IRET Congressional Advisory

February 24, 2000 No. 98

JOHN McCAIN'S TAX PLAN — A MIXED BAG

The tax plan issued by Senator John McCain in his bid for the Republican Party's Presidential nomination prompts a response of, "Yes, but..." The McCain plan includes some welcome income tax cuts that would reduce tax burdens and biases. But the plan would offset almost two thirds of the tax relief with revenue-raising provisions that would increase tax burdens and biases elsewhere. Thus, the McCain plan would take back with one hand the majority of what it gave with the other. On net, Senator McCain would dedicate less than 7% of the total federal budget surplus projected for the next 5 years to income and estate tax relief. (Senator McCain prepared his plan using the budget surplus projections that government estimators calculated last summer. The percentages cited here refer to those projections. The percentages going to tax relief would be lower relative to the projections issued by the Congressional Budget Office this January.)

> ***The McCain plan includes some welcome income tax cuts that would reduce tax burdens and biases. But the plan would offset almost two thirds of the tax relief with revenue-raising provisions that would increase tax burdens and biases elsewhere.***

Senator McCain and his advisors have described their plan as moving gradually toward a flat tax "from the bottom up". A well designed flat tax, however, requires both a single low rate and a principled reform of the tax base. While some parts of the McCain plan do move in that direction, other parts move away from the proper tax base.

Senator McCain offers a set of principles to guide Social Security reform, including giving people the choice of using private retirement accounts as an alternative to Social Security. But Senator McCain would leave the details of the reform to a bipartisan panel appointed after the Presidential election. Despite the absence of a specific Social Security reform proposal, Senator McCain wants to "reserve" for Social Security 89% of the total federal budget surplus projected for the next 5 years (100% of the off-budget surplus and 62% of the on-budget surplus). With no concrete reform proposal on the table, it is uncertain now how much of the "reserved" funds would go to meaningful Social Security reform and how much to accounting gimmicks or short-term band-aids.

Income Taxes

The federal income tax is strongly biased against saving and investment. Earnings used for immediate consumption are generally taxed only once. (There is no additional federal tax on consumption purchases and the enjoyment provided by consumption, except for a few products subject to excise taxes.) However, earnings that are saved are taxed repeatedly. (There is income tax on the earnings and also income tax on the returns on the saving.) The basic bias is worsened by other features of the tax code. For example, some provisions understate expenses required to produce revenues, which causes income to be overstated. A special problem with investments in corporate equity is that the combination of the individual and corporate income taxes creates two tiers of income tax on the same income. The capital gains tax is another problem because it places an up-front tax on the capitalized value of future earnings that will also

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be taxed when they occur. (Assets' prices generally equal the current value of the after-tax earnings they are expected to produce.) The estate tax charges an extra tax at death on saving on which income taxes have usually already been paid, or, in the case of tax-deferred retirement plans, which will be taxed as income to the heirs.

> ***Senator McCain would steeply increase income taxes on people's business activities: $150 billion over 5 years... Senator McCain's list of "loophole" closers includes a few subsidies, but most of the provisions he has targeted ... are not loopholes; they lessen, but do not fully remove, tax biases against saving and investment.***

To fully remove these biases and create a tax system that is ***neutral*** between saving and consumption uses of income, saving and investment need to be put on the same tax footing as consumption and be subject to income tax only once. One way to do this is to defer tax on saving and then tax the gross distributions from saving (the same treatment as given saving in regular IRAs and tax-deferred employee pensions). Another option is to tax funds that are saved but not the returns on the saving (the same treatment given by Roth IRAs and tax-exempt bonds). Fortunately, the current tax system does take a few steps towards neutrality. For instance, it allows limited amounts, subject to various restrictions, to be saved through IRAs, tax-deferred retirement pensions, and life insurance policies. Without such features, the tax system's anti-saving, anti-investment biases would be even more powerful.

> ***Higher taxes on people's business activities have the political attraction that they are not readily visible. Nevertheless, it is always people who end up paying these taxes - as business owners, employees, and customers.***

As explained in more detail below, the McCain plan offers some features that would cut people's tax burdens and reduce the tax biases against saving and investment. But the plan also calls for many tax increases that would raise people's tax burdens and aggravate tax biases against saving and investment.

Income tax increases

Senator McCain would steeply increase income taxes on people's business activities: $150 billion over 5 years. According to the McCain plan, these tax hikes are fair and efficient because they "will eliminate the numerous inequitable and unnecessary corporate and special interest loopholes, subsidies, and set asides" that now mar the tax code. The preceding discussion of tax neutrality provides a principled benchmark against which to evaluate Senator McCain's claims. According to the tax-neutrality benchmark, tax provisions which help counteract tax biases against saving and investment are appropriate and laudable. The chief criticism of those provisions is that they may not go far enough and should be expanded. Only provisions that go beyond neutrality and subsidize saving and investment are genuine loopholes. They should be curtailed unless there are compelling public policy reasons to continue them.

Senator McCain's list of "loophole" closers includes a few subsidies, but most of the provisions he has targeted belong in the tax code and, indeed, should be expanded. They are not loopholes; they lessen, but do not fully remove, tax biases against saving and investment. Consider a few examples from the Senator's long list of proposed tax increases.

- <u>Eliminate deferral of capital gains tax on like-kind exchanges of real estate.</u> Tax-deferred roll-overs are correct policy because the tax deferral helps mitigate the bias of the capital gains tax. Instead of being attacked, the tax-deferred roll-over rule should be extended to all capital assets or, better, the capital gains tax should be eliminated.

• Eliminate deduction for 50% of the costs of business entertainment. To measure income accurately, the costs businesses incur in generating revenues need to be deducted. That includes business entertainment, which is an effective sales tool and is a legitimate business expense. (It might be argued that in some cases business entertainment is disguised compensation to employees, but automatically disallowing 50% of the deduction already gives the tax collector too big an adjustment for that, and one that is poorly targeted to cases of abuse.)

> ***[T]he Senator's disinclination to lower the high marginal tax rates now imposed on upper-middle-class and upper-income individuals reduces the potential of his proposed tax relief to improve the economy's efficiency... [And his] proposed shift of hundreds of billions of dollars of income tax collections from individuals to businesses conflicts with the public policy goal of making taxes as visible as possible.***

• Eliminate tax-free conversion of regular (Subchapter C) corporations into Subchapter S corporations. Income generated by regular corporations is subject to two income taxes, the corporate and individual. That is widely acknowledged to be double taxation. Subchapter S Corporations are treated like partnerships and their income is only taxed at the individual level. The conversions permitted by present law are only a "loophole" if one thinks that the income generated by people's business activities ought to be hit with two separate income taxes and that a hostage should be taken, in the form of a conversion tax, to keep it that way.

> ***The best provisions in the McCain plan would protect more saving from multiple taxation at the individual level. In the cases where they applied, they would help overcome the basic income tax bias against saving.***

• Raise taxes on the income American companies earn abroad. The McCain plan would impose higher U.S. taxes on the income American companies earn abroad. The U.S. rules governing the taxation of foreign source income are already extraordinarily complex and often place U.S. firms at a tax disadvantage compared to foreign companies. The McCain plan would add to those problems. This is not to say that no abuses occur in this extremely complicated area, but overtaxing large numbers of legitimate investments in order to penalize a few bad ones is not good tax policy.

• Force businesses to amortize rather than expense advertising costs. Under present law, businesses can deduct advertising costs when they are incurred (expensing). The McCain plan calls that a loophole and would force businesses to deduct advertising expenses over time. In fact, current law is correct. To measure income properly, business costs should be deducted when they are incurred. If firms must delay taking deductions, inflation and the time value of money will reduce the present value of the deductions below the real value of the costs, causing income to be overstated in present value terms and resulting in excessive taxation relative to true income.

Most of the proposed revenue raisers would be on people's business activities. Higher taxes on people's business activities have the political attraction that they are not readily visible. Nevertheless, it is always *people* who end up paying these taxes — as business owners, employees, and customers. Indeed, the total burden on people actually exceeds business tax collections. It also includes tax compliance costs, which tend to be high with business taxes because they are often very complicated, and the amount of potential output lost due to disincentives and distortions caused by the taxes, which may also be large.

Some critics have noted that a few of the items on Senator McCain's list recently became law and, thus, are not still available as new revenue raisers. These errors suggest that the tax-increase list was prepared quickly. Senator McCain and his advisers should rethink their plan and cross off the list all the proposed changes that would worsen tax biases against saving and investment. A well designed flat tax should not be constructed on a biased, non-neutral tax base.

Income tax relief

The McCain plan would primarily lower tax burdens on middle and upper income couples filing jointly, middle income taxpayers with dependent children, and people saving for children's educations and other purposes. There would be more modest relief for single taxpayers and taxpayers with lower incomes. The McCain plan would reduce marginal tax rates for many people in the middle class but would not, in general, lower marginal tax rates for upper-middle-class and upper-income individuals.

Two aspects of the proposed individual tax cuts are poor public policy. First, the Senator's disinclination to lower the high marginal tax rates now imposed on upper-middle-class and upper-income individuals reduces the potential of his proposed tax relief to improve the economy's efficiency. The Senator's tax-cut program would be much more powerful if, like those of Presidents Kennedy and Reagan, it provided proportional cuts in all marginal tax rates. Second, the proposed shift of hundreds of billions of dollars of income tax collections from individuals to businesses conflicts with the public policy goal of making taxes as visible as possible. Taxes should be highly visible in order that voters can accurately gauge the price of government when deciding how much government spending to support.

A number of Senator McCain's ideas for reducing people's income taxes will now be examined.

<u>Expand saving plans.</u> The best provisions in the McCain plan would protect more saving from multiple taxation at the individual level. In the cases where they applied, they would help overcome the basic income tax bias against saving. Some of the provisions use the deductible IRA approach, in which withdrawals from saving are taxed while contributions to saving are tax deferred, and some use the Roth IRA approach, in which contributions to saving are taxed but subsequent earnings are not.

One provision would raise by 50% the yearly contribution limit on 401(k) and 403(b) plans to $15,000 and on 457 plans (for state and local government employees) to $12,000. Another would double, to $1,000 per child annually, the contribution limit for the recently created Education Savings Accounts (ESAs).

The most innovative provision would establish new "Family Security Accounts" (FSAs). FSAs would be similar to tax-deductible IRAs in that tax would be deferred on contributions and assessed in full on gross distributions. People could make yearly contributions of up to $3,000 for singles and $6,000 for couples. Unlike IRAs and education saving plans, with their many government-imposed withdrawal restrictions, people could withdraw funds from FSAs without penalty, for any purpose, provided only that the funds had been invested for at least 1 year. (People would pay regular income tax on withdrawals, of course.) This is a superb proposal for simultaneously combatting the inefficiency and complexity of the tax system. FSAs would expand the amount people could save

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without being subject to the tax system's anti-saving bias. Moreover, the flexibility of FSAs regarding withdrawals would let people better meet their saving needs and have the bonus of keeping the accounts simpler than otherwise. In particular, the provision would benefit low income savers. Low income individuals often cannot afford to save separately for retirement and emergencies. Rather than risk a tax penalty on an emergency withdrawal from an IRA or pension, they leave their money in ordinary saving accounts and lose the benefit of tax-deferred compounding. The McCain plan would eliminate this concern and extend the benefit of tax deferral to the people most in need of it.

The wider 15% bracket would lower taxes for people currently in all brackets above 15%, but not for people currently in the 15% bracket.

In addition, the McCain plan would exclude from taxable income $200 in interest and dividends for singles and $400 for couples. In effect, this provision would provide Roth IRA treatment on a small amount of personal saving: funds would be taxed when earned, but returns on those already-taxed funds would not be taxed also. As such, it is a step in the direction of tax neutrality, and it also has the advantage of simplicity. It would be more effective, though, if its dollar limit were not so low. For example, if a person saves in a bank at 5% interest, the provision would only cover $4,000 of saving for singles and $8,000 for couples. That would be sufficient to protect people who save little from the basic income tax bias against saving, but it would not reduce the income tax bias, at the margin, for the people who do the majority of saving and investing in the United States, and, therefore, would not encourage those people to save more.

Senator McCain correctly notes that ... [the Social Security earnings test] deters millions of "highly skilled and experienced workers from continuing to contribute to America's prosperity" and promises to end it "immediately and entirely." Because the Senator discusses the earnings penalty only in the context of seniors ages 65 through 69, however, it is not clear if he also seeks to repeal it for Social Security beneficiaries ages 62 through 64. His proposal would be good in any case, but better if it applies to all Social Security beneficiaries.

<u>Marriage penalty relief.</u> The "marriage penalty" arises when a married couple pays more income tax than they would if single. A marriage penalty is possible because the standard deduction for a couple, although larger than that for a single person, is smaller than that for two singles, and the rate brackets for a couple, while wider in most cases than those for a single person, are not twice as wide. Senator McCain's recommendation is to make the standard deduction twice as big and the 15% tax bracket twice as wide for married couples filing jointly as for single filers. After Senator McCain released his proposal, the House passed roughly similar marriage-penalty-relief legislation.

The McCain proposal would raise the top of the 15% bracket to an income that is now almost halfway into the 28% bracket. It would prevent millions of couples from being pushed by marriage from the 15% to the 28% tax bracket. In addition to relief from the marriage penalty, it would provide such couples with more incentive at the margin to work and save. Higher income couples who would still remain in the 28% bracket or above would save money from the change, but would not have any added incentive to work and save.

Attempting to relieve the marriage penalty is surprisingly tricky, and the McCain proposal has some problems. Almost as many couples enjoy a marriage bonus (less income tax for a married couple than for two single filers) as suffer a marriage penalty. Couples usually receive a marriage bonus when one spouse either does not work or earns substantially less than the other. Because the McCain proposal would lower taxes for both groups of couples, it raises fairness and revenue issues. The larger marriage bonuses might make many singles feel that too much of the income tax burden was being shifted to them. Also, if limited revenue is set aside for tax reform, the larger marriage bonuses will displace other potential tax relief or require significant offsetting tax increases (of which the McCain plan has many). In addition, the larger standard deduction, although expensive, would generally not lower couples' marginal tax rates and, thus, would be ineffective in reducing anti-production tax biases.

A more targeted approach for reducing the marriage penalty was adopted in the early years of the Reagan Administration (and has reappeared in the tax plan of George W. Bush). It would exclude from taxable income 10% of the first $30,000 of earnings of the lower earning spouse. This alternative approach is more focused than that of Senator McCain because the marriage penalty rarely appears unless both spouses work. Further, if the lower earning spouse's income does not exceed $30,000, it would lower marginal tax rates for second-earner spouses, whose labor participation is usually very sensitive to after-tax wages.

Expand the 15% Rate Bracket. The McCain plan would gradually expand the 15% tax bracket by 36% for singles (from $25,750 to $35,000). Since the plan would make the 15% bracket twice as wide for couples as for singles, the 15% bracket for couples would also expand, extending up to $70,000. The wider 15% bracket would lower taxes for people currently in all brackets above 15%, but not for people currently in the 15% bracket. It would also improve production incentives for the millions of taxpayers that it moved from the 28% tax bracket to the 15% tax bracket. However, it would not decrease marginal tax rates, and the associated disincentives against working, saving, and investing, for people already in the 15% bracket or people remaining in the 28% and higher tax brackets after the change because their marginal tax rates would not be cut.

Double the child credit from $500 to $1,000. Doubling the recently enacted child credit would lower the income tax bills of millions of families with children. Its incentive effects would be mixed, though. It would reduce the marginal tax rate for those families now in the 15% bracket that it removed from the income tax rolls. However, it is bad policy to remove large numbers of people from the tax rolls. It makes them think government spending is a free good. The bottom half of the income distribution already pays less than 5% of total income taxes. Another problem with the proposal is that it would sharply increase what is already a large marginal tax rate spike for taxpayers in the credit's phase-out zone. The child credit starts phasing out at an adjusted gross income of $75,000 for a single individual and $110,000 for a couple. The income range over which taxpayers lose the credit is $10,000 per child. With a $500 credit, that produces a 5% jump in the effective marginal tax rate over the phaseout range. But if a doubled credit is phased out over the same income range, the spike in the marginal tax rate would double to 10%. For instance, if a taxpayer with 1 or more dependent children is in the phase-out range and has a statutory tax rate of 28%, the phaseout pushes the taxpayer's effective marginal tax rate to 33% under current law and 38% under the McCain proposal.

Instead of eliminating the estate and gift tax, Senator McCain would raise the exemption to $5 million over a decade. His proposal would be stronger ... if it increased the exemption quickly, and if it included rate reduction.

Repeal the Social Security earnings test. The Social Security earnings test reduces Social Security checks for beneficiaries between the ages of 62 and 69 who continue working and earn above a certain amount at their jobs. Above the earnings limit, the loss is $1 of benefits for $3 of earnings for beneficiaries between ages 65 and 69. Beneficiaries between ages 62 and 64 have a much lower earnings limit and lose $1 of benefits for $2 of excess earnings. Together with the payroll tax, the regular federal and state income taxes, and the phase-in of income tax on a portion of Social Security benefits, the earnings test can produce astonishingly high marginal tax rates of between 68% and 110%! Senator McCain correctly notes that it deters millions of "highly skilled and experienced workers from continuing to contribute to America's prosperity" and promises to end it "immediately and entirely." Because the Senator discusses the earnings penalty only in the context of seniors ages 65 through 69, however, it is not clear if he also seeks to repeal it for Social Security beneficiaries ages 62 through 64. His proposal would be good in any case, but better if it applies to all Social Security beneficiaries. Legislation to end the earnings penalty for workers ages 65 through 69 is advancing swiftly in the House, and the President has indicated that he would not veto it.

The Senator's outline contains the excellent idea of letting people prepare for their retirements through private retirement accounts... [But] restricting funding for this reform to the on-budget surplus has two bad consequences. It hurts efforts to reduce and reform other taxes by taking away much of the potential funding from those efforts. It also unduly limits the amount that can be committed to meaningful Social Security reform.

<u>Alternative minimum tax (AMT).</u> The McCain plan accurately calls the AMT "one of the anomalies of the tax code." The AMT is a complicated, confusing, parallel tax system that sometimes traps taxpayers, usually for taking "too many" legitimate deductions and credits. The IRS National Taxpayer Advocate recommended in its *Annual Report to Congress* that the AMT be repealed, noting that the AMT "is widely regarded as being unnecessarily complex and burdensome" (Reprinted in *Daily Tax Report*, January 5, 2000, pages L-4 to L-26.) The McCain plan says it would protect taxpayers in the 15% bracket from being pushed into the AMT by his proposals, but, disappointingly, does not recommend any other changes in either the individual or corporate AMT.

<u>Estate and gift tax relief.</u> The "death tax" is extremely complicated, has very high marginal rates, must be prepared under the most traumatic circumstances, and taxes, again, savings that have been taxed multiple times during life or, in the case of tax-deferred saving plans, will be taxed as income to the heirs. People who think their estates might be subject to the death tax have a strong incentive to consume more than otherwise and to engage in elaborate, costly, and inconvenient tax planning. Because the estate and gift tax violates at many levels the principles of a good tax system, it should be abolished. Most estates are shielded from the death tax by an exemption that is increasing gradually to $1 million. Instead of eliminating the estate and gift tax, Senator McCain would raise the exemption to $5 million over a decade. His proposal would be stronger, though, if it increased the exemption quickly, and if it included rate reduction. At an estate size of $5 million, the death tax has a statutory rate of 55%. Because of the mechanics of how the tax is calculated, that rate would kick in on the first dollar above $5 million under the McCain proposal. With the government charging a 55% marginal tax rate, people expecting to leave large estates would still confront a very powerful saving and investment disincentive.

<u>Moratorium on taxation of Internet transactions.</u> One of the gravest threats to the continued remarkable development of the Internet is the possible imposition of literally thousands of different taxes by state and local governments across

the country. Two major classes of taxes are access fees, which already heavily burden telephone service, and sales taxes. Access fees, which have proliferated in recent years on telephone service, have three strikes against them: they are distortionary, complicated, and largely hidden. They should be repealed on telephone service and not imposed on Internet service. As for sales taxes, they should not be collected on Internet transactions unless a number of questions can be answered satisfactorily. Three of the questions are: Is it administratively feasible for merchants to collect what could be thousands of different state and local sales taxes? Is it appropriate to require merchants to collect sales taxes for jurisdictions in which they have no physical presence? Could adequate safeguards be erected to prevent state and local governments from taxing transactions between businesses, which, rather than retail sales, comprise the overriding majority of Internet transactions presently? By putting a "Hands Off" sign on new Internet taxes, Senator McCain's Internet tax proposal would buy time to address these issues.

Other proposed relief. The McCain plan would also expand Medical Savings Accounts, provide an above-the-line deduction for long-term-care insurance, create a new tax credit for charitable contributions to schools, and exempt from U.S. tax much of the income military personnel earn overseas. As with the other tax relief items, tax increases would pay for about two-thirds of these provisions.

Social Security

Senator McCain is to be commended for stating forthrightly that Social Security should be reformed. However, the amount he claims must be dedicated to the task is startlingly high: nearly nine-tenths of projected budget surpluses. To justify channeling such a huge share of future surpluses into Social Security, Senator McCain should lay out a concrete proposal telling exactly how he would use the funds. Instead, Senator McCain offers a number of do's and don'ts, but says the actual plan should be put together by a bipartisan commission, guided by his principles, after he is elected.

Senator McCain would reserve the Social Security portion of the budget surplus for the Social Security Trust Funds, as if that would keep the funds available for paying benefits to future retirees. In fact, there is no money in the trust funds... To "redeem" the trust fund "bonds" at that time, the Treasury will have to use general tax revenue (if the rest of the budget has a surplus) or borrow from the public or ask the Congress to cut other spending, just as if the trust funds did not exist.

In effect, he is asking American taxpayers to set aside more than a trillion dollars during the next 5 years, with additional trillions to follow, in the hope that a commission he appoints will decide to spend it wisely.

The outline of a McCain Social Security plan can be gleaned from his list of do's and don'ts. The Senator's "Social Security Principles of Reform" says that we should "dedicate 62% of the non-Social Security Surplus to the Social Security Trust Fund...[where it would be] available for implementing private retirement accounts. [Emphasis added.]" He hopes people would be able to contribute to these accounts at least 20% of what they would otherwise have to pay to Social Security. To keep the government from spending the money, he thinks the accounts should be individually owned. Senator McCain says the Social Security portion of the budget surpluses should be added to the Social Security Trust Fund and kept there to "assure the funding necessary to pay promised benefits."

The Senator's outline contains the excellent idea of letting people prepare for their retirements through private retirement accounts. Such fully funded accounts, in which contributions are saved and grow with interest, and the retirees receive the accumulated income and principle on retirement, are financially stable and administratively feasible, as demonstrated, for instance, by the track records of companies offering annuities, life insurance policies, and mutual funds. Moreover, because they rely on the fruits of real saving and investment to pay benefits, they often provide retirement benefits far outstripping those of the government's Social Security system. Social Security, despite government efforts to make it look like a saving system, is a tax-and-transfer system involving no real saving: the bulk of workers' contributions go straight to retirees for their consumption.

Providing for a larger retiree population requires higher levels of output of real goods and services by a relatively smaller group of future workers... [This] requires the types of tax reduction that assist and encourage people to save ... and the types of tax reduction that encourage business fixed investment... Using the Social Security and on-budget surpluses for these purposes would do more to help the country cope with an aging population than would paying down the national debt. Rejecting tax reduction to pump up the trust funds would only mask the real problem and worsen the eventual financial crisis by delaying true reform.

An objection to the mechanics of Senator McCain's private accounts, though, is that if the surplus is to be divided (artificially) between Social Security and non-Social Security components, the funding for Social Security reform should come, first, from the Social Security surplus. (The funding is needed to replace payments that would go into the accounts instead of going to Social Security and being paid out to retirees. The best financing option from the perspective of economic growth would be to cut government spending). Restricting funding for this reform to the on-budget surplus has two bad consequences. It hurts efforts to reduce and reform other taxes by taking away much of the potential funding from those efforts. It also unduly limits the amount that can be committed to meaningful Social Security reform. Because the private accounts would be financed with a portion of the non-Social-Security surplus, Senator McCain feels constrained to force wage earners to continue paying about 80% of their money into Social Security, with only about 20% going into the new private accounts. The reform would be more thorough and the private accounts would grow much more quickly if the Senator were willing to finance the new accounts from the Social Security portion of the budget surplus. There may be other problems with regard to the new accounts and their funding, but the Senator has not provided enough details to know. (Seemingly minor details in a Social Security plan can have a major effect on how it would operate.)

Senator McCain would reserve the Social Security portion of the budget surplus for the Social Security Trust Funds, as if that would keep the funds available for paying benefits to future retirees. In fact, there is no money in the trust funds. The Treasury uses any Social Security surplus either to pay for other federal programs, or, if the rest of the budget is in surplus, to pay down the national debt. As Treasury uses the surpluses to buy back debt from the public, the money is given to the bondholders. It is no longer in the possession of the government, and is not also available to be paid to future Social Security recipients.

When the Treasury uses the Social Security surpluses for other purposes, it records the amount as "borrowing" from the trust funds, and credits the trust funds with a like amount of Treasury bonds. These bonds are just IOUs issued by one part of the federal government to another. They are not money, and cannot be used to pay benefits. In the future, when Social Security is running deficits, the Social Security Administration will want the Treasury to "use the trust fund" to cover some of the benefits. To "redeem" the trust fund "bonds" at that time, the

Treasury will have to use general tax revenue (if the rest of the budget has a surplus) or borrow from the public or ask the Congress to cut other spending, **just as if the trust funds did not exist.**

The trust fund arrangement is, in reality, analogous to a couple taking 15% of their income, saying they will save it for retirement, writing themselves an IOU for it, carefully putting the IOU in a piggy bank, and then spending all the money. (To make the analogy with Social Security more realistic, the couple will also write themselves large, additional quantities of IOUs based on the "interest" earned by their previous IOUs.) At retirement, the couple will have a huge pile of their own IOUs — but not a cent of retirement money.

Historically, the government has spent Social Security surpluses on other programs. Senator McCain claims that would not happen under his watch and points to his solid voting record in opposing government waste. Nonetheless, the pressure in government to spend money left lying around is enormous and would likely defeat his good intentions. But even if Senator McCain could reserve the surpluses to pay down the debt, that is a second best approach to caring for an aging population.

If the government were to pay down the national debt, rather than spend the surpluses, there would be a reduction in future interest outlays owed to the general public. If taxes are not cut, the future general revenue surpluses due to the interest reduction could be used to pay some of SocialSecurity's future deficits. But the projected deficits in Social Security will be five to seven times larger than the amount of interest savings. Social Security must still be reformed.

Senator McCain has said he wished he could have provided more tax relief in his plan but was constrained by the budget numbers. Fortunately ... the Congressional Budget Office has revised upward substantially its budget surplus projections. The new, much larger numbers provide Senator McCain with an excellent opportunity to discard most of the damaging tax increases in his current plan while upgrading the tax relief.

Providing for a larger retiree population requires higher levels of output of real goods and services by a relatively smaller group of future workers. That requires boosting the productivity of future workers by encouraging capital formation, which requires more saving by the nation's citizens. Achieving these goals requires the types of tax reduction that assist and encourage people to save (such as large payroll tax cuts combined with the Senator's expanded saving incentives), and the types of tax reduction that encourage business fixed investment (such as expensing of plant and equipment). Using the Social Security and on-budget surpluses for these purposes would do more to help the country cope with an aging population than would paying down the national debt. Rejecting tax reduction to pump up the trust funds would only mask the real problem and worsen the eventual financial crisis by delaying true reform.

Conclusion

Senator McCain's tax package is, on net, extremely modest. Much more should be done. Projected budget surpluses could finance anti-bias reforms of the income tax base, significant reductions in marginal tax rates, and a rapid and major shift from Social Security transfer payments to private retirement saving accounts based on real saving. Instead, the Senator offers a mixture of modest tax cuts, soak-the-rich tax hikes, and a promise of a timid Social Security reform that appears to be inadequate to the task.

Senator McCain has said he wished he could have provided more tax relief in his plan but was constrained by the budget numbers. Fortunately, since the McCain plan was first issued, the Congressional Budget Office has revised upward substantially its budget surplus projections. The new, much larger numbers provide Senator McCain with an excellent opportunity to discard most of the damaging tax increases in his current plan while upgrading the tax relief. With the changes, Senator McCain could issue a revised tax plan more supportive of tax neutrality, economic growth, and retirement security than his current proposal.

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