down, at the margin, the retirement (Old Age Insurance, or OAI) portion of Social Security. Current retirees continue to receive their full retirement benefits, and current workers receive all the retirement benefits now owed to them, but that's it. There is no further accrual of Old Age benefits.

* Step 2 eliminates the employee FICA taxes (7.65 percentage points of the total 15.3 percentage point employer plus employee tax), directing these contributions to individual Personal Security accounts. The employer FICA contribution continues to finance Social Security disability, survivor, and Medicare benefits.

* Step 3 uses a roughly 10 percent federal retail sales tax to replace employee FICA taxes and pay off all accrued Old Age benefits. Over time, the sales tax rate falls as more and more of the accrued benefits are paid off.

* Step 4 has married workers split their contributions 50-50 with their spouses/legal partners leaving each with an equal sized Personal Security account. This protects dependents who are secondary earners.

* In step 5 the government matches the Personal Security contributions of low-income workers, making the new system as progressive as it wants. It also contributes on behalf of the disabled and the unemployed.

* Step 6 invests all Personal Security account balances in a global, market-weighted index fund of stocks, bonds, and real estate securities. "Market-weighted index" means buying assets in proportion to their share of the financial market. The allocation of the portfolio is thus determined solely by the marketplace, not the government.

* Step 7 limits the risk of market downturns by having the government guarantee that at retirement Personal Security balances will equal at least the sum of past contributions adjusted for inflation.

* In step 8, each participant's holdings of the global index fund is gradually sold off between ages 57 and 67. The proceeds from the sale are used to purchase inflation-protected annuities (pensions). These annuities are paid out beginning at age 62. Between ages 62 and 67, participants receive additional annuities based on the sale of remaining balances. Participants dying prior to age 67 bequeath their nonannuitized account balances.

* Step 9 has the Social Security Administration administer all Personal Security transactions at very low cost. It collects the contributions, manages the accounts, buys and sells the global index fund, and handles the annuitization of account balances at retirement. Wall Street plays no role and collects no fee. The Social Security trustees determine which foreign financial markets to include in the global index fund.

The most controversial aspect of the plan is switching from payroll to consumption taxation. But a moment's thought indicates that this is not only generationally equitable, but highly progressive. The payroll tax is levied only up to a fairly low ceiling, currently $87,900. Bill Gates pays his annual payroll taxes in minutes. But with a retail sales tax, Gates would pay taxes not only on all his earnings, but also on all his current wealth, the minute he spends these funds. Saving or bequeathing earnings or wealth postpones but doesn't avoid the tax. Whenever these funds are spent, they and any accumulated interest, are subject to the retail sales tax. Thus, taxing consumption is an indirect way to tax earnings and wealth.

How about the poor? Wouldn't they be hurt by having to pay higher prices due to the sales tax? The answer is no. In the case of the elderly poor, Social Security's cost of living adjustment would protect the real purchasing power of their benefits. The same would hold for the unemployed and welfare recipients provided their benefits are adjusted for the price rise. Poor workers would also be better off because the burden of the sales tax would be less than the burden of paying employee FICA taxes.

The Personal Security System pulls no punches. It entirely replaces a system that is broke and well beyond its prime. It asks everyone in society, except the poor, to contribute to paying off the old system's bills. And it sets up a new, safe, low cost, progressive, and efficient retirement system that Democrats as well as Republicans can call their own.