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Entitlement Reforms Should Cut Benefits And Taxes

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Almost everyone agrees that without significant entitlement program reform, there is little hope for a solution to the looming decade of out-of-control deficit spending. That said, there is little agreement on how to do so. The inclination on the right is to cut spending; the inclination on the left is to raise taxes.

Critics of proposals to reduce spending claim that younger workers will be short-changed. For example, when Paul Ryan proposed to reform Medicare by making the federal government's contribution ("premium support") grow less rapidly than the rate of medical inflation, critics charged that this would shift costs to future retirees.

What the critics missed: If future Medicare benefits are smaller, then the taxes needed to pay for Medicare will also be smaller. In other words, Medicare benefit cuts produce partly offsetting taxpayer gains.

The same principle applies to Social Security. Most Social Security reform proposals would result in fewer benefits for future retirees. However, if the program pays out less in benefits, the payroll taxes needed from younger workers to support the program will be lower than they otherwise would be.

In some cases workers would come out ahead, with the value of the tax reductions exceeding the loss resulting from benefit cuts, according to a National Center for Policy Analysis report by our colleagues Andrew Rettenmaier and Liqun Liu.

For political reasons, most entitlement reform proposals under consideration would leave current retirees' benefits untouched and reduce benefits only for future retirees. The question for young people is: Are smaller benefits acceptable in return for lower taxes?

The study analyzes three commonly discussed ways of reducing Social Security benefits:
Progressive price indexing of benefits: a way of tying the growth of benefits to worker income.
Changing the benefit formula: a way of reducing the size of monthly benefit checks.

Raising the retirement age: increasing it to age 70 by 2032 followed by increases of one month every two years.
In each case, the current system is made hypothetically sustainable by raising the Social Security payroll tax enough to make the system solvent, indefinitely into the future. The proposed benefit cuts allow a reduction in this hypothetical payroll tax.

The study found that raising to 70 the retirement age of a 41-year-old with a lifetime average annual income would reduce lifetime benefits by about $60,000. But the taxes required to fund these reduced benefits would be $40,000 less than otherwise. This lower tax burden would offset two-thirds of the benefit loss.

Raising the retirement age for a 41-year-old, poverty-level worker would reduce lifetime benefits by $26,000. But the lower tax burden would offset 40% of the benefit loss. For a very high-income worker (16 times the poverty level), the lower tax burden would offset 90% of the benefit loss.

Changing the benefit formula to make it less generous causes the 41-year-old, average-income worker's taxes to drop by more than the loss of benefits. Under progressive price indexing, these lower taxes exceed the accompanying benefit loss by $30,000.

For 26-year olds, raising the retirement age would reduce a very high-income earner's taxes by more than the reduction in benefits.

For an average income earner, the tax reduction would make up for 95% of his benefit loss.

The fall in taxes for a poverty-level worker would offset about half of his lost benefits.

Progressive price indexing would reduce the tax burden for today's 26-year-olds in every income group by more than their benefit loss when compared with fully funding current law benefits.

Changing the benefit formula would reduce the taxes of a very high-income 26-year-old by more than the reduction in benefits.

The benefit loss of an average wage worker would be almost entirely offset by tax reductions.

The poverty-level worker's benefit loss would be offset 85% by lower taxes.

What about eliminating the cap on the payroll tax, an idea favored by many on the left?

Raising the taxable maximum would increase the taxes of very high-income workers, but half of the tax increase would be offset by increased benefits the government would have to pay to those same workers.

The biggest problem with raising the maximum taxable wage is that it commits the government to a more expensive program — in contrast to the first three reforms, which make the program smaller. Moreover, if progressivity is the chief concern, progressive price indexing produces similar progressivity, but it is more fiscally responsible in the long run.

In other words, you can achieve a similar fiscal improvement and do so in an equally progressive way by cutting the benefits of high-income people rather than increasing their taxes.

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