Comments for the Record

House Ways and Means Committee

Subcommittee on Social Security

Hearing on Social Security's Finances
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Chairman Johnson and Ranking Member Becerra, thank you for the opportunity to submit my comments on this topic.

The sources of Social Security's revenues

We will leave it to the government's witnesses to explain how Social Security was initially funded with payroll taxes, to the extent that revenues were used by the general fund until original participants retired or the general agreement on increasing tax rates with time in order to build up revenue streams to so that the program would be self funding.

We will add, however, that Social Security was part of a new social compact which, along with very high marginal tax rates and partnership with organized labor, built the middle class while keeping corporate capitalism in place. In a very real way, these programs were a reaction to not only the Great Depression, but a preventative to a very real movement toward more direct employee control and ownership of the workplace by the union movement. The passage of *Taft-Hartley Act* restrictions on concentrated ownership of the workplace were set in place as much to protect management from being swept away as they were a desire to diversify pension assets to protect workers.

This social context is important to understanding options for the future of Social Security.

How those sources have changed over time

As the advisory for this hearing stated, payroll taxes began at the 2% level for employers and employees, with increasing rates and income caps over time to accommodate the growth of the number of covered retirees from zero to entire generations.

In the early 1980s, Social Security was close to having to draw from the General Fund. Ronald Reagan's conservatism was ascendant, with recently passed income tax cuts being phased in over a three year period and a beginning of the end of the bargain with the union movement to maintain labor peace in exchange for not pushing for a larger ownership share. Indeed, for all practical purposes, labor had become de-radicalized over time. It had moved to seeking to preserve benefit levels rather than advancing the interests of workers into the management suite.

In this context, a new grand bargain was created to save Social Security. Payroll taxes were increased to build up a Trust Fund for the retirement of the Baby Boom generation. The building of this allowed the government to use these revenues to finance current operations, allowing the President and his allies in Congress to honor their commitment to preserving the last increment of his signature tax cut, where the only other realistic option at the time was to abandon some or all of them, which was politically unacceptable given Republican control of the White House and the Senate.

Options for change and their impacts

Actions should be taken as soon as possible, especially when they must be phased in, as it is a truism that a little action early will have a larger impact later.

This trust fund is now coming due, with the expectation that shortfalls in Social Security payroll taxes will be covered by both income from interest income from the Social Security trust fund and eventually revenue from the general fund. The cash flow problem currently experienced by the Trust Fund is not the Trust Fund's problem, but a problem for the Treasury to address, either through further borrowing – which will require a quick resolution to the debt limit extension or through higher taxes on those who received the lion's share of the benefit's from the tax cuts of 1981, 1986, 2001, 2003 and 2010. At some point, Congress must ignore the interests of its major donors (to both parties) and honor the bargain it made to shore up the trust fund. This is entirely appropriate, given the fact that much of the Trust Fund was built up in order to preserve the income tax cuts of 1981.

As luck would have it, adequate personal income tax increases to finance repaying the Trust Fund will occur automatically on January 1, 2013. This revenue profile, not current tax rates, must be considered the baseline on which any new bargain is formed.

The complication, and there are always complications, is that low tax rates enacted on capital gains, income and dividends during the Clinton and Bush administrations have created two asset based recessions, the first in the technology sector and the second in housing.

The recent recession is more accurately described as a Depression, since the financing of the real estate bubble has still not been resolved, even while economic growth numbers have begun to rebound. This new has both temporary and permanent effects on the trust fund's cash flow. The temporary effect is a decline in revenue caused by a slower economy and the temporary cut in payroll tax rates to provide stimulus.

The permanent effect is the early retirement of many who had planned to work longer, but because of the recent recession and slow recovery, this cohort has decided to leave the labor force for good when their extended unemployment ran out. This cohort is the older 99ers who need some kind of income now. The combination of age discrimination and the ability to retire has led them to the decision to retire before they had planned to do so, which impacts the cash flow of the trust fund, but not the overall payout (as lower benefit levels offset the impact of the decision to retire early on their total retirement cost to the system).

At the very least, the constraints on borrowing to fund the conversion of Social Security trust fund assets to debt held by the public must be dealt with by enacting a clean debt limit extension, or at the very least, automatically allowing the debt limit to increase to facilitate this conversion. The only alternative to this is immediately increasing income taxes before they go up automatically in 2013. While Social Security may not be a legal obligation to retirees, the funds which back it are under the 14th Amendment, so it would be unconstitutional to not give their repayment first priority.

Let us be clear that August 4th is not the real deadline which is of concern, but December 31, 2012. The only leverage against automatic tax increases is a deal in advance of their expiration and the only leverage for such a deal is the debt limit extension.

It would be entirely inappropriate to renege on promises to the baby boomers to fund further income tax cuts by further extending the retirement age, cutting promised Medicare benefits or by enacting an across the board increase to the OASI payroll tax as a way to subsidize current spending or tax cuts. The current fiscal crisis should not be an excuse to use regressive Old Age and Survivors Insurance payroll taxes to subsidize continued tax cuts on the top 20% of wage earners who pay the majority of income taxes. Retirement on Social Security for those at the lowest levels is still inadequate. Any change to the program should, in time, allow a more comfortable standard of living in retirement.

The ultimate cause of the trust fund's long term difficulties is not financial but demographic. Thus, the solution must also be demographic – both in terms of population size and income distribution. The largest demographic problem facing Social Security and the health care entitlements, Medicare and Medicaid, is the aging of the population. In the long term, the only solution for that aging is to provide a decent income for every family through more generous tax benefits.

The free market will not provide this support without such assistance, preferring instead to hire employees as cheaply as possible. Only an explicit subsidy for family size overcomes this market failure, leading to a reverse of the aging crisis.

The recommendations for raising net income are within the context of comprehensive tax reform, where the first 25-28 percent of personal income tax rates, the corporate income tax, unemployment insurance taxes, the Hospital Insurance payroll tax, the Disability Insurance payroll tax and the portion of the Survivors Insurance payroll tax funding survivors under the age of 60 have been subsumed by a Value Added Tax (VAT) and a Net Business Receipts Tax (where the net includes all value added, including wages and salaries).

Net income would be adjusted upward by the amount of the VAT percentage and an increased child tax credit of $500 per child per month. This credit would replace the earned income tax credit, the exemption for children, the current child tax credit, the mortgage interest deduction and the property tax deduction. This will lead employers to decrease base wages generally so that the average family with children and at an average income level would see no change in wage, while wages would go up for lower income families with more children and down for high income earners without children.

Gross income would be adjusted by the amount of tax withholding transferred from the employee to the employer, after first adjusting net income to reflect the amount of tax benefits lost due to the end of the home mortgage and property tax deductions.

This shift in tax benefits is entirely paid for and it would not decrease the support provided in the tax code to the housing sector – although it would change the mix of support provided because the need for larger housing is the largest expense faced by growing families. Indeed, this reform will likely increase support for the housing sector, as there is some doubt in the community of tax analysts as to whether the home mortgage deduction impacted the purchase of housing, including second homes, by wealthier taxpayers.

Within twenty years, a larger number of children born translates into more workers, who in another decade will attain levels of productivity large enough to reverse the demographic time bomb faced by Social Security in the long term.

Such an approach is superior to proposals to enact personal savings accounts as an addition to Social Security, as such accounts implicitly rely on profits from overseas labor to fund the dividends required to fill the hole caused by the aging crisis. This approach cannot succeed, however, as newly industrialized workers always develop into consumers who demand more income, leaving less for dividends to finance American retirements. The answer must come from solving the demographic problem at home, rather than relying on development abroad.

This proposal will also reduce the need for poor families to resort to abortion services in the event of an unplanned pregnancy. Indeed, if state governments were to follow suit in increasing child tax benefits as part of coordinated tax reform, most family planning activities would be to increase, rather than prevent, pregnancy. It is my hope that this fact is not lost on the Pro-Life Community, who should score support for this plan as an essential vote in maintaining a perfect pro-life voter rating.

Obviously, this proposal would remove both the mortgage interest deduction and the property tax deduction from the mix of proposals for decreasing tax rates while reducing the deficit. This effectively ends the notion that deficit finance can be attained in the short and medium term through tax reforms where the base is broadened and rates are reduced. The only alternatives left are a generalized tax increase (which is probably necessary to finance future health care needs) and allowing tax rates for high income individuals to return to the levels already programmed in the law as of January 1, 2013. In this regard, gridlock is the friend of deficit reduction. Should the President show a willingness to let all rates rise to these levels, there is literally no way to force him to accept anything other than higher rates for the wealthy.

This is not to say that there is no room for reform in the Social Security program. Indeed, comprehensive tax reform at the very least requires calculating a new tax rate for the Old Age and Survivors Insurance program. My projection is that a 6.5% rate on net income for employees and employers (or 13% total) will collect about the same revenue as currently collected for these purposes, excluding sums paid through the proposed enhanced child tax credit. This calculation is, of course, subject to revision.

While these taxes could be merged into the net business income/revenue tax, VAT or the Fair Tax as others suggest, doing so makes it more complicated to enact personal retirement accounts. My proposal for such accounts differs from the plan offered in by either the Cato Institute or the Bush Commission (aka the President’s Commission to Save Social Security).

As I wrote in the January 2003 issue of Labor and Corporate Governance, I would equalize the employer contribution based on average income rather than personal income. I would also increase or eliminate the cap on contributions. The higher the income cap is raised, the more likely it is that personal retirement accounts are necessary.

A major strength of Social Security is its income redistribution function. I suspect that much of the support for personal accounts is to subvert that function – so any proposal for such accounts must move redistribution to account accumulation by equalizing the employer contribution.

I propose directing personal account investments to employer voting stock, rather than an index funds or any fund managed by outside brokers. There are no Index Fund billionaires (except those who operate them). People become rich by owning and controlling their own companies. Additionally, keeping funds in-house is the cheapest option administratively. I suspect it is even cheaper than the Social Security system – which operates at a much lower administrative cost than any defined contribution plan in existence.

Safety is, of course, a concern with personal accounts. Rather than diversifying through investment, however, I propose diversifying through insurance. A portion of the employer stock purchased would be traded to an insurance fund holding shares from all such employers. Additionally, any personal retirement accounts shifted from employee payroll taxes or from payroll taxes from non-corporate employers would go to this fund.

The insurance fund will save as a safeguard against bad management. If a third of shares were held by the insurance fund than dissident employees holding 25.1% of the employee-held shares (16.7% of the total) could combine with the insurance fund held shares to fire management if the insurance fund agreed there was cause to do so. Such a fund would make sure no one loses money should their employer fail and would serve as a sword of Damocles' to keep management in line. This is in contrast to the Cato/ PCSSS approach, which would continue the trend of management accountable to no one. The other part of my proposal that does so is representative voting by occupation on corporate boards, with either professional or union personnel providing such representation.

The suggestions made here are much less complicated than the current mix of proposals to change bend points and make OASI more of a needs based program. If the personal account provisions are adopted, there is no need to address the question of the retirement age. Workers will retire when their dividend income is adequate to meet their retirement income needs, with or even without a separate Social Security program.

No other proposal for personal retirement accounts is appropriate. Personal accounts should not be used to develop a new income stream for investment advisors and stock traders. It should certainly not result in more "trust fund socialism" with management that is accountable to no cause but short term gain. Such management often ignores the long-term interests of American workers and leaves CEOs both over-paid and unaccountable to anyone but themselves.

Progressives should not run away from proposals to enact personal accounts. If the proposals above are used as conditions for enactment, I suspect that they won't have to. The investment sector will run away from them instead and will mobilize their constituency against them. Let us hope that by then workers become invested in the possibilities of reform.

Indeed, real reform is only possible if workers become more radicalized to the possibilities of workplace ownership and democracy. The purpose of this testimony is to remind workers of the bargain struck in the Roosevelt era, which I mentioned at the outset, to allow capitalism to exist in exchange for moving workers into the middle class. As that bargain has been abandoned on one side, there is no reason for workers not to pick up old demands for workplace democracy. Indeed, it is essential that they do so in order to quit losing ground.

All of the changes proposed here work more effectively if started sooner. The sooner that the income cap on contributions is increased or eliminated, the higher the stock accumulation for individuals at the higher end of the age cohort to be covered by these changes – although conceivably a firm could be allowed to opt out of FICA taxes altogether provided they made all former workers and retirees whole with the equity they would have otherwise received if they had started their careers under a reformed system. I suspect, though, that most will continue to pay contributions, with a slower phase in – especially if a slower phase in leaves current management in place.

Thank you for this opportunity to share these ideas with the subcommittee.

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