

Pair Tax Cuts with Social Security Reform



During his campaign for the presidency, George W. Bush proposed a general reduction of federal income tax rates and a partial privatization of Social Security. As president, Bush should continue to promote those two measures as a package rather than delay the necessary first steps toward replacing Social Security with a system of private retirement accounts.

The prospect of a large unified budget surplus over the next 10 years presents a rare opportunity to address several major

long-term problems of the federal budget. The most severe of those problems is the Social Security system: Current payroll tax rates will not be sufficient to pay the promised benefits once the baby-boom generation retires, and the rate of return on the payroll taxes of young workers is already far less than on alternative investments. Another major problem is the federal income tax code: The current structure of marginal tax rates, in combination with the numerous phase-out provisions and the payroll tax, substantially reduces economic growth, and the increasing complexity of the tax code is a national scandal.

There are two reasons for addressing those problems as a package—one substantive, one marketing. For any taxpayer, the effective marginal tax rate on earnings is the sum of the income tax rate and the payroll tax rate; for this reason, changes in the income tax rates should take into account the structure of the payroll taxes. Second, addressing income tax rate cuts and private retirement accounts as a package should reduce concern about the distribution of the benefits of those measures. Any reduction in income tax rates would most benefit those in the upper half of the income distribution, because they now pay more than 95 percent of federal income taxes. In contrast, allowing workers to set aside a part of their payroll tax in a private retirement account would most benefit lower-wage workers, who pay a substantial payroll tax and little or no income tax. Combining these two measures, thus, would lead to a

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broader distribution of benefits and should increase support for both proposals.

This is not the place to describe the details of a package of Social Security and tax reforms. My preferences, however, lead me to recommend that this package include the following major provisions:

1. Allow any worker to set aside 6.2 percentage points of the payroll tax in a private retirement account in exchange for forgoing all future Social Security pension benefits. (A minimum retirement income would be guaranteed through a public or private arrangement as part of the plan.) This offer would be especially attractive to younger, mostly lower-wage, workers.
2. Increase the upper limit on the 15 percent income tax bracket to include all earnings subject to the Social Security tax. This would benefit primarily middle-income families, especially those with two workers, and would effectively end the marriage penalty. For workers in this earnings range, the combined marginal tax rate (including the 15.3 percent payroll tax) would be 30.3 percent.
3. Reduce the top income tax rate to 28 percent. The direct benefits of this provision, of course, would accrue to higher-income taxpayers, but this provision would also have the largest positive effect on general economic growth. For workers in this earnings range, the combined marginal tax rate (including the 2.9 percent Medicare tax) would be 30.9 percent.
4. Finally, do not worry about tapping into the so-called Social Security surplus. There is no economic difference between the economic effects of the on-budget surplus and the Social Security surplus, and there is no reason to worry about reducing the Social Security surplus if the above measures lead to a larger reduction in the huge implicit debt to provide promised Social Security benefits.

Approval of this package would be the critical major step toward both a sustainable pension system and a flat-rate tax system. Good economics. Good politics. Seize the day!

—William A. Niskanen