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Collection/Office of Origin: Chief of Staff, White House Office of
Series: Sununu, John, Files
Subseries: Issues Files

OA/ID Number: 29171
Folder ID Number: 29171-006

Folder Title:
Social Security 1991

Stack:	Row:	Section:	Shelf:	Position:
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THE WHITE HOUSE
WASHINGTON

April 24, 1991

TO: CHIEF OF STAFF

FROM: PHILLIP D. BRADY
Assistant to the President and
Staff Secretary

FYI

April 24, 1991

Congressional Phone Calls

Bingaman and Breaux - yes

Bingaman - plan to support "tabling"

Breaux - why -- with you on this

Bryan and Dixon - thinking about it

Bryan - not taken a position - will think about it - have been with you

Dixon - mind not made up yet - will give it every consideration

Shelby - did not reach (l.w.)

Seymour - yes, if we need him

Specter - I think o.k. - will talk to Dole per phone call from the President

Vote on Moynihan
is at 12:30

Withdrawal/Redaction Sheet

(George Bush Library)

Document No. and Type	Subject/Title of Document	Date	Restriction	Class.
01. Memo	From Frederick McClure to POTUS, Re: Recommended Phone Calls (1 pp.)	4/24/91	P5	

Collection:

Record Group: Bush Presidential Records
Office: Chief of Staff, White House Office of
Series: Sununu, John, Files
Subseries: Issues Files
WHORM Cat.:
File Location: Social Security 1991

Open on Expiration of PRA
 (Document Follows)
 By JP (NLGB) on 4/21/08

Date Closed:	1/5/2005	OA/ID Number:	29171-006
FOIA/SYS Case #:	1998-0004-F[2]	Appeal Case #:	
Re-review Case #:	2005-0426-S	Appeal Disposition:	
P-2/P-5 Review Case #:		Disposition Date:	
AR Case #:		MR Case #:	
AR Disposition:		MR Disposition:	
AR Disposition Date:		MR Disposition Date:	

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P-1 National Security Classified Information [(a)(1) of the PRA]
 P-2 Relating to the appointment to Federal office [(a)(2) of the PRA]
 P-3 Release would violate a Federal statute [(a)(3) of the PRA]
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 P-6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Removed as a personal record misfile.

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THE WHITE HOUSE

WASHINGTON

91 APR 24 AM 9:40

RECOMMENDED TELEPHONE CALLS BY THE PRESIDENT

TO: SENATOR JOHN SEYMOUR (R-CA)
SENATOR ARLEN SPECTER (R-PA)

DATE: April 24, 1991

RECOMMENDED BY: Frederick D. McClure *fm*

PURPOSE: { To request that these Senators support the **motion to table** the Moynihan amendment to the First Concurrent Budget Resolution for Fiscal Year 1992.

BACKGROUND: { During Senate consideration of the First Concurrent Budget Resolution for Fiscal Year 1992 today a **motion to table** will be offered on the Moynihan amendment relating to the Social Security payroll tax.

{ This vote looks very close. Senator Moynihan has made his amendment more attractive to conservatives by deleting the wage cap increase. We believe Senator Specter is leaning against the motion to table and Senator Seymour is leaning in favor of the motion. If Moynihan is tabled today, we may be able to avoid a repeat of last year's "tax fairness" debate.

KEY POINTS: See Attachment.

DATE OF SUBMISSION: April 24, 1991

ACTION:

Specter
Seymour

① → called Casey, ask him to appoint Teresa

to interview → popular position on all sides to be for it - "support you if you need me" want Specter to vote other way.

Seymour

Seymour - want to be flexible every way to help. My problem - is purely political - on record vocally for Cap. Gurnea - I am will say want to try accommodate (will give in vote if needed)

Withdrawal/Redaction Sheet

(George Bush Library)

Document No. and Type	Subject/Title of Document	Date	Restriction	Class.
02a. Memo	From Frederick McClure to POTUS, Re Recommended Phone Calls (1 pp.)	4/23/91	P5	

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Open on Expiration of PRA
 (Document Follows)
 By JP (NLGB) on 10/28/05

Date Closed: 1/5/2005	OA/ID Number: 29171-006
FOIA/SYS Case #: 1998-0004-F[2]	Appeal Case #:
Re-review Case #: 2005-0426-S	Appeal Disposition:
P-2/P-5 Review Case #:	Disposition Date:
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THE WHITE HOUSE

WASHINGTON

91 APR 23 PM 7:00

RECOMMENDED TELEPHONE CALLS BY THE PRESIDENT

TO: SENATOR JEFF BINGAMAN (D-NM)
SENATOR JOHN BREAUX (D-LA)
SENATOR RICHARD BRYAN (D-NV)
SENATOR ALAN DIXON (D-IL)
SENATOR RICHARD SHELBY (D-AL)

DATE: April 23, 1991

RECOMMENDED BY: Frederick D. McClure *fm*

PURPOSE: To request that these Senators support the motion to table the Moynihan amendment to the First Concurrent Budget Resolution for Fiscal Year 1992.

BACKGROUND: During Senate consideration of the First Concurrent Budget Resolution for Fiscal Year 1992 on Wednesday a motion to table will be offered on the Moynihan amendment relating to the "firewall" protecting the Social Security Trust Fund. The budget negotiations last fall resulted in an agreement to separate Social Security from the Federal budget and a requirement of a super-majority vote to protect against efforts to deplete the trust fund. A loophole was slipped into the final budget legislation without the knowledge of those who made the agreement.

Senator Lloyd Bentsen (D-TX), Chairman of the Senate Finance Committee, is leading the effort on the Democrat side to protect this provision. He recommended that you call the Senators whose names are shown above. All of them are currently in the "undecided" or "leaning yes" (supporting the Administration position) category.

KEY POINTS: See Attachment.

DATE OF
SUBMISSION: April 23, 1991

Withdrawal/Redaction Sheet

(George Bush Library)

Document No. and Type	Subject/Title of Document	Date	Restriction	Class.
02b. Note	POTUS Handwritten note on Senators' Reactions (1 pp.)	n.d.	P -5	

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ACTION:

OK Bingaman plan to support "tabling" -

OK Breaux why with you on this 10 AM

Bryan not taken a position - will think 10:05
about it - have been with you. 10:10

Dixon mind not made up mind yet -
will give it every consideration

Shelby

*Social
Security*

THE WHITE HOUSE
Office of the Press Secretary

For Immediate Release

April 23, 1991

The President has sent identical letters to the following individuals:

The Honorable George J. Mitchell, Majority Leader, United States Senate

The Honorable Robert Dole, Republican Leader, United States Senate

#

THE WHITE HOUSE

WASHINGTON

April 23, 1991

Dear Bob:

Six months ago, the Administration and a bipartisan majority in the Congress agreed to separate Social Security from the Federal budget. The advocates of this action argued that this separation was necessary to help protect Social Security. To this end, we also agreed to implement a "firewall" procedure requiring a super-majority vote in the Senate to protect against efforts to deplete the Social Security trust fund balances.

It now appears that there is a Senate loophole in those procedures. It was slipped into last year's budget legislation without the knowledge or approval of many of those who participated in the budget summit. Recently, you and Senator Domenici introduced legislation to repair the Social Security "firewall." I support this legislation and urge the Senate to adopt it immediately.

It is my understanding that some may attempt to exploit this loophole during Senate consideration of the Congressional Budget Resolution. They may propose an amendment to clear the way for legislation to weaken the Social Security system. Senator Moynihan's proposal, for example, would return Social Security to the same financing scheme that drove the system to the brink of insolvency in 1982. His proposal would drain roughly \$23 billion from Social Security trust fund reserves in 1992 and \$170 billion by the end of 1996. Under pessimistic economic assumptions, adoption of this legislation could again threaten to bankrupt the Social Security system.

We rescued the Social Security system eight years ago on a bipartisan basis. When we did, we made a promise to every American who receives Social Security benefits, to those who support the system today, and to those who will rely on it when they retire. We have worked together to assure that today's benefits are protected and that the system will be strong enough to continue providing benefits to future retirees. I intend to assure that we keep our promise.

Sincerely,

/s/ George Bush

The Honorable Robert Dole
Republican Leader
United States Senate
Washington, D.C. 20510

DeLay/Tallon

H.R. 960

The Economic Growth and Jobs Creation Act

1. REDUCING THE COST OF LABOR

- **Cut the Social Security payroll tax to pay-as-you-go**
 - current law 12.4% (6.2% employee's share)
 - new rate 10.6% (5.3% employee's share) effective July 1, 1991
 - no increase in the wage base

2. REDUCING THE COST OF CAPITAL

- **Cut the capital gains rate**
 - top rate for individuals of 15% (7.5% for individuals in 15% tax bracket)
 - top rate for corporations of 15%
 - capital gains would be indexed for inflation
- **Adopt a neutral cost recovery system for capital investments**
 - depreciation schedules would be adjusted for inflation and allow a normal rate of return on invested principal

3. INCREASING NATIONAL SAVINGS

- **Create IRA-Plus Accounts**
 - allows contributions of \$2,000 per year, per spouse
 - increases to \$3,000 in 1995
 - contributions are not tax deductible
 - withdrawals of principal and interest are tax-free upon retirement
 - up to 25% of funds may be withdrawn tax-free to:
 - purchase first home
 - pay medical expenses
 - pay educational expenses

	1991	1992	1993	1994	1995	1996
CURRENT LAW						
PYRLL TX RATE	12.400%	12.400%	12.400%	12.400%	12.400%	12.400%
EMPLOYEE SHARE	6.200%	6.200%	6.200%	6.200%	6.200%	6.200%
SURPLUS (Billions)	\$63	\$73	\$80	\$91	\$102	\$115
MAX TXBL WAGE	\$53,400	\$55,800	\$59,100	\$62,400	\$65,700	\$69,300
TRST FND RATIO*	83%	100%	117%	135%	154%	173%
DELAY/TALLON	(July 1st)					
PYRLL TX RATE	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%
EMPLOYEE SHARE	5.30%	5.30%	5.30%	5.30%	5.30%	5.30%
SURPLUS (Billions)	\$39	\$18	\$18	\$21	\$23	\$26
MAX TXBL WAGE	\$53,400	\$55,800	\$59,100	\$62,400	\$65,700	\$69,300
TRST FND RATIO*	83%	91%	92%	92%	93%	95%
TAX SAVINGS						
PYRLL TX RATE	0.90%	1.80%	1.80%	1.80%	1.80%	1.80%
EMPLOYEE	0.45%	0.90%	0.90%	0.90%	0.90%	0.90%
MAX INDV TAX CUT	\$240	\$502	\$532	\$562	\$591	\$624
TTL TX CUT(Billions)	\$23	\$48	\$51	\$54	\$57	\$61

*Trust Fund balance at start of year as % of year's outlays.

BUDGET EFFECT OF THE DELAY/WALLOP BILL

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
OFF-BUDGET REVENUE LOSS							
SOC. SEC.	-9.7	-45.4	-49.5	-52.9	-56.4	-60.0	-273.9
ON-BUDGET REVENUE INCREASE							
INCOME TAX	1.0	4.5	5.0	5.3	5.6	6.0	27.4
ON-BUDGET OUTLAY DECREASE							
FED. EMP.							
SOC. SEC.	0.2	0.9	0.9	1.0	1.1	1.2	5.4
TTL ON-BDGT	1.2	5.4	5.9	6.3	6.8	7.2	32.8

*Figures are in billions for fiscal years as estimated by the Congressional Budget Office

ESTIMATE OF PRESIDENT'S BUDGET PROPOSAL FOR A
REDUCTION IN TAXES ON CAPITAL GAINS

We have now had the opportunity to study the President's proposal on capital gains in some detail. Although we still have some questions about some of the specifics of the proposal which I outline below, this memorandum provides you with our current estimate of the proposal.

The President's Proposal

The President's budget proposal would allow individuals an exclusion of 45 percent of the gain realized upon the disposition of qualified capital assets. Further, the maximum tax rate applicable to any gains on qualified assets would be 15 percent. The exclusion would not be a preference for purposes of the alternative minimum tax. Taxpayers with gain on qualified assets would be able to exclude 100 percent of the gain, if the taxpayer's adjusted gross income (calculated including 55 percent of the gain) is less than \$20,000 (\$10,000 for single taxpayers or married taxpayers filing separately). Taxpayers with an adjusted gross income less than \$20,000 but who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion.

Qualified capital assets generally would be capital assets as defined under present law other than depreciable, depletable, and amortizable property used in the taxpayer's trade or business. Collectibles would not be treated as qualified assets. The special section 1231 assets, i.e., certain interests in timber, coal, iron ore, livestock, and unharvested crops, would not be treated as qualified assets.

In addition, to be a qualified asset, the taxpayer must satisfy a holding period requirement. The asset must have been held for more than 12 months if the asset is sold in 1989, 1990, 1991, or 1992; for more than 24 months if the asset is sold in 1993 or 1994; and for more than 36 months if the asset is sold in any year after 1994.

The proposal would be effective for assets sold on or after July 1, 1989.

Estimated Revenue Effect

The table below provides our current revenue estimate of the President's proposal, subject to some qualifications which I discuss below.

The first line presents the revenue effect which would result from a 45 percent exclusion, with a maximum 15 percent rate, for capital gains regardless of asset type, and assuming a one-year holding period and an effective date of sales on or after January 1, 1989. This calculation is based on baseline realizations from CBO's January economic forecast¹ and includes our estimate of the revenue effect which would result from a tax-induced increase in realizations. Consistent with recent economic analysis of capital gain realization behavior, our estimate reflects a larger short-run than long-run behavioral response.

The second line presents the estimated revenue effect which would result from moving the effective date of this proposal from January 1, 1989, to July 1, 1989. The third line presents the estimated revenue effect which results from excluding collectibles and depreciable property from the proposal. The fourth line presents the revenue effect of the lengthening, on a phased-in basis, of the holding period. The fifth line estimates the effect of providing the additional 100 percent exclusion to those eligible taxpayers with adjusted gross income less than \$20,000.

Projected Revenue Effect (Billions of Dollars)

<u>Item</u>	<u>Fiscal Years</u>						
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1989-94</u>
1. 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	
2. Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	
3. Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	
4. 3-Year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	
5. Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	
Total Revenue Effect	0.7	3.3	-4.0	-6.4	-6.9	-10.9	-24.2

¹ The CBO baseline forecast differs from that made by OMB which forms the baseline for the Treasury estimate.

We have not estimated the revenue effect for years beyond 1994 because the CBO baseline does not extend beyond that date. If the baseline realizations were to continue to grow at the same rate as between 1989 and 1994, we would estimate that the proposal loses revenue in the years beyond 1994. However, the magnitude of the losses would not increase smoothly, as the table above might suggest, because of the effect of the phase-in of the lengthened holding period.

Qualifications to the Estimate

The President's proposal lacks details which could materially affect our estimated revenue effects. For example, our estimate of the President's proposal assumes the enactment of very strong rules to prevent gains on collectibles and depreciable property from qualifying for the exclusion. Such rules have not yet been fully specified by Treasury. We are concerned that both C and S corporate structures could be used in some circumstances to qualify collectibles and depreciable property for the exclusion. In the absence of effective rules preventing this behavior, we would estimate a greater revenue loss.

The President's proposal does not detail how it will interact with the kiddie tax (dependents age 13 or under) or how it will affect the taxation of income of other dependents. It may be possible for high income taxpayers to shift assets with accrued capital gains to their dependents whose adjusted gross income is less than \$10,000. Although our current estimate assumes very limited income shifting, substantial income shifting would increase the revenue loss.

The President's proposal does not specify certain aspects of the treatment that capital losses would receive. It is not clear whether a taxpayer will be permitted to deduct 50 or 100 percent of net long-term losses and whether the losses on collectibles will be unlimited or allowed to offset gains on qualified capital assets. For the purpose of this estimate we have assumed that the taxpayer is permitted to deduct 50 percent of net long-term losses and that losses on qualified assets must be netted against gains on qualified assets, while losses on non-qualified assets must be netted separately against gains on non-qualified assets.

The preceding discussion should not be construed as an exhaustive list of those areas which are unclear in the President's proposal. I included the above examples to suggest that our estimate of the revenue effects may change as the details are developed.

TO: MW

FROM: MH

RE: WALLOP-DELAY MEETING WITH THE WHITE HOUSE

*Maynick - Master } veto tax cut
Burger Rule } on heels of tax increase*

I talked to the White House staff this morning about your visit tomorrow to discuss your economic growth package with the President.

They had a general idea about your package, but it was only very general. They did not realize it had four parts:

- ☒ a. Payroll tax cut (from 12.4% to 10.6%).
- ☒ b. Reduction in Capital Gains Tax to 15% and inflation indexed.
- ☒ c. Neutral capital cost (depreciation) recovery tax schedule.
- ☒ d. IRA account revisions (the Roth plan).

The White House questions focused on the cost. I explained that we are using Treasury figures for capital gains (\$12.4 billion in new revenues over five years) not Joint Tax (\$11.7 billion in lost revenue over five years). Also, under the new budget rules (from the 1990 budget summit agreement), a reduction in Social Security taxes reduces the deficit -- so the payroll tax cut does not have to have a revenue offset. Reducing the Social Security tax will provide greater income to workers (and increased personal income taxes), and greater business taxable income (Social Security payments are deductible expenses) -- so tax revenue would increase because of greater collections from corporate and personal income taxes. Also, government interest payments to the Social Security fund would be reduced as a further budget savings.

So, the session tomorrow may be directed to the budget impact of your legislation -- judging from the questions from the White House today.



TAX FOUNDATION

Special Report

APRIL 1991

Tax Freedom Day 1991 Is May 8

State Tax Freedom Days Range from April 24 to May 26

by Paul G. Merski

"The residents of fifteen states and the District of Columbia will work past the nationwide Tax Freedom Day of May 8 before earning enough to pay their taxes."

The nation's Tax Freedom Day for 1991 falls on May 8. This latest ever date means the average American will work 128 days — from January 1 to May 8 — to satisfy all federal, state and

local tax obligations, with every cent "earned" from the beginning of the year going to the tax collectors.

While Tax Freedom Day nationwide is May 8, each state has its own specific Tax Freedom Day which falls earlier or later in the year depending on local tax and income circumstances.

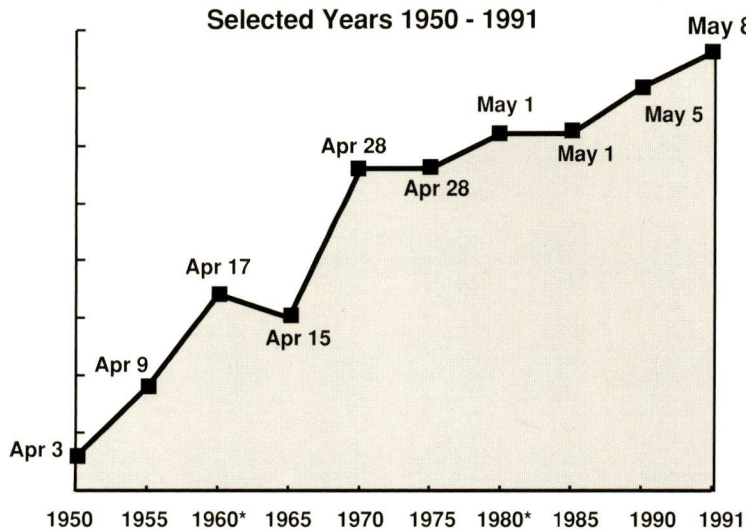
Table 1 presents Tax Freedom Day by state

Table 1
Tax Freedom Day By State
Calendar Year 1991

State	Tax Freedom Day	Number of Days	Rank
United States	May 8	128	-
Alabama	April 25	115	50
Alaska	May 11	131	10
Arizona	May 7	127	21
Arkansas	April 26	116	49
California	May 7	127	22
Colorado	May 2	122	38
Connecticut	May 17	137	4
Delaware	May 21	141	3
Dist. of Columbia	May 26	146	2
Florida	May 4	124	32
Georgia	May 3	123	35
Hawaii	May 16	136	5
Idaho	April 28	118	47
Illinois	May 9	129	16
Indiana	May 2	122	36
Iowa	May 7	127	23
Kansas	May 5	125	29
Kentucky	April 29	119	43
Louisiana	May 4	124	33
Maine	May 8	128	19
Maryland	May 11	131	12
Massachusetts	May 8	128	18
Michigan	May 12	132	8
Minnesota	May 14	134	6
Mississippi	April 24	114	51
Missouri	April 28	118	46
Montana	May 4	124	31
Nebraska	May 7	127	25
Nevada	May 8	128	17
New Hampshire	April 29	119	44
New Jersey	May 14	134	7
New Mexico	May 7	127	20
New York	May 26	146	1
North Carolina	May 3	123	34
North Dakota	May 6	126	27
Ohio	May 6	126	26
Oklahoma	May 2	122	37
Oregon	May 10	130	15
Pennsylvania	May 7	127	24
Rhode Island	May 12	132	9
South Carolina	May 1	121	41
South Dakota	April 28	118	48
Tennessee	April 29	119	45
Texas	May 5	125	30
Utah	May 1	121	40
Vermont	May 10	130	13
Virginia	May 2	122	39
Washington	May 10	130	14
West Virginia	May 1	121	42
Wisconsin	May 11	131	11
Wyoming	May 6	126	28

Source: Tax Foundation.

Figure 1
Tax Freedom Day
Selected Years 1950 - 1991



* Leap year causes the calendar date of Tax Freedom Day to appear one day earlier.
Source: Tax Foundation.

Paul Merski is Director of Fiscal Affairs at the Tax Foundation.

and rank. Tax Freedom Day estimates are calculated to represent "tax burdens" and should not be confused with tax collections. The tax burden is defined as total taxes as a percentage of total income for each state. The Tax Freedom Day by state methodology is designed to determine the geographic incidence of taxes.¹

Those Who Pay Taxes the Longest

The residents of fifteen states and the District of Columbia will work past the nationwide Tax Freedom Day of May 8 before earning enough to pay their taxes (see map on page 3). Tax Freedom Day arrives the latest in the following "top ten" taxpaying states:

Table 2
Tax Freedom Day by State
Total, Federal and State/Local Taxes
Calendar Year 1991

Total Taxes				Federal Taxes				State/Local Taxes			
	Number of Days	Tax Freedom Day	Rank		Number of Days	Tax Freedom Day	Rank		Number of Days	Tax Freedom Day	Rank
U.S. Total	128	May 8	-	U.S. Total	83	March 24	-	U.S. Total	45	February 14	-
Mississippi	114	April 24	51	Alaska	72	March 13	51	New Hampshire	33	February 2	51
Alabama	115	April 25	50	Mississippi	72	March 13	50	Tennessee	37	February 6	50
Arkansas	116	April 26	49	Utah	75	March 16	49	Missouri	37	February 6	49
South Dakota	118	April 28	48	Idaho	76	March 17	48	Alabama	38	February 7	48
Idaho	118	April 28	47	West Virginia	76	March 17	47	Arkansas	39	February 8	47
Missouri	118	April 28	46	South Carolina	76	March 17	46	Florida	39	February 8	46
Tennessee	119	April 29	45	Wyoming	77	March 18	45	Nevada	39	February 8	45
New Hampshire	119	April 29	44	Kentucky	77	March 18	44	South Dakota	40	February 9	44
Kentucky	119	April 29	43	South Dakota	77	March 18	43	Virginia	41	February 10	43
West Virginia	121	May 1	42	Alabama	77	March 18	42	Illinois	41	February 10	42
South Carolina	121	May 1	41	Arkansas	77	March 18	41	Texas	42	February 11	41
Utah	121	May 1	40	Maine	78	March 19	40	Pennsylvania	42	February 11	40
Virginia	122	May 2	39	Louisiana	78	March 19	39	Indiana	42	February 11	39
Colorado	122	May 2	38	New Mexico	78	March 19	38	Mississippi	42	February 11	38
Oklahoma	122	May 2	37	Montana	78	March 19	37	Kentucky	42	February 11	37
Indiana	122	May 2	36	Arizona	78	March 19	36	Connecticut	42	February 11	36
Georgia	123	May 3	35	Oklahoma	79	March 20	35	Georgia	42	February 11	35
North Carolina	123	May 3	34	Colorado	79	March 20	34	Idaho	43	February 12	34
Louisiana	124	May 4	33	Iowa	79	March 20	33	Colorado	43	February 12	33
Florida	124	May 4	32	North Carolina	80	March 21	32	New Jersey	43	February 12	32
Montana	124	May 4	31	Georgia	80	March 21	31	Ohio	43	February 12	31
Texas	125	May 5	30	Indiana	80	March 21	30	North Carolina	43	February 12	30
Kansas	125	May 5	29	Dist. of Columbia	81	March 22	29	Massachusetts	43	February 12	29
Wyoming	126	May 6	28	North Dakota	81	March 22	28	Kansas	43	February 12	28
North Dakota	126	May 6	27	Virginia	81	March 22	27	Oklahoma	43	February 12	27
Ohio	126	May 6	26	Missouri	81	March 22	26	California	44	February 13	26
Nebraska	127	May 7	25	Nebraska	81	March 22	25	South Carolina	44	February 13	25
Pennsylvania	127	May 7	24	Kansas	81	March 22	24	Rhode Island	44	February 13	24
Iowa	127	May 7	23	Tennessee	81	March 22	23	West Virginia	45	February 14	23
California	127	May 7	22	Hawaii	82	March 23	22	Washington	45	February 14	22
Arizona	127	May 7	21	Wisconsin	82	March 23	21	North Dakota	45	February 14	21
New Mexico	127	May 7	20	Oregon	82	March 23	20	Delaware	45	February 14	20
Maine	128	May 8	19	Vermont	83	March 24	19	Nebraska	45	February 14	19
Massachusetts	128	May 8	18	Texas	83	March 24	18	Louisiana	46	February 15	18
Nevada	128	May 8	17	Minnesota	83	March 24	17	Utah	46	February 15	17
Illinois	129	May 9	16	California	83	March 24	16	Maryland	46	February 15	16
Oregon	130	May 10	15	Ohio	83	March 24	15	Montana	46	February 15	15
Washington	130	May 10	14	Massachusetts	85	March 26	14	Vermont	47	February 16	14
Vermont	130	May 10	13	Maryland	85	March 26	13	Iowa	47	February 16	13
Maryland	131	May 11	12	Washington	85	March 26	12	Oregon	47	February 16	12
Wisconsin	131	May 11	11	Pennsylvania	85	March 26	11	Michigan	48	February 17	11
Alaska	131	May 11	10	Michigan	85	March 26	10	Arizona	49	February 18	10
Rhode Island	132	May 12	9	Florida	85	March 26	9	New Mexico	49	February 18	9
Michigan	132	May 12	8	New York	86	March 27	8	Wyoming	49	February 18	8
New Jersey	134	May 14	7	New Hampshire	86	March 27	7	Wisconsin	50	February 19	7
Minnesota	134	May 14	6	Illinois	87	March 28	6	Maine	50	February 19	6
Hawaii	136	May 16	5	Rhode Island	87	March 28	5	Minnesota	51	February 20	5
Connecticut	137	May 17	4	Nevada	89	March 30	4	Hawaii	55	February 24	4
Delaware	141	May 21	3	New Jersey	91	April 1	3	Alaska	60	March 1	3
Dist. of Columbia	146	May 26	2	Connecticut	94	April 4	2	New York	60	March 1	2
New York	146	May 26	1	Delaware	96	April 6	1	Dist. of Columbia	65	March 6	1

Source: Tax Foundation

¹ Tax Foundation, *Federal Tax Burden by State*, 8pp.

Mississippi and Alabama residents will finish paying off their taxes more than two weeks earlier than the average American and more than a month earlier than the residents of New York and the District of Columbia.

Federal vs. State/Local Burden

Tax Freedom Day by state and type of tax is presented in Table 2. Here the effects of federal and state/local taxes are examined separately.

Figure 2

Tax Freedom Day by State

Calendar Year 1991

Legend:

- May 9 or later
- May 8 or earlier

State	Day	Count
WA	May 10	#14
OR	May 10	#15
MT	May 4	#31
ND	May 6	#27
MN	May 14	#6
WI	May 11	#11
MI	May 12	#8
IL	May 9	#16
IN	May 2	#36
OH	May 6	#26
PA	May 7	#24
NY	May 26	#1
VT	May 10	#13
NH	April 29	#44
ME	May 8	#19
MA	May 8	#18
RI	May 12	#9
CT	May 17	#4
NJ	May 14	#7
DE	May 21	#3
MD	May 11	#12
DC	May 26	#2
VA	May 2	#39
WV	May 1	#42
NC	May 3	#34
SC	May 1	#41
GA	May 3	#35
FL	May 4	#32
AL	April 25	#50
MS	April 24	#51
TN	April 29	#45
KY	April 29	#43
MO	April 28	#46
IA	May 7	#23
NE	May 7	#25
KS	May 5	#29
OK	May 2	#37
TX	May 5	#30
AR	April 26	#49
LA	May 4	#33
NM	May 7	#20
AZ	May 7	#21
UT	May 1	#40
NV	May 8	#17
CA	May 7	#22
ID	April 28	#47
WY	May 6	#28
SD	April 28	#48
AK	May 11	#10
HI	May 16	#5

Source: Tax Foundation

Tax Freedom Day Calculation

Tax Freedom Day represents the nation's "effective" tax rate or total taxes as a percentage of total income. For 1991, the Tax Foundation estimates that rate to be 35.1 percent. The associ-

ated 1991 tax and income figures for the U.S. and each state's share of these totals are presented in table 6. In the state of Texas, for example, total taxes are \$105.7 billion and total state income is estimated at \$309.7 billion. Therefore, Texas's ratio of taxes to income is 34.1 percent — 1 percent lower than the national average. While nationwide Tax Freedom Day is May 8, Texas's lower overall tax rate causes its Tax Freedom Day to occur three days earlier on May 5.

The 1991 estimated totals for federal and state/local tax and income amounts are based on National Income and Product Account (NIPA) data produced by the U.S. Department of Commerce, Bureau of Economic Analysis. The Tax Foundation, in cooperation with other organizations, has developed a special allocation methodology to distribute the total federal and state/local tax burden by state.² This allocation determines the geographic origin of taxes to show where the burden of taxes is actually borne. Total income in the Tax Freedom Day analysis is represented by net national product (NNP).³ Each state's share of this income total is allocated based on its specific state product and personal income.

While the results presented in this report are useful in making broad state-by-state comparisons, caution should be used in drawing conclusions from any one table.

A single analysis cannot fully reveal the entire story about a state's taxation. While this analysis specifically examines each state's total tax revenues, states may collect significant amounts of revenues from non-tax sources.

Despite the allocation of each state's tax and income amounts based on their geographic origin, the exact degree of tax burden that a state may export to nonresidents is not quantifiable. For example, a portion of sales taxes in a high tourist state will be paid by nonresidents.

Finally, relatively small differences in the tax and income figures between states may cause big differences in rankings.

Table 6
Taxes as a Percentage of Income by State
Total, Federal and State/Local Taxes
Calendar Year 1991

	Taxes (\$Billions)			Income (NNP)	Taxes as a Percent of Total Income		
	Total	Federal	State/Local		Total	Federal	State/Local
U.S. Total	\$1,780.1	\$1,157.9	\$622.2	\$5,069.8	35.1%	22.8%	12.3%
Alabama	20.6	13.8	6.8	65.1	31.6	21.2	10.4
Alaska	6.0	3.3	2.7	16.7	36.0	19.6	16.4
Arizona	22.7	14.0	8.7	65.2	34.8	21.5	13.3
Arkansas	11.4	7.6	3.8	36.0	31.8	21.2	10.6
California	233.7	153.1	80.5	672.2	34.8	22.8	12.0
Colorado	22.6	14.7	7.9	67.6	33.4	21.7	11.7
Connecticut	34.8	24.0	10.8	92.8	37.5	25.9	11.6
Delaware	5.6	3.8	1.8	14.4	38.7	26.3	12.5
Dist. of Columbia	6.7	3.7	3.0	16.8	39.9	22.1	17.7
Florida	88.0	60.5	27.5	259.5	33.9	23.3	10.6
Georgia	40.3	26.4	13.9	119.9	33.6	22.0	11.6
Hawaii	8.9	5.3	3.6	23.8	37.3	22.3	15.0
Idaho	5.2	3.3	1.9	16.1	32.4	20.7	11.7
Illinois	89.8	60.9	28.9	254.7	35.3	23.9	11.4
Indiana	34.3	22.6	11.8	102.4	33.5	22.0	11.5
Iowa	17.7	11.1	6.6	51.0	34.7	21.8	13.0
Kansas	16.4	10.7	5.7	48.1	34.2	22.2	11.9
Kentucky	19.4	12.5	6.9	59.4	32.6	21.0	11.6
Louisiana	22.2	14.0	8.3	65.7	33.9	21.3	12.6
Maine	8.1	4.9	3.2	23.1	35.0	21.2	13.7
Maryland	41.0	26.5	14.5	114.5	35.8	23.2	12.7
Massachusetts	53.3	35.2	18.1	152.2	35.0	23.2	11.9
Michigan	68.1	43.6	24.5	187.7	36.3	23.2	13.1
Minnesota	32.8	20.3	12.5	89.2	36.8	22.8	14.0
Mississippi	11.1	7.0	4.1	35.7	31.2	19.6	11.6
Missouri	31.7	21.7	10.0	97.6	32.5	22.2	10.3
Montana	4.5	2.8	1.7	13.2	34.1	21.4	12.7
Nebraska	10.0	6.4	3.6	28.9	34.7	22.2	12.5
Nevada	8.7	6.1	2.6	24.8	35.0	24.4	10.6
New Hampshire	8.5	6.1	2.4	26.0	32.6	23.5	9.1
New Jersey	78.3	53.3	25.0	213.5	36.7	25.0	11.7
New Mexico	8.1	5.0	3.1	23.3	34.9	21.3	13.5
New York	175.6	102.9	72.7	439.0	40.0	23.4	16.6
North Carolina	39.2	25.4	13.7	115.9	33.8	21.9	11.8
North Dakota	3.6	2.3	1.3	10.4	34.6	22.1	12.4
Ohio	71.8	47.3	24.5	207.3	34.6	22.8	11.8
Oklahoma	17.7	11.4	6.3	53.0	33.5	21.6	11.9
Oregon	18.5	11.7	6.8	52.1	35.5	22.5	13.0
Pennsylvania	83.7	56.0	27.7	241.3	34.7	23.2	11.5
Rhode Island	7.5	5.0	2.5	20.8	36.1	24.0	12.1
South Carolina	18.4	11.6	6.7	55.6	33.0	20.9	12.1
South Dakota	3.7	2.4	1.3	11.4	32.2	21.1	11.1
Tennessee	27.4	18.8	8.6	84.2	32.5	22.3	10.2
Texas	105.7	70.4	35.3	309.7	34.1	22.7	11.4
Utah	8.6	5.3	3.3	25.9	33.2	20.6	12.6
Vermont	3.8	2.4	1.4	10.8	35.6	22.7	12.9
Virginia	44.6	29.7	14.9	133.9	33.3	22.2	11.1
Washington	34.7	22.6	12.1	97.5	35.6	23.2	12.4
West Virginia	8.8	5.5	3.3	26.6	33.0	20.7	12.3
Wisconsin	33.8	21.0	12.8	93.8	36.0	22.4	13.6
Wyoming	3.1	1.9	1.2	8.9	34.5	21.0	13.5

Source: Tax Foundation methodology and published and unpublished data from U.S. Department of Commerce, Bureau of Economic Analysis; and Government Finance Division, Bureau of the Census.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has been monitoring tax and fiscal activities at all levels of government since 1937.

Delaware, Connecticut and New Jersey face the highest federal tax burdens this year while the residents of the District of Columbia, New York, and Alaska pay the most in state and local taxes.

Tax Bite in the Eight-Hour Day

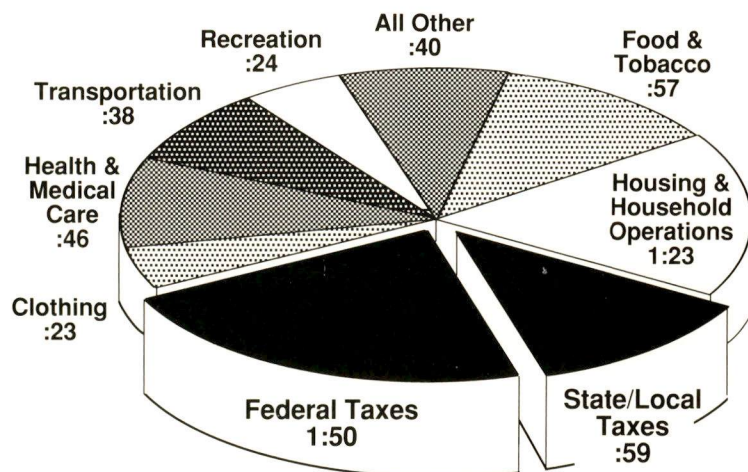
How much time does the average American work each day to pay all taxes? How much does this time differ from state to state?

Measuring the bite that taxes take from the typical worker's 8-hour day offers another illustration of government's weight on the

nation's private production. In 1991, the average American will spend 2 hours and 49 minutes each workday satisfying federal, state and local tax collectors. Of that, the federal government will claim 1 hour and 50 minutes while state and local governments will take a 59-minute chunk.

From state to state these times vary widely (see table 3). The residents of Connecticut, for example, will need 2 hours and 4 minutes of the workday to pay their federal tax burden — one half-hour more each day than taxpayers in Mississippi who will work about one and one-half

Figure 3
Tax Bite in the Eight-Hour Day
Calendar Year 1991



Tax Bite in the Eight-Hour Day
1990-1991
(hours:minutes)

	1990	1991
Total Taxes	2:44	2:49
Federal	1:47	1:50
State and Local	:57	:59
Total Personal Consumption Expenditures	5:16	5:11
Housing and Household Operations	1:26	1:23
Food and Tobacco	:58	:57
Health and Medical Care	:44	:46
Transportation	:39	:38
Recreation	:24	:24
Clothing	:24	:23
All Other	:41	:40
8-Hour Day	8:00	8:00

Source: Tax Foundation

Table 3
Tax Bite in the Eight-Hour Day
State-by-State Comparison
Calendar Year 1991

	Hours : Minutes		
	Total Taxes	Federal Taxes	State/Local Taxes
U.S. Total	2:49	1:50	:59
Alabama	2:32	1:42	:50
Alaska	2:53	1:34	1:19
Arizona	2:47	1:43	1:04
Arkansas	2:32	1:42	:50
California	2:47	1:49	:58
Colorado	2:40	1:44	:56
Connecticut	3:00	2:04	:56
Delaware	3:06	2:06	1:00
Dist. of Columbia	3:11	1:46	1:25
Florida	2:43	1:52	:51
Georgia	2:41	1:46	:55
Hawaii	2:59	1:47	1:12
Idaho	2:35	1:40	:55
Illinois	2:49	1:55	:54
Indiana	2:41	1:46	:55
Iowa	2:47	1:45	1:02
Kansas	2:44	1:47	:57
Kentucky	2:37	1:41	:56
Louisiana	2:43	1:42	1:01
Maine	2:48	1:42	1:06
Maryland	2:52	1:51	1:01
Massachusetts	2:48	1:51	:57
Michigan	2:54	1:51	1:03
Minnesota	2:57	1:49	1:08
Mississippi	2:30	1:34	:56
Missouri	2:36	1:47	:49
Montana	2:44	1:43	1:01
Nebraska	2:46	1:47	:59
Nevada	2:48	1:57	:51
New Hampshire	2:36	1:53	:43
New Jersey	2:56	2:00	:56
New Mexico	2:47	1:42	1:05
New York	3:12	1:52	1:20
North Carolina	2:42	1:45	:57
North Dakota	2:46	1:46	1:00
Ohio	2:46	1:49	:57
Oklahoma	2:41	1:43	:58
Oregon	2:50	1:48	1:02
Pennsylvania	2:46	1:51	:55
Rhode Island	2:53	1:55	:58
South Carolina	2:39	1:41	:58
South Dakota	2:35	1:41	:54
Tennessee	2:36	1:47	:49
Texas	2:44	1:49	:55
Utah	2:39	1:39	1:00
Vermont	2:51	1:49	1:02
Virginia	2:40	1:46	:54
Washington	2:51	1:51	1:00
West Virginia	2:38	1:40	:58
Wisconsin	2:53	1:48	1:05
Wyoming	2:46	1:41	1:05

Source: Tax Foundation

Tax Freedom Day 1991

hours to pay Uncle Sam. At the state/local level, taxpayers in New Hampshire will spend 43 minutes each workday to pay state/local tax obligations because there is no broad-based personal income tax and no general sales tax. At the high end, the residents of the District of Columbia will work nearly an hour and a half every day to satisfy their local tax collectors.

In 1991, the residents of 43 states and the District of Columbia will have to work longer

than they did in 1990 before reaching their state-specific Tax Freedom Days, and in 27 of the states the increased burden exceeds the three-day advance in the nationwide date (see table 4). The taxpayers in four states will be done with taxes earlier in 1991 than in 1990, and three states have the same date this year as last. The steepest increases in tax burdens are occurring in Connecticut, Georgia, Louisiana, Nebraska, New Hampshire and West Virginia, where Tax Freedom Day is six days later than in 1990.

Table 4
Tax Freedom Day by State
Calendar Years
1990 – 1991

	Tax Freedom Day 1990	Tax Freedom Day 1991	Change from 1990 to 1991
U.S. Total	May 5	May 8	3
Alabama	April 21	April 25	4
Alaska	May 11	May 11	0
Arizona	May 2	May 7	5
Arkansas	April 22	April 26	4
California	May 3	May 7	4
Colorado	April 28	May 2	4
Connecticut	May 11	May 17	6
Delaware	May 18	May 21	3
Dist. of Columbia	May 21	May 26	5
Florida	May 2	May 4	2
Georgia	April 27	May 3	6
Hawaii	May 16	May 16	0
Idaho	April 25	April 28	3
Illinois	May 6	May 9	3
Indiana	April 28	May 2	4
Iowa	May 5	May 7	2
Kansas	May 1	May 5	4
Kentucky	April 25	April 29	4
Louisiana	April 28	May 4	6
Maine	May 6	May 8	2
Maryland	May 8	May 11	3
Massachusetts	May 3	May 8	5
Michigan	May 8	May 12	4
Minnesota	May 13	May 14	1
Mississippi	April 19	April 24	5
Missouri	April 25	April 28	3
Montana	May 6	May 4	-2
Nebraska	May 1	May 7	6
Nevada	May 9	May 8	-1
New Hampshire	April 23	April 29	6
New Jersey	May 9	May 14	5
New Mexico	May 4	May 7	3
New York	May 23	May 26	3
North Carolina	May 1	May 3	2
North Dakota	May 5	May 6	1
Ohio	May 1	May 6	5
Oklahoma	April 28	May 2	4
Oregon	May 5	May 10	5
Pennsylvania	May 3	May 7	4
Rhode Island	May 9	May 12	3
South Carolina	April 26	May 1	5
South Dakota	April 28	April 28	0
Tennessee	April 25	April 29	4
Texas	May 2	May 5	3
Utah	May 2	May 1	-1
Vermont	May 11	May 10	-1
Virginia	April 28	May 2	4
Washington	May 9	May 10	1
West Virginia	April 25	May 1	6
Wisconsin	May 8	May 11	3
Wyoming	May 2	May 6	4

Source: Tax Foundation

Table 5
Tax Freedom Day and
Tax Bite in the 8-Hour Day
Selected Calendar Years
1929 – 1991

Year	Tax Freedom Day	Tax Bite in the Eight-Hour Day (Hours:Minutes)
1929	February 9	:52
1931	February 15	1:00
1933	March 5	1:24
1935	March 1	1:17
1937	March 6	1:24
1939	March 6	1:24
1940*	March 8	1:29
1941	March 17	1:40
1942	March 19	1:43
1943	April 6	2:06
1944*	March 30	1:58
1945	April 1	1:59
1946	March 31	1:57
1947	April 3	2:01
1948*	March 28	1:55
1949	March 24	1:48
1950	April 3	2:02
1951	April 10	2:11
1952*	April 10	2:12
1953	April 10	2:12
1954	April 6	2:05
1955	April 9	2:09
1956*	April 11	2:13
1957	April 13	2:14
1958	April 10	2:12
1959	April 14	2:16
1960*	April 17	2:22
1961	April 18	2:22
1962	April 18	2:21
1963	April 19	2:23
1964*	April 15	2:18
1965	April 15	2:17
1966	April 18	2:21
1967	April 20	2:24
1968*	April 25	2:32
1969	May 1	2:38
1970	April 28	2:34
1971	April 25	2:31
1972*	April 29	2:36
1973	April 29	2:36
1974	May 3	2:41
1975	April 28	2:35
1976*	May 1	2:40
1977	May 3	2:41
1978	May 3	2:41
1979	May 3	2:41
1980*	May 1	2:39
1981	May 4	2:43
1982	May 3	2:41
1983	April 30	2:38
1984*	April 28	2:36
1985	May 1	2:38
1986	May 2	2:40
1987	May 4	2:43
1988*	May 3	2:43
1989	May 4	2:44
1990	May 5	2:44
1991e	May 8	2:49

Source: Tax Foundation.

* Leap year makes Tax Freedom Day appear a calendar day earlier.

Tax Freedom Day History

Table 5 traces the history of Tax Freedom Day since 1929. In that year, taxpayers had satisfied their total tax obligations by February 9th. Forty years later in 1969, Tax Freedom Day pushed into the month of May for the first time, landing on May 1st.

May 8, 1991, is the latest Tax Freedom Day on record, continuing the decades-long trend of rising tax obligations. In the 1980s, tax cuts under the Economic Recovery Tax Act of 1981 (ERTA) helped reduce the federal tax burden, so Tax Freedom Day retreated to April 28 in 1984. Since then, major tax bills have boosted the date to its present high of May 8. Sixteen separate tax bills passed since ERTA have increased taxes, and except for the Tax Reform Act of 1986, tax legislation since 1981 has been purely an exercise in revenue-raising.

The state/local tax burden peaked in the 1976-1977 period before Proposition 13 in California set off a successful round of tax limitation measures in the states which caused it to dip until 1981. Then resumed its steady long-term rise, and continued fiscal pressures in many states indicate this trend is likely to continue.

Tax Freedom Day Outlook

Although the average American will work until May 8 and forfeit over 35 percent of his total income in 1991, the government will spend all that money and more. Tax Freedom Day does not reflect the estimated \$318 billion in federal deficit spending for 1991, but the impact of this deficit will be felt in future tax increases and/or a weaker economy.

Spending a record 128 days from January 1 to May 8 to pay off the tax collectors may come as a shock to many Americans. But the combined pressures of a persistent federal budget deficit, demands to expand funding for new and existing programs, budget crises in numerous states and the slowdown in income growth could easily postpone Tax Freedom Day even further in years to come.

FICA CUT TALKING POINTS

- 1) Don't box yourself in
Political arguments - entire base of GOP supports payroll tax cut
- 2) We need an actuarially sound Social Security system
The surplus is too large now
- 3) There will be an de facto tax increase if we do nothing
- 4) Economic benefits
300,000 new jobs created in this decade
- 5) Take away the Democrats "Fairness" issue
- 6) Don't box yourself in
Nothing to gain, everything to lose from coming out at this time

Withdrawal/Redaction Sheet

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Presidential Records Act - [44 U.S.C. 2204(a)]

P-1 National Security Classified Information [(a)(1) of the PRA]
 P-2 Relating to the appointment to Federal office [(a)(2) of the PRA]
 P-3 Release would violate a Federal statute [(a)(3) of the PRA]
 P-4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
 P-5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
 P-6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Removed as a personal record misfile.

Freedom of Information Act - [5 U.S.C. 552(b)]

(b)(1) National security classified information [(b)(1) of the FOIA]
 (b)(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
 (b)(3) Release would violate a Federal statute [(b)(3) of the FOIA]
 (b)(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
 (b)(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
 (b)(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
 (b)(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
 (b)(9) Release would disclose geological or geophysical information

THE WHITE HOUSE
WASHINGTON

Tax Policy

DATE: 4-15-91

FROM THE PRESIDENT *CB*

TO: Chief of Staff
Fred McClure

Lloyd Bentsen came for lunch today. He is all out for Fast Track, having held seminars in Texas etc etc.

He states that the letter due on May 1st to the committees is critical. It MUST be a good letter answering all the questions raised etc.

I suggested to Lloyd that Pres. Salinas would be delighted to have George Mitchell come see him in Mexico. Lloyd will check with Mitchell, then let me know if Mitchell willing to accept and invitation from Salinas.

The Senator feels Sec. Martin and Bill Reilly can be extraordinarily helpful in all this. He suggests close contact with Bob Kyl in his office. I told him both Lynn Martin and Bill Reilly want ~~to~~ help in any way possible. I suggest someone contact Kyl to see how those two can help the most.

THE WHITE HOUSE
WASHINGTON

DATE:

FROM THE PRESIDENT

To: Sen Bentsen page -2-2

We discussed IRA's. Bentsen will not
push for his IRA plan because
too difficult to pay for it.

Social Security: Bentsen will
continue to oppose Moynihan.
There are 20 UNDECIDED Democrats

cc: Amb. Carla Hills
Sec. Martin
Admin. Reilly.



INSTITUTE FOR POLICY INNOVATION

IPI ISSUE BRIEF — No.110-1
Social Security/Payroll Tax Cuts

March 14, 1991

(This Issue Brief is an abstract of an IPI report entitled "Reducing Social Security Taxes: Sound Policy for Today and Tomorrow?")

SOCIAL SECURITY TAX CUTS: TOO GOOD TO BE TRUE?

By Aldona and Gary Robbins

Social Security is the largest government program. It is also one of the most misunderstood. Recent increases in payroll tax rates have created huge surpluses. Most people believe these surpluses are being saved in a trust fund to help ensure that future retirees will receive promised benefits. They are not. Payroll taxes not needed to pay current beneficiaries are borrowed and spent by the federal government and are replaced with government bonds. The government bonds held in Social Security's trust funds represent claims against future taxpayers.

Senators Daniel Moynihan (D-NY) and Robert Kasten (R-WI) have introduced legislation, S. 11, to reduce the Social Security payroll tax. Specifically, their proposal would phase-in a two percentage point reduction in the payroll tax rate over the next five years while increasing the Social Security wage base to \$82,200 by 1996 instead of the \$69,300 expected under current law.

Proponents of a payroll tax cut argue it would reduce the tax burden on low- and middle-income workers, serve as a recession-fighting measure, and help maintain the long-term financial integrity of the program. Opponents argue that cutting payroll tax rates will undermine Social Security's ability to pay retirement benefits to baby boomers or cause additional government borrowing, thereby raising interest rates.

Who is right? This *Issue Brief* examines the current tax burden on workers and how two different versions of a payroll tax cut would affect GNP, employment, and the stock of capital. It also analyzes how these options would affect federal revenues.

Payroll Tax Burden on Today's Workers

While income tax rates were reduced during the 1980s, Social Security payroll tax rates increased — from 12.26 percent in 1980 to 15.3 percent in 1990. Today many workers pay more in Social Security taxes

than they do in income taxes. Income tax changes legislated during the 1980s lowered the federal tax burden at all income levels.

- Marginal rates were substantially reduced relative to what they were in 1980.
- The personal exemption was doubled from \$1,000 in 1980 to \$2,000 by 1989, and the standard deduction was increased by over 50 percent for most taxpayers.
- As many as 4 million low-income taxpayers no longer pay income taxes.

Rising payroll tax rates, however, have increased the Social Security tax burden for all workers. According to Table 1, which compares the income and Social Security taxes paid by single and married taxpayers:

- At least 35 percent of taxpayers pay more in Social Security payroll taxes than they do in income taxes when only the employee's share of the tax (7.65 percent) is considered.
- When the employer's share is included — which most economists believe appropriate — at least 55 percent of today's taxpayers pay more in Social Security than income taxes.
- When fully phased-in, a two percentage point reduction in payroll tax rates would put \$600 more a year in the *average* worker's pocket.

Table 1

**AVERAGE INCOME & SOCIAL SECURITY TAXES, 1990
BY ADJUSTED GROSS INCOME, SINGLE FILERS**

Adjusted Gross Income	Cumulative Workers (in thous)	Taxpayer Distribution	Income Taxes	Social Security Taxes Employee Only	Employee & Employer
Nonfilers	4,305	8.2%	\$0	\$189	\$378
\$3,500	14,372	35.5%	\$0	\$189	\$378
\$10,000	10,655	55.8%	\$608	\$540	\$1,081
\$20,000	13,176	80.9%	\$2,091	\$1,160	\$2,319
\$30,000	5,823	91.9%	\$3,694	\$1,889	\$3,777
\$45,000	2,437	96.6%	\$7,733	\$2,965	\$5,929
\$60,000	900	98.3%	\$12,407	\$3,924	\$7,849
\$85,000	716	99.7%	\$20,338	\$3,924	\$7,849
\$175,000	122	99.9%	\$45,416	\$3,924	\$7,849
\$375,000	51	100.0%	\$87,697	\$3,924	\$7,849
\$1,700,000	9	100.0%	\$444,210	\$3,924	\$7,849
Taxes Paid by Average Filed Return			\$4,057	\$1,845	\$3,690

Table 1 (continued)

**AVERAGE INCOME & SOCIAL SECURITY TAXES, 1990
BY ADJUSTED GROSS INCOME, JOINT FILERS**

Adjusted Gross Income	Cumulative Workers (in thous)	Taxpayer Distribution	Social Security Taxes		
			Income Taxes	Employee Only	Employee & Employer
Non-filers	4,210	5.5%	\$0	\$189	\$378
\$3,500	3,161	9.6%	\$0	\$189	\$378
\$10,000	5,479	16.7%	\$0	\$540	\$1,081
\$20,000	13,899	34.7%	\$1,015	\$1,160	\$2,319
\$30,000	14,699	53.8%	\$2,452	\$1,889	\$3,777
\$45,000	12,972	70.7%	\$4,383	\$2,965	\$5,929
\$60,000	9,748	83.3%	\$6,972	\$3,932	\$7,863
\$85,000	10,872	97.5%	\$12,131	\$4,531	\$9,061
\$175,000	1,488	99.4%	\$34,397	\$5,537	\$11,075
\$375,000	361	99.9%	\$85,143	\$5,887	\$11,773
\$1,700,000	111	100.0%	\$384,499	\$5,887	\$11,773
Taxes Paid by Average Filed Return			\$2,521	\$1,845	\$3,690

Reducing Payroll Tax Rates

Accumulating government debt in the Social Security trust funds does not assure today's workers that they will receive their promised benefits. In addition to having paid higher than necessary payroll taxes while working, they are likely to face higher income taxes in retirement to pay their own benefits.

A number of proposals would remove the unnecessary payroll tax burden. *Rather than hurting Social Security's chances to meet its promises, cutting payroll taxes would actually improve them.* The reason is that a reduction in payroll taxes would enhance take-home pay, increase labor supply, and lower labor costs. As a result, the economy would experience higher employment, capital accumulation, and output than otherwise. This higher level of growth would heighten the ability of taxpayers to pay Social Security's bills in the future.

Conversely, higher payroll taxes raise labor costs and reduce output, jobs and investment. In an earlier study, we estimated that the 1988 and 1990 Social Security payroll tax increases (from 14.3 percent to 15.3 percent) would result in 512,000 fewer jobs.¹ Between June and November of last year, civilian employment declined by over one million.² The payroll tax hikes by themselves would have caused an economic slowdown. The combination of banking system problems, higher oil prices, war in the Persian Gulf, taxes enacted in last fall's budget agreement, and the payroll tax increases helped end the longest peacetime expansion and push the economy into its current recession.

We have estimated the economic and revenue impact of the following two options over the next ten years:³

Option 1:

A phased-in 2 percentage reduction in the OASDI payroll tax rate — from 12.4 percent to 11.4 percent (7/1/91) to 11 percent (1/1/94) to 10.4 percent (1/1/96) — plus an increase in the wage base to \$60,600 in 1992, \$64,200 in 1993, \$70,200 in 1994, \$73,800 in 1995, and \$82,200 in 1996 (similar to S. 11 by Senators Moynihan and Kasten).

Option 2:

The same phased-in 2 percentage point reduction in the OASDI rate without the corresponding increases in the wage base.

The Economic Effects of a Payroll Tax Cut

Both options would benefit the economy by lowering the cost of labor. In the long run, the phased-in reduction of

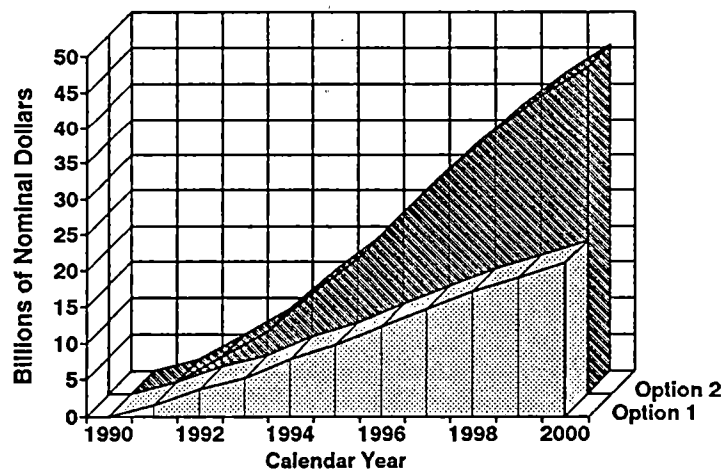
payroll tax rates would lower the cost of labor by four percent. Over the same time frame, increasing the wage base in addition to a phased-in rate reduction would lower the cost of labor by 1.9 percent.⁴

Raising the wage base would negate a significant part of the economic benefits from a rate reduction. The reason is that, although relatively few workers are affected, the incentive effects are substantial.⁵ The marginal rates on these workers increase from zero to 12.4 percent (the current OASDI rate) on their entire wages thereby dampening the reduction in the economy-wide average marginal tax rate on labor.⁶

Graphs 1, 2, and 3 depict the effect of the two options on GNP, job creation, and capital accumulation.

Graph 1

ADDITIONAL GROSS NATIONAL PRODUCT From Reducing Payroll Taxes

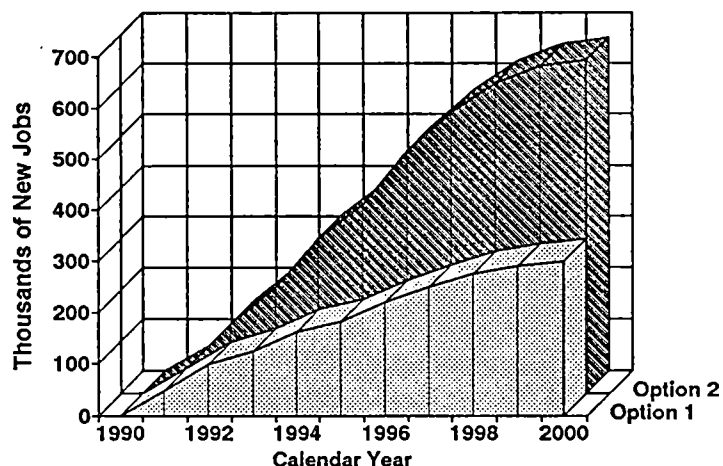


Gross national product: Over the next ten years, a phased-in two percentage point reduction in the payroll tax rate with corresponding increases in the wage base

would increase GNP by \$112.2 billion (in nominal dollars). The same reduction *without* a corresponding increase in the wage base would increase GNP by \$226.2 billion over the same period.

Graph 2

ADDITIONAL EMPLOYMENT
From Reducing Payroll Taxes

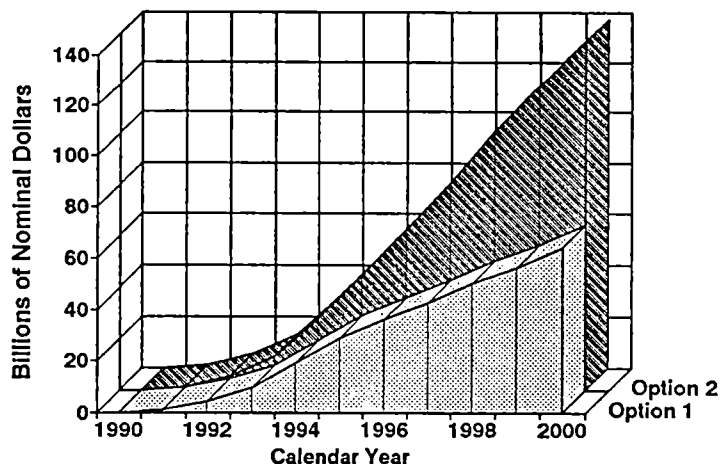


New jobs: By the year 2000, a phased-in two percentage point reduction in the payroll tax rate with corresponding increases in the wage base would result in 299,000 more jobs than otherwise. The same reduction *without* a corresponding increase in the wage base would result in 650,000 more jobs.

Capital accumulation: By the year 2000, a phased-in two percentage point reduction in the payroll tax rate with corresponding increases in the wage base would increase the capital stock by \$64.4 billion (in nominal dollars). The same reduction *without* a corresponding increase in the wage base would increase the capital stock by \$137 billion.

Graph 3

ADDITIONAL CAPITAL STOCK
From Reducing Payroll Taxes



Revenue Effects

Official revenue estimates are static in nature because they ignore the economic effects of a tax change. A reduction in payroll taxes would lead to more jobs, output, and investment. This would increase payroll and income tax revenue to federal, state, and local governments.

Table 2 summarizes the static and dynamic (which include economic effects) revenue estimates over the next five and ten calendar years for the two options.

Table 2

**Static and Dynamic Revenue Effects
of Two Payroll Tax Cut Options
(Amounts in \$billions; calendar years)**

	Phased-in Cut		Plus Higher Wage Base	
	1991- 1995	1991- 2000	1991- 1995	1991- 2000
Static Tax Change from FICA Reduction	-146.5	-511.5	-124.7	-424.9
Additional Federal Payroll, Income, Excise Tax Revenues	16.4	72.5	9.5	35.6
Dynamic Federal Tax Change	-130.1	-439.0	-115.2	-389.3
Efficiency*	88.8%	85.8%	92.4%	91.6%
Additional State & Local Taxes	8.8	40.0	5.1	19.5
Total Dynamic Change	-121.2	-399.1	-110.1	-369.8
Efficiency*	82.8%	78.0%	88.3%	87.0%

* Efficiency refers to the amount of revenue actually lost for every dollar of static revenue loss. It is calculated as the dynamic tax change divided by the static tax change and is averaged over the five and ten year periods.

On a static basis the phased-in cut with the increased wage base would lose \$124.7 billion in payroll tax revenues over the next five years. Over the same time period, the phased-in cut without an increase in the wage base would lose \$146.4 billion.

The added growth and jobs, however, would generate additional federal revenues of \$9.5 billion and \$16.4 billion respectively.

- Over 1991 through 1995, for every dollar in static revenue loss the actual federal revenue loss would be an average of 92 cents for the phased-in cut with the increased wage base and 89 cents for the phased-in cut without the increased wage base.
- By the year 2000, the actual federal revenue loss would be 92 cents for the phased-in cut with increased base and 86 cents for the rate cut without an increased wage base.
- When the additional revenues to state and local governments are included, the actual loss for every dollar in static revenue loss would be an average of 88 cents and 83 cents, respectively, over 1991 through 1995.
- By the year 2000, the actual total revenue loss would be 87 cents for the phased-in cut with an increased wage and 78 cents for the phased-in cut without an increased base.

Will Interest Rates Rise?

Reducing payroll tax rates holds greater potential for helping Social Security keep its promises than allowing the trust fund accumulation of government debt to continue. The economic gains of a payroll tax cut include: (1) up to 650,000 more jobs than

otherwise; (2) additional output that could amount to \$226 billion by the turn of the century; and (3) the capital stock, which represents the fruits of *real* saving, could be as much as \$137 billion higher by the year 2000.

Naysayers who claim that the payroll tax cut would hurt saving are wrong. Although they hold the view that the trust fund surpluses represent real saving, how these surpluses translate into plant, equipment, and jobs is not exactly clear. One argument is that trust fund surpluses mean the federal government has to borrow less from the public, thereby lowering interest rates. By reducing payroll taxes, Social Security surpluses would be less, thereby raising federal borrowing and interest rates.

The problem with this argument is that federal borrowing does not have much, if any, effect on interest rates. Outstanding debt in U.S. credit markets is about \$13.2 trillion.⁷ The impact of an added \$50 to \$100 billion in federal borrowing on U.S. credit markets and, therefore, on interest rates is virtually negligible. Moreover, capital trades in a world market whose size is many times that of the U.S.

What naysayers ignore is that the trust fund surpluses do not magically appear. They come from somewhere, specifically the pockets of working Americans. Higher payroll taxes have an economic cost which any reduction in interest rates — if ever forthcoming — would fall far short of offsetting. As shown earlier, higher payroll taxes raise the cost of labor and result in fewer jobs, output, and capital accumulation. Better to cut payroll tax rates now and enjoy the beneficial economic effects than accumulate trust surpluses that mean higher taxes now and even higher taxes in the future.

Conclusion

Reducing Social Security payroll tax rates makes sense for several reasons. Reducing payroll tax rates by two percentage points would:

- stimulate the economy and add as many as 650,000 more jobs years than if there were no tax cut;
- reduce the burden of a tax that falls particularly hard on lower- and middle-income workers; and,
- increase the total output of goods and services and the accumulation of capital, thereby improving the economy's ability to meet the future demands of Social Security.

Note: Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation or as an attempt to aid or hinder passage of any legislation before Congress.

NOTES

1. Aldona and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Washington, DC: Institute for Research on the Economics of Taxation, *Economic Report* No. 39, February 1988.

2. The Federal Reserve Bank of St. Louis, *National Economic Trends*, January 1991, p. 2.

3. The baseline is that of the Congressional Budget Office for the fiscal year 1992 Budget. Using the standard Cobb-Douglas production function, we have derived relationships to determine the changes in the amounts of capital services, labor services, and output that will occur in response to a change in the tax on labor. The long-term adjustments in response to a tax change will depend upon: (1) the size of the tax change; (2) the nature of the production process, i.e., how capital and labor are combined in the most effective way; (3) the responsiveness of workers to a change in their aftertax wage rate, or the elasticity of labor supply; and (4) the amount of U.S. capital affected by the tax change. In these policy simulations we used a labor supply elasticity of 0.3, which is well within the range of empirical estimates.

4. See the forthcoming IPI Report, "Reducing Social Security Taxes: Sound Policy for Today and Tomorrow?", for detailed tables on the economic effects.

5. Over the last several years, about 90.5 percent of wages and salaries subject to Social Security tax are below the wage ceiling. Apart from the years 1937 to 1941, when Social Security taxes were first paid, this percentage is the highest in the program's history. In 1937, the wage base was \$3,000 and only 70 percent of wage and salaries were subject to tax; today 96.5 percent are covered by Social Security. See *Social Security Bulletin, Annual Statistical Supplement, 1988*, December 1988, Table 4.B1, Pg. 127.

6. See the forthcoming IPI Report, "Reducing Social Security Taxes: Sound Policy for Today and Tomorrow?", for an explanation of the wage base effects.

7. *Federal Reserve Bulletin*, September 1990.

FICA CUT TALKING POINTS

- 1) Don't box yourself in
Political arguments - entire base of GOP supports payroll tax cut
- 2) We need an actuarially sound Social Security system
The surplus is too large now
- 3) There will be an de facto tax increase if we do nothing
- 4) Economic benefits
300,000 new jobs created in this decade
- 5) Take away the Democrats "Fairness" issue
- 6) Don't box yourself in
Nothing to gain, everything to lose from coming out at this time

BUDGET EFFECT OF THE DELAY/WALLOP BILL

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
OFF-BUDGET REVENUE LOSS							
SOC. SEC.	-9.7	-45.4	-49.5	-52.9	-56.4	-60.0	-273.9
ON-BUDGET REVENUE INCREASE							
INCOME TAX	1.0	4.5	5.0	5.3	5.6	6.0	27.4
ON-BUDGET OUTLAY DECREASE							
FED. EMP.							
SOC. SEC.	0.2	0.9	0.9	1.0	1.1	1.2	5.4
TTL ON-BDGT	1.2	5.4	5.9	6.3	6.8	7.2	32.8

*Figures are in billions for fiscal years as estimated by the Congressional Budget Office

ESTIMATE OF PRESIDENT'S BUDGET PROPOSAL FOR A
REDUCTION IN TAXES ON CAPITAL GAINS

We have now had the opportunity to study the President's proposal on capital gains in some detail. Although we still have some questions about some of the specifics of the proposal which I outline below, this memorandum provides you with our current estimate of the proposal.

The President's Proposal

The President's budget proposal would allow individuals an exclusion of 45 percent of the gain realized upon the disposition of qualified capital assets. Further, the maximum tax rate applicable to any gains on qualified assets would be 15 percent. The exclusion would not be a preference for purposes of the alternative minimum tax. Taxpayers with gain on qualified assets would be able to exclude 100 percent of the gain, if the taxpayer's adjusted gross income (calculated including 55 percent of the gain) is less than \$20,000 (\$10,000 for single taxpayers or married taxpayers filing separately). Taxpayers with an adjusted gross income less than \$20,000 but who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion.

Qualified capital assets generally would be capital assets as defined under present law other than depreciable, depletable, and amortizable property used in the taxpayer's trade or business. Collectibles would not be treated as qualified assets. The special section 1231 assets, i.e., certain interests in timber, coal, iron ore, livestock, and unharvested crops, would not be treated as qualified assets.

In addition, to be a qualified asset, the taxpayer must satisfy a holding period requirement. The asset must have been held for more than 12 months if the asset is sold in 1989, 1990, 1991, or 1992; for more than 24 months if the asset is sold in 1993 or 1994; and for more than 36 months if the asset is sold in any year after 1994.

The proposal would be effective for assets sold on or after July 1, 1989.

Estimated Revenue Effect

The table below provides our current revenue estimate of the President's proposal, subject to some qualifications which I discuss below.

The first line presents the revenue effect which would result from a 45 percent exclusion, with a maximum 15 percent rate, for capital gains regardless of asset type, and assuming a one-year holding period and an effective date of sales on or after January 1, 1989. This calculation is based on baseline realizations from CBO's January economic forecast¹ and includes our estimate of the revenue effect which would result from a tax-induced increase in realizations. Consistent with recent economic analysis of capital gain realization behavior, our estimate reflects a larger short-run than long-run behavioral response.

The second line presents the estimated revenue effect which would result from moving the effective date of this proposal from January 1, 1989, to July 1, 1989. The third line presents the estimated revenue effect which results from excluding collectibles and depreciable property from the proposal. The fourth line presents the revenue effect of the lengthening, on a phased-in basis, of the holding period. The fifth line estimates the effect of providing the additional 100 percent exclusion to those eligible taxpayers with adjusted gross income less than \$20,000.

Projected Revenue Effect (Billions of Dollars)

<u>Item</u>	<u>Fiscal Years</u>						
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1989-94</u>
1. 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	
2. Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	
3. Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	
4. 3-Year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	
5. Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	
Total Revenue Effect	0.7	3.3	-4.0	-6.4	-6.9	-10.9	-24.2

¹ The CBO baseline forecast differs from that made by OMB which forms the baseline for the Treasury estimate.

We have not estimated the revenue effect for years beyond 1994 because the CBO baseline does not extend beyond that date. If the baseline realizations were to continue to grow at the same rate as between 1989 and 1994, we would estimate that the proposal loses revenue in the years beyond 1994. However, the magnitude of the losses would not increase smoothly, as the table above might suggest, because of the effect of the phase-in of the lengthened holding period.

Qualifications to the Estimate

The President's proposal lacks details which could materially affect our estimated revenue effects. For example, our estimate of the President's proposal assumes the enactment of very strong rules to prevent gains on collectibles and depreciable property from qualifying for the exclusion. Such rules have not yet been fully specified by Treasury. We are concerned that both C and S corporate structures could be used in some circumstances to qualify collectibles and depreciable property for the exclusion. In the absence of effective rules preventing this behavior, we would estimate a greater revenue loss.

The President's proposal does not detail how it will interact with the kiddie tax (dependents age 13 or under) or how it will affect the taxation of income of other dependents. It may be possible for high income taxpayers to shift assets with accrued capital gains to their dependents whose adjusted gross income is less than \$10,000. Although our current estimate assumes very limited income shifting, substantial income shifting would increase the revenue loss.

The President's proposal does not specify certain aspects of the treatment that capital losses would receive. It is not clear whether a taxpayer will be permitted to deduct 50 or 100 percent of net long-term losses and whether the losses on collectibles will be unlimited or allowed to offset gains on qualified capital assets. For the purpose of this estimate we have assumed that the taxpayer is permitted to deduct 50 percent of net long-term losses and that losses on qualified assets must be netted against gains on qualified assets, while losses on non-qualified assets must be netted separately against gains on non-qualified assets.

The preceding discussion should not be construed as an exhaustive list of those areas which are unclear in the President's proposal. I included the above examples to suggest that our estimate of the revenue effects may change as the details are developed.

CUTTING SOCIAL SECURITY PAYROLL TAXES:

A WAY TO CREATE JOBS, INCREASE GROWTH, AND HELP WORKING AMERICANS

In early February, Rep. Armey and Rep. Frank Guarini introduced H.R. 524, a bill to reduce Social Security taxes by two-percent. Rep. Armey considers it one of his top priorities this year.

The Problem

Historically, Social Security was a "pay as you go" program--the money people paid in Social Security taxes was used to pay Social Security benefits. In 1983, however, lawmakers decided to raise payroll taxes and allow extra money to accumulate in the Social Security trust fund and make the system more secure. The concept was well-intended, but it wasn't implemented in good faith. The so-called Social Security trust fund quickly became just another revenue source for increased federal spending. Money from it was used to finance pork barrel projects and wasteful programs of every kind.

The Solution

This problem could be corrected by reducing the payroll tax and returning Social Security to its original "pay as you go" basis. Under the Guarini-Army proposal, the payroll tax would be rolled back from 6.2% to 5.7% on July 1, 1991 for both the employee and the employer. This would be an excellent way to get the economy moving again, allowing employers to hire workers, allowing workers to keep more of their wages, and keeping money out of the hands of the big spenders in Congress. Business and labor groups support this legislation, as does the Committee to Preserve Social Security and Medicare. If passed, it will insure that the money people pay for Social Security will be used for Social Security.

ANALYSIS OF H.R. 524

THE GUARINI-ARMEY "SOCIAL SECURITY TAX CUT ACT OF 1991"

Reduces FICA Tax Rate:

Rate is currently 6.2% for employee and employer.

July 1, 1991 drops .5% to 5.7%
January 1, 1994 drops .2% to 5.5%
January 1, 1996 drops .3% to 5.2%

Rate remains at 5.2% through year 2009, after which it will rise slowly over the next forty years in line with the traditional "pay as you go" principle.

Modestly Raises Wage Base:

The taxable wage base upon which Social Security taxes will be levied will rise over the next five years under current law. Current law ties these scheduled "wage base" increases to the increase in the "average wage" of all workers in the economy. Under Guarini-Armeay the increase will be slightly higher between 1992-1996 than under current law. This chart illustrates the higher wage base under Mr. Armeay's bill.

	Current law	Armeay
1992	\$55,800	\$60,600
1993	\$59,100	\$64,200
1994	\$62,400	\$70,200
1995	\$65,700	\$73,800
1996	\$69,300	\$82,200

(Note: Despite the higher wage base, no employee or employer will pay higher taxes under the Guirini-Armeay bill.)

Will Boost the Economy:

According to a recent study by former Treasury Department experts Gary and Aldona Robbins, H.R. 524 will:

- * Create 300,000 new jobs
- * Increase GNP by \$112 billion

Attracts Wide Interest Group Support:

A wide range of groups support cutting the payroll tax including the U.S. Chamber of Commerce, the National Federation of Independent Business, National Committee to Preserve Social Security and Medicare, Democratic National Committee, Democratic Leadership Council, AFL-CIO, Citizens for a Sound Economy and the American Academy of Actuaries, The Heritage Foundation and the Cato Institute.

HOW TO RESPOND TO ARGUMENTS AGAINST FICA TAX CUT

1. "You can't beat their plan with their plan. You have to have a different plan."

Response: Just because a Democrat came up with the plan to cut the FICA tax doesn't mean that it's a bad plan. Gramm was a Democrat when Gramm-Latta passed, for example. In fact, the Moynihan plan is a good plan, although not perfect. The fact that so many prominent Democrats do not support Moynihan tells us that many Democrats are nervous supporting a tax cut. The FICA tax cut was not proposed by Republicans initially because of the traditional fear of the Social Security issue being turned against Republicans in elections. By having a prominent Democrat develop the plan, the danger of the issue has been lessened greatly. In essence, good cover has been given to what would naturally be a solid Republican issue.

Also, at present, there really isn't "a different plan" being pushed by Gramm or the Administration. Due to the White House's handling of domestic issues, this is the only pro-growth game in town.

2. "Republicans will be put in an awkward position when the Democrats offer an amendment to raise the wage base higher. We don't want to be put in a position of stopping a tax cut just because it hits the rich with a tax increase. We shouldn't support a bill that may lead in a bad direction."

Response: This argument could be made about virtually any Republican issue, whether capital gains cut, tax reform, anti-drug legislation, etc. An amateurish effort on any issue (such as last year's budget agreement) will lead to bad results. However, the 1980's should have taught us something. A FICA cut should be promoted as a pro-growth tax cut, that is only acceptable if it is a tax cut for everybody. The so-called Social Security Trust Fund is running huge surpluses that are being raided by the general fund for programs designed mostly by Congressional Democrats. Supporters of the FICA cut should adopt the position that it is only fair if everyone has their FICA taxes reduced. The Moynihan bill gives everyone a tax cut, although the lower income workers get a larger tax cut than the higher income workers.

Second, there is a good reason that Moynihan has adjusted the base but will not support adjusting it higher or removing the cap. The Social Security concept would be drastically changed if contributions to the system were not directly tied to retirement payments later. The Social Security system would become a welfare system if the cap were eliminated (or otherwise many recipients would be getting enormous payments) and Democrats as well as Republicans have an interest in protecting the integrity of the system.

The President has shown great ability on other issues using this strategy. The President firmly stated his opposition to the Civil Rights bill last year because he disagreed with the specifics of the bill. While stating he wants a "good" Civil Rights bill, he was able to maintain the high ground on an even more delicate issue. On the FICA tax cut, the President and other supporters should firmly state up front that no increase in the wage base beyond the Moynihan bill would be acceptable.

3. "Regressive taxes are better than progressive taxes. Republicans should not be supporting a tax plan that, like Moynihan, is progressive."

Under current law, the Social Security wage base is scheduled to increase to \$69,300 by 1996. This is without a reduction in the FICA tax rate. This scheduled increase would represent a substantial increase in the marginal rate for those making a salary equal to the wage base. The Moynihan tax cut plan would insure a fair plan with tax cuts for all Americans rather than a tax increase on many Americans.

4. "The President's position of 'don't mess with Social Security' is the popular position. Republicans should not "mess" with a good program."

Response: Again, the wage base is already scheduled to increase to \$69,300 in 1996 without any additional Congressional action. Second, the federal government, by raiding the surplus SS funds, is "messing" with SS in the worst way. In essence, the SS fund has become simply a supplement to the federal income tax, paying for extravagant government spending.

Also, Republicans' fear of "messing" with Social Security is based on previous election activity by senior citizen lobby groups. This time, the most aggressive elderly group, James Roosevelt's Committee to Preserve Social Security, is actively supporting the Moynihan bill and the American Association of Retired People (AARP) has not taken a position on the issue.

5. "In the final vote, the Democrats are going to make Republicans vote for a tax cut for the lower income workers to be paid for by the wealthy. Republicans need to think how they will vote when we go down that path."

Response: The Democrats may indeed lead us down that path. Since they control both houses of Congress, the final vote may be a trade-off between higher income and lower income workers. If the Democrats are convinced that soaking the rich will sell politically, they will force a trade-off vote whether Republicans get involved or not. If Republicans do a poor job of convincing the American people that a pro-growth tax cut should benefit all Americans, Republicans will be forced into the losing side of the debate. However, if Republicans fail to engage the debate at all, they will certainly be forced onto the losing side.

6. "In the end, the Democrats will make us pay for the FICA tax cut through higher taxes in other areas."

Response: Due to Republican's poor negotiating in last year's budget summit, the pay-as-you-go provision relies on outdated and biased scorekeeping. Pro-growth tax cuts that we all know will generate additional revenue will be scored using static analysis that will inevitably show a tax revenue loss to the treasury. The proper time to fight this was during the budget summit.

However, due to the Social Security Trust Fund being removed from the deficit calculations, a loophole exists for only one tax cut--the FICA tax. While a FICA tax cut will reduce the surplus in the SS Trust Fund, studies show that it will actually increase funds to the general fund. This is one example where Republicans benefit by making the Democrats play by their own rules.

**REDUCING SOCIAL SECURITY TAXES:
SOUND POLICY FOR TODAY AND TOMORROW?**

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I. INTRODUCTION

Social Security is the largest government program, collecting payroll taxes from 130 million working Americans and providing retirement, disability, survivor, and medical benefits to over 40 million people. Despite its size and the number of people it serves, the nature of Social Security and the way it is financed are often misunderstood.

Late in 1989, Senator Daniel Patrick Moynihan (D-NY) generated considerable debate by proposing a reduction in the payroll tax rate — currently set at 15.3 percent. The debate over the merits of a payroll tax cut continues today. Senator Moynihan, together with Senator Robert Kasten (R-WI), has re-introduced legislation to reduce the payroll tax. Similar legislation has been introduced in the House of Representatives by Frank Guarini (D-NJ) and Richard Armey (R-TX).

Proponents of a payroll tax cut argue it would reduce the tax burden on low- and middle-income workers, serve as a recession-fighting measure, and help maintain the long-term financial integrity of the program. Opponents argue that cutting payroll taxes will undermine Social Security's ability to pay retirement benefits to baby boomers or cause additional government borrowing, thereby raising interest rates.

Who is right? This report analyzes how a payroll tax cut would affect individuals, the economy, and the long-term financial integrity of the Social Security system. First, it reviews the financial state of Social Security, both now and in the future. It then examines the current tax burden on workers and retirees and estimates how this burden will grow if current practices continue. Next, it projects how two different versions of a payroll tax cut would affect GNP, employment and the stock of capital. Finally, two appendices elaborate points made in the text.

EXECUTIVE SUMMARY

Social Security is the largest government program. It is also one of the most misunderstood. Recent increases in payroll tax rates have created huge surpluses. Most people believe these surpluses are being saved in a trust fund to help ensure that future retirees will receive promised benefits. They are not. Payroll taxes not needed to pay current beneficiaries are borrowed and spent by the federal government and are replaced with government bonds. The government bonds held in Social Security's trust funds represent claims against future taxpayers.

Senators Daniel Patrick Moynihan (D-NY) and Robert Kasten (R-WI) have introduced legislation to reduce the Social Security payroll tax. Specifically, their proposal would phase-in a two percentage point reduction in the payroll tax over the next five years while increasing the Social Security wage base to \$82,200 by 1996 instead of the \$69,300 expected under current law.

Although a payroll tax cut would help stimulate the economy, the economic effects would be magnified if wage ceiling increases were limited to those prescribed by current law. By the year 2000, a phased-in two percentage point reduction in the payroll tax would:

- Increase GNP by \$112.2 billion (expressed in nominal dollars) over the next ten years. Without an increase in the wage base above those already scheduled under current law, the increase in GNP would be \$226.2 billion over that same period.
- Create 299,000 additional jobs. Without the additional wage base increase, employment would grow by 650,000 jobs.
- Increase the U.S. capital stock by \$64.4 billion (expressed in nominal dollars). Without the additional wage base increase, the increase in the capital stock would be \$137 billion.

In addition to providing a recession-fighting measure, reducing payroll taxes would lessen the burden of a tax that falls particularly hard on low- and middle-income workers. Today many workers pay more in Social Security payroll taxes than they do in income taxes. While the federal income tax burden was lowered during the 1980s at all income levels, the payroll tax burden increased. Social Security payroll tax rates rose from 12.26 percent in 1980 to 15.3 percent in 1990. As a result:

- At least 35 percent of taxpayers pay more in Social Security payroll taxes than they do in income taxes when only the employee's share of the tax (7.65 percent) is considered.
- When the employer's share is included — which most economists and policy analysts believe appropriate — at least 55 percent of today's taxpayers pay more in Social Security than income taxes.

- When fully phased-in, a two percentage point reduction in payroll tax rates would put \$600 more a year in the *average* worker's pocket.

Furthermore, a payroll tax cut would not come at the expense of future retirees. It would likely help, not hurt, Social Security's ability to meet its obligations in the long run. Some argue that cutting payroll taxes will undermine the Social Security trust fund reserves needed to pay benefits after the baby boom generation begins to retire around the year 2010. Trust fund reserves, however, are nothing more than government IOUs. They are not real savings. Redeeming these reserves to help pay benefits will require an infusion of general revenues into the trust funds sometime between 2010 and 2018, depending upon economic conditions.

At that time, income tax rates may well have to be raised to provide the additional general revenues for Social Security to meet its commitments. The income tax increase would affect not only future workers but retirees as well. Today approximately 15 percent of individual income taxes are paid by taxpayers age 65 and over — a percentage that will increase over time as the relative size of the elderly population and their incomes grow.

As a result, *workers age 40 and under today are likely to pay twice for their Social Security benefits*. Not only will they have paid higher payroll taxes while working, they are also likely to find their aftertax incomes reduced during retirement. Under favorable economic conditions:

- A *35-year old worker today* is likely to pay increased income taxes upon retiring in 2020 to bail out the Old-Age Survivor's and Disability Insurance (OASDI) trust fund. The increased tax would effectively reduce his or her Social Security benefit by up to 3 percent. An additional reduction of up to 11 percent could be needed to bail out Medicare.
- A *30-year old worker today* is likely to pay increased income taxes upon retiring in 2025 that would effectively reduce his or her Social Security benefit by up to 8 percent. An additional reduction of up to 15 percent could be needed to bail out Medicare.
- A *25-year old worker today* is likely to pay increased income taxes upon retiring in 2030 that would effectively reduce his or her Social Security benefit by up to 11 percent. An additional reduction of up to 19 percent could be needed to bail out Medicare.
- Under pessimistic economic conditions, these benefit reductions due to higher income taxes could be two or three times as large.

In summary, cutting payroll tax rates would stimulate the economy, reduce taxes on lower- and middle-income Americans and increase the likelihood that future Social Security commitments could be honored without major increases in general tax rates.

II. DEBUNKING COMMON SOCIAL SECURITY MYTHS

Even though Social Security is the largest government program, it is also one of the most misunderstood. An analysis of how a payroll tax cut would affect individuals, the economy, and the financial integrity of Social Security first requires debunking some myths about the program.

The Social Security system is actually composed of several parts. The largest part — the Old-Age and Survivors Insurance program (OASI) dispenses cash benefits to retirees, survivors, and their dependents. The Disability Insurance program (DI) dispenses cash benefits to disabled workers. These two programs, referred to as OASDI, are paid for by payroll taxes on workers and their employers. Currently, the tax rate is 12.4 percent (employers and employees each pay 6.2 percent) on the first \$53,400 in wages and salaries.

Medicare — Social Security's third major part — pays hospital and doctor bills for retirees age 65 and over and to disabled workers. Part A of Medicare, or the Hospital Insurance (HI) program, is financed by a payroll tax of 2.9 percent on the first \$125,000 in wages and salaries. Part B, or the Supplementary Medical Insurance (SMI) program, is 75-percent financed from general revenues with the remainder coming from premiums paid by beneficiaries.¹ The combined tax rate for all three programs is 15.3 percent.

All these programs operate on a pay-as-you-go basis. As such, benefits disbursed in any one year must be paid from tax revenues collected in that same year. In years when payroll taxes exceed benefits, the surplus is borrowed by the government and the Social Security "trust funds" receive credits in the form of government bonds. When payroll taxes fall short of benefits, these government bonds, or "reserves," are redeemed through general tax dollars and the proceeds placed in the trust funds. Because government bonds are redeemed by raising general taxes, or by further borrowing, Social Security's reserves are ultimately secured by the government's ability to tax.

The mechanics of how Social Security operates need further exploration since they are the root of many common misconceptions.² These points are also explored in greater detail in subsequent sections.

■ *There is no separate Social Security "trust fund" that collects payroll taxes and disburses benefits.* The trust fund exists only on paper as an accounting entry on the Treasury Department's books. As they are received and spent by the government, there is no difference between income taxes and Social Security payroll taxes.

¹ The budget package passed last October raised the Hospital Insurance wage base from \$51,300, applicable to the OASDI tax rate, to \$125,000. The package also increased the Medicare Part B premium so that beneficiaries will pay a somewhat larger share of costs.

² See Aldona and Gary Robbins, "Cutting Social Security Payroll Taxes: Honest Reform or Sleight-of-Hand?" Dallas, TX: The Institute for Policy Innovation, *IPI Policy Report* No. 103, February 1990 for a discussion of common Social Security myths.

Employers withhold both income and payroll taxes from their employees and deposit these taxes with Federal Reserve System banks. The Fed credits the combined amounts of income and payroll taxes to the Treasury's account which is used to pay the government's bills. The government then estimates the appropriate split between payroll and income taxes and credits the Social Security trust fund with estimated payroll taxes. If there are any unused credits after Social Security sends out its checks, the trust fund receives a government IOU in the form of a Treasury bond.

What the trust fund does is to give Social Security authority to spend money without going through the annual budget process that other government programs must. As long as there are Treasury IOU's in the trust fund, Social Security can continue to send out benefit checks. When the trust fund has cashed in all its IOU's, as happened in 1982, then the Congress must act.

■ *Higher payroll tax rates that have resulted in surpluses have not transformed Social Security from a "pay-as-you-go" to a "reserve" financing plan.* Recent payroll tax increases are primarily a product of the 1983 Social Security Amendments whose main objective was to get Social Security through the next ten years without another financial crisis.

Social Security is now, always has been, and without some fundamental change will continue to be a pay-as-you-go insurance program. The build-up of the trust funds now underway exists only on paper and does not alter the way benefits today are paid or the way future benefits will be paid. Whether in 1990 or 2020, Social Security benefits will be paid by taxing the wages or income of taxpayers in that same year.

■ *The Social Security trust fund is not as healthy as it appears.* On paper, the combined-OASDI trust fund does appear to be in excellent shape. The government projects that reserves, which currently stand at approximately \$215 billion, will grow by \$386 billion over the next five years and will peak in the year 2030 at some \$12 *trillion*.³ Unfortunately, appearances are deceiving.

The fact is that the federal government has already borrowed and spent the \$215 billion in reserves already generated; it will borrow and spend the \$386 billion accumulated during the next five years; and, at least until federal budget deficits are eliminated, it will borrow and spend all the reserves generated in the future. Moreover, interest owed on government bonds held by the trust fund as collateral are paid with additional government bonds.

Accumulating large paper reserves composed entirely of government IOUs does nothing to help ensure that future retirees will receive promised benefits. The net effect of these financing activities is to create additional federal liabilities — making it more difficult for Social Security to honor its long-term commitments. Ultimately, these federal liabilities can be repaid from only one source: future taxpayers.

³ Executive Office of the President, *Budget of the United States Government Fiscal Year 1992*, Washington, DC: Office of Management and Budget, February 1991. The \$386 billion consists of \$243 billion in excess payroll taxes and \$143 billion in interest.

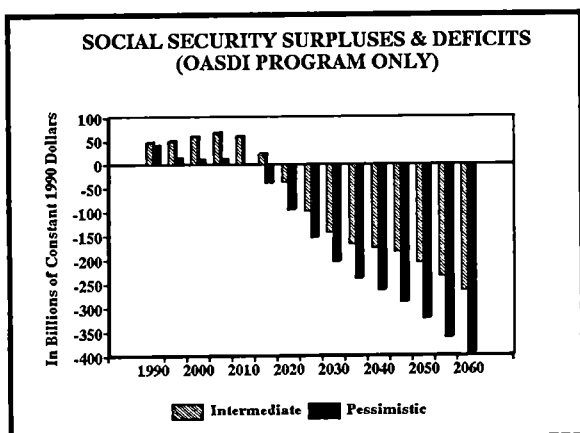
III. FINANCIAL OUTLOOK: SOUND OR SORRY?

Unlike private pension plans that provide benefits from income-producing assets in investment portfolios managed by trustees, Social Security is a pay-as-you-go retirement insurance plan that is paid for with current taxes. The Social Security system does have trustees, however, and one of their roles is to issue a report on the financial condition of the system over the next 75 years.⁴

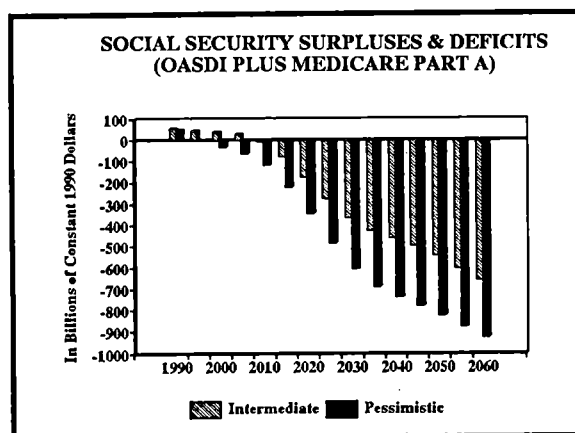
According to the most recent Trustees' report, Social Security will experience financing problems in the future. While expected to run modest surpluses over the next decade, the OASDI program could begin running deficits before 2010 — the time when the baby boom generation begins to retire — depending upon how the U.S. economy performs. As Graph 1 illustrates, these deficits will continue and grow larger each year.⁵

When Medicare Part A is added, the picture worsens considerably. As Graph 2 shows, initial surpluses are smaller while deficits begin earlier and grow much larger.

Graph 1



Graph 2



What will happen when deficits appear? As in the past, Social Security will dip into its trust fund "reserves." Specifically, when Social Security payroll taxes exceed benefits paid out, the excess payroll taxes are spent on other government programs, *not invested*. In exchange, the Treasury issues an interest-earning government bond to the Social Security trust funds. When Social Security payroll taxes fall short of benefits paid out, the trust fund

⁴ The Social Security Trustees have traditionally consisted of the Secretary of the Treasury, who is Managing Trustee, the Secretary of Health and Human Services, and the Secretary of Labor. The 1983 Social Security Amendments added two public trustees who are appointed by the Congress and the President.

⁵ Appendix A contains tables showing income, outgo, and surpluses/deficits in nominal and constant 1990 dollars.

cashes in some of its government bonds to cover the shortfall. In order to redeem the IOU held by the trust fund, Treasury must dig into general revenues. If the federal government is running a deficit — as has been the case and likely to continue in the future — taxes must be raised, or spending cut somewhere else, or more must be borrowed from private credit markets. More will be said about these possibilities in the next section.

The Effect of Changing Economic Conditions

Social Security's future is highly sensitive to the economy and population trends. Trustees' report projections use several different sets of assumptions. Table 1 summarizes the major differences between the "intermediate" and "pessimistic" long-run forecasts depicted in the graphs.

Table 1

KEY VARIABLES IN INTERMEDIATE AND PESSIMISTIC TRUSTEES' LONG-RUN FORECASTS

Variable	Intermediate	Pessimistic
Real GNP growth	1.8 %	1.3 %
Real wage growth	1.3 %	0.8 %
Inflation (CPI)	4.0 %	5.0 %
Fertility rate	1.90	1.60

Because the intermediate scenario is thought to be most likely, it generally forms the basis for policy changes. Although there is not that much difference between the assumptions in the intermediate and pessimistic paths, their differing impact on Social Security is substantial. While strained under either case, the system will be in far worse shape if the economy follows something closer to the pessimistic scenario.

Real wage growth is vitally import to social security's immediate and longer run financial condition. Real wages, in conjunction with employment, determine Social Security's tax base. As real wages lag, so do payroll tax receipts.⁶ Over the last 10 years, real wages have grown at an annual rate of 0.9 percent.

The fertility rate is an important determinant of the long-run picture. Higher fertility rates mean higher population growth and more workers to support the retired population.

⁶ The trustees' estimate that each one-half percentage point increase in real wages decreases OASDI's long-run deficit by 0.52 percent of taxable payroll. *1990 Annual Report of the Board of Trustees' of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Washington, DC, April 1990, p. 106.

Fertility rates have been declining over the last 10 years — averaging 1.85 — but it is too early to know whether they will approach the pessimistic scenario's assumption of 1.6 children for every woman of child-bearing age.⁷

Only time will tell which scenario proves closer to reality. Because the future could go either way and because the financial health of the system varies dramatically, analysis of Social Security should consider both the intermediate and pessimistic scenarios.

Social Security and the 1990 Budget Summit Agreement

The Omnibus Budget Reconciliation Act of 1990 (H.R. 5835) removes the Social Security trust funds from the deficit. Under Gramm-Rudman-Hollings, the Social Security trust funds were included in calculations of the deficit that could trigger a sequester. Because the trust funds have been running surpluses, no longer including them enlarges the apparent size of the federal deficit.

In fact, *the real deficit has not increased as a result of this accounting change*. When Social Security receives more in payroll taxes than it pays out in benefits, the excess payroll taxes are still used for other government spending, and the trust funds receive Treasury IOUs in exchange. In other words, excess payroll taxes reduce the amount that the government must borrow in private credit markets.

Recent estimates suggest that Social Security will run surpluses of \$386 billion over the next five years. Because Social Security is exempt from deficit calculations and these surpluses no longer artificially reduce the size of the deficit, it may prove tempting to spend the surpluses to increase benefits. This would further compound Social Security's long-term financing problems. The budget agreement recognized this possibility and established new voting majorities to make fundamental changes to Social Security more difficult.⁸

In sum, removing Social Security from deficit calculations neither increases saving in the short run nor improves the chances that future retirees will receive promised benefits.

⁷ Although fertility rates have increased slightly in the last two years, experts disagree whether this indicates a reversal of the previous trend or the result of women in their thirties, who postponed families, now having children. The trustees estimate that a fertility rate of 1.6 versus 1.9 increases OASDI's long-run deficit by 0.51 percent of taxable payroll. *1990 OASDI Trustees' Report*, p. 103.

⁸ Omnibus Reconciliation Act of 1990 (H.R. 5835), Conference Report, pp. 1160-61. The House bill creates a "fire wall" point of order (as free-standing legislation) to prohibit the consideration of legislation that would change the actuarial balance of the trust funds over a 5-year or 75-year period. The Senate requires a super-majority (60 votes) to enact changes in Social Security.

IV. SOCIAL SECURITY AND "TAX FAIRNESS": WHO REALLY PAYS?

There has been rising concern over the "fairness" of the tax system. While income tax rates were reduced during the 1980s, Social Security payroll tax rates increased — from 12.26 percent in 1980 to 15.3 percent in 1990. Because payroll taxes are imposed only on wages and salaries, which compose over 90 percent of the income of average working families, some have charged that it was unfair to reduce income taxes while increasing Social Security taxes.⁹

The economic reasons for reducing high income tax rates are not the subject of this paper. Social Security payroll tax rates, however, increased for their own reasons — reasons that bear no relationship to changes in income tax rates. Social Security is a pay-as-you-go system financed primarily through payroll taxes. As benefits increase — as they have over time — payroll taxes must also increase.

- In 1947, Social Security spending amounted to 0.2 percent of GNP while total federal spending composed 17.2 percent.
- By 1982, Social Security amounted to 6.2 percent of GNP while total federal spending was 19.7 percent.

This dramatic increase in Social Security spending has been reflected in the composition of federal receipts.¹⁰ As Graph 3 shows, payroll taxes as a share of total federal receipts have grown from 12 percent in 1955 to 28 percent today.

Ever-growing payroll taxes have generally not kept pace with ever-growing Social Security needs, however. As Graph 4 shows, payroll taxes — which compose 95 percent of Social Security income — were insufficient to pay benefits from 1971 through 1984.¹¹ During that time the trust fund cashed in its government debt so that benefit checks could continue. To redeem federal government IOUs, Treasury had to come up with approximately \$94.2 billion in general revenues, expressed in constant 1982 dollars. In other words,

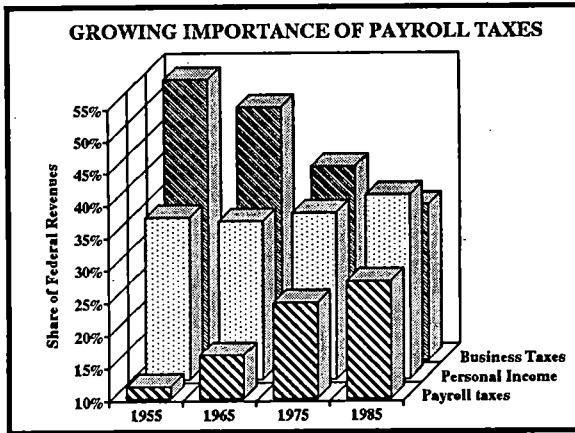
⁹ Kevin Phillips, *The Politics of Rich and Poor*, New York: Random House, 1990, p. 80.

¹⁰ The dramatic increase in Social Security has occurred for a number of reasons. First is the maturation of a pay-as-you-go system. Initially, there are far more workers than retirees. As workers age and retire, however, benefit payments go up. Second is the addition of new programs, such as Disability Insurance and Medicare, and benefit liberalization, such as permitting the receipt of reduced benefits at age 62. Third, the 1972 Social Security Amendments contained a flawed benefit formula that rapidly increased benefits. The 1977 Amendments, which corrected the flaw, still left benefits an average of one-third higher in real terms than during the previous 40 years of the system.

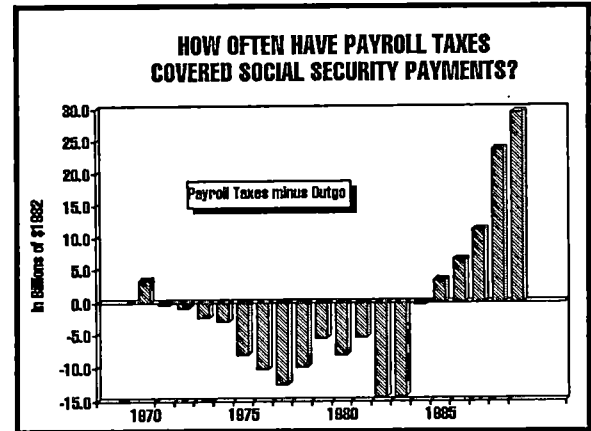
¹¹ In 1989, payroll taxes composed 94.7 percent of trust fund income; income from the taxation of Social Security benefits added another 0.9 percent; and interest income contributed 4.4 percent.

- Between 1971 and 1984, income taxes were higher than they would have been otherwise in order to bailout the Social Security trust funds.

Graph 3



Graph 4



Since 1985, the Social Security trust funds have run surpluses. This turnaround is a result of the 1983 Social Security Amendments which raised payroll tax rates higher than needed to pay current benefits. Some believe the resulting accumulation of trust fund IOUs is necessary to pay benefits when the baby boom generation retires.

Payroll Tax Burden on Today's Workers

Today many workers pay more in Social Security payroll taxes than they do in income taxes. Income tax changes legislated during the 1980s lowered the federal tax burden at all income levels.

- Marginal rates were substantially reduced relative to what they were in 1980.
- The personal exemption was doubled from \$1,000 in 1980 to \$2,000 by 1989, and the standard deduction was increased by over 50 percent for most taxpayers.
- As many as 4 million low-income taxpayers no longer pay income taxes.
- Income taxes for a family with \$10,000 in income are 134 percent lower than they would have been without the changes of the 1980s; for a family with \$20,000 in income the reduction is 83 percent.¹²

¹² Aldona and Gary Robbins, "Tax Fairness: Myths and Realities," Dallas, TX: National Center for Policy Analysis, *NCPA Policy Report No. 90*, Forthcoming. For example, a family with \$10,000 in income paid \$369 in federal income taxes in 1990 but would have paid \$863 if 1980 tax law had still been in effect.

Table 2

**AVERAGE INCOME & SOCIAL SECURITY TAXES, 1990
BY ADJUSTED GROSS INCOME, SINGLE FILERS**

Adjusted Gross Income	Cumulative Workers (in thous)	Taxpayer Distribution	Income Taxes	Social Security Taxes Employee Only	Employee & Employer
Nonfilers	4,305	8.2%	\$0	\$189	\$378
\$3,500	14,372	35.5%	\$0	\$189	\$378
\$10,000	10,655	55.8%	\$608	\$540	\$1,081
\$20,000	13,176	80.9%	\$2,091	\$1,160	\$2,319
\$30,000	5,823	91.9%	\$3,694	\$1,889	\$3,777
\$45,000	2,437	96.6%	\$7,733	\$2,965	\$5,929
\$60,000	900	98.3%	\$12,407	\$3,924	\$7,849
\$85,000	716	99.7%	\$20,338	\$3,924	\$7,849
\$175,000	122	99.9%	\$45,416	\$3,924	\$7,849
\$375,000	51	100.0%	\$87,697	\$3,924	\$7,849
\$1,700,000	9	100.0%	\$444,210	\$3,924	\$7,849
Taxes Paid by Average Filed Return			\$4,057	\$1,845	\$3,690

**AVERAGE INCOME & SOCIAL SECURITY TAXES, 1990
BY ADJUSTED GROSS INCOME, JOINT FILERS**

Adjusted Gross Income	Cumulative Workers (in thous)	Taxpayer Distribution	Income Taxes	Social Security Taxes Employee Only	Employee & Employer
Non-filers	4,210	5.5%	\$0	\$189	\$378
\$3,500	3,161	9.6%	\$0	\$189	\$378
\$10,000	5,479	16.7%	\$0	\$540	\$1,081
\$20,000	13,899	34.7%	\$1,015	\$1,160	\$2,319
\$30,000	14,699	53.8%	\$2,452	\$1,889	\$3,777
\$45,000	12,972	70.7%	\$4,383	\$2,965	\$5,929
\$60,000	9,748	83.3%	\$6,972	\$3,932	\$7,863
\$85,000	10,872	97.5%	\$12,131	\$4,531	\$9,061
\$175,000	1,488	99.4%	\$34,397	\$5,537	\$11,075
\$375,000	361	99.9%	\$85,143	\$5,887	\$11,773
\$1,700,000	111	100.0%	\$384,499	\$5,887	\$11,773
Taxes Paid by Average Filed Return			\$2,521	\$1,845	\$3,690

Source: Fiscal Associates Tax Model.

Rising payroll tax rates, however, have increased the Social Security tax burden for all workers. According to Table 2, which compares the income and Social Security taxes paid by single and married taxpayers:

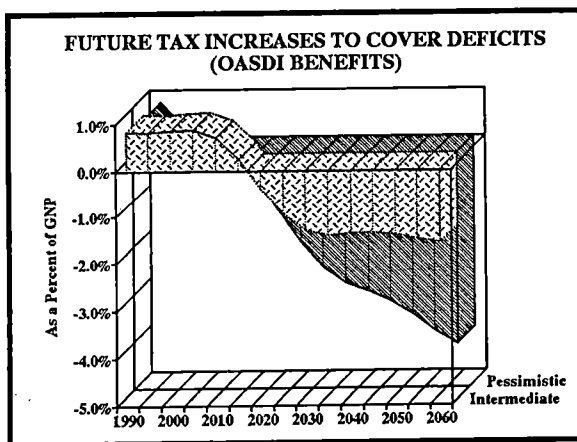
- At least 35 percent of taxpayers pay more in Social Security payroll taxes than they do in income taxes when only the employee's share of the tax (7.65 percent) is considered.
- When the employer's share is included — which most economists and policy analysts believe appropriate — at least 55 percent of today's taxpayers pay more in Social Security taxes than they pay in income taxes.

Taxes on Future Retirees

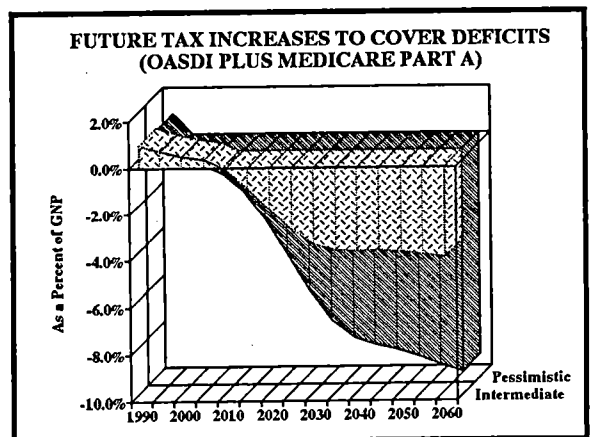
Currently higher-than-necessary payroll taxes are being imposed on today's workers reportedly to accumulate trust fund reserves that will help pay their retirement benefits. Because these reserves are in the form of government IOUs, an infusion of general revenues into the trust funds will be needed sometime between 2010 and 2018, depending upon economic conditions.

As Graph 5 shows, future tax increases to meet promised obligations of the OASDI program could reach between 2 and 3 percent of GNP by 2020. When part A of Medicare is included, that amount could be between 3 and 5 percent of GNP, as shown in Graph 6.

Graph 5



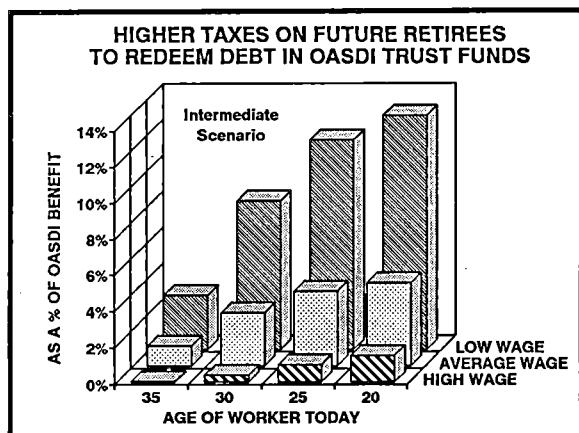
Graph 6



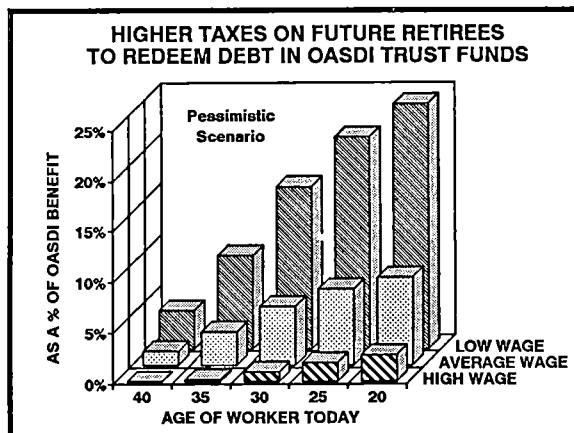
At that time, income tax rates may well have to be raised to provide the additional general revenues for Social Security. The income tax increase would affect not only future workers but retirees as well. Today approximately 15 percent of individual income taxes are

paid by taxpayers age 65 and over.¹³ This percentage will increase over time as the relative size of the elderly population and their incomes grow.

Graph 7



Graph 8



As a result, workers age 40 and under today are likely to find their aftertax incomes reduced during retirement. Graphs 7 through 10 show the potential increase in income taxes needed to pay currently promised Social Security and Medicare benefits. The increased taxes, which reduce aftertax income, are expressed as a percent of the cash retirement (OASDI) benefit. Each graph shows the percent reduction for low-, average-, and high-wage workers under the intermediate and pessimistic scenarios.¹⁴

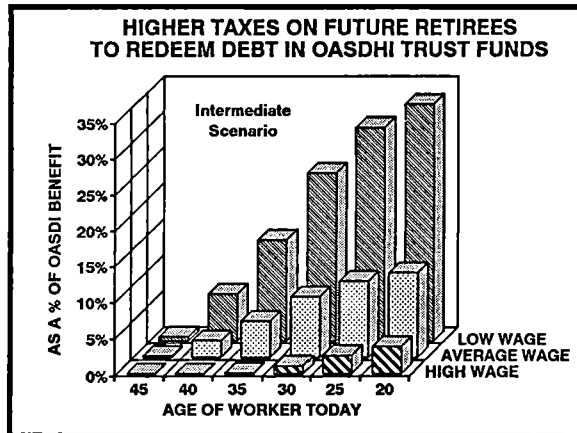
- **A 35-year old worker today** is likely to pay increased income taxes upon retiring in 2020 in order to bail out the OASDI trust fund. The increased tax would effectively reduce his or her Social Security benefit by up to 3 percent. An additional reduction of up to 11 percent could be needed to bail out the HI trust fund under the intermediate scenario. These amounts roughly triple under the pessimistic scenario.
- **A 30-year old worker today** is likely to pay increased income taxes upon retiring in 2025 to bail out the OASDI trust fund. The increased tax would effectively reduce his or her Social Security benefit by up to 8 percent. An additional reduction of up to 15 percent could be needed to bail out the HI trust fund under the intermediate scenario. These amounts roughly double under the pessimistic scenario.

¹³ Internal Revenue Service, *Statistics of Income--1986, Individual Income Tax Returns*, Washington, DC, 1989, Tables 1.1 and 2.5.

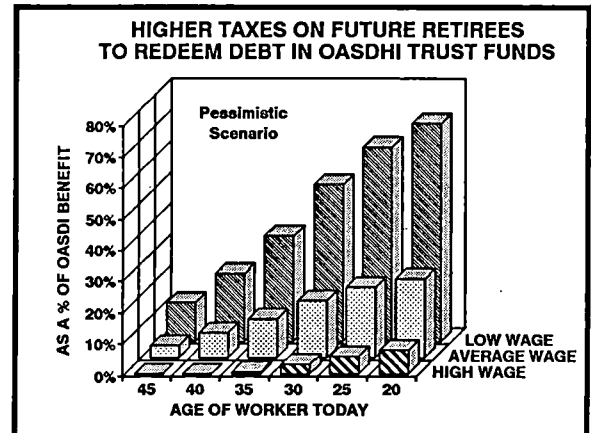
¹⁴ A low-wage worker always earns 45 percent of the Social Security average wage; an average-wage worker always earns the average wage (about \$21,500 in 1990); and a high-wage worker always earns the OASDI taxable maximum (\$53,400 in 1991). While the graphs show results for single workers, those for married couples are similar. We assume the worker's retirement income, including Social Security, equals his last year's wages. Tables in Appendix A contain the underlying numbers for both singles and marrieds.

- A **25-year old worker** today is likely to pay increased income taxes upon retiring in 2030 to bail out the OASDI trust fund. The increased tax would effectively reduce his or her Social Security benefit by up to 11 percent. An additional reduction of up to 19 percent could be needed to bail out the HI trust fund under the intermediate scenario. These amounts roughly double under the pessimistic scenario.

Graph 9



Graph 10



If we continue with current policy, future reductions in retirement incomes seem almost inevitable to meet Social Security promises. If the policy of accumulating government debt in the trust funds continues, those reductions will most likely come in the form of higher income taxes on future retirees. *Thus, today's workers will pay twice for their Social Security benefits.*

- During their working years they will have endured higher payroll taxes so that the trust funds could accumulate government debt.
- During their retirement years these workers will face higher income taxes in order to pay off accumulated trust fund debt so they can receive their "promised" Social Security benefits.

V. ALTERNATIVES: REDUCING PAYROLL TAXES

Today's workers are not necessarily doomed to having their retirement income cut. There are alternatives that could leave them better off than under current law.

Accumulating government debt in the Social Security trust funds does not assure today's workers that they will receive their promised benefits. In addition to having paid higher than necessary payroll taxes while working, they are likely to face higher income taxes in retirement to pay their own benefits.

A number of legislative proposals would remove the unnecessary payroll tax burden now. *Rather than hurting Social Security's chances to meet its promises, cutting payroll taxes would actually improve them.* The reason is that a reduction in payroll taxes would enhance take-home pay, increase labor supply, and lower labor costs. As a result, the economy would experience higher employment, capital accumulation, and output than otherwise. This higher level of growth would heighten the ability of taxpayers to pay Social Security's bills in the future.

Conversely, higher payroll taxes raise labor costs and reduce output, jobs and investment. In an earlier study, we estimated that the 1988 and 1990 Social Security payroll tax increases (from 14.3 percent to 15.3 percent) would result in 512,000 fewer jobs.¹⁵ Between June and November of last year, civilian employment declined by over one million.¹⁶ The payroll tax hikes by themselves would have caused an economic slowdown. The combination of banking system problems, higher oil prices, war in the Persian Gulf, higher taxes enacted in last fall's budget agreement, and the payroll tax increases helped end the longest peacetime expansion and push the economy into its current recession.

We have estimated the economic and revenue impact of the following two options over the next ten years:¹⁷

¹⁵ Aldona and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Washington, DC: Institute for Research on the Economics of Taxation, *Economic Report* No. 39, February 1988.

¹⁶ The Federal Reserve Bank of St. Louis, *National Economic Trends*, January 1991, p. 2.

¹⁷ The baseline is that of the Congressional Budget Office for the fiscal year 1992 Budget. Using the standard Cobb-Douglas production function, we have derived relationships to determine the changes in the amounts of capital services, labor services, and output that will occur in response to a change in the tax on labor. The long-term adjustments in response to a tax change will depend upon: (1) the size of the tax change; (2) the nature of the production process, i.e., how capital and labor are combined in the most effective way; (3) the responsiveness of workers to a change in their aftertax wage rate, or the elasticity of labor supply; and (4) the amount of U.S. capital affected by the tax change. In these policy simulations we used a labor supply elasticity of 0.3, which is well within the range of empirical estimates.

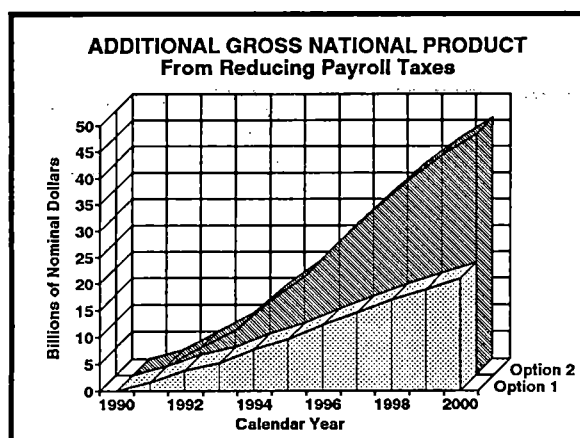
Option 1: A phased-in two percentage point reduction in the OASDI payroll tax rate — from 12.4 percent to 11.4 percent (beginning July 1, 1991) to 11 percent (beginning January 1, 1994) to 10.4 percent (beginning January 1, 1996) — plus an increase in the wage base to \$60,600 in 1992, \$64,200 in 1993, \$70,200 in 1994, \$73,800 in 1995, and \$82,200 in 1996 (similar to the Moynihan/Kasten bill as introduced).

Option 2: The same phased-in two percentage point reduction in the OASDI rate without the corresponding increases in the wage base.

Economic Effects of Reducing Payroll Taxes

Both options would benefit the economy by lowering the cost of labor. In the long run, the phased-in reduction of payroll tax rates would lower the cost of labor by four percent. Over the same time frame, increasing the wage base in addition to a phased-in rate reduction would lower the cost of labor by 1.9 percent.¹⁸

Graph 11



Raising the wage base would negate a significant part of the economic benefits from a rate reduction. The reason is that, although relatively few workers are affected, the incentive effects are substantial.¹⁹ The marginal rates on these workers increase from zero to 12.4 percent (the current OASDI rate) on their entire wages thereby dampening the reduction in the economy-wide average marginal tax rate on labor.²⁰

Graphs 11, 12, and 13 depict the effects of the two options on GNP, job creation, and capital accumulation.

- **Gross national product:** Over the next ten years, a phased-in two percentage point reduction in the payroll tax rate with corresponding increases in the wage base would increase GNP by \$112.2 billion (expressed in nominal

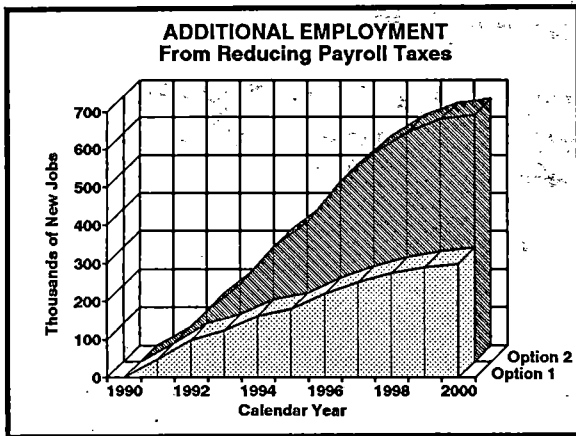
¹⁸ See Appendix A for detailed tables on the economic effects.

¹⁹ Over the last several years, about 90.5 percent of wages and salaries subject to social security tax are below the wage ceiling. Apart from the years 1937 to 1941, when social security taxes were first paid, this percentage is the highest in the program's history. In 1937, the wage base was \$3,000 and only 70 percent of wage and salaries were subject to tax; today 96.5 percent are covered by social security. See *Social Security Bulletin, Annual Statistical Supplement, 1988*, December 1988, Table 4.B1, p. 127.

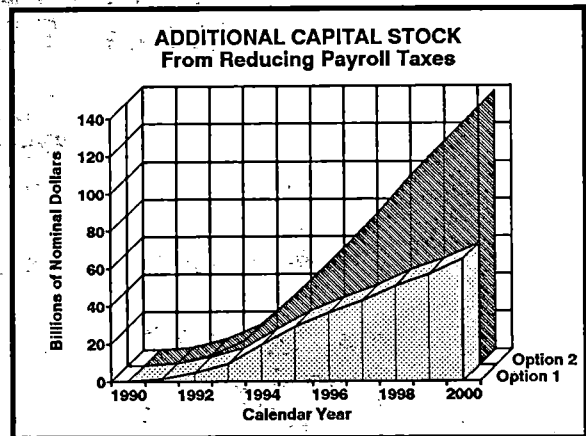
²⁰ See Appendix B for an explanation of the wage base effects.

dollars). The same reduction *without* a corresponding increase in the wage base would increase GNP by \$226.2 billion.

Graph 12



Graph 13



- **New jobs:** By the year 2000, a phased-in two percentage point reduction in the payroll tax rate with corresponding increases in the wage base would result in 299,000 more jobs than otherwise. The same reduction *without* a corresponding increase in the wage base would result in 650,000 more jobs.
- **Capital accumulation:** By the year 2000, a phased-in two percentage point reduction in the payroll tax rate with corresponding increases in the wage base would increase the capital stock by \$64.4 billion (expressed in nominal dollars). The same reduction *without* a corresponding increase in the wage base would increase the capital stock by \$137 billion.

Revenue Effects

Official revenue estimates are static in nature because they ignore the economic effects of a tax change. A reduction in payroll taxes would lead to more jobs, output, and investment. This would increase payroll and income tax revenue to federal, state, and local governments. Table 3 summarizes the static and dynamic (which include economic effects) revenue estimates over the next five and ten calendar years for the two options. (Appendix A contains a detailed, year-by-year breakdown of the revenue effects.)

On a static basis the phased-in cut with the increased wage base would lose \$124.7 billion in payroll tax revenues over the next five years. Over the same time period, the phased-in cut without an increase in the wage base would lose \$146.4 billion. The added growth and jobs, however, would generate additional federal revenues of \$9.5 billion and \$16.4 billion respectively.

Table 3

**Static and Dynamic Revenue Effects
of Two Payroll Tax Cut Options
(Amounts in \$billions; calendar years)**

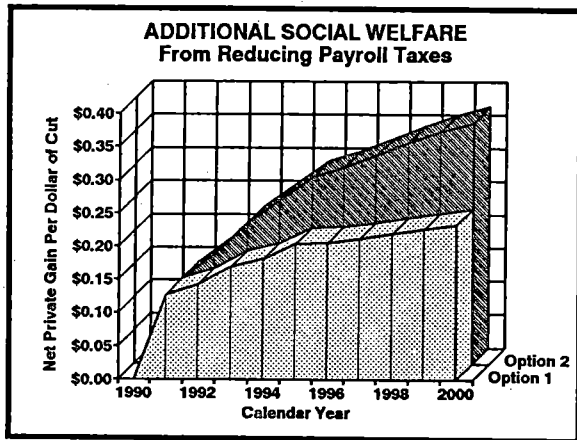
	Phased-in Cut		Plus Higher Wage Base	
	1991- 1995	1991- 2000	1991- 1995	1991- 2000
Static Tax Change	-146.5	-511.5	-124.7	-424.9
Additional Federal Payroll, Income, Excise, etc. Taxes	16.4	72.5	9.5	35.6
Dynamic Federal Tax Change	-130.1	-439.0	-115.2	-389.3
Efficiency*	88.8%	85.8%	92.4%	91.6%
Additional State & Local Taxes	8.8	40.0	5.1	19.5
Total Dynamic Change	-121.2	-399.1	-110.1	-369.8
Efficiency*	82.8%	78.0%	88.3%	87.0%

* Efficiency refers to the amount of revenue actually lost for every dollar of static revenue loss. It is calculated as the dynamic tax change divided by the static tax change and is averaged over the five and ten year periods.

- Over 1991 through 1995, for every dollar in static revenue loss the actual federal revenue loss would be an average of 92 cents for the phased-in cut with the increased wage base and 89 cents for the phased-in cut without the increased wage base.
- By the year 2000, the actual federal revenue loss would be 92 cents for the phased-in cut with increased wage base and 86 cents for the rate cut without an increased wage base.

- When the additional revenues to state and local governments are included, the actual loss for every dollar in static revenue loss would be an average of 88 cents and 83 cents, respectively, over 1991 through 1995.
- By the year 2000, the actual total revenue loss would be 87 cents for the phased-in cut with an increased wage base and 78 cents for the phased-in cut without an increased wage base.

Graph 14



Another criteria for evaluating alternative proposals is to measure their social welfare effects. The change in social welfare is the increase in private sector incomes less the decrease in public sector revenues.²¹ As Graph 14 shows, the phased-in reduction with a higher wage base would increase overall private goods and services by 23 cents and a phased-in reduction without a wage base increase would increase private welfare by 36 cents.

Will Interest Rates Rise?

Reducing payroll tax rates holds greater potential for helping Social Security keep its promises than allowing the trust fund accumulation of government debt to continue. The economic gains of a payroll tax cut include: (1) up to 650,000 more jobs than otherwise; (2) additional output that could amount to \$226 billion by the turn of the century; and (3) the capital stock, which represents the fruits of *real* saving, could be as much as \$137 billion higher by the year 2000.

Naysayers who claim that the payroll tax cut would hurt saving are wrong. Although they hold the view that the trust fund surpluses represent real saving, how these surpluses translate into plant, equipment, and jobs is not exactly clear. One argument is that trust fund surpluses mean the federal government has to borrow less from the public, thereby lowering interest rates. By reducing payroll taxes, Social Security surpluses would be less, thereby raising federal borrowing and interest rates.

²¹ The private sector receives the increase in GNP from the tax cut and the net reduction in payroll taxes (static revenue loss minus the dynamic economic gains). The amount the private sector gets to keep is further reduced by the actual revenue loss either through less goods and services provided by the government or increased borrowing from the private sector. If there were no dynamic gains, the private sector would get the tax cut but have to give it all back through reduced government spending or increased borrowing for a net gain of zero.

The problem with this argument is that federal borrowing does not have much, if any, effect on interest rates. Outstanding debt in U.S. credit markets is about \$13.2 trillion.²² The impact of an added \$50 to \$100 billion in federal borrowing on U.S. credit markets and, therefore, on interest rates is virtually negligible. Moreover, capital trades in a world market whose size is many times that of the U.S.

What naysayers ignore is that the trust fund surpluses do not magically appear. They come from somewhere, specifically the pockets of working Americans. Higher payroll taxes have an economic cost which any reduction in interest rates — if ever forthcoming — would fall far short of offsetting. As shown previously, higher payroll taxes raise the cost of labor and result in fewer jobs, output, and capital accumulation. Better to cut payroll tax rates now and enjoy the beneficial economic effects than accumulate trust fund surpluses that mean higher taxes now and even higher taxes in the future.

Other Reforms

While preferable to accumulating trust fund debt, the economic benefits from reducing payroll taxes will not cure all of Social Security's long run problems. Deficits will still remain.

The only way these deficits can be further reduced is through benefit reform. Possible reforms run the gamut of slowing the real growth in benefits to means-testing benefits to privatizing some or all of Social Security. Such reforms have been the subject of Social Security Advisory Councils, think-tank research, and Congressional proposals.

Time is running out, particularly for baby boomers. Unless serious benefit reform is undertaken soon, deficits in the OASDI and Medicare programs will mean disappointed future retirees who will face the prospect of higher taxes, or broken promises, or both. Even though there is no Social Security crisis this year, now is the time to begin a serious consideration of broad Social Security reform.

²² *Federal Reserve Bulletin*, September 1990.

VI. CONCLUSIONS

Social Security, while not experiencing an immediate crisis, does face serious longer run problems. The economy, on the other hand, is in the middle of what is likely to be a moderate recession that could last four to six quarters. Action could be taken today that would help both circumstances.

- Reducing payroll tax rates by two percentage points would stimulate the economy and add as many as 650,000 more jobs over the next five years than if there were no tax cut.
- Reducing payroll tax rates would also lower the burden of a tax that falls particularly hard on lower and middle income workers. Over one-half of workers today pay more in payroll taxes than they do in income taxes.
- These payroll tax cuts would not come at the expense of future retirees. All that excess payroll taxes do is to help finance government spending. They are not invested. All Social Security is left with are government IOUs that will likely have to be honored by higher income taxes on future taxpayers.
- Some of these future taxpayers will be retirees. Thus, today's workers will get to pay twice — higher payroll taxes now and higher income taxes in the future. They will have less to spend from the fruits of their labor today only to find out that Social Security's promises were empty.
- Reducing payroll tax rates would increase the total output of goods and services and the accumulation of capital above what they would be without the cut. The higher rate of growth and stock of real capital would improve the economy's ability to meet the future demands of Social Security.
- Reducing payroll taxes is not a panacea for Social Security, however. Deficits would still remain. It is still necessary for policymakers to revisit the issue of how Social Security can best meet its long-term commitments — and the sooner the better.

Note: Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation or as an attempt to aid or hinder the passage of any bill before Congress.

Appendix A

Table A-1A:	SOCIAL SECURITY INCOME, OUTGO, SURPLUSES AND DEFICITS, OLD-AGE SURVIVOR'S & DISABILITY INSURANCE (OASDI), Intermediate and Pessimistic Forecasts
Table A-1B:	SOCIAL SECURITY INCOME, OUTGO, SURPLUSES AND DEFICITS, OLD-AGE SURVIVOR'S & DISABILITY INSURANCE (OASDI) AND MEDICARE HOSPITAL INSURANCE (HI), Intermediate and Pessimistic Forecasts
Table A-2A:	HIGHER INCOME TAXES NEEDED TO REDEEM DEBT HELD BY OASDI AND HI TRUST FUNDS -- Intermediate Forecast
Table A-2B:	HIGHER INCOME TAXES NEEDED TO REDEEM DEBT HELD BY OASDI AND HI TRUST FUNDS -- Pessimistic Forecast
Table A-3:	ALL FEDERAL TAXES Under Two Options
Table A-4:	DYNAMIC REVENUE CHANGES Under Two Options
Table A-5:	TAXES AT ALL LEVELS Under Two Options
Table A-6:	REVENUE AND INCENTIVE EFFECTS Under Two Options
Table A-7:	ECONOMIC IMPACT OF TAX CUT Under Two Options

Table A-1A

**SOCIAL SECURITY INCOME, OUTGO, SURPLUSES AND DEFICITS
OLD-AGE SURVIVOR'S & DISABILITY INSURANCE (OASDI)**

***** 1990 TRUSTEES' REPORT INTERMEDIATE FORECAST *****

Year	Non-Interest				Surplus/	
	Income	\$1990	Outgo	\$1990	Deficit	\$1990
1990	299.1	299.1	253.5	253.5	45.6	45.6
1995	406.4	329.3	345.1	279.6	61.3	49.7
2000	547.3	364.5	458.8	305.5	88.5	58.9
2005	736.5	403.1	615.3	336.8	121.2	66.3
2010	983.3	442.4	853.0	383.8	130.3	58.6
2015	1,290.1	477.1	1,231.2	455.3	58.9	21.8
2020	1,677.4	509.8	1,798.2	546.5	(120.8)	(36.7)
2025	2,173.7	543.0	2,560.7	639.7	(387.0)	(96.7)
2030	2,822.3	579.5	3,516.4	722.0	(694.1)	(142.5)
2035	3,674.0	620.0	4,662.7	786.9	(988.7)	(166.9)
2040	4,772.0	661.9	6,029.7	836.4	(1,257.7)	(174.5)
2045	6,181.2	704.7	7,794.5	888.7	(1,613.3)	(183.9)
2050	7,992.5	749.0	10,180.4	954.0	(2,187.9)	(205.0)
2055	10,345.8	796.9	13,396.2	1,031.8	(3,050.4)	(234.9)
2060	13,410.2	849.0	17,580.5	1,113.0	(4,170.3)	(264.0)

***** 1990 TRUSTEES' REPORT PESSIMISTIC FORECAST *****

Year	Non-Interest				Surplus/	
	Income	\$1990	Outgo	\$1990	Deficit	\$1990
1990	293.5	293.5	254.0	254.0	39.5	39.5
1995	387.0	293.5	369.5	280.2	17.5	13.3
2000	532.8	316.6	515.9	306.6	16.9	10.0
2005	729.4	339.6	705.1	328.3	24.3	11.3
2010	994.0	362.6	994.6	362.8	(0.6)	(0.2)
2015	1,327.9	379.6	1,460.4	417.4	(132.5)	(37.9)
2020	1,753.4	392.7	2,173.9	486.9	(420.5)	(94.2)
2025	2,300.4	403.7	3,174.1	557.0	(873.7)	(153.3)
2030	3,015.3	414.6	4,493.6	617.8	(1,478.3)	(203.2)
2035	3,948.3	425.3	6,163.5	664.0	(2,215.2)	(238.6)
2040	5,148.7	434.6	8,261.0	697.3	(3,112.3)	(262.7)
2045	6,676.5	441.5	11,040.0	730.1	(4,363.5)	(288.6)
2050	8,624.3	446.9	14,844.5	769.2	(6,220.2)	(322.3)
2055	11,128.6	451.8	20,024.8	813.0	(8,896.2)	(361.2)
2060	14,362.9	456.9	26,824.3	853.3	(12,461.4)	(396.4)

Table A-1B

**SOCIAL SECURITY INCOME, OUTGO, SURPLUSES AND DEFICITS
OLD-AGE SURVIVOR'S & DISABILITY INSURANCE (OASDI)
AND MEDICARE HOSPITAL INSURANCE (HI)**

***** 1990 TRUSTEES' REPORT INTERMEDIATE FORECAST *****

Year	Non-Interest				Surplus/ Deficit	
	Income	\$1990	Outgo	\$1990		\$1990
1990	371.5	371.5	317.5	317.5	54.0	54.0
1995	504.3	408.6	450.8	365.3	53.5	43.3
2000	678.6	451.9	626.0	416.9	52.6	35.0
2005	912.2	499.3	864.9	473.4	47.3	25.9
2010	1,216.9	547.5	1,229.6	553.2	(12.7)	(5.7)
2015	1,594.4	589.6	1,805.4	667.6	(211.0)	(78.0)
2020	2,070.3	629.2	2,635.7	801.1	(565.4)	(171.8)
2025	2,679.6	669.4	3,780.8	944.5	(1,101.2)	(275.1)
2030	3,476.3	713.8	5,250.4	1,078.0	(1,774.1)	(364.3)
2035	4,523.6	763.4	7,040.5	1,188.2	(2,516.9)	(424.8)
2040	5,875.2	815.0	9,193.6	1,275.3	(3,318.4)	(460.3)
2045	7,609.9	867.6	11,941.7	1,361.5	(4,331.8)	(493.9)
2050	9,838.2	921.9	15,600.3	1,461.9	(5,762.1)	(540.0)
2055	12,731.7	980.6	20,493.0	1,578.4	(7,761.3)	(597.8)
2060	16,499.5	1,044.5	26,900.6	1,703.0	(10,401.1)	(658.5)

***** 1990 TRUSTEES' REPORT PESSIMISTIC FORECAST *****

Year	Non-Interest				Surplus/ Deficit	
	Income	\$1990	Outgo	\$1990		\$1990
1990	364.4	364.4	317.8	317.8	46.6	46.6
1995	480.3	364.2	481.9	365.5	(1.6)	(1.2)
2000	660.4	392.4	714.5	424.6	(54.1)	(32.1)
2005	902.8	420.3	1,034.6	481.7	(131.8)	(61.4)
2010	1,229.1	448.4	1,550.1	565.5	(321.0)	(117.1)
2015	1,639.4	468.6	2,407.0	688.0	(767.6)	(219.4)
2020	2,161.3	484.0	3,700.8	828.8	(1,539.5)	(344.8)
2025	2,831.2	496.8	5,580.0	979.1	(2,748.8)	(482.3)
2030	3,706.4	509.6	8,097.0	1,113.2	(4,390.6)	(603.7)
2035	4,849.2	522.4	11,253.6	1,212.3	(6,404.4)	(689.9)
2040	6,320.2	533.5	15,080.6	1,272.9	(8,760.4)	(739.4)
2045	8,191.3	541.7	19,973.6	1,320.9	(11,782.3)	(779.2)
2050	10,573.6	547.9	26,467.7	1,371.5	(15,894.1)	(823.6)
2055	13,633.0	553.5	35,167.5	1,427.8	(21,534.5)	(874.3)
2060	17,582.3	559.3	46,585.0	1,481.9	(29,002.7)	(922.6)

Table A-2A

**HIGHER INCOME TAXES NEEDED TO REDEEM DEBT HELD BY
OASDI AND HI TRUST FUNDS -- INTERMEDIATE FORECAST**

		OASDI Benefit for Worker Retiring in					
		2010	2015	2020	2025	2030	2035
WORKER							
LOW-WAGE		13,550	17,542	22,437	27,301	35,344	45,761
AVERAGE-WAGE		22,379	28,976	37,064	45,094	58,382	75,586
HIGH-WAGE		34,544	45,612	58,614	71,368	92,408	119,630
COUPLE							
LOW-WAGE		20,325	26,313	33,656	40,952	53,016	68,642
AVERAGE-WAGE		33,569	43,464	55,596	67,641	87,573	113,379
HIGH-WAGE		51,816	68,418	87,921	107,052	138,612	179,445
		Change in Income Tax to Redeem OASDI Debt					
		2010	2015	2020	2025	2030	2035
WORKER							
LOW-WAGE		0	0	2	97	338	676
AVERAGE-WAGE		(356)	(186)	395	1,319	2,403	3,452
HIGH-WAGE		(1,795)	(828)	1,752	5,848	10,720	15,489
COUPLE							
LOW-WAGE		0	0	22	159	398	686
AVERAGE-WAGE		(332)	(177)	413	1,373	2,515	3,630
HIGH-WAGE		(1,898)	(878)	1,859	6,169	11,320	16,370
		Change in Income Tax as % of Social Security Benefit					
		2010	2015	2020	2025	2030	2035
WORKER							
LOW-WAGE		0.0%	0.0%	0.0%	0.4%	1.0%	1.5%
AVERAGE-WAGE		-1.6%	-0.6%	1.1%	2.9%	4.1%	4.6%
HIGH-WAGE		-5.2%	-1.8%	3.0%	8.2%	11.6%	12.9%
COUPLE							
LOW-WAGE		0.0%	0.0%	0.1%	0.4%	0.8%	1.0%
AVERAGE-WAGE		-1.0%	-0.4%	0.7%	2.0%	2.9%	3.2%
HIGH-WAGE		-3.7%	-1.3%	2.1%	5.8%	8.2%	9.1%
		Change in Income Tax to Redeem OASDI & HI Debt					
		2010	2015	2020	2025	2030	2035
WORKER							
LOW-WAGE		0	0	7	277	864	1,720
AVERAGE-WAGE		35	666	1,848	3,753	6,141	8,788
HIGH-WAGE		175	2,965	8,200	16,641	27,401	39,429
COUPLE							
LOW-WAGE		0	0	103	451	1,018	1,746
AVERAGE-WAGE		32	634	1,932	3,907	6,427	9,241
HIGH-WAGE		185	3,146	8,699	17,554	28,934	41,673

Table A2-A
HIGHER INCOME TAXES NEEDED TO REDEEM DEBT HELD BY
OASDI AND HI TRUST FUNDS -- INTERMEDIATE FORECAST
(Continued)

Change in Income Tax to Redeem OASDI & HI Debt						
	2010	2015	2020	2025	2030	2035
WORKER						
LOW-WAGE	0.0%	0.0%	0.0%	1.0%	2.4%	3.8%
AVERAGE-WAGE	0.2%	2.3%	5.0%	8.3%	10.5%	11.6%
HIGH-WAGE	0.5%	6.5%	14.0%	23.3%	29.7%	33.0%
COUPLE						
LOW-WAGE	0.0%	0.0%	0.3%	1.1%	1.9%	2.5%
AVERAGE-WAGE	0.1%	1.5%	3.5%	5.8%	7.3%	8.2%
HIGH-WAGE	0.4%	4.6%	9.9%	16.4%	20.9%	23.2%

Table A2-B
HIGHER INCOME TAXES NEEDED TO REDEEM DEBT HELD BY
OASDI AND HI TRUST FUNDS -- PESSIMISTIC FORECAST

OASDI Benefit for Worker Retiring in						
	2010	2015	2020	2025	2030	2035
WORKER						
LOW-WAGE	14,182	18,800	24,588	30,628	40,603	53,825
AVERAGE-WAGE	23,409	31,033	40,607	50,589	67,064	88,903
HIGH-WAGE	36,135	48,850	64,217	80,065	106,150	140,707
COUPLE						
LOW-WAGE	21,273	28,200	36,881	45,943	60,904	80,737
AVERAGE-WAGE	35,114	46,549	60,911	75,884	100,596	133,355
HIGH-WAGE	54,202	73,274	96,326	120,098	159,224	211,060

Change in Income Tax to Redeem OASDI Debt						
	2010	2015	2020	2025	2030	2035
WORKER						
LOW-WAGE	0	0	41	295	746	1,398
AVERAGE-WAGE	2	415	1,347	2,919	5,040	7,694
HIGH-WAGE	8	1,826	5,932	12,819	22,241	34,084
COUPLE						
LOW-WAGE	0	0	113	436	985	1,757
AVERAGE-WAGE	2	401	1,399	3,012	5,222	8,001
HIGH-WAGE	9	1,936	6,287	13,498	23,437	35,945

Table A-2B
HIGHER INCOME TAXES NEEDED TO REDEEM DEBT HELD BY
OASDI AND HI TRUST FUNDS -- PESSIMISTIC FORECAST
(Continued)

Change in Income Tax as % of Social Security Benefit						
	2010	2015	2020	2025	2030	2035
WORKER						
LOW-WAGE	0.0%	0.0%	0.2%	1.0%	1.8%	2.6%
AVERAGE-WAGE	0.0%	1.3%	3.3%	5.8%	7.5%	8.7%
HIGH-WAGE	0.0%	3.7%	9.2%	16.0%	21.0%	24.2%
COUPLE						
LOW-WAGE	0.0%	0.0%	0.3%	0.9%	1.6%	2.2%
AVERAGE-WAGE	0.0%	0.9%	2.3%	4.0%	5.2%	6.0%
HIGH-WAGE	0.0%	2.6%	6.5%	11.2%	14.7%	17.0%
Change in Income Tax to Redeem OASDI & HI Debt						
	2010	2015	2020	2025	2030	2035
WORKER						
LOW-WAGE	0	0	151	929	2,216	4,043
AVERAGE-WAGE	895	2,406	4,931	9,182	14,970	22,243
HIGH-WAGE	4,396	10,581	21,718	40,331	66,056	98,540
COUPLE						
LOW-WAGE	0	0	413	1,371	2,924	5,079
AVERAGE-WAGE	834	2,321	5,124	9,476	15,510	23,133
HIGH-WAGE	4,644	11,215	23,016	42,467	69,608	103,921
Change in Income Tax to Redeem OASDI & HI Debt						
	2010	2015	2020	2025	2030	2035
WORKER						
LOW-WAGE	0.0%	0.0%	0.6%	3.0%	5.5%	7.5%
AVERAGE-WAGE	3.8%	7.8%	12.1%	18.2%	22.3%	25.0%
HIGH-WAGE	12.2%	21.7%	33.8%	50.4%	62.2%	70.0%
COUPLE						
LOW-WAGE	0.0%	0.0%	1.1%	3.0%	4.8%	6.3%
AVERAGE-WAGE	2.4%	5.0%	8.4%	12.5%	15.4%	17.3%
HIGH-WAGE	8.6%	15.3%	23.9%	35.4%	43.7%	49.2%

Table A-3

ALL FEDERAL TAXES
Under Two Options

Calendar Year	Static Tax Change	Dynamic Tax Change	Dynamic Efficiency of Tax Change
Phased-in Two Percentage Point Payroll Tax Cut			
1991	-12.0	-11.4	94.81%
1992	-25.4	-23.6	92.68%
1993	-26.9	-23.9	88.81%
1994	-39.8	-35.0	87.98%
1995	-42.3	-36.2	85.49%
1996	-64.3	-56.2	87.31%
1997	-68.4	-58.5	85.50%
1998	-72.7	-61.2	84.19%
1999	-77.4	-64.6	83.49%
2000	-82.3	-68.5	83.32%
Plus Additional Wage Base Increase			
1991	-12.0	-11.4	94.81%
1992	-23.4	-22.0	94.10%
1993	-22.4	-20.5	91.74%
1994	-35.3	-32.8	92.79%
1995	-31.6	-28.5	90.18%
1996	-52.9	-49.0	92.67%
1997	-56.2	-51.6	91.81%
1998	-59.8	-54.5	91.12%
1999	-63.6	-57.8	90.77%
2000	-67.7	-61.3	90.54%

Table A-4

DYNAMIC REVENUE CHANGES
Under Two Options

Calendar Year	Federal Soc.Sec Tax	Federal Corporate Inc.Tax	Federal Personal Inc.Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
Phased-in Two Percentage Point Payroll Tax Cut							
1991	0.1	0.1	0.3	0.0	0.6	0.3	0.9
1992	0.4	0.3	1.0	0.1	1.9	1.0	2.8
1993	0.7	0.6	1.6	0.1	3.0	1.6	4.6
1994	1.1	0.9	2.6	0.2	4.8	2.6	7.4
1995	1.4	1.1	3.3	0.3	6.1	3.3	9.5
1996	1.9	1.5	4.4	0.4	8.2	4.5	12.6
1997	2.3	1.8	5.3	0.5	9.9	5.5	15.4
1998	2.7	2.0	6.1	0.6	11.5	6.4	17.9
1999	3.1	2.3	6.7	0.7	12.8	7.1	19.9
2000	3.4	2.4	7.2	0.7	13.7	7.7	21.4
Plus Additional Wage Base Increase							
1991	0.1	0.1	0.3	0.0	0.6	0.3	0.9
1992	0.3	0.3	0.8	0.1	1.4	0.7	2.1
1993	0.4	0.3	1.0	0.1	1.8	1.0	2.8
1994	0.6	0.5	1.3	0.1	2.5	1.4	3.9
1995	0.8	0.5	1.6	0.2	3.1	1.7	4.8
1996	1.0	0.7	2.0	0.2	3.9	2.1	6.0
1997	1.2	0.8	2.4	0.2	4.6	2.5	7.1
1998	1.4	0.9	2.8	0.3	5.3	2.9	8.2
1999	1.5	1.0	3.0	0.3	5.9	3.3	9.1
2000	1.7	1.1	3.3	0.3	6.4	3.6	10.0

Table A-5

**TAXES AT ALL LEVELS
Under Two Options**

Calendar Year	Static Tax Change	Dynamic Tax Change	Dynamic Efficiency of Tax Change
Phased-in Two Percentage Point Payroll Tax Cut			
1991	-12.0	-11.1	92.13%
1992	-25.4	-22.6	88.86%
1993	-26.9	-22.3	82.89%
1994	-39.8	-32.5	81.53%
1995	-42.3	-32.9	77.62%
1996	-64.3	-51.7	80.35%
1997	-68.4	-53.0	77.49%
1998	-72.7	-54.9	75.42%
1999	-77.4	-57.5	74.28%
2000	-82.3	-60.8	73.95%
Plus Additional Wage Base Increase			
1991	-12.0	-11.1	92.13%
1992	-23.4	-21.3	91.01%
1993	-22.4	-19.5	87.37%
1994	-35.3	-31.4	88.87%
1995	-31.6	-26.8	84.82%
1996	-52.9	-46.9	88.63%
1997	-56.2	-49.1	87.29%
1998	-59.8	-51.6	86.21%
1999	-63.6	-54.5	85.66%
2000	-67.7	-57.7	85.27%

Table A-6

REVENUE AND INCENTIVE EFFECTS
Under Two Options

Calendar Year	Payroll Tax Rate Changes	Payroll Tax Revenue Changes	Percent Change in Labor Tax Rate
------------------	-----------------------------------	--------------------------------------	---

Phased-in Two Percentage Point Payroll Tax Cut

1991	-0.5%	-12.0	-1.1%
1992	-1.0%	-25.4	-2.1%
1993	-1.0%	-26.9	-2.1%
1994	-1.4%	-39.8	-3.0%
1995	-1.4%	-42.3	-2.8%
1996	-2.0%	-64.3	-4.2%
1997	-2.0%	-68.4	-4.2%
1998	-2.0%	-72.7	-4.2%
1999	-2.0%	-77.4	-4.2%
2000	-2.0%	-82.3	-4.0%

Plus Additional Wage Base Increase

1991	-0.5%	-12.0	-1.1%
1992	-1.0%	-23.4	-1.3%
1993	-1.0%	-22.4	-1.0%
1994	-1.4%	-35.3	-1.4%
1995	-1.4%	-31.6	-1.2%
1996	-2.0%	-52.9	-1.9%
1997	-2.0%	-56.2	-1.9%
1998	-2.0%	-59.8	-1.9%
1999	-2.0%	-63.6	-1.9%
2000	-2.0%	-67.7	-1.9%

Table A-7

ECONOMIC IMPACT OF TAX CUT
Under Two Options

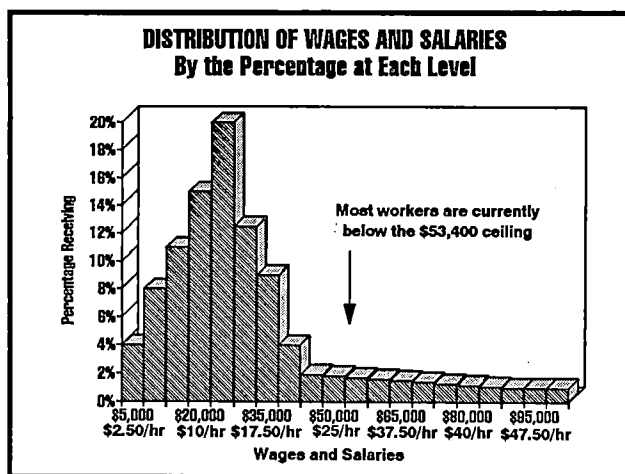
Calendar Year	Output		Employment		Capital Stock	
	\$bil	% change	mil	% change	\$bil	% change
Phased-in Two Percentage Point Payroll Tax Cut						
1991	1.6	0.03%	48	0.05%	1.1	0.01%
1992	5.0	0.09%	135	0.13%	5.3	0.03%
1993	8.4	0.15%	205	0.19%	13.0	0.07%
1994	13.8	0.23%	302	0.28%	28.3	0.13%
1995	18.5	0.29%	369	0.33%	45.4	0.20%
1996	25.1	0.36%	474	0.42%	62.8	0.27%
1997	31.0	0.42%	549	0.48%	81.0	0.33%
1998	36.6	0.47%	604	0.52%	101.2	0.39%
1999	41.4	0.50%	638	0.54%	119.2	0.43%
2000	45.4	0.52%	650	0.54%	137.0	0.47%
Plus Additional Wage Base Increase						
1991	1.6	0.03%	48	0.05%	1.1	0.01%
1992	3.7	0.07%	99	0.09%	4.4	0.02%
1993	5.2	0.09%	124	0.11%	9.4	0.05%
1994	7.8	0.13%	161	0.15%	19.4	0.09%
1995	9.7	0.15%	181	0.16%	28.9	0.13%
1996	12.4	0.18%	219	0.19%	36.3	0.15%
1997	14.7	0.20%	250	0.22%	42.8	0.17%
1998	17.1	0.22%	274	0.23%	50.5	0.19%
1999	19.0	0.23%	289	0.24%	56.5	0.20%
2000	21.0	0.24%	299	0.25%	64.4	0.22%

Appendix B

Marginal and Average Payroll Tax Rates

There is growing awareness that increases in taxes on labor have negative employment effects. The initial effect of an increase in payroll tax rates is to increase the amount of labor compensation that goes for taxes and reduce the amount available for all other purposes. Labor compensation is based upon the contribution of workers to output, or the value of their product. Historically, labor has received two-thirds of private sector output and capital has received one-third. This observed empirical result is due to long-run technological factors.

A business must cover all the costs of employing workers, including money wages, fringe benefits, and all the taxes associated with labor such as social security and unemployment compensation. An increase in payroll tax rates, although ostensibly split between employer and employee, must come out of the total pay package, or labor's share of output. Unless a way can be found to offset the payroll tax increase, its effect will be to increase the labor costs of businesses and to reduce the take-home pay of workers.

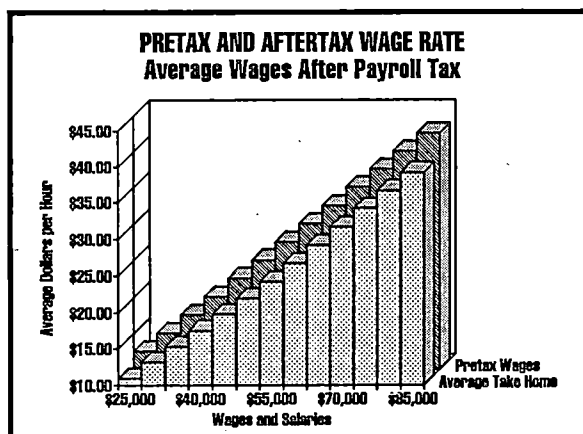


Graph B-1

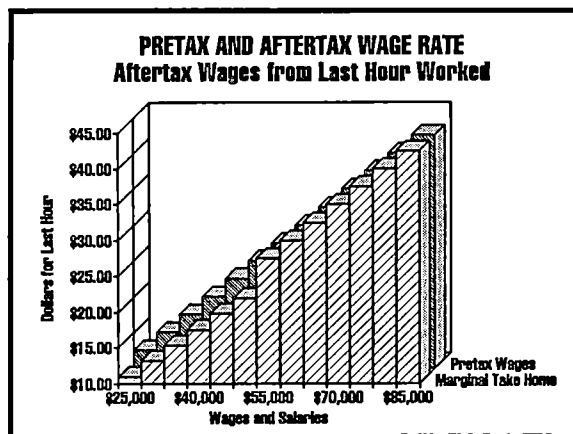
Social security taxes are levied on covered wages and salaries up to a stated maximum, or "wage ceiling." The wage ceiling for 1991 is \$53,400. Individual workers and their employers pay 6.2 percent each on wages below the ceiling. Since it is generally agreed that the employee pays the entire amount, we shall ignore the accounting difference between who writes the check and consider that the employee pays 12.4 percent up to the ceiling. In order to assess the impact of a change in the structure of the tax on the U.S. economy, we must look at all U.S. employees and calculate an average impact

of the rate change based on the percentage of workers affected by the change.

Graph B-1 shows the projected distribution of wages and salaries in the U.S. during 1991 by the percent of workers at each level of earnings. Most workers earn a wage near the mean, and the number of workers receiving much higher levels decreases rapidly as salary size increases. Well over 85 percent of workers earn less than the current \$53,400 maximum tax base. These workers will be unaffected by an increase in the payroll tax ceiling.



Graph B-2

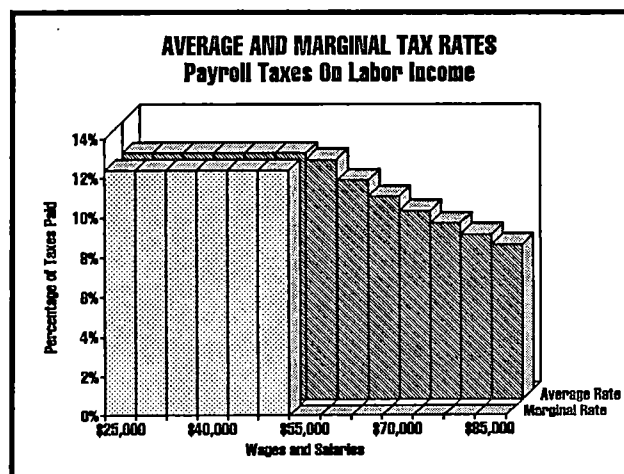


Graph B-3

Graph B-2 and Graph B-3 compare the impact of the payroll tax on average wages and on the last hour worked. Take-home pay is a constant percent of the average wage up to the ceiling. Above the ceiling the tax is capped and take-home pay becomes an increasing percentage of pretax wages. Take-home pay from the last hour worked is also a constant percentage of pretax wages up to the ceiling. In contrast to the average, take-home pay on the last hour worked for wage rates above the ceiling is equal to pretax wages.

Graph B-4 translates the pretax and aftertax wage levels into effective average and marginal tax rates. On average, the payroll tax is flat up to the ceiling and a falling percentage of wages above the ceiling. The tax rate on the last hour worked — the marginal tax rate — is constant up to the ceiling and zero above it.

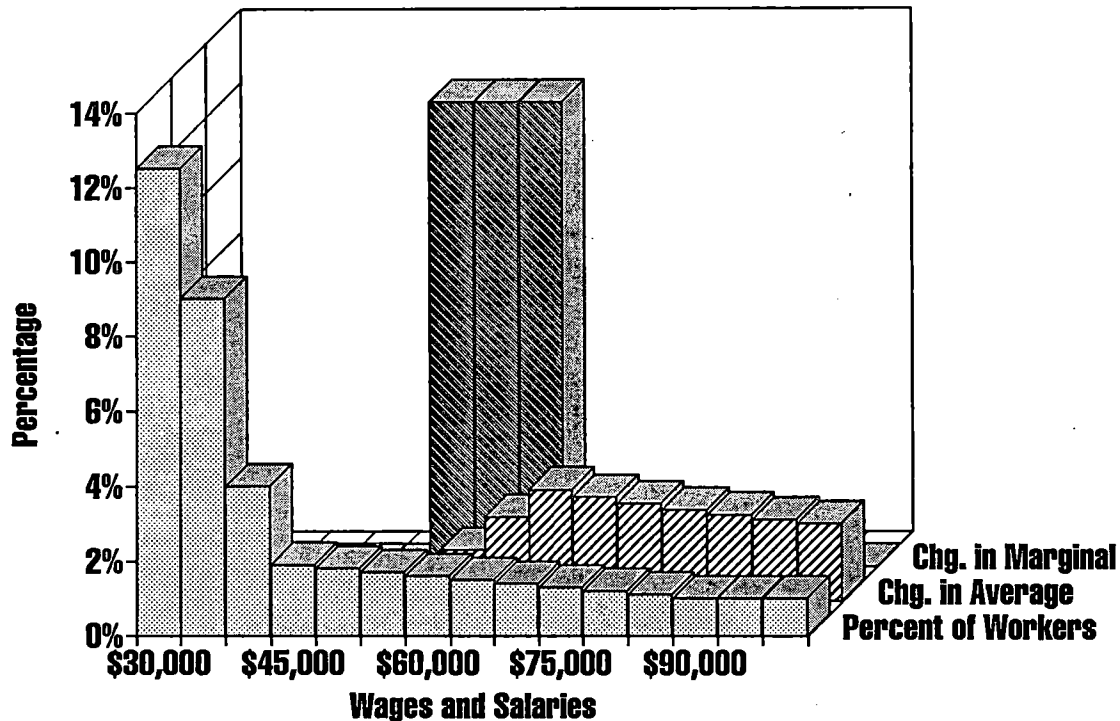
Raising the ceiling is simply an extension of the previous graphs. The point at which the average rate begins to fall (and the marginal falls to zero) occurs at a higher level of income. Graph B-5 shows the changes in the average and marginal rates. The change in the average rate increases up to the new ceiling and then falls as the increased maximum tax becomes a smaller percentage of wages. The marginal tax rate is increased by the total payroll tax rate for those salary levels, formerly above the ceiling, which are now below the new ceiling.



Graph B-4

The foreground distribution provides the percentage of workers affected by the average and marginal changes. The economy-wide change is the sum of the change at each level times the percentage of workers at that level. The less-than-13 percent of workers

EFFECT OF CEILING INCREASE On Average and Marginal Tax Rates



Graph B-5

above the current ceiling will experience an average rate change of about 2.1 percent, or less than a 0.26 percentage point rate increase. About 38 percent of the affected workers will also have an increase in their marginal tax rate of 12.4 percent. The marginal rate change is 5.9 times the average rate change and it applies to 38 percent of the affected workers. This means that the effective economy-wide marginal rate change is about 2.2 times as great as the average rate change.

The average rate change is used to determine how much revenue the ceiling increase will raise. The marginal rate change determines the disincentive effect of the ceiling increase. The ceiling increase will raise revenue but at a relatively high cost to workers' incentives. The dynamic economic analysis suggests that more than one half of the employment effect due to a rate reduction is lost due to the ceiling increase.

ABOUT THE AUTHORS

Aldona Robbins, Vice President of Fiscal Associates, a Washington area economic consulting firm, and Research Associate with IPI, has extensive experience with public and private retirement programs. As senior economist in the Office of Economic Policy, U.S. Department of the Treasury from 1979 to 1985, Dr. Robbins performed staff work for the Secretary in his capacity as Managing Trustee of the Social Security trust funds. Recent publications include an *IPI Report* entitled "Cutting Social Security Payroll Taxes: Honest Reform or Sleight-of-hand?," a *National Center for Policy Analysis (NCPA) and IPI Report* entitled "Paying People Not To Work: The Economic Cost of the Social Security Retirement Earnings Limit," a book entitled *The ABCs of Social Security*, and *Institute for Research on the Economics of Taxation Economic Reports* entitled "Effects of the 1988 and 1990 Social Security Tax Increases" and "The Insurance Value of Catastrophic Coverage." Articles on Individual Retirement Accounts and Medicare have appeared in *The Wall Street Journal*. She received a master's and doctorate in Economics from the University of Pittsburgh.

Gary Robbins is President of Fiscal Associates and Research Associate with the IPI. Mr. Robbins has developed a general equilibrium model of the U.S. economy that specifically incorporates the effects of taxes and government spending. Before joining the private sector, he was Chief of the Applied Econometrics Staff at the U.S. Treasury Department from 1982 to 1985, Assistant to the Under Secretary for Tax and Economic Affairs from 1981 to 1982, and Assistant to the Director of the Office of Tax Analysis from 1976 to 1981. Recent publications include an *IPI Report* entitled "Will Raising Taxes Reduce the Deficit? (The Economic and Revenue Effects of a Tax Increase)," an *NCPA and IPI Report* entitled "Taxing Capital Gains," an *NCPA Report* on "Taxing the Savings of Elderly Americans," and an article "Encouraging Private Provision for Long-Term Care" in *Compensation and Benefits Management*. Articles on various tax policy issues have appeared in *The Wall Street Journal*. He received his master's in Economics from Southern Methodist University.



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THE WHITE HOUSE
WASHINGTON

April 15, 1991

NOTE FOR THE CHIEF OF STAFF:

Director Darman wanted to be sure you saw the attached documents on Social Security, which will forward more broadly as you suggest.

Thank you.



Phillip D. Brady



**AARP OPPOSES PAYROLL TAX CUTS
RESERVES NOT YET SUFFICIENT TO PROTECT BENEFITS**

AARP opposes reducing Social Security payroll taxes and returning the system to pay-as-you-go financing. With the important role that Social Security plays in our society, the program should have at least a one-and-one-half year reserve to cushion it against economic fluctuations.

More than 40 million Americans--retired and disabled workers, their spouses and children and widows/ers--receive Social Security benefits to help make up for the loss of income due to the retirement, death or disability of a breadwinner. No fundamental change in Social Security should be enacted until all of the consequences of that change are fully understood.

Proposals to "rollback" the taxes collected for the Old-Age, Survivors and Disability Insurance (OASDI) trust funds, as popular as they might seem on the surface, fail to address serious concerns about the current and future stability of Social Security. While some would argue the wisdom of building up a long-term reserve in the program, that debate can await another day. The short-term outlook is sufficiently cloudy to give anyone pause.

The reserve in the OASDI trust funds is not now at a level sufficient to protect the system and its beneficiaries from short-term cyclical economic conditions. Current projections by the Social Security Administration (SSA) actuaries indicate that the reserve in the trust funds will not reach the level of over one year of benefits until late in 1992 and the level of 18 months of benefits until 1995. These projections include a short and shallow recession as part of their economic assumptions.

Last year's estimates by the actuaries, prior to the current recession, assumed that the trust funds would reach the one year level by the beginning of 1992. These changing projections illustrate how sensitive the Social Security trust funds are to any downturn in the economy.

Reducing income to the trusts funds by cutting payroll taxes would simply make the funds more vulnerable. Under "normal" economic conditions (the SSA actuaries' II-B assumptions), a reduction in the payroll tax of one percent, as proposed in S. 11, would mean that the OASDI reserves do not reach 18 months of benefits before the turn of the century. Even more disturbing, the actuaries estimate that the trust funds would have no reserve within 15 years under long-term negative economic conditions (alternative III assumptions), if S. 11 were enacted.

Page 2
Statement on Payroll Tax Cuts

While some would argue that the III assumptions are unrealistic, SSA Commissioner Gwen King recently stated, "The current economic circumstances actually mirror alternative III--the worst case scenario."¹

Confidence in Social Security has slowly been increasing since the adoption of the 1983 amendments which rescued the program from imminent bankruptcy. Anything that endangers this confidence building among younger workers should be viewed with great apprehension. Reducing payroll taxes could unwittingly cause Social Security's stability to be drawn into question--an outcome that can only suit the interests of those who do not support social insurance or those who want to scare older voters into thinking that Social Security is in jeopardy.

If the concern underlying most pay-as-you-go proposals is that the Federal government is borrowing Social Security reserves to finance deficit spending, then that issue should be dealt with directly. We must not throw away the hard-won financial stability of Social Security because of concerns, however valid, about the deficit. Reducing payroll taxes is a bet not worth making--the odds are too long and the stakes too high.

js--04/10/91

¹March 20, 1991, Hearing of the House Appropriations Subcommittee on Labor/Health and Human Services

THE ECONOMIC EFFECTS OF UNCOMPEN- SATED CHANGES IN THE FUNDING OF SOCIAL SECURITY

SUMMARY

The economic effects of moving toward pay-as-you-go funding of Social Security and away from the present system (which has some advance funding), would be negligible if the changes in the budget deficit that would be implied by this change in fiscal policy were offset by other fiscal measures.

If, however, there are no offsetting changes in fiscal policy--whether through changes in other taxes or through changes in government spending--then the change in the federal deficit from a change to pay-as-you-go funding of Social Security is likely to be reflected in a decline in national saving over the first 25 years (relative to what would occur if the current system was maintained), and an increase in national saving afterward.

CBO simulations--which assume no offsetting fiscal measures--with three economic models suggest that during the period of declining national saving, output would rise briefly and then fall, while interest rates, prices, and the exchange value of the dollar would all increase. In the period of rising national saving, output would rise, while interest rates, prices and the exchange value of the dollar would all fall.

INTRODUCTION

A number of changes have been proposed in the Social Security system recently. The system currently entails some advance funding through a payroll tax, and consequently is building up substantial surpluses in the trust funds that will eventually be run down to pay for the retirement benefits of the contributors. Some proposals would fund the system on a pay-as-you-go basis--that is, by paying for benefits in a given period out of taxes and other revenues collected during approximately the same period. These proposals would involve lowering the Social Security payroll tax rate now, since the trust funds' income currently far exceeds benefit payments, and raising the tax rate later to meet higher future benefit payments. Some proposals would also raise the maximum earnings subject to taxation, in response to what is perceived as a lack of fairness in the current system. Still other proposals would reduce the trust fund surpluses by increasing benefits rather than by reducing tax collections--for example, by allowing people over the age of 65 to increase their earned income without losing Social Security benefits.¹

This memorandum examines only the macroeconomic issues involved in changing to pay-as-you-go funding of Social Security. The change to a pay-as-you-go system, if it was not offset by other fiscal changes, would raise a number of other important issues not examined here: issues of equity between generations, since currently working generations would gain at the expense of later generations; issues that concern the sensitivity of the system's funding to economic fluctuations because

1. See an article by Spencer Rich in the *Washington Post*, February 18, 1991, for a description of these many proposals.

there would be a smaller buffer between the system's income and its outgo; and issues of equity among classes of current taxpayers, since Social Security taxes are more regressive than most other major federal taxes.

While this study examines the macroeconomic effects of a change in Social Security funding, the most important channel through which these changes in funding would affect the economy is in the budget deficit. The macroeconomic effects described in this study would not be significantly different from the macroeconomic effects of other fiscal policies that produced the same changes in the budget deficit as those produced by the alternative Social Security funding schemes. Put another way, if the changes in the deficit caused by changes in the funding of Social Security were offset by changes in other taxes or changes in government expenditures, then the overall macroeconomic effects would be slight.

The government's ability to finance a given schedule of Social Security benefits is not inherently related to the solvency of the Social Security trust funds. Rather, the ability of the government to pay for a given schedule of benefits is more closely related to the future strength of the economy. This is because the assets of the Social Security trust funds do not represent any real stock of resources set aside to pay for benefits in the future. Benefits due in a given year must be financed by government revenues collected in that year or by borrowing. The only way to make either measure easier is by taking steps to increase the future size of the economy as much as possible. Increasing the assets of the Social Security trust funds now will improve the government's ability to pay for benefits in the future by raising

government saving and, with it, national saving. This higher level of government saving, assuming it is not completely offset by lower private saving, increases the potential for economic growth that will raise the future tax base and future tax revenues. Also, higher government saving now implies a lower stock of government debt in the future, and hence lower interest payments. These two factors would put the government in a better position to pay for a given schedule of future benefits out of its own future revenues.

Clearly, higher levels of saving, which improve the government's ability to finance given future benefit payments out of its own revenues can be obtained whether the Social Security trust funds are currently accumulating assets, running down assets, or even if the funds are abolished. Whatever is the situation with the Social Security trust funds, other taxes can be raised and government spending can be reduced in order to increase national saving through reductions in the federal deficit.

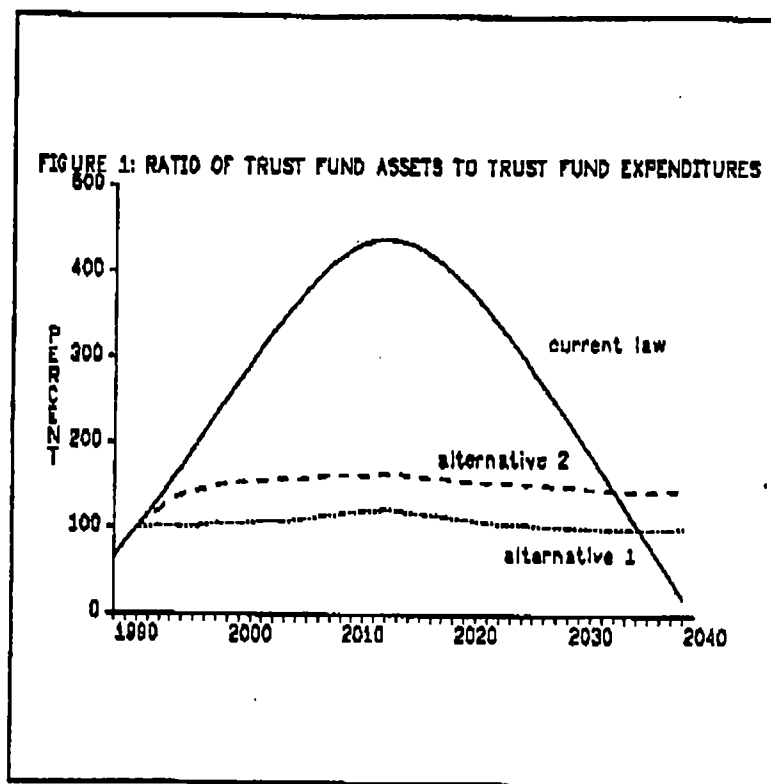
However, the fact remains that changes in the funding of Social Security, if enacted in isolation (that is, without changes in other taxes or in government expenditures), could have a substantial effect on national saving. The system currently accounts for about 10 percent of total gross national saving, and that ratio will rise over the next 20 years if, as expected, the trust funds' income grows faster than outgo. Pay-as-you-go, in the absence of offsetting changes in fiscal policy, would mean a sharp reduction in gross national saving during the next 20 years or so, followed by an even larger increase afterward.

The Focus of This Study

CBO compared the current funding system for Social Security with two pay-as-you-go alternatives. The first alternative would require the trust funds to maintain assets equal to 100 percent of annual expenditures, while the other alternative would require the funds to maintain assets equal to 150 percent of annual expenditures. Both cases assume no changes in other taxes or in government expenditures. Figure 1 shows the ratio of trust fund assets to trust fund expenditures under the current system and under the two alternatives. A rising ratio of assets to expenditures implies that trust fund income (trust fund collections plus interest income) is growing faster than expenditures (benefits plus administrative expenses); a declining ratio implies the opposite (with fund assets being drawn down to make up the shortfall); and a flat ratio implies that trust fund income is growing at the same rate as expenditures.

The quantitative results described in this memorandum should be interpreted with caution for two reasons. First, this study necessarily compares a pay-as-you-go system with the current system on the assumptions that the current system will not be changed over the next several decades and that other aspects of fiscal policy will not be changed. But these assumptions are highly implausible: Figure I shows that the current financing arrangements, if unchanged, would exhaust the trust funds in the first half of the next century. Before that time the Social Security system is virtually certain to undergo changes, perhaps toward a pay-as-you-go system or toward financing from the government's general fund. For this reason, the current

system does not represent an entirely appropriate baseline scenario against which to compare alternative funding schemes.



Second, the results from the simulations of the economic models may understate the effects on the economy of changing Social Security funding because of a characteristic of the models examined. In all of the models, growth in total factor productivity is assumed to be constant.² But comparisons of saving, investment, and productivity among countries suggest that there is a correlation

2. Total factor productivity describes the productivity of all factors of production together, rather than just labor, and its growth is usually attributed to changes in education and to technological progress.

between growth in total factor productivity and the rate of saving and investment.³ Some analysts interpret this correlation in the data to mean that changes in the rate of saving and investment *cause* changes in the growth of total factor productivity, and would thus argue that the impacts on real GNP described in this memorandum ought to be increased, probably by around 50 percent. However recent studies have argued for a different interpretation of the data that would not lead to any change in the impacts on real GNP described by the models.⁴

MACROECONOMIC EFFECTS

The macroeconomic effects of moving toward pay-as-you-go funding of Social Security and away from the present system (without compensating changes in other parts of the federal budget) are best illustrated by examining two distinct time periods: the period of lower tax rates and reduced national saving (1992 to about 2016); and the period of higher tax rates and increased national saving (about 2017 and beyond). The shift toward pay-as-you-go funding that CBO analyzes in the next section of this memorandum involves cuts of one to two percentage points in the combined employers' and employees' payroll tax. As Table A.1 shows, a continuation of current policy would hold the combined tax rate at an average level of roughly 12.4 percent over the next several decades. By contrast, the pay-as-you-go

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3. The evidence was examined in Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994* (January 1989), Chapter III.
 4. See, for instance, J. Benhabib and B. Jovanovic, "Externalities and Growth Accounting," *American Economic Review*, vol.#81, no.#1 (March 1991), pp.#82-113.

approach would initially involve a cut in the combined rate to a level of about 10.5 percent followed by a steady increase to a level of 16 percent or more.

During the first period in the simulation, the changes in Social Security increase the federal deficit, thereby using up more of the private sector's saving and leading to a reduced rate of overall or national saving. Reduced national saving leads to a reduction in the growth of potential output. This is masked in the first few years because lower saving and higher consumption lead to more intensive use of existing productive capacity. Eventually, however, lower national saving reduces the growth rate of the capital stock used in producing output, and GNP becomes lower than it would otherwise be. The higher consumption persists, however, and this fact, along with the reduction in potential output, increases interest rates, prices, and the exchange value of the dollar. In the second period, when national saving is higher than it would otherwise be, all of these effects are reversed: potential output eventually rises, and interest rates, prices, and the exchange rate are all lower than they would otherwise have been.

These changes are unlikely to have significant long-lasting effects on employment, so in the long run changes in productivity would largely mirror changes in GNP. However, during the first few years of the lower tax rates--when utilization of capacity temporarily increases--employment is likely to rise a little. Thus, during

this period growth in labor productivity is likely to be reduced even before there are significant negative effects on real GNP.⁵

The Period of Reduced National Saving (1992-2016)

Effects on GNP The most important effect of the reduction in Social Security tax rates during the period of reduced national saving is to reduce the growth of GNP. The reduction comes about because the bigger federal deficit uses up more of the available supply of saving, forcing interest rates upward and reducing productive investment. The decline in investment eventually reduces the growth of GNP by making less machinery, factories, infrastructure, and other productive capital available.

It is possible that these effects could be muted if households increase their own saving when the government deficit increases, but it is likely that this effect is limited. Some economists have pointed out that if people foresee the higher taxes that will eventually be necessary to offset the increase in the deficit that comes about as a result of a cut in Social Security taxes, they will increase their own saving to cushion the effects of the taxes. Were they to do this, national saving would fall less when the deficit increases, and the growth of GNP would slow down by less as well.

5. The models that CBO used in this analysis do not have explicit representations of employment. Quantitative discussions of the effects on employment are therefore difficult.

The models that CBO has used suggest, however, that this offsetting effect is likely to be slight in practice.

The decline in the growth of GNP is not likely to be observable during the first years after the policy change. This is because higher consumption is likely to increase aggregate demand and cause the economy to grow faster following the current recession by helping put idle workers and factories back to work. The reduction in Social Security taxes is likely to lead to higher consumption by increasing disposable incomes. The lower payroll tax rates themselves leave more after-tax income for wage earners. In addition, the reduction in the employer's share of the payroll tax should lead to lower prices, and these also increase real disposable incomes. Finally, as the discussion below points out, the tax cut is likely to lead to an appreciation of the dollar, reducing the prices of imported goods and further increasing real disposable incomes.

Eventually, however, no more idle productive capacity will be available, and the effects of the cut in Social Security taxes in slowing the growth of GNP will be evident. For the remainder of the period of lower saving, real GNP is likely to be lower than it would have been had Social Security taxes not been reduced.

Effects on the Exchange Rate and the Balance of Trade The cut in payroll taxes during the first years after a change in Social Security financing policy is likely to affect United States foreign trade as well. Because there is less national saving, the United States spends more of its national income and the trade deficit increases.

This increase in the trade deficit is helped along by a rise, or appreciation, in the value of the dollar on foreign exchange markets. The increase in interest rates that results from the cut in tax rates makes financial investments in this country more attractive, drawing more investment funds into the country and forcing the exchange value of the dollar higher.

Effects on the Price Level Prices are affected in two opposing ways, but they should eventually rise as a result of changes in Social Security. The increase in prices results from both an increase in aggregate demand and a reduction in the economy's capacity to supply output to meet this demand. Both factors contribute to upward pressures on wages and prices--pressures that are likely to lead to permanent increases in prices.

During the first few months or years after the tax cut, however, the increase in prices is likely to be offset by two factors leading to a temporary decline in prices rather than an increase: the appreciation of the dollar, and the reduction in the employer's share of the Social Security tax. The appreciation of the exchange value of the dollar, mentioned above, reduces the prices of imported goods and domestic goods that compete with imports. In addition, during the first months or years after the cut in Social Security taxes prices are likely to fall because the reduction in the employer's share of the Social Security tax reduces employers' costs and reduces pressures on prices from this source. While some of the reduction in employer costs is likely to give rise to higher wages, part of it should also be passed on to consumers in the form of lower prices.

The Period of Increased National Saving (2017 and Beyond)

During the period when payroll tax rates are higher than under current law, the effects described in the previous section are reversed, as government saving and national saving increase. The government's increased ability to finance expenditures out of its own funds reduces the overall demand for loanable funds, which in turn reduces interest rates. Investment increases, and this increases the growth of potential output. Eventually, as the capital stock rises above its baseline value, potential and actual output rise above levels that would be attainable with the current Social Security funding system. (As stated earlier, the baseline for this analysis assumes that no fiscal policy changes--in Social Security or elsewhere--are made over the next several decades. But since the funding of the system will apparently have to be changed by then in order to avoid exhausting the assets of the trust funds, it is not clear that shifting to a pay-as-you-go system now would improve national income prospects in the next century.)

As compared with current law, pay-as-you-go funding reduces interest rates in this second period and thus reduces the relative demand for dollar-denominated securities. The result is a fall in the exchange value of the dollar. This fall has a positive effect on net exports by increasing the price competitiveness of U.S. exports in foreign markets and reducing the price competitiveness of foreign goods in domestic markets. Net exports are further boosted by an overall decline in consumer expenditures (on domestic as well as foreign goods), the result of a decline in disposable incomes caused by the higher payroll taxes.

GNP eventually rises as the increases in net exports and investment outweigh the decline in consumption. All of this increase in GNP is likely to be reflected in higher labor productivity, with little or no long-run impact on levels of employment. Domestic prices fall as potential output rises relative to aggregate demand, putting downward pressure on domestic prices despite the influence of higher prices of imported goods.

Throughout this analysis monetary policy has been assumed to be unchanged. The Federal Reserve's response to the changes in fiscal policy implied by these changes in Social Security taxes could significantly alter the analysis presented above. The implied fiscal policy would be expansionary over the first 20 or so years, and contractionary afterward; the Federal Reserve might choose either to accommodate or to try to offset the changes, depending on economic conditions at a particular time.

Quantitative Estimates of the Effects of Two Alternative Social Security Funding Schemes

Both of the alternative Social Security funding schemes that CBO has examined are modified pay-as-you-go schemes. As such, they differ from the system now in place (which entails some advance funding). Also, the overall impacts of the two alternatives on national saving and wealth would be similar. The first alternative (ALT1) requires the Social Security trust funds to maintain assets equal to 100 percent of annual expenditures, while the second alternative (ALT2) requires the

trust funds to maintain assets equal to 150 percent of annual expenditures. Table A.1 gives a summary of the changes in Social Security trust fund collections that are implied by these two schemes, as well as the assumptions for payroll tax rates, economic growth, and inflation from which these changes are derived.⁶

CBO used three models to analyze the effects of these alternative funding schemes. This first is a simple growth model (GROWTH) developed at CBO to examine these and similar questions.⁷ CBO also used two more complex models: the McKibbin-Sachs Global model (MSG) and the INTERMOD model.⁸ These models differ from the growth model by allowing for the effects of forward-looking or model-consistent expectations and by taking into account economic activity outside the United States. Forward-looking expectations mean that the decisions economic agents make today reflect to some extent the agents' expectations of future events. Moreover, these expectations of future events are consistent with the behavior of the economy as described by the economic model. Such forward-looking models are particularly appropriate for the analysis of alternative Social Security

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6. All of these key assumptions coincide with the Social Security Administration's II-B assumptions, which contain predictions of moderate economic growth and inflation. See Social Security Administration, *The Federal Old-Age, Survivors and Disability Insurance Trustees Report, 1990* (1990).
 7. See Congressional Budget Office, *The Economic and Budget Outlook Fiscal Years 1990-1994* (January 1989).
 8. The MSG model was developed by Warwick McKibbin of the Brookings Institution and Jeffrey Sachs of Harvard University. INTERMOD is a world model developed at the Canadian Department of Finance. For the specification and properties of these models see Warwick McKibbin and Jeffrey Sachs, "The McKibbin-Sachs Global Model," Brookings Discussion Paper in International Economics No. 78 (Washington, D.C.: Brookings Institution, 1989); and Guy Meredith, "INTERMOD 2.0: Model Specification and Simulation Properties," Working Paper No. 89-7 (Ottawa: Department of Finance, 1989).

funding schemes, since these schemes involve a timetable of known future changes in payroll taxes that are likely to affect economic decisions made today. The fact that the models are world models implies that they also reflect the way in which changes in the U.S. economy interact with a world economy, in particular showing the effect on exchange rates.

Tables I and II show the effects of the two funding schemes on a few important macroeconomic variables according to these models.⁹

The effects on real GNP, consumption, and other variables are similar for both schemes, because once the targets for asset-expenditure ratios have been reached, the tax rates of the two pay-as-you-go alternatives are very similar (see Table A.1). Because ALT1 involves a deeper initial tax cut than ALT2, interest rates, prices, and exchange rates rise slightly more in ALT1, and national saving and the capital stock fall more. However, both schemes have roughly the same effects after 50 years.

An alternative means of illustrating the effects of these changes in Social Security funding on real GNP is shown in Tables 3 and 4. These tables express the effects on GNP in 1991 dollars (adjusted for changes in the price level), in real per-

9. The tables do not present estimates of the effects on employment or productivity of the fiscal changes. In the case of employment, any changes are likely to be temporary, as discussed above. In the case of productivity, the models used are not detailed enough to provide predictions of changes in commonly recognized productivity measures. The productivity measures shown by these models mirror almost precisely the models' predictions for output changes, since employment does not change.

MAINTENANCE OF TRUST FUND RESERVES EQUAL TO 100 PERCENT OF ANNUAL EXPENDITURES (In percent difference from baseline, except where noted)

	1992-1996	1997-2006	2007-2016	2017-2026	2027-2036	2037-2046
Real GNP						
MSG	0.0	-0.4	-0.6	-0.4	0.1	0.6
INTERMOD	0.2	-0.2	-0.3	N.A.	N.A.	N.A.
GROWTH	-0.4	-1.1	-1.0	-0.1	1.2	2.0
Consumption						
MSG	0.7	0.4	-0.1	-0.7	-0.7	-0.6
INTERMOD	0.6	0.1	0.0	N.A.	N.A.	N.A.
GROWTH	0.5	-0.3	-0.8	-0.8	0.1	0.9
Prices						
MSG	0.3	0.8	0.7	0.1	-0.6	-0.7
INTERMOD	0.1	0.5	0.6	N.A.	N.A.	N.A.
GROWTH	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal Short-term Interest Rate^a						
MSG	0.8	1.1	0.9	-0.1	-1.2	-1.2
INTERMOD	0.1	0.2	0.3	N.A.	N.A.	N.A.
GROWTH	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Real Short-term Interest Rate^a						
MSG	0.7	1.0	0.9	0.0	-1.1	-1.2
INTERMOD	0.1	0.2	0.2	N.A.	N.A.	N.A.
GROWTH	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal Long-term Interest Rate^a						
MSG	1.0	1.0	0.5	-0.5	-1.0	-0.9
INTERMOD	0.2	0.2	0.2	N.A.	N.A.	N.A.
GROWTH	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Real Long-term Interest Rate^a						
MSG	0.9	1.0	0.6	-0.3	-0.9	-0.9
INTERMOD	0.1	0.2	0.1	N.A.	N.A.	N.A.
GROWTH	0.2	0.5	0.4	-0.0	-0.4	-0.6
Real Exchange Rate						
MSG	2.1	1.5	-0.3	-2.5	-3.0	-2.1
INTERMOD	1.0	0.9	0.4	N.A.	N.A.	N.A.
GROWTH	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
National Saving Rate^a						
MSG	-0.5	-0.7	-0.6	-0.1	0.5	0.8
INTERMOD	-0.1	-0.3	-0.2	N.A.	N.A.	N.A.
GROWTH	-0.8	-0.6	-0.2	0.6	0.9	0.8
Capital Stock						
MSG ^b	-0.2	-0.9	-1.3	-0.7	0.6	1.4
INTERMOD	0.0	-0.1	-0.1	N.A.	N.A.	N.A.
GROWTH	-2.4	-4.5	-2.6	0.5	5.5	8.0

NOTE: n.a. = not applicable.
N.A. = not available.

a. Numbers represent the difference from baseline, in percent.

b. Levels for the baseline capital stock were approximated by the Congressional Budget Office.

TABLE 2.

RESULTS OF SIMULATION ANALYSIS, USING THREE ECONOMIC MODELS, OF ALT1: MAINTENANCE OF TRUST FUND RESERVES EQUAL TO 150 PERCENT OF ANNUAL EXPENDITURES (In percent difference from baseline, except where noted)

	1992-1998	1997-2004	2007-2016	2017-2026	2027-2036	2037-2046
Real GNP						
MSG	0.1	-0.3	-0.6	-0.3	0.2	0.5
INTERMOD	0.2	-0.2	-0.3	n.a.	n.a.	n.a.
GROWTH	-0.2	-0.9	-1.0	-0.0	1.3	2.0
Consumption						
MSG	0.4	0.4	-0.1	-0.7	-0.7	-0.4
INTERMOD	0.8	0.1	-0.0	N.A.	N.A.	N.A.
GROWTH	0.3	-0.1	-0.7	-0.7	0.2	0.9
Prices						
MSG	-0.1	0.6	0.7	0.1	-0.6	-0.7
INTERMOD	-0.0	0.5	0.6	n.a.	n.a.	n.a.
GROWTH	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal Short-term Interest Rate^a						
MSG	0.1	1.0	0.9	-0.2	-1.1	-1.2
INTERMOD	0.1	0.2	0.2	n.a.	n.a.	n.a.
GROWTH	N.A.	N.A.	N.A.	N.A.	N.A.	n.a.
Real Short-term Interest Rate^a						
MSG	0.1	0.9	0.9	-0.1	-1.1	-1.1
INTERMOD	0.1	0.1	0.2	n.a.	n.a.	n.a.
GROWTH	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Nominal Long-term Interest Rate^a						
MSG	0.6	1.0	0.4	-0.6	-0.9	-0.9
INTERMOD	0.2	0.2	0.1	n.a.	n.a.	n.a.
GROWTH	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Real Long-term Interest Rate^a						
MSG	0.5	0.9	0.6	-0.4	-0.9	-0.9
INTERMOD	0.1	0.2	0.1	n.a.	n.a.	n.a.
GROWTH	0.1	0.4	0.3	-0.1	-0.4	-0.6
Real Exchange Rate						
MSG	1.5	1.6	-0.2	-2.5	-2.8	-1.9
INTERMOD	0.8	0.9	0.4	n.a.	n.a.	n.a.
GROWTH	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
National Saving Rate^a						
MSG	-0.2	-0.6	-0.6	0.0	0.6	0.9
INTERMOD	-0.1	-0.2	-0.3	n.a.	n.a.	n.a.
GROWTH	-0.4	-0.6	-0.2	0.6	0.9	0.6
Capital Stock						
MSG ^b	-0.1	-0.6	-1.2	-0.6	0.7	1.4
INTERMOD	0.1	-0.1	-0.1			
GROWTH	-1.2	-3.8	-2.5	0.8	5.6	8.0

NOTE: n.a. = not applicable.
N.A. = not available.

a. Numbers represent the difference from baseline, in percent.

b. Levels for the baseline capital stock were approximated by the Congressional Budget Office.

TABLE 3. RESULTS OF SIMULATION ANALYSIS, USING THREE ECONOMIC MODELS, OF ALT1: THE EFFECT ON REAL GNP (Annual Averages)

	1992-1996	1997-2006	2007-2016	2017-2026	2027-2036	2037-2046
Difference of Real GNP from Baseline in Billions of 1991 Dollars						
MSG	0	-30	-53	-42	13	76
INTERMOD	13	-15	-27	N.A.	N.A.	N.A.
GROWTH	-25	-81	-89	-11	152	303
Difference of Real Per Capita GNP from Baseline in 1991 Dollars						
MSG	0	-105	-179	-136	40	234
INTERMOD	47	-53	-90	N.A.	N.A.	N.A.
GROWTH	-95	-290	-298	-34	476	936
Difference of Real GNP from Baseline in Billions of 1991 "Dollar Equivalents"						
MSG	0	-24	-36	-24	6	30
INTERMOD	12	-12	-18	N.A.	N.A.	N.A.
GROWTH	-24	-65	-59	-6	71	118

NOTE: N.A. = not available.

TABLE 4. RESULTS OF SIMULATION ANALYSIS, USING THREE ECONOMIC MODELS, OF ALT2: THE EFFECT ON REAL GNP (Annual Averages)

	1992-1996	1997-2006	2007-2016	2017-2026	2027-2036	2037-2046
Difference of Real GNP from Baseline in Billions of 1991 Dollars						
MSG	6	-22	-53	-32	25	76
INTERMOD	13	-15	-27	N.A.	N.A.	N.A.
GROWTH	-13	-67	-89	0	165	303
Difference of Real Per Capita GNP from Baseline in 1991 Dollars						
MSG	24	-79	-179	-102	79	234
INTERMOD	47	-53	-90	N.A.	N.A.	N.A.
GROWTH	-47	-237	-298	0	515	936
Difference of Real GNP from Baseline in Billions of 1991 "Dollar Equivalents"						
MSG	6	-18	-36	-18	12	30
INTERMOD	12	-12	-18	N.A.	N.A.	N.A.
GROWTH	-12	-53	-59	0	77	118

NOTE: N.A. = not available.

capita terms (further adjusting for the growth in population), and in terms of 1991 "dollar equivalents" (real dollar value that have been discounted so that they are commensurate with today's income levels).¹⁰

Differences in Results Among the Models

Though the model results presented in Tables I and II are qualitatively similar--that is, for most of the variables, the models predict changes in the same direction--they differ substantially in their magnitude. These differences occur because of differences in the properties of the models.

In general, the growth model predicts larger macroeconomic effects from changing Social Security than the two more complex models. There are three reasons for this. First, the more complex models predict smaller effects on real GNP of a change in Social Security because, unlike the growth model, they can simulate the effects of changing Social Security taxes on the exchange rate. Because the exchange rate appreciates on average in this first period, the cost of imported intermediate goods falls and potential output is a little higher than it would have been had the exchange rate not moved. The appreciation of the exchange rate also reduces the cost of consumer goods, making possible a substantial and persistent increase in consumption.

10. These "present value" dollar numbers are calculated by discounting the dollar differences from baseline in these future time periods, at a rate equal to the average growth rate of real GNP between now and the particular time period.

Second, unlike the other two models, the growth model does not predict any changes in private saving to offset changes in government saving. Thus, during the period of declining national saving the growth model predicts that national saving falls by the full amount of the increase in the government's deficit. On the other hand, because consumers in the two more complex models are forward looking, they are assumed to increase their saving to reflect their expectations of having to pay higher taxes in the future. This means that national saving falls by less than the increase in the government's deficit. For these two models, the smaller change in national saving compared to the growth model implies smaller changes in investment, in the capital stock, and in real GNP.

The third factor accounting for the smaller macroeconomic effects in the more complex models is international capital flows. Unlike the growth model, which assumes that net exports are constant, the other two models show large changes in net exports that are generated by changes in exchange rates and changes in aggregate demand. During the period of declining national saving, the deterioration in net exports that occurs in the larger models implies a substantial increase in borrowing from other countries. Foreign borrowing partially substitutes for the decline in national saving, so that domestic investment (and hence the capital stock) do not fall as much in the two larger models as in the growth model.

During the period of declining national saving, both of the more complex models show interest rates and exchange rates rising. However, INTERMOD has markedly milder increases in these variables than does MSG. This is because

interest rates are much more sensitive in MSG to changes in the real money supply (which declines by about the same extent in both models).¹¹ The larger increase in MSG's interest rates is directly responsible for that model's prediction of a larger increase in the value of the dollar.

11. Empirical studies of U.S. money demand functions suggest that the relationship between interest rates and real money balances is probably more accurately described in MSG than in Intermod.

TABLE A.1. BASELINE ECONOMIC ASSUMPTIONS AND ALTERNATIVE SOCIAL SECURITY TRUST FUND COLLECTIONS USED IN CBO SIMULATIONS (Annual Averages)

	1992-1996	1997-2006	2007-2016	2017-2026	2027-2036	2037-2046
Baseline Real GNP Growth Rate (Percent)	2.3	2.1	1.8	1.8	1.8	1.8
Baseline GNP Deflator Growth Rate (Percent)	4.1	4.1	3.9	3.6	3.7	3.7
Baseline Nominal GNP (In billions of dollars)	7,163	11,411	20,286	34,686	59,098	101,411
Baseline Social Security Tax Rate (Percent)	12.4	12.4	12.4	12.4	12.4	12.4
Baseline Social Security Trust Fund Collections (In billions of dollars)	374	587	1,031	1,729	2,889	4,865
ALT1 Social Security Tax Rate (Percent)	10.5	10.5	11.5	13.9	15.8	16.3
Change in Social Security Trust Fund Collections: Baseline minus ALT1 (In billions of dollars)	-59	-90	-71	225	793	1,554
ALT2 Social Security Tax Rate (Percent)	11.3	10.5	11.5	14.1	15.7	16.0
Change in Social Security Trust Fund Collections: Baseline minus ALT2 (In billions of dollars)	-34	-89	-69	251	774	1,422

SOURCES: Social Security Administration, *The Federal Old Age, Survivors and Disability Insurance Trustees Report 1990*; Congressional Budget Office

THE WHITE HOUSE

WASHINGTON

April 8, 1991

Dear Pete:

I understand you intend to introduce legislation next week to repair the "firewall" established in last year's budget agreement to protect social security. I am heartened to learn that both Republicans and Democrats will support your legislation. Such bipartisanship was necessary to reach last year's agreement and will be necessary to ensure that its provisions are honored.

Last fall, when all parties to the budget summit agreed to take social security both off the budget and out of the deficit calculations, we realized that this might lead to attempts to reduce the social security trust fund balances. For this reason, more stringent procedures were agreed to that were intended to protect social security. In particular, we agreed that a super-majority of 60 votes would be needed to raid the trust fund balances.

It now appears that there is a loophole in those procedures as they would apply to the Senate. The loophole was not agreed to by all parties to the budget summit -- and, indeed, was apparently not known to many until recently. Your legislation will close this loophole and restore the law to its intended and agreed-upon form, thus restoring the "firewall" that I believe is required as long as social security is not afforded the protections of normal budget discipline.

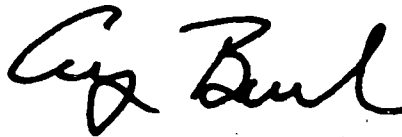
Eight years ago, after much debate which created fear among senior citizens, Congress adopted measures to ensure the short-term solvency and the long-term stability of the social security system. Congress should resist any temptation now to undermine that stability by permitting raids on

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the trust fund balances. Both current beneficiaries and workers who will become beneficiaries must remain confident that the system will continue to meet its promises.

I commend you on your efforts to repair the social security "firewall" and strongly urge Congress to adopt your legislation.

Sincerely,

A handwritten signature in black ink, appearing to read "Pete Domenici", written in a cursive style.

The Honorable Pete V. Domenici
United States Senate
Washington, D.C. 20510