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TO "SAVE" SOCIAL SECURITY, CUT TAXES, NOT DEBT

President Clinton wants to "use the budget surplus" to save Social Security. Stripped of rhetoric, Mr. Clinton's plan is to avoid tax cuts now to have money to bail out Social Security later, without having to raise tax rates again. Rather than cut taxes, he would use the near term budget surpluses to pay down the national debt. He pledges a large amount of future revenue, from taxes or borrowing, to aid Social Security when it starts running deficits (in token of which he would create Treasury bonds out of thin air and give them to the Social Security trust fund as IOUs). The Clinton plan fails to trim Social Security benefits to match projected payroll taxes, leading to eventual insolvency.

President Clinton wants to "use the budget surplus" to save Social Security. Stripped of rhetoric, Mr. Clinton's plan is to avoid tax cuts now to have money to bail out Social Security later, without having to raise tax rates again.

The real problem with an aging population isn't financing Social Security. The real problem is how to enable a relatively smaller future work force to produce sufficient goods and services for itself and a relatively larger retired population. Cutting taxes to promote higher real saving and investment would raise output per worker. The elderly could then consume the added output created by the added capital instead of taking a bigger share of existing levels of output away from future workers through higher taxes.

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The Administration claims that running surpluses to retire the national debt would make it easier to pay for Social Security in the future. What does that mean? Lower debt would free up future revenue that would otherwise be used to pay interest. But the Administration also contends -- and some Republicans seem to agree -- that, with less debt outstanding, it would be easier in the future to reissue the repaid debt (and more) to pay Social Security benefits. The Administration further claims -- and some Republicans agree -- that surpluses and debt reduction would add to national saving, reduce interest rates, and raise investment, productivity and output. (If so, wouldn't future borrowing to redeem Treasury bonds in the trust fund have the opposite effect?)

The Administration's analysis is flawed. National income accountants at the Commerce Department define federal budget surpluses as part of "national saving" (along with private saving by individuals and businesses), but it is wrong to assume that budget surpluses add to national saving. Budget surpluses displace private saving; they don't add to national saving, they reduce it.

Surpluses are taxes in excess of outlays. Unnecessarily high taxes reduce private disposable income; people must cut consumption or saving. Which gets the ax? Administration analysts assume that higher taxes cause people to cut consumption, not saving. By contrast, they assume that bondholders save every

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penny they get back when Treasury retires debt, and spend nothing. Consequently, the analysts assume that federal budget surpluses add to national saving. They also assume that the added saving would lower interest rates, thereby encouragingbusinesses to borrow the freed-up saving for investment, boosting growth. All these assumptions are suspect.

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There's no evidence that when you take money from people they cut their consumption, and when you give money to them, they save it. Higher taxes cause people to cut saving so they can keep spending. (Milton Friedman's permanent income theory of consumption suggests that consumption habits are slow to change, and that shifts in income shift saving.) Recent gains in tax revenue have come mostly from upper income taxpayers and businesses, who save a lot. Business taxes come straight out of business saving (via cuts in retained earnings and depreciation allowances).

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Meanwhile, some Treasury bondholders spend their redemptions, and others reinvest abroad. Treasury debt is widely held by retirees, who tend to consume, and foreigners, who might take the money home. U.S. interest rates are tied to global credit markets, not to Treasury borrowing. Even if bondholders saved the redemption money, there would be little effect on U.S. interest rates.

What really matters is what taxes do to incentives to save and invest. Business investment depends on expected after-tax profit. Personal saving depends on expected after-tax returns. Recent tax hikes have been the types that depress incentives to save and invest: higher marginal tax rates due to real income growth and explicit rate hikes, longer depreciation lives, passive loss limits on real estate investment, limits on access to deductible IRAs and pensions, and dozens of nitpicking business tax changes. These tax hikes can cut private saving and investment in the United States by more than the projected revenue gain to the government. Such surpluses reduce national saving and growth, rather than add to it. By contrast, rolling back such taxes can stimulate saving and investment in the U.S. capital stock.

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Pro-investment tax cuts -- faster depreciation, ending double taxation of corporate dividends and capital gains, or full-blown tax reform -- and expanding personal retirement accounts to replace all or part of Social Security would do more to raise national saving, encourage investment in the United States, and deal with an aging population than would debt reduction. It is not even a close call.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.