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# DAILY TAX REPORT



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## HIGHLIGHTS

### **VIEWPOINT: Finding a Fair, Practical 'Fix' for Social Security**

Allen Buckley of The Saylor Law Firm LLP in Atlanta examines means for fixing Social Security's financial problems with an eye toward finding a fair and practical solution. Buckley says that it is important the system's problems be solved because of both the tremendous number of people who rely on Social Security for survival and the fact that in terms of the overall financial problems of the United States, the problems of Social Security are relatively small. "If the problems of Social Security cannot be solved, then it is unlikely the larger problems can be solved," he writes. **J-1**

### **Durbin Says Goal Is Having Senate Pass Health Care Bill by End of Year**

Senate Majority Whip Durbin says the Democrats' goal is now for the Senate to pass its own version of a health care overhaul by the end of the year, rather than complete a final bill that can be sent to the president's desk by that time. The Senate bill includes roughly \$357 billion in new taxes and fees—including a 40 percent excise tax on high-value health insurance plans—to help pay for the health care reforms. The legislative timeline has slid repeatedly after plans to have a bill sent to President Obama "in the fall" evaporated amid intense debate within the Finance Committee over how to find a bipartisan compromise. **G-6** . . . Meanwhile, Finance Chairman Baucus says work will continue on legislation (S. 1733) aimed at reducing U.S. greenhouse gas emissions through a cap-and-trade program, but a date has not been set on incorporating a tax title. **G-4**

### **Effective Date of Interest Crediting Rates for Hybrid Plans Pushed Back**

IRS and Treasury say in Announcement 2009-82 they are giving sponsors of hybrid pension plans, such as cash balance plans, more time to bring their plans into compliance with pending regulations, which would prohibit hybrid plans from using interest crediting rates that are greater than a market rate of return. By extending the compliance deadline from Dec. 31, 2009, to Jan. 1, 2011, IRS and Treasury will gain additional time to formulate guidance on what constitutes "an above market rate of return," and practitioners with clients that sponsor hybrid plans will be rid of uncertainty. **G-1**

### **IRS Develops Section 409A Audit Information to Identify Exam Issues**

IRS tells BNA it has developed two documents to assist agents in examining nonqualified plans subject to tax code Section 409A. The documents are an audit lead sheet to provide audit steps to assist in developing issues related to nonqualified deferred compensation and tax code Section 409A, and a document designed to develop information document requests (IDRs) for cases with potential Section 409A issues during the years 2006 through 2008. **G-2**

### **Type III Supporting Organizations Get Time to Adjust Payout Rules**

The effective date for the nonfunctionally integrated Type III supporting organizations to start paying out 5 percent of their assets to their supported orga-

## TEXT

### **RETIREMENT PLANS: IRS**

Announcement 2009-82 on relief for sponsors of statutory hybrid plans that must amend interest crediting rate. **TaxCore**

**TAX TREATIES:** Treasury technical explanations for tax treaty with Malta and tax protocols with France and New Zealand and prepared remarks of JCT Chief of State Barthold (JCX-54-09), Treasury International Tax Counsel Corwin for Senate Foreign Relations Committee hearing. **TaxCore**

**CLIMATE CHANGE:** Carol Berrigan, Nuclear Energy Institute, prepared remarks for Senate Finance Committee hearing on climate change. **TaxCore**

**ELECTRONIC FILING:** IRS news release (IR-2009-103) on Nov. 18 webinar for tax professionals on benefits of e-file. **TaxCore**

**TAX ADMINISTRATION:** IRS news release (IR-2009-104) on 2010 VITA grant recipients. **TaxCore**

**TAX HAVENS:** Sen. Levin, Rep. Doggett letter to president on tax transparency, Panama Trade Promotion Agreement, and White House response to earlier letter. **TaxCore**

**TAXCORE:** For a complete listing of today's full text documents, look in the contents section.

# Viewpoint

## Fixing Social Security: What Is Fair and Practical?

BY ALLEN BUCKLEY

**M**any articles have been written about Social Security's financial problems and possible means of solving them—however, little analysis has been done regarding what is fair and practical.

Perhaps the best means of addressing Social Security's problems is to determine what is fair and practical and then craft repairs to produce a fair and practical result.

### Why It Is So Important To Solve Social Security's Problems

For at least two reasons, it is very important that Social Security's problems be solved. First, a tremendous number of people rely on Social Security for their survival.

According to a 2005 report by the Government Accountability Office (GAO), Social Security comprised 39 percent of total household income for elderly persons in 2002. Social Security provides most of the income for a majority of people age 65 or older. Significant disability benefits are also supplied by Social Security.

Second, in terms of the overall financial problems of the United States, the problems of Social Security are relatively small. According to the 2009 Social Security and Medicare trustees report, the present value of the unfunded liabilities of Social Security is approximately \$17.5 trillion. In contrast, the present value of the unfunded liabilities of Medicare is approximately \$89.3 trillion. Pure debt now exceeds \$7.5 trillion.

If the problems of Social Security cannot be solved, then it is unlikely the larger problems can be solved. The magnitude and significance of these problems are discussed more thoroughly below.

### Social Security's Benefit Formula

Social Security's benefit formula is skewed in favor of low-to middle-income workers. Generally, monthly earnings over the highest 35 years of a worker's work-

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ing career are indexed for wage inflation, averaged, and then subjected to a formula to produce the monthly benefit.

For 2009, the normal retirement benefit formula is as follows:

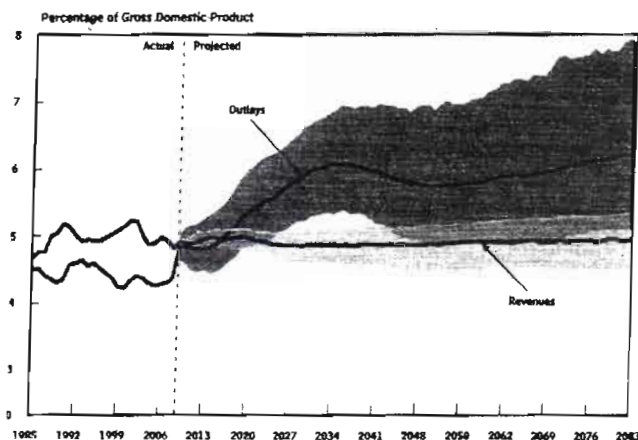
- for the first \$744 of indexed monthly earnings average, 90 percent;
- for the indexed monthly earnings average more than \$744 but less than \$4,483, 32 percent; and
- for the indexed monthly earnings average greater than \$4,483, 15 percent.

The benefit is reduced if early retirement is elected.

In contrast, employer-provided benefits under a tax-qualified profit sharing plan ordinarily can be supplied using a fixed percent of compensation benefit formula. To help offset the skewed nature of Social Security, a tax-qualified plan can have a benefit formula that is "integrated" with Social Security, thereby providing even greater benefits to higher-income workers.

### Social Security's Financial Standing

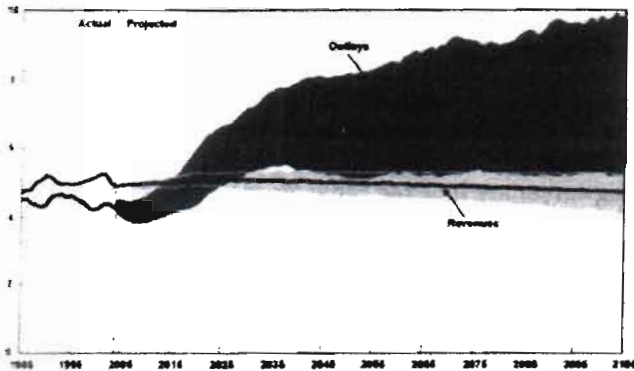
The chart below summarizes Social Security's financial problems. The chart was provided by the Congressional Budget Office (CBO) in its August 2009 report titled *CBO's Long-Term Projections for Social Security: 2009 Update*.



In 2016, expenditures are anticipated to exceed revenues. In order for the current system to continue working in 2016 and thereafter, repayment of the bonds issued by the general fund of the federal government to the Social Security trust fund in exchange for loaned surpluses will be necessary.

Unfortunately, there is no security for the bonds. While defenders of Social Security's funding means will state the trust fund is solvent until the 2037 (or later, depending whom you ask), the reality of the situation is that outlays exceed income in 2016 and thereafter.

Note that the chart shows revenues and expenses being close to equal until 2016. A few years ago, CBO produced the following chart, showing significant surpluses until 2017.

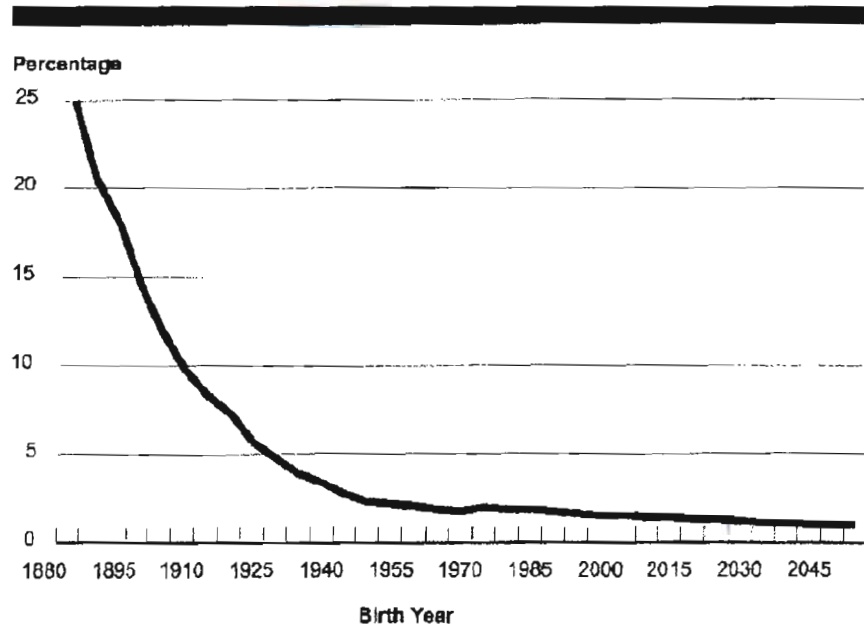


Accordingly, the recession has hurt Social Security's financial standing.

According to the conclusion of the highlights of the 2009 Old-Age, Survivors, and Disability Insurance program trustee report:

For the combined OASDI Trust Funds to remain solvent throughout the 75-year projection period, the combined payroll tax rate could be increased during the period in a manner equivalent to an immediate and permanent increase of 2.01 percentage points, benefits could be reduced during the period in a manner equivalent to an immediate and permanent reduction of 13.3 percent, general revenue transfers equivalent to \$5.3 trillion in present value could be made during the period, or some combination of approaches could be adopted. Significantly larger changes would be required to maintain solvency beyond 75 years.

**Figure 1: Social Security's Implicit Rates of Return Are Higher for Earlier Beneficiaries**



Note: Inflation-adjusted rates, average for all workers in each birth year. These estimates do not include Social Security disability contributions and benefits. They do reflect tax rates that would maintain actuarial balance on a pay-as-you-go basis. They also reflect employer as well as employee contributions. This is the most complete set of estimates by birth year and one of very few that compute average rates of return for all workers born in a given year.

Source: Dean R. Leimer, *Cohort-Specific Measures of Lifetime Net Social Security Transfers* working paper 69 (Washington, D.C.: SSA, Office of Research and Statistics, Feb. 1994).

### What Is Fair?

In any given set of circumstances, reasonable persons can differ as to what is fair with respect to a particular matter. However, unless some consensus can be reached on a range of fairness parameters, it appears little will be accomplished in terms of fixing Social Security's problems.

The chart below, produced by the Social Security Administration, provides the implicit rate of return for Social Security beneficiaries based on year of birth.

Solely based on this chart, the younger a person is, the worse he or she is treated by the Social Security system in terms of return on investment. But is the chart the whole story? (Note: The chart shows average returns. Because of the progressive nature of Social Security, lower-income persons will have higher returns than those shown and higher-income persons will have lower returns than those shown.)

On pages 1 and 2 of its August 2009 report, CBO said:

CBO's projections indicate that future Social Security beneficiaries will receive larger benefits during retirement—and will have paid higher payroll taxes—than current beneficiaries do, even after accounting for inflation and even if scheduled payments are reduced because the trust funds are exhausted. However, under both scenarios, those benefits will be equal to a smaller percentage of beneficiaries' preretirement earnings than they do now, CBO estimates.

The foregoing quote assumes the bonds payable to the Social Security trust fund will be repaid in full. According to the CBO, if the bonds are repaid in full, exhaustion will not occur until 2043.

The foregoing quote from CBO does not change the conclusion that is drawn from the implicit rate of return

chart—i.e. the younger a person is, the worse is his or her return from Social Security. Accordingly, if Social Security truly is a trust fund entitlement, to be fair while considering only retirement benefits, people who deposit more money in inflation-adjusted dollars should receive more real (i.e. inflation-adjusted) benefits from the system than people who deposit less money in inflation-adjusted dollars.

In that case, a financially fair thing to do to place all Social Security taxpayers on equal footing would be to reduce retirees' benefits to make the implicit return chart closer to a straight line that is horizontal to the x axis. Surpluses that would accrue from the reductions would need to be invested to produce benefits in the future necessary to establish the straight line of return. Note: Current beneficiaries can make a strong case that they are being treated unfairly now, because they could have earned greater returns on their own than the returns they will receive from Social Security. They could argue that reducing their returns to boost the returns of future retirees would make their already unfair situation more unfair.

However, if Social Security is not a pure trust fund entitlement, it is necessary to look further.

### **Is Social Security A Pure Trust Fund Entitlement?**

The Social Security wage base (i.e., the maximum amount of compensation subject to tax in a year) has grown over the years with wage inflation. The wage base has grown from \$3,000 in 1950 to \$106,800 in 2009. In 1979, the wage base was \$22,900.

While the wage base has grown with wage inflation, the rate of tax has also gradually increased over time. Initially, the rate was 1 percent on employer and employee. In 1950, it increased to 1.5 percent. In 1955, it was 2 percent. By 1968, the rate had grown to 3.8 percent. Since 1990, the rate has been 6.2 percent.

Similar to the Social Security tax, the Medicare tax (for Part A) has only grown over time. Like the Social Security tax, the Medicare tax applies to both employer and employee. The initial tax rate was 0.35 percent in 1966. In 1971, the Medicare tax rate was 0.6 percent. By 1976, the rate had increased to 0.9 percent. Since 1985, it has been 1.45 percent. Prior to 1994, the taxable amount was limited to the Social Security wage base. Since 1993, there has been no cap on amounts subject to tax. This change is particularly significant to self-employed persons (including most professionals), because the Medicare tax rate applicable to their self-employment earnings is 2.9 percent.

Life expectancies have been increasing, meaning the younger a person is, the longer he or she should receive benefits. However, to (at least partially) address increasing life expectancy, the Social Security normal retirement age is now gradually being increased from 65 to 67.

These factors must be taken into account in any cost and benefits analysis. When all factors are considered, one conclusion can be reached: To be fair, if Social Security were a true trust fund, the younger the person, the more he or she should receive from Social Security in inflation-adjusted dollars. However, Social Security is not a true trust fund.

A true trust fund would dedicate its revenues solely to paying benefits. Because Social Security annually runs

surpluses and those surpluses are loaned to the general fund of the federal government, substantively, Social Security is not a trust fund.

Every year since 1983, surpluses have existed. Combined, the surpluses since 1983 total approximately \$2.1 trillion. (At the end of 2008, the combined retirement and disability surplus was approximately \$2.4 trillion.) If those surpluses had been invested and earned 8 percent per year, approximately \$4 trillion would now exist in hard assets in the trust fund.

Coincidentally, in 2005, the Government Accountability Office (GAO) said that \$4 trillion was needed to fix Social Security over the next 75 years.

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**Security revenues are merely one of several  
sources of revenue of the federal government.**

**Similarly, Social Security benefit payments are one  
type of outlay of the federal government.**

**Accordingly, it would not be fair to look at Social  
Security taxes in isolation.**

With surpluses now anticipated to cease in 2016, money printing and substantial immigration aside, the only way benefits will continue to be paid pursuant to the existing system after 2016 is for income taxes to be increased or additional debt to the public (and foreigners) be incurred. (If no additional taxes or debt were incurred, benefits would gradually diminish relative to current system benefits.)

Instead of being a separate trust fund, Social Security revenues are merely one of several sources of revenue of the federal government. Similarly, Social Security benefit payments are one type of outlay of the federal government. Accordingly, it would not be fair to look at Social Security taxes in isolation. Rather, all federal taxes must be considered as a pool that pays federal outlays.

It is important to note that persons who have no compensation or self-employment income are completely exempt from the Social Security system. They pay no tax and receive no benefits. To the extent the Social Security surpluses have been loaned to the general fund, they have received somewhat of a benefit (assuming the alternative to the loan regime would have been increased income taxation of all income tax payers pro rata).

As the federal government has grown over time, so have benefits provided to citizens. These factors need to be considered. For example, an average person who worked during World War II and retired in the early 1950s likely paid substantial federal taxes during the last decade of his or her working career, but likely did not pay substantial federal taxes (at least by current standards) prior thereto. However, such a person would not have received any Medicare benefits until the mid-1960s (assuming he or she lived that long). The highest

incremental income tax rate ever—94 percent—applied during 1944 and 1945.

There is no perfect means of analyzing what is fair in terms of taxes paid and benefits received. However, persons retiring after the mid-1960s have received both Medicare and Social Security benefits. At all times, the United States has remained safe from foreign militaries.

## Taxes Over Time

According to the Congressional Budget Office, since 1980, federal taxes as a percent of gross domestic product (GDP) have ranged from a low of 16.3 percent in 2004 to a high of 20.9 percent in 2000. The average over the past 40 years has been 18.3 percent of GDP. According to the Tax Policy Center, the figure for 2008 was 17.7 percent.

Looking back to 1934, prior to 1942, the total did not exceed 7.6 percent. From 1942 to 1944, the percent increased from 10.1 percent in 1942 to 20.9 percent in 1944. By 1949, the percent dropped to 14.5 percent. The 16.3 percent figure for 2004 was the low going back to 1959, when the percent was 16.2 percent. During the 1950s, the low was 14.4 percent (1950) and the high was 19 percent (1952). From 1960 through 1999, the percent remained between 17 percent and 20 percent. Accordingly, over the past 49 years, with the exception of a few years at the beginning of this decade, the tax burden as a percent of GDP has remained within a relatively constant small range.

## Analyzing Four Household Types Since 1954

Below, an analysis is undertaken of four different household types—lower-income, middle-income, upper-middle-income, and upper-income. In each case the household is presumed to be composed of a husband and wife and two children.

For each household type, total tax burden under an assumed set of facts that is adjusted for inflation is analyzed in 1954, 1971, 1979, 1989, 1999, and 2008. For the various time periods, income, gains, and expenses are indexed for inflation by the applicable Consumer Price Index (CPI). The tax is then indexed by the CPI. (The table and chart provided below follow the numerical analysis.)

### Lower-Income Household

The lower-income household has \$2,500 of wages income in 1954. No income taxes are due on this income. Social Security tax of \$50 is payable. Adjusted to 2009 dollars using the CPI of 8.01, the tax liability in 2009 dollars is \$401.

In 1971, the CPI-adjusted wage income is \$3,775. No income tax is payable. Federal Insurance Contributions Act tax of \$196 is payable. The liability is \$1,045 in 2009 dollars.

In 1979, the CPI-adjusted wage income is \$6,757. No income tax is payable. FICA tax of \$414 is payable. However, an earned income credit of \$403 is available, reducing the tax burden to \$11. In 2009 dollars, the liability equals \$33.

In 1989, the CPI-adjusted wage income is \$11,554. No income tax is payable. The FICA tax is \$868. However, the earned income credit is \$778, producing a net tax burden of \$90. Those 1989 dollars are worth \$157 in 2009 dollars.

In 1999, the CPI-adjusted wage income is \$15,482. No income tax is payable. FICA tax of \$1,184 would be payable. However, the earned income credit would be \$3,181, resulting in a negative liability (i.e. cash to the household) of \$1,997. In 2009 dollars, this negative liability figure is (\$2,576) (i.e., the tax burden is (\$2,576)).

In 2008, the CPI-adjusted wage income is \$19,972. No income tax is payable. FICA tax of \$1,528 would be payable. The earned income credit would be \$4,564, resulting in a negative liability (i.e., net cash to the individual or household) of \$3,036 (i.e., the tax burden is (\$3,036)).

### Middle-Income Household

The middle-income household has \$7,947 of gross wages in 1954. No other income exists. Total deductible expenses equal \$2,775. They are comprised of mortgage interest of \$1,656, charitable contributions of \$166, real estate tax of \$331, state income tax of \$331, state and local sales tax of \$132 and credit card interest of \$159. FICA tax was levied at a rate of 2 percent. That tax was \$159. Income tax would be \$554. Adjusted for inflation, the total tax of \$713 would be \$5,711 in 2009 dollars.

It is noteworthy that in 1954, the tax on married persons filing jointly was calculated by dividing taxable income in half, computing the tax and then doubling the computed tax.

The middle-income household has \$12,000 of CPI-adjusted gross wages income in 1971. The 1954 expenses are indexed by the CPI inflation factor of 1.51. For 1971, the middle income household would have paid \$831 in federal income tax and \$624 in FICA (Social Security and Medicare combined) tax. Projecting this \$1,455 total to 2009 using the 5.33 CPI factor produces a 2009 tax burden of \$7,755.

For 1979, all of the middle-income household's gross wages and expense figures would be increased by the Department of Labor's CPI inflation factor covering the

## Taxes Over Time (in 2009 Dollars)

YEAR	LOWER	MIDDLE	UPPER-MIDDLE	UPPER
1954	401	5,711	58,898	430,361
1971	1,045	7,755	64,706	420,942
1979	33	9,002	85,741	482,675
1989	157	9,303	66,555	255,100
1999	(2,576)	7,547	72,962	328,873
2008	(3,036)	8,563	70,458	238,974

1971-1979 time frame of 1.79. Applying the 1979 tax laws to the projected figures produces an income tax of \$1,714 and a FICA tax of \$1,317. Projecting the total of these two amounts (i.e., \$3,031) to 2009 using the DOL's CPI calculator figure of 2.97 for the 1979-2009 time period produces a 2009 tax burden of \$9,002.

For 1989, after indexing income and expenses using the methodology described above, income tax of \$2,587 and FICA tax of \$2,758 would have been payable. The present value of this total (\$5,345), computed applying the CPI index from 1989 to 2009, is \$9,303. Note that for this year and years afterward, unlike 1954, 1971, and 1979, state sales taxes and credit card interest are not deductible.

For 1999, the indexed wages and expenses result in income tax of \$2,536 and FICA tax of \$3,314. Applying the 1.29 CPI for the 1999-2009 time frame to the total (\$5,850) results in a 2009 tax burden of \$7,547.

For 2008, the indexed wages and expenses result in income tax of \$3,679 and FICA tax of \$4,884. The total is \$8,563. (To date, the CPI from 2008 to 2009 is 1.0.)

**Upper-Middle-Income Household**

For 1954, the upper-middle-income household of four has gross self-employment income of \$33,113. Dividends (all of which are "qualified") total \$662. Interest income is \$662. Tax-deductible itemized expenses for interest, charitable contributions, and taxes total \$6,954. Income tax liability is \$7,245. Self-employment tax is \$108. The total of \$7,353 has a 2009 present value of \$58,898. Interestingly, the self-employment tax rate was 3 percent, and the wage base was \$3,600.

Adjusting the 1954 figures for inflation by the CPI, the upper-middle-income household of four persons has \$50,000 of self-employment income, \$1,000 of interest, and \$1,000 of dividends for 1971. Tax-deductible expenses for 1971 are mortgage interest of \$3,500, charitable contributions of \$1,000, state income taxes of \$2,500, state and local sales taxes of \$1,500, and real estate tax of \$2,000. For 1971, the upper-middle-income

household would have paid \$11,555 of income tax and \$585 of self-employment tax. In 2009 dollars (using the CPI index of 5.33), the sum of these amounts is a tax burden of \$64,706.

For 1979, the indexed self-employment income and expenses result in income tax of \$27,014 and self-employment tax of \$1,855. The total is \$28,869. In 2009 figures, this amount is \$85,741.

For 1989, the indexed self-employment income and expenses result in income tax of \$32,000 and self-employment tax of \$6,250. In 2009 dollars, the sum of \$38,250 is \$66,555.

For 1999, the indexed self-employment income and expenses result in income tax of \$41,610 and self-employment tax of \$14,950. In 2009 dollars, the sum of \$58,540 is \$72,962.

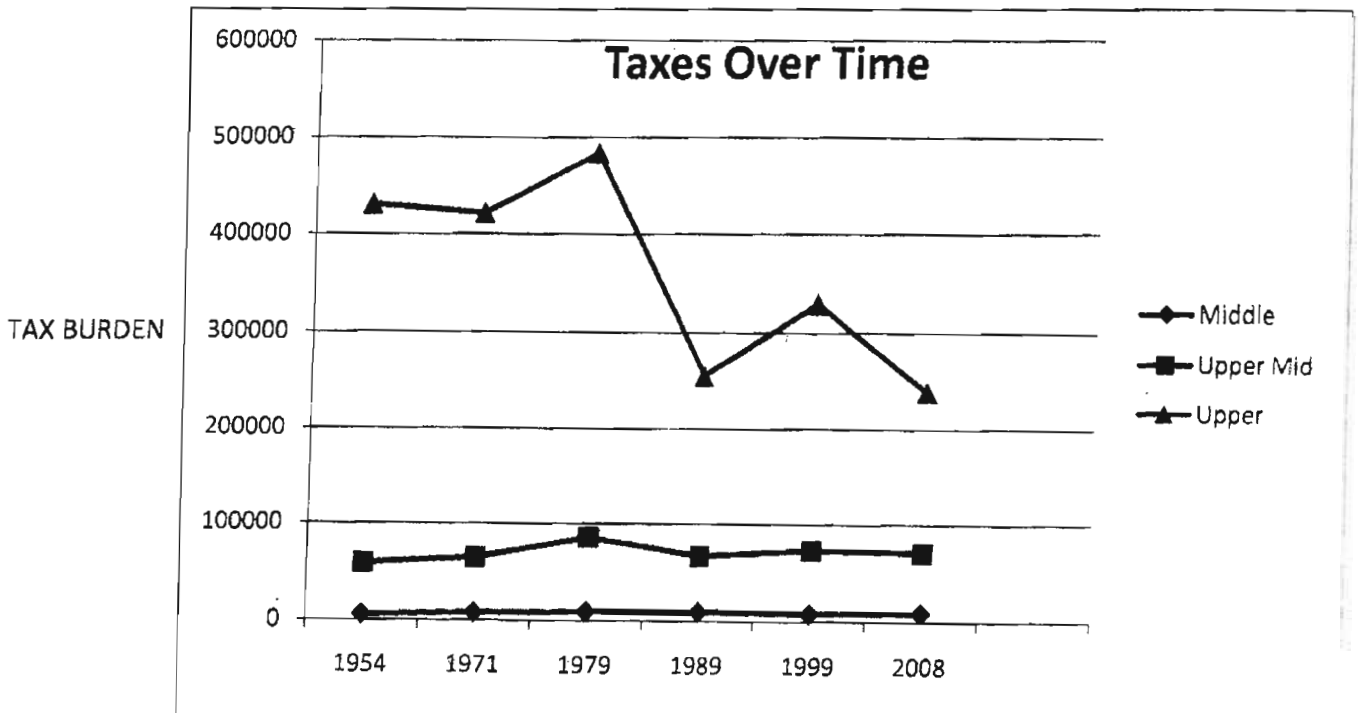
For 2008, the indexed self-employment income and expenses result in income tax and alternative minimum tax of \$50,138 and self-employment tax of \$20,320. The total is \$70,458.

**Upper-Income Household**

For 1954, the upper-income household is assumed to have \$60,000 of employee income, \$30,000 of taxable interest income, \$30,000 of dividend income (all of which is "qualified") and \$10,000 of long-term capital gains. Assumed tax-deductible expenses for 1954 are charitable contributions of \$9,000, state income tax of \$5,500, state and local sales taxes of \$1,500, and real estate tax of \$5,000.

The 1954 income tax burden on the upper-income family is \$53,656. The incremental income tax bracket is 72 percent. The FICA tax on the employee is only \$72. The wage base was \$3,600 and the rate was 2 percent. The total 1954 tax burden was \$53,728 (i.e., \$53,656 + \$72). Growing this figure to 2009 dollars using the CPI of 8.01 produces a 2009 tax burden of \$430,361.

The 1971 income, gain, and expense figures for the upper-income household are the 1954 figures multiplied by 1.51, to account for the CPI inflation factor



from 1954 to 1971. The total tax burden is \$78,976. In 2009 CPI-adjusted figures, this amount is \$420,942.

The 1979 income, gain, and expense figures for the upper-income household are the 1971 figures multiplied by 1.79, to account for CPI inflation from 1971 to 1979. The total tax burden is \$162,587. In 2009 CPI-adjusted figures, this amount is \$482,675. Noteworthy: The incremental income tax rate for this household was 70 percent for 1979.

The 1989 income, gain, and expense figures for the upper-income household are the 1979 figures multiplied by 1.71, to account for inflation from 1979 to 1989. State and local sales taxes are not deductible for 1989. The total tax burden is \$146,609. In 2009 CPI-adjusted figures, this amount is \$255,100.

The 1999 income, gain, and expense figures for the upper-income household are the 1989 figures multiplied by 1.34, to account for inflation from 1989 to 1999. The total tax burden is \$254,940. In 2009 CPI-adjusted figures, this amount is \$328,873.

The 2008 income, gain, and expense figures for the upper-income household are the 1999 figures multiplied by 1.29, to account for the inflation from 1999 to 2008. The total tax burden is \$238,974.

### Other Taxes

While income and FICA taxes are the most significant taxes to individuals, other taxes are worth noting.

For taxes levied in percentage terms, if the percent has not increased, the tax has remained constant in inflation-adjusted terms. For example, the tax on sports fishing equipment was 10 percent in 1979 and it remains 10 percent in 2009.

Other taxes are in fixed dollar amounts. The non-farm diesel fuel tax was 15 cents per gallon in 1979. It is 24.4 cents per gallon in 2009. If the tax had been adjusted for CPI inflation, the tax would have grown from 15 cents to 44.6 cents. In contrast, the tax on gasoline has grown at a rate greater than the inflation rate. In 1954, the gas tax was 2 cents per gallon. In 1979, the gas tax was 4 cents per gallon. Today, it is 18.4 cents per gallon. Growth by the inflation rate would have increased the 1954 tax to 16 cents per gallon and the 1979 tax to 11.9 cents per gallon, in today's dollars.

The "sin" taxes have increased substantially. To the extent they are passed on to individuals, corporate taxes increase individuals' tax burdens.

The overall effect of these other taxes does not significantly change the overall picture set forth above.

Analyzing the past 55 years, it is clear that tax burdens were not tremendously greater at any point with respect to middle-income and upper-middle-income taxpayers. The poor and the wealthy have fared better in recent years than they have at any point in the past 55 years. The poor and the rich aside, individuals cannot legitimately argue that they bore a significantly greater tax burden in the past than the burden being borne in recent years.

## The Future Tax Burden

The future tax burden, to the extent it can be foretold, must be considered.

For the past several years, the GAO, the audit arm of the federal government, has been telling anyone willing to listen that federal fiscal policy (i.e., taxes and spending) must change tremendously. In 2007, the GAO re-

ported that the sum of existing debt plus the present value of the "unfunded liabilities" for Medicare and Social Security (i.e., liabilities for which there is no adequate future dedicated tax source) over the next 75 years equaled \$52.7 trillion, while the total net worth of all Americans combined equaled \$58.6 trillion. In 2008, the head of the Federal Reserve Bank of Dallas gave his own estimate of the present value of these liabilities: \$99.2 trillion.

The GAO produced the present value of the liabilities by discounting (i.e., reverse compounding) the liabilities at a rate of 5.7 percent per year.

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**Prior to the \$800 billion-plus Troubled Asset Relief Program, the \$787 billion American Recovery and Reinvestment Act, and the deficit of approximately \$1.4 trillion for the fiscal year ended Sept. 30, 2009, the GAO termed fiscal policy as "unsustainable."**

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In 2008, the net worth of all Americans combined decreased to \$51.5 trillion, making the United States insolvent on a long-term basis, while considering all citizens' combined wealth.

The foregoing liabilities analyzed by the GAO do not consider Medicaid, national defense, or any ordinary government functions, such as the federal justice system. Infrastructure needs, which are significant, are not considered. Practically, what this means is the United States is insolvent on a present-value basis. Under current federal spending policy, in order for the country to persevere without tremendously increased immigration of people who can be taxed substantially, the federal government will need to consume all currently existing wealth and future earnings thereon, plus a substantial portion of future wealth.

The GAO liability figures take all sorts of pertinent actuarial factors into account, including anticipated immigration, increased longevity, and anticipated growth of the economy. In a sense, the liability figures are optimistic because they assume health care costs will grow at a rate of anticipated GDP per capita growth plus 1 percent, whereas over the past several decades, health care costs have grown at the GDP per capita rate plus 2.5 percent.

Prior to the \$800 billion-plus Troubled Asset Relief Program (TARP), the \$787 billion American Recovery and Reinvestment Act (ARRA), and the deficit of approximately \$1.4 trillion for the fiscal year ended Sept. 30, 2009 (on approximately \$2.1 trillion of revenue), the GAO termed fiscal policy as "unsustainable," and said, "GAO's long-term simulations continue to show ever larger deficits resulting in a federal debt burden that ultimately spirals out of control." Query what happens to the value of the currency and our nation in general if the debts spiral out of control?

Consistent with the foregoing conclusions, *The Economist* magazine reported in its Feb. 28-March 6, 2009, edition that, using reasonable policy assumptions,

economists Bill Gale of the Brookings Institution and Alan Auerbach of the University of California at Berkeley recently concluded regarding the Obama administration's spending plans that "higher taxes or lower spending equal to a staggering 8% of GDP a year are necessary to contain those costs and stabilize the long-run debt." For 2008, GDP was \$14.2 trillion. Eight percent thereof is \$1.136 trillion—which equates to 38 percent of federal spending for the fiscal year ended Sept. 30, 2008.

On Jan. 18, 2007, David Walker, then comptroller general of the United States (head of the GAO), said to the Senate Budget Committee, "We are on an imprudent and unsustainable long-term fiscal path, and while the short-term fiscal deficits have improved in recent years, the long term is getting worse every second of every minute of every day and the time for action is now."

On the same day to the same committee, Federal Reserve Board Chairman Ben Bernanke said we needed to start fixing these problems 10 years ago.

Regarding Social Security and Medicare, in an Oct. 30, 2008, article by Walker titled *Call This a Crisis? Just Wait*, Walker said, "The costs of these programs start to threaten our solvency in the next several years."

The anticipated growth of health care costs is a very large piece of the problem. On July 9, 2007, the CBO reported that if health care costs continue to grow at the rate that they have over the past four decades (i.e., GDP per capita plus 2.5 percent), and raising tax rates will be the only solution to the problem, then by 2050 the income tax rates will need to increase from 10 percent for the lowest bracket, 25 percent for the middle bracket, and 35 percent for the highest bracket to 26 percent, 66 percent, and 92 percent, respectively.

Clearly, for both public and private health care, cost increases must be significantly curtailed. However, even if this need is accomplished, substantial other changes will be needed. Medicare is the primary driver—too many people (baby boomers) living too long with health care cost increases regularly exceeding the rate of inflation. The health care bills now being considered by Congress would do little to address these problems.

Money printing aside, if nothing will be done to substantially curtail the growth of health care costs, the only means of dealing with these problems are increased taxes, increased debt, increased immigration, and decreased government. With the debt owed to the public now exceeding \$7.5 trillion and anticipated to grow substantially very soon, low interest rates can continue for only so long. Given the magnitude of the liability figures, the increases and decreases (of whatever combination) will need to be very significant.

Concerning substantially increasing immigration of people who would produce a lot of tax revenue, unless the immigrants and their offspring would reproduce at a much greater rate than 1-to-1 and the economy grew correspondingly, the need for a pyramid scheme would be created (or exacerbated), thus necessitating even greater immigration in the future. Because of the progressivity of Social Security and the standard benefits structure of Medicare, adding lower-income workers only creates a much larger mess for the future. The land mass does not grow. Other countries with similar problems do not want to lose their prime tax candidates.

On Aug. 25, White House and congressional reports were issued that estimate \$9 trillion more debt over the next decade. In August, CBO reported:

Debt held by the public is projected to exceed 61 percent of GDP by the end of next year, which is the highest level since 1952, and reach 68 percent by the end of 2019. That accumulating federal debt, coupled with rising interest rates, would lead to a near tripling of net interest payments (relative to the size of the economy) between 2009 and 2019 . . . . Over the long term (beyond the 10-year baseline projection period), the budget remains on an unsustainable path. Unless changes are made to current policies, the nation will face a growing demand for budgetary resources caused by rising health care costs and the aging of the population. Continued large deficits and the resulting increases in federal debt over time would reduce long-term economic growth by lowering national saving and investment relative to what would otherwise occur, causing productivity and wage growth to gradually slow.

Last year, outlays for Social Security, Medicare, and Medicaid combined accounted for about 9 percent of GDP. Outstripping the growth of GDP, spending for those programs is expected to rise rapidly over the next 10 years, totaling nearly 12 percent of GDP by 2019. Under long-term projections recently published by CBO, such spending would continue to rise under current laws and policies and could total 17 percent of GDP by 2035.

More bad news from the GAO: State and local governments face similar challenges. (Their pension plans and post-retiree medical plans are not subject to the funding requirements of federal law applicable to private employer plans.)

Historically, at least since the advent of World War II, government has generally only grown relative to the size of the economy. For example, from 2001-2006, government spending grew approximately 7 percent per year (on average), while the economy averaged growth of approximately 3 percent per year. The only logical conclusion is that, unless there is a dramatic change in direction in the United States in terms of the services and entitlements provided by the federal government, substantial tax increases are inevitable.

## Printing of Money

A relatively simple solution to the problem would be to print more money. The Treasury Department could simply print money to pay for benefit increases once Social Security's surpluses run out in 2016. If the amounts were not significant, the impact on inflation would be negligible.

Looking back in history, loose monetary policy and loose fiscal policy have been the downfall of empires and countries. Other causes contributed as well, but watering down the currency was a significant piece of the problem. Consider the fall of Rome and the fall of the Weimar Republic of Germany (that led to Nazi Germany).

With the aging of the baby boomers, there will be pressure from politicians on the Federal Reserve Bank to create much more money. As noted above, Medicare benefits are now anticipated to mushroom as the baby boomers move into retirement. If money growth exceeds the growth rate of the economy, inflation ensues. Ordinarily, price inflation is coupled with wage inflation, which results in increased Social Security benefits. The inflation rate for health care has significantly exceeded the general inflation rate, and nothing substan-



tial is currently proposed to attack this problem. In short, printing of money is not a solution.

So, absent a "black swan" breakthrough that greatly reduces medical costs, it should be clear that younger people will bear a tax burden that is greater than the burden experienced by anyone currently receiving Social Security retirement benefits and anyone who will begin receiving them in the near future. Thus, there is no reasonable basis to argue younger persons should receive a lesser return from Social Security than current retirees or people who will retire soon.

### In a Corner

It should be clear we are in a corner with respect to Social Security. Repaying the bonds issued to Social Security without incurring more debt necessitates more taxes be paid primarily by working people, thereby reducing the implicit rate of return.

Incurring more debt when the debt burden is already expected to spiral out of control (per the GAO) would be financially imprudent. Reducing benefits with respect to old people who cannot make much (or any) money is not desirable. Given the surpluses that have existed and been spent since the early 1980s, citizens would be fully justified in being outraged.

### Seeking a Financially Fair Solution

It is time to stop dumping on young people. Most young people do not understand Social Security, Medicare, or economics in general. They are busy learning in school and elsewhere. They should be able to rely on older persons to be unselfish and do the right thing—i.e., not create an economic mess for future generations. It is also time to stop treating the federal government as a feeding trough for special interest groups, including retirees.

It appears most people want Social Security to remain a defined benefit program. Perhaps it would be best to keep it so in order to provide diversity, since defined contribution plans have proliferated in the private sector in recent years and, absent incurrence of debt or a dedicated tax, there is no substantial source of funds to produce individual accounts. With GAO foreseeing the nation's debts spiraling out of control, incurring additional debt should not be part of Social Security's fix.

According to a September article by the Economic Policy Institute, titled *Americans Agree on How to Fix Social Security*, a survey conducted jointly by the Rockefeller Foundation and the National Academy of Social Insurance found that 77 percent of Americans agreed with the following position statement: "It is critical that we preserve Social Security for future generations, even if it means increasing working Americans' contributions to Social Security."

The article also said that 83 percent agreed with the following statement: "Lift the Social Security tax cap of \$106,800, so that workers earning more than that would pay Social Security tax on their entire salary just like everyone else."

The Aug. 17 edition of *Fortune* magazine included an article by Allan Sloan about Social Security titled *The Next Great Bailout*. (The article is featured on the cover.) In it, Sloan, age 65, discussed the problems of Social Security and called for action. His article provided:

I've been writing about Social Security's problems for more than a decade, arguing that having the government borrow several trillion dollars to bail out Social Security so that it can pay its promised benefits would impose an intolerable burden on our public finances.

However, I've changed my mind about what "intolerable" means. With the government spending untold trillions to bail out incompetent banks, faddish mortgage borrowers, General Motors, Chrysler, AIG, GMAC, and Wall Street, it should damn well bail out Social Security recipients too

Query whether Sloan would feel this way if he were age 30? And, who would bear the burden of such a bailout?—current and future taxpayers.

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The Sloan *Fortune* article provided the following quote from former GAO chief David Walker: "The Social Security 'trust fund has no financial significance,' . . . 'If you did (bookkeeping like) that in the private sector, you'd go to jail.'" Indeed, if Social Security was a private sector plan with the federal government as the plan sponsor, numerous federal pension laws would be broken, including the prohibition on loaning plan assets to the plan sponsor and the requirement that plan assets be diversified.

Increasing Social Security taxes alone only makes the implicit rate of return worse for younger generations. (The implicit rate of return chart produced by the Social Security Administration in 1994 reflects tax rates that would maintain actuarial balance on a pay-as-you-go basis.) If taxes were increased and the taxed amounts invested in traditional pension assets for the benefit of the persons taxed, then the implicit rate of return for future beneficiaries could be increased, potentially causing the return line to get closer to a straight line or possibly even exceed a straight line return.

While such a possibility is plausible, would it ever happen? Historically, Congress has taken any surpluses and spent them. Investment in traditional pension assets would involve risk greater (but should produce greater return) than that experienced to date by the Social Security trust fund. Given that Social Security taxes have only increased over time and the implicit rate of return has only decreased over time, should individuals be forced to pay more taxes into such a system when they can invest on their own? Note: If the federal debt situation gets as bad as anticipated by the GAO, at some

point, traditional pension assets will be a less risky investment than Treasury bonds.

According to the 2009 Social Security and Medicare trustees report, repayment of the debt owed the Social Security trust fund permits payments to continue until 2037. At that point, Social Security tax revenue would be sufficient to produce roughly 75 percent of ordinary benefits. Given the corporate income tax burden is now relatively high, repayment of the Social Security trust fund bonds through increase of the individual income tax would, similar to an increase in the Social Security tax, indirectly reduce the implicit rate of return. However, different people would be impacted, because a different group would pay the tax. (A substantial overlap would exist between the two groups.)

Repayment from the income tax would move a significant piece of the burden to wealthier individuals. Unlike funding from the Social Security tax, lower-income persons who pay no income tax would bear none of the burden, thus making Social Security more beneficial to lower-income persons in terms of taxes and benefits combined.

Addition of a sales tax or value-added tax (VAT) would cause the burden to be spread more widely. Results from other countries show that when such a tax is added, it is there to stay. The United States would lose a tax advantage it presently holds over other countries.

Substantial additional immigration aside, in order to keep Social Security a defined benefit system while not incurring more debt and not raising taxes, a reduction to benefits would be necessary. (Perhaps some politicians will propose Social Security taxation without benefits as part of an amnesty program for illegal aliens.)

Although current retirees and those close to retirement age do not want to hear it, from a purely financial perspective while considering current retirees and future retirees as a group, a benefit cut is a fair means of handling Social Security's problems. The implicit rate of return chart remains the standard for analysis. Further increasing the normal retirement age would only decrease the implicit rate of return for younger persons. Absent tremendous immigration of high-income persons (unrealistic) or a significant shift in the size and direction of government, taxes as a whole will only be greater for future generations.

Absent something catastrophic, future generations will live longer than people now retired. However, the implicit rate of return chart considers longevity. As shown above, older persons cannot argue their overall tax burden was greater than the burden that will be experienced by younger persons.

Many actuarial analyses note that changing the cost of living adjustment (COLA) to an index that reflects spending by seniors would reduce Social Security's problems. If so, such a change should be implemented.

A benefits cut could take the form of a benefits freeze that occurs over a period of years necessary for the cut to be implemented. If a 10 percent benefit cut was necessary to produce a constant return (assuming surplus assets would be invested in traditional pension assets for later payment to future beneficiaries instead of being loaned to the general fund of the federal government to be spent), a person receiving \$1,500 of benefits per month could continue to receive that amount until the ordinarily applicable COLA increased the ordinary benefit amount to \$1,650. Thereafter, the COLA would restart with respect to \$1,500. Future retirees would

need to experience their cuts when benefits first become payable. The obvious downside of a benefits cut is a reduced standard of living for impacted retirees.

A pure benefits cut would impact all persons—old, middle age and young persons, because it would be permanent in nature. However, to be fair from a financial perspective, a benefit cut would need to, as closely as possible, produce a constant return on investment. In other words, as much as possible, the implicit rate of return chart should show a horizontal line parallel to the x axis. Such a cut would necessitate investing amounts cut currently for payment in the future to future beneficiaries to produce the constant rate of return. As noted, to date, Congress has taken and spent Social Security's surpluses. (Calculating a horizontal rate of return, assuming the Social Security tax system continues as is with the exception of transferring benefits from current retirees to future retirees, would necessitate a means of determining financial need. It would also necessitate significant actuarial calculations using life expectancies and estimated earnings returns.)

## What Is Practical?

### Detrimental Reliance

As is often done in litigation, people who have already retired and people close to retirement will argue: "You can't reduce my benefits because I've relied on a given life annuity. I made financial commitments and saved based on the assumed annuity. I would have saved more if I had known my Social Security benefits would be less."

The person age 67 will make the argument, as will the person who is age 60. Where can the line be drawn? There should be no attempt to draw a line.

Elderly persons characterize Social Security as a promise that cannot (or should not) be broken. But what promises are made to young people? That they cannot rely on Social Security? (A few years ago, disclaimer language was added to Social Security benefits statements.)

Some elderly people will have already exceeded the constant rate of return horizontal line. For them, in a benefit cut scenario, the financially pure fair thing to do would be to completely cut off benefits. However, with respect to people lacking sufficient wealth to maintain a decent standard of living absent Social Security benefits, cutting off benefits would be inhumane.

Concerning benefits received and reduction, given the progressive nature of Social Security, the rate of return would need to be calculated on an individual basis, to adjust for different earnings histories. For relatively high earners, the return rate will be lower than the average earner's rate. For example, if the desire existed to reduce a group rate from 4 percent to 2 percent, a high earner's return might be 2 percent and need to be reduced to zero percent.

For retired individuals who have not yet received sufficient return on investment to reach the horizontal line return, perhaps actuarial equivalent options could be provided to allow these persons to choose how they wish to receive benefits anticipated to take them to the horizontal line of return. From a humanitarian perspective, as noted above, some people would need to receive benefits producing more than the constant rate of return.

Some people may suggest means testing is appropriate. However, as noted, Social Security's benefit formula already is very skewed against higher-income workers. Ordinarily, means testing would not be fair. However, perhaps it is fair on an individual basis to the extent necessary to cause benefits to fall in line so that a constant rate of return is produced (or to minimize the difference between the actual and desired constant rate of return).

Alternative approaches to cutting benefits and investing the savings from the cuts for future retirees exist. One option would be to take the remaining annual surpluses (expected to expire in 2016) and invest them in traditional pension assets, hold a national referendum to decide upon a benefits cut or a tax increase and provide matching contributions for younger workers.

Based on 2008 Social Security figures, assuming constant annual earnings of approximately 7 percent and a one-year increase in the normal retirement age to 68 for people born after 1985, an increase in the tax rate from 6.2 percent to 7.0 percent or a benefits cut of 11 percent phased in over three years would supply benefits until the early 2050s. Assuming the targeted earnings goal was achieved, adding dollar-for-dollar matching contributions up to 2 percent of an average worker's pay contributed to an individual retirement account or qualified plan for people born after 1985 would produce accounts equaling approximately 150 percent of forgone benefits due to reduced Social Security tax revenue in the 2050s. Lesser contributions (e.g., 1 percent) could be required of lower-income persons to produce the 2 percent match.

Investment funds could be provided by the federal government for people who did not wish to invest their accounts. Matching contributions could be forfeitable if the elective deferrals were taken prior to retirement for any reason other than death or disability. A phase-in could apply to people born prior to 1985 but expected to live beyond the 2050s insolvency date.

Such an approach would make Social Security part defined benefit (with the benefit equal to the pro rata amount of the traditional formula benefit based on cash received from taxpayers) and part defined contribution in nature for younger workers.

Two problems with such an approach are the risk involved with achieving the investment returns and the fact that funding for the match comes from current

taxes (i.e., from the people who will receive the matching contributions). But such an approach would solve Social Security's problems indefinitely. An indefinite fix is needed.

Some people think younger workers (e.g., under age 30) should be allowed to opt out of Social Security. Because Social Security is a pay-go system, opt-outs would create a need to incur more debt or raise taxes to fill the gap created by persons who opted out.

### **Fairness and Practicality**

A combination of fairness and practicality must be the basis for reform. It should be clear it is very difficult to craft a fair and practical solution. Another tax increase or an increase in the normal retirement age merely makes financial unfairness worse. If a benefits cut is the means of addressing the problems, at a minimum, benefits should cease with respect to people who do not need the money and whose return exceeds the constant rate of return (as adjusted for earnings history as noted above).

This matter should come down to doing the right thing. For politicians, the easy thing to do is the thing that has been done—nothing. Because the percentage of older people who vote is much larger than the percentage of younger people who vote, politicians naturally favor older voters. They might argue that, from a political perspective, reducing benefits is impractical. However, from a financial perspective, due to the time value of money, the sooner action is taken, the greater the likelihood a financially fair result can be achieved.

Realistically, because repayment of the bonds owed the Social Security trust fund is the most politically palatable course of action, it likely will be the course of action pursued, perhaps coupled with an increase in the normal retirement age and matching contributions or something in the nature thereof for younger workers to help cushion the 25 percent reduction anticipated when the bonds are fully paid. If the federal government's financial problems can be put under control, such an approach would be practical. Whether it would be fair is another story.

In any event, it is time to draw the line with Social Security. Specifically, it is time to start facing our nation's financial problems and tackling them in a debt-free manner.