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POLICY BRIEF

Social Security Needs Fixing, Tax Increases on Savings Are Not the Solution

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When the latest *Social Security Trustees Report* was released in March 2023, we were reminded yet again of the parlous financial condition of the Social Security program.[1] According to the report, the combined trust funds will be depleted in 2034, and Social Security's cumulative financing deficit equates to more than 25 percent of all projected benefit claims over the next 75 years. Unfortunately, few politicians are willing to show the political courage necessary and propose the reforms needed to align the program's benefit promises with financial realities and put Social Security on a sustainable financial path.

Thankfully, some scholars are still offering creative ideas to help solve this problem. The American Enterprise Institute's Andrew Biggs and Boston College's Alicia Munnell have just published a new report entitled "The Case for Using Subsidies for Retirement Plans to Fix Social Security."[2] Unfortunately, while we have the utmost respect for Biggs and Munnell and regard them as friends and colleagues, we believe the plan they lay out would fail to address the serious challenges within Social Security itself, in addition to significantly weakening retirement savings outside of the Social Security program.

As this brief will show, the Biggs-Munnell proposal rests on two foundational assumptions, both of which we believe to be mistaken. First, its authors propose to end the current tax-deferred treatment of retirement savings accounts, including employer-sponsored retirement plans and IRAs, arguing that it is the equivalent of an inefficient, regressive spending program whose funds could be better used elsewhere. Second, the authors propose to bail out Social Security using the trillions in tax revenues generated by the change. While we are no fans of our current income-tax system or many of the spending programs administered through the tax code and agree that changes are necessary, we find that, instead of ending an inequitable tax preference, the Biggs-Munnell proposal would raise taxes massively by effectively double-taxing retirement savings. In addition, bailing out Social Security with this huge infusion of general revenues would bear substantial adverse ramifications for the Social Security program as a whole as well as for its individual participants.

Consider the traditional metaphor of the three-legged stool of retirement security.[3] The three legs consist of Social Security, employer-sponsored retirement programs, and individual savings. All three together are supposed to provide a stable and secure retirement. The Biggs-Munnell proposal would effectively cut two legs off the stool—the employer retirement programs and individual savings—thus creating a pogo stick of retirement policy.

THE BIGGS-MUNNELL PROPOSAL

In their new report, Biggs and Munnell argue that the tax treatment of employer-sponsored retirement plans and IRAs is an expensive tax preference that should be gutted. The authors emphasize the high cost of tax expenditures attributed to employer-sponsored retirement plans,[4] which was around $185 billion in 2020 alone. They consider this to be a subsidy provided mostly to higher-income earners that has been proven to generate very weak incentives to save. They also suggest that the revenue raised from taxing these savings should be redirected to cover much of the long-term funding gap of Social Security.

MISCHARACTERIZATION OF THE TAX TREATMENT OF SAVING

The taxation system in the United States is inherently problematic in large part owing to its internally inconsistent definitions of income. As a result, it is susceptible to influence from special interest groups, and politicians find it difficult to resist using the tax code to incentivize particular behaviors. In the prevailing tax framework, the concept of 'tax expenditure' encompasses two distinct elements. One is the set of privileges extended to select politically influential special interest groups (such as the mortgage interest deduction). The others are the modifications to the income tax structure aimed at rectifying tax-code inefficiencies (such as the reduced tax rate for capital gains). This amalgamation of two disparate concepts under the single category of tax expenditures causes confusion and complicates the discourse surrounding tax reform.

Unfortunately, the Biggs-Munnell proposal elides this distinction and as a result places the current tax deferral for savings in the wrong category. They characterize tax-deferred saving accounts (TDAs), such as 401(k)s and IRAs, as subsidies for wealthy taxpayers rather than what they actually are, namely, a means of preventing the double taxation of savings. In this case, the money that individuals set aside in such accounts is typically income that has already been taxed, in the case of a Roth-style account, or, in the case of a traditional IRA, will be taxed only once upon withdrawal.

Taxing the returns on these savings again would amount to a second layer of taxation on the same income. To say that it will be extremely disruptive of Americans' saving is an understatement.

The damage resulting from such a change to tax policy would extend well beyond undercutting retirement savers. Savings are the bedrock of investment and capital formation, which are in turn critical for economic growth and job creation. If savings are excessively taxed—and double taxation would surely qualify as excessive—they are heavily discouraged, leading to lower levels of investment and a slower rate of economic growth. Biggs and Munnell downplay this concern with the finding that the current exemptions do not encourage savings. However, there are reasons to question this claim.

Over at the economic Substack *Liberty Lens*, the Hoover Institution's Joshua Rauh and the American Enterprise Institute's Stan Veuger write:

> It is not at all clear that TDAs do not increase national saving. Biggs and Munnell rely heavily on a study that looks at a policy change in Denmark that made one type of TDA less attractive. In response, some but not all savers stop relying on this type of TDA, only to pivot toward a different kind, as one might expect. It is not at all clear how this evidence relates to net savings in the absence of TDAs altogether. In fact, the same study finds significant increases in total savings from employer contributions to TDAs and from mandatory contributions to retirement accounts: households did not offset these elsewhere.[5]

Coauthor Andrew Biggs's own pathbreaking work on retirement savings testifies to the success of individual savings accounts and thus to the potential damage of taxing away this saving. About that success, specifically of the 401(k) revolution in increasing savings for retirement, Biggs wrote:

> In reality, retirement saving and retirement incomes have improved and 401(k)s have been part of that story. We can't know what the "right" level of retirement saving is for any given household. But the trends are toward more Americans saving more for retirement. If you're concerned about undersaving for retirement, the 401(k) revolution is looking to be a success. . . Again, we don't know if Americans are saving the right amounts for retirement in our new 401(k) world. But the trends point toward more Americans saving for retirement and larger amounts being saved. If today's retirees are doing okay—and three-quarters tell Gallup they have enough money to live comfortably—then more working-age Americans saving more should mean better retirements in the future, not worse ones.[6]

Given the success of these retirement savings vehicles as analyzed by Biggs and others, whether government is needed to actively promote and finance additional savings is an open question. However, our tax code certainly should not create *dis*incentives for people to save for their retirement by taxing their savings multiple times as Biggs and Munnell propose doing and, thereby, induce them to rely more heavily on Social Security.

Social Security already displaces a tremendous amount of retirement savings that would likely otherwise occur—a phenomenon that would be exacerbated if savings were subject to double taxation and the proceeds poured into the Social Security program. The Congressional Budget Office has found that Social Security benefits alone replace 55 percent of a median worker's annual earnings averaged over her working career.[7] Since a typical retirement planner recommends that retirement income be sufficient to replace about 70 percent of preretirement earnings, this means that Social Security gets a median worker 79 percent of the way toward their retirement income target before that individual saves a penny. Many low-income workers actually expect higher standards of living in retirement than while working—not because their retirement benefits are lavish but because their working income is so modest. To doubly tax individual savings so that politicians can avoid moderating the rate of growth of Social Security costs would destroy the remaining incentive or capacity for countless families to save anything at all. The bottom line is that the starting point of the Biggs-Munnell paper, that tax deferred-saving accounts are essentially a government spending program for the rich, one that we may as well spend in a different way, is fundamentally flawed.

THE CASE AGAINST A SOCIAL SECURITY BAILOUT

Biggs and Munnell further suggest that federal tax revenue currently foregone to defer taxation of retirement savings would be better collected and allocated to Social Security. We disagree.

Social Security has its problems and challenges. It also has some cardinal virtues, however, one of them being that it's not permitted to spend more on benefits than the resources collected for its trust funds, the vast majority of which consist of payroll taxes paid by participating workers.[8] Individually, one's Social Security benefit is a direct function of one's earnings subject to the Social Security tax, and collectively, the program may not pay more in benefits than workers are deemed to have funded with their contributions. This is the critical distinction that separates Social Security from welfare both politically and substantively. Largely because of this feature, workers' Social Security benefits have historically been secure and reliable, without the persistent renegotiation of eligibility rules and benefit levels to which welfare programs are subjected.

To bail out Social Security with general revenues, regardless of the rationale, would effectively put an end to Social Security's continued functioning as an earned-benefit program. Thereafter, there would be no rhyme or reason to the benefit levels that Social Security offers. Once disconnected from the amounts of workers' contributions, benefits would simply be whatever politicians say they are. This would be the worst of both worlds from a policy standpoint, in that program spending would effectively be unleashed from the constraints of self-financing, while at the same time workers' benefits would be less secure, since they could no longer be defended as earned. Social Security would simultaneously become more expensive and less reliable.

Importantly, the changes proposed by Biggs and Munnell also would effectively eliminate any remaining incentives for legislators to engage in the challenging but necessary task of moderating Social Security's benefit growth. The fundamental problem underlying Social Security's finances is not primarily a revenue deficiency; rather, it's that its rate of automatic cost growth is persistently faster than the growth of its tax base in workers' earnings and indeed faster than the growth of GDP.[9] The Biggs-Munnell proposal would simply excuse lawmakers from dealing with the problematic reality—that program cost growth must ultimately be moderated to a sustainable rate.

Also of note, bailing out Social Security with general revenues would exacerbate the program's already severe generational inequities. Social Security imposes net income losses on younger workers under current law, because their Social Security tax burdens exceed the present value of the benefits the system can pay them.[10] This can only be corrected if the growth of scheduled benefits for older generations is moderated. A general revenue bailout, by contrast, commits additional future tax revenues in an attempt to chase these spiraling costs, thus locking in the net income losses Social Security would impose on the young.

Other proposals to bail out Social Security with general revenues, including a proposal by one of the coauthors of the Biggs-Munnell paper, have been offered with different rationales.[11] However, regardless of the rationale provided, all proposals for general revenue bailouts suffer from the same fundamental problems: they would lock in the generational inequities that result from a failure to moderate Social Security's cost growth, and they would destroy the self-financing principle that has been the foundation of Social Security's historical efficacy, fairness, security, and bipartisan popularity.

HISTORICAL EVIDENCE ON PRIOR TAX INCREASES[12]

Though any major reform to Social Security will undoubtedly involve political compromise between spending and revenues,[13] we believe that Biggs and Munnell err in assuming that such a large tax increase would resolve Social Security's huge funding shortfall. We believe history shows this outcome to be unlikely. The reason is that politicians can't resist the temptation to increase spending whenever they think more tax revenue might be available. As Milton Friedman warned, "History shows that over a long period of time government will spend whatever the tax system raises plus as much more as it can get away with."[14]

Jack Salmon and one of us (Veronique de Rugy) summarized the literature on this issue this way:

> Amid the tax-spend debate of the 1980s and 1990s, a study by economist Richard Vedder and his co-authors found that every $1.00 raised by new taxes generated $1.58 of new spending. The study was revised at least three times (in 1991, 2007 and 2010) and continued to be influential during the years of heightened deficit spending following the 2008

financial crisis. Observing the period 1947–2009, using different financial data and different control variables, the study's revised and updated models estimated that each $1.00 of new tax revenue resulted in between $1.05 and $1.81 of new spending.[15]

We believe things wouldn't be any different under the Biggs-Munnell proposal.

CONCLUSION

There is an urgent need to reform the Social Security program. The proposal by Andrew Biggs and Alicia Munnell to transfer subsidies from private retirement plans to Social Security, however, is fundamentally flawed. We believe that their approach, which involves ending the deferral of taxes for employer-sponsored retirement plans and IRAs and using the generated revenue to bail out Social Security, is based on a misinterpretation of the tax treatment of savings and overlooks the detrimental impact on both Social Security reform and American savings.

The Biggs-Munnell proposal incorrectly categorizes tax-deferred saving accounts as subsidies for the wealthy, glossing over their essential function of preventing double taxation of savings for all Americans. Moreover, the idea of using these funds to bail out Social Security would not only undermine the program's self-funded nature but also exacerbate generational inequities, placing an unfair financial burden on younger generations.

Furthermore, the assumption that a significant tax increase would solely address Social Security's funding shortfall is overly optimistic. History suggests that the additional funds may not be used as intended but rather may contribute to further fiscal irresponsibility. Additionally, all three of us have proposed reforms to Social Security that would maintain the traditional financing structure of the program, while acknowledging that tradeoffs and compromises need to be made. There is no "free lunch" when it comes to reforming Social Security, and we applaud efforts and ideas that help inform and drive the debate forward.[16]

In sum, the Biggs-Munnell proposal, while well-intentioned, is a misguided solution that could have far-reaching negative consequences. It overlooks a fundamental aspect of tax policy and the broader economic implications of an income tax bailout of Social Security. A more nuanced and comprehensive approach is needed to address the challenges facing Social Security, one that maintains the program's financing discipline, preserves the connection between worker contributions and their benefits, and ameliorates intergenerational inequities, while at the same time preserving the health of our private retirement savings system.[17]

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NOTES

1. Social Security Administration, *The 2023 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds (Trustees Report)*, March 31, 2023.
2. Andrew G. Biggs and Alicia H. Munnell, "The Case for Using Subsidies for Retirement Plans to Fix Social Security" (Issue in Brief 24-2, Center for Retirement Research at Boston College, Chestnut Hill, MA, January 16, 2024), https://crr.bc.edu/the-case-for-using-subsidies-for-retirement-plans-to-fix-social-security-2/.
3. "Research Note #1: Origins of the Three-Legged Stool Metaphor for Social Security," Social Security Administration, last modified May 1996, https://www.ssa.gov/history/stool.html.
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6. Andrew Biggs, "Was the 401K Revolution a Mistake?" *Forbes*, January 3, 2017.

7. Congressional Budget Office, *Social Security Replacement Rates and Other Benefit Measures: An In-Depth Analysis*, April 2019, Exhibits 5 and 6, 18–19.

8. A small percentage of revenues, typically about 4 percent, also comes from the income taxation of Social Security benefits.

9. Social Security Administration, *Trustees Report,* part G.

10. Social Security Administration, *Trustees Report,* part F.

11. Alicia Munnell, opinion, "The Problem in Social Security Lies in Its History," *Washington Post*, October 6, 2016, https://www.washingtonpost.com/news/in-theory/wp/2016/10/06/the-problem-with-social-security-lies-in-its-history/.

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14. Milton Friedman, "Friedman on the Surplus," interview with Peter Robinson, *Hoover Digest*, April 30, 2001.

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16. See, for example, Charles Blahous and Jason J. Fichtner, "Unleashing the Economic Growth America Needs," in *The 4% Solution*, ed. Brendan Miniter (New York: Crown Business, 2012); Charles Blahous and Jason J. Fichtner, "Limiting Social Security's Drag on Economic Growth (Mercatus Policy Research, Mercatus Center at George Mason University, Arlington VA, November 2012); Veronique de Rugy, "Republicans' and Democrats' Refusal to Reform Social Security and Medicare Is Political Malpractice," *Reason*, April 7, 2023; and Charles P. Blahous, "An Analytical Framework for Strengthening Social Security" (Mercatus Policy Research, Mercatus Center at George Mason University, Arlington, VA, September 2020), https://www.mercatus.org/media/document/blahous-social-security-mercatus-research-v2pdf.

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