CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

May 6, 2005

WILL A SOCIAL SECURITY BILL BECOME A VEHICLE FOR BUDGET-BUSTING TAX CUTS?

Chairman Thomas Outlines a Fiscally Risky Course

by Robert Greenstein

The potential is growing that efforts to address the Social Security shortfall could become a vehicle for budget-busting tax cuts. At a press conference on April 29, House Ways and Means Committee Chairman Bill Thomas (R-CA) and Social Security Subcommittee Chairman Jim McCrery (R-LA) suggested combining the broad type of Social Security benefit reductions that President Bush has proposed with additional tax cuts on savings and investments by higher-income people, such as making permanent the capital gains and dividend tax cuts enacted in 2003. The *Washington Post* reported May 5 that Chairman Thomas also is considering including large increases in contribution limits for IRAs and 401(k)s in his Social Security legislation.[1]

Reps. Thomas and McCrery made no mention at the press conference of paying for these tax cuts, a number of which have been shown to have very large long-term costs. If they are not paid for, the tax cuts under consideration would add to the nation's budget deficits. That would conflict with one of the key reasons to take action to close Social Security's long-term financing gap — to help address the nation's severe long-term budget problems.

Thomas and McCrery justified the idea of including such tax cuts in Social Security legislation on the grounds that the tax cuts would compensate middle- and upper-income workers for the larger reductions in Social Security benefits they would face under proposals like the President's. But the specific tax cuts they mentioned would primarily benefit those at the top of the income spectrum, while offering relatively few benefits to ordinary middle-income workers. Moreover, these tax-cut benefits appear to exceed any reductions in Social Security benefits that very high-income people would face. In the end, the combination of policies being floated could not only worsen the nation's fiscal problems but also make the distribution of retirement income more regressive, with the gaps between very high-income retirees and other retirees widening significantly.

Chairman Thomas Puts More Tax Cuts on the Table

Chairman Thomas indicated that he intends to consider, as part of Social Security legislation, such proposals as:

- expanding tax breaks for Individual Retirement Accounts (Rep. Thomas did not elaborate, but this presumably may include abolishing the $160,000 income cap on who can use Roth IRA tax breaks, and the *Washington Post* reported that he is

[1] Jonathan Weissman and Jeffrey H. Birnbaum, "Bush Ally in House Alters Social Security Debate Strategy," *Washington Post*, May 5, 2005.

considering doubling the amount that can be placed in an IRA each year, from $5,000 to $10,000);

- making permanent the capital gains and dividend tax cuts enacted in 2003;
- and providing other tax cuts and tax breaks on investment income and pensions.[2]

There are a number of tax cuts whose backers have been waiting for such an opportunity; an array of proposals for new pension and investment tax cuts heavily oriented toward the well-off has emerged in the past few years. Many of these proposals are designed to be *backloaded* — i.e., to lose little or no revenue over the first five or ten years but to cause large revenue losses in future decades.

Some of these proposals — in particular, proposals for "Retirement Saving Accounts" and "Lifetime Saving Accounts" — have been included in each of the last three Bush Administration budgets. Other proposals, such as a proposal to allow a portion of tax-deductible 401(k) and IRA contributions to be withdrawn *tax free* in retirement if used for health care costs, have been developed by elements of the financial services industry such as Fidelity and marketed by industry lobbyists.

Such tax proposals would entail large costs in future decades and presumably would be deficit-financed. If so, the cost of such tax cuts would be layered on top of the several trillion dollars in new borrowing costs that would be needed for a number of decades to finance the transition to private accounts under most plans, including the President's, to establish Social Security private accounts.

Rep. McCrery said that the tax cuts could make up for the Social Security benefit cuts that "middle-class, upper middle-class and wealthy individuals" would bear. In fact, as described below, under some of the tax cut ideas that Chairman Thomas floated, the benefits would go overwhelmingly to people at high income levels. The result could be a "free lunch" or better for those at the top of the income scale, even as many moderate-income families faced significant Social Security benefit reductions.

Suggested Tax Cuts Would Be Costly and Tilted to the Top

The type of retirement and savings proposals that Thomas and McCrery are considering packing into Social Security legislation have two things in common.

- First, they can have very large costs in future decades, even though that is the time when large numbers of baby boomers will be retiring and the nation will face the specter of explosive deficits. (As one example of how tax cuts related to savings can have little initial cost but massive long-term costs, the Administration's Retirement Savings Accounts and Lifetime Savings Accounts would have only a tiny cost in the traditional 10-year budget window because their costs do not show up until people withdraw money from the accounts, but

[2] "Thomas Sets June Target for Moving Bill Through Panel…," *Congress Daily PM*, April 28, 2005. See also transcript of news conference in FDCH Political Transcripts (April 29, 2005).

the Urban Institute-Brookings Institution Tax Policy Center estimates that over 75 years, the costs of these proposals would exceed one-third of the Social Security shortfall.[3])

- Second, their benefits tend to be heavily tilted toward people at the top of the income spectrum, who can easily afford to make the maximum allowable contributions to tax-sheltered accounts (generally without increasing the overall amount they save because they can shift money from non-tax sheltered accounts) and who benefit the most from each dollar placed in such tax-sheltered vehicles because they are in the highest marginal tax bracket. Most middle-income people, by contrast, do not contribute anything close to the maximum amounts they already are allowed to contribute to IRAs and 401(k)s today, since they do not have that much extra discretionary income to set aside. They consequently would not be helped by costly measures to increase the maximum amounts that can be contributed to IRAs and 401(k)s.

Further, these potential new tax cuts would come on top of the rather massive tax cuts that people at the top of the income scale already are receiving. The Tax Policy Center has found that when the 2001 and 2003 tax cuts are fully in effect, people with annual incomes of more than $1 million a year will receive tax cuts averaging $136,000 each, in today's dollars. The Tax Policy Center also reports that an actual majority (53 percent) of the tax-cut benefits from the capital gains and dividend tax cuts that Chairman Thomas would consider making permanent as part of a Social Security bill are going to the 0.2 percent of households with incomes of more than $1 million. The Tax Policy Center estimates that the annual tax reductions such households are realizing from the capital gains and dividend tax cuts average $38,000 in 2005.

Making the Distribution of Retirement Income More Regressive

If such tax cuts are included in Social Security legislation modeled along the lines the President has proposed, the combined effect on middle-income workers — and very possibly on lower-income workers as well — could be quite deleterious. The distribution of retirement income could become significantly more regressive, with the gaps between very high-income retirees and other retirees widening significantly.

The Social Security benefit reductions under the "progressive price indexing" proposal the President endorsed would be larger for those with higher incomes than for those in the middle of the income spectrum. But Social Security benefits represent a much larger share of total retirement income of middle-income people than for those at higher income levels. As a result, the proposed benefit cuts would represent much larger percentage reductions in the retirement income of middle-income people than for high-income people. Yet the tax breaks being contemplated, supposedly to offset the benefit reductions, would increase after-tax income far more for those at the top of the income scale than for those in the middle.

[3] Leonard Burman, William G. Gale, and Peter R. Orszag, "Key Thoughts on RSAs and LSAs," Urban Institute-Brookings Institution Tax Policy Center, February 4, 2004.

- Under the Social Security proposal that President Bush endorsed April 29 (known as "progressive price indexing"), the average worker who retired in 2075 would face a Social Security benefit reduction equal in size to 10 percent of the worker's average pre-retirement income. A worker who earned 60 percent above the average wage (a little under $60,000 today) and retiring in 2075 would face Social Security benefit reductions equal to nearly 13 percent of the worker's pre-retirement income. In contrast, the Social Security benefit cut for those earning $1 million a year would equal only one percent of their pre-retirement income.

- On the tax-cut front, ordinary middle-income workers would benefit little from increasing IRA income and contribution limits, making capital gains and dividend tax cuts permanent, or creating new tax-sheltered retirement vehicles. Those at the top of the income scale would reap bonanzas from such tax breaks. Such tax cuts would increase the after-tax incomes of those at the highest income levels by much larger percentages than they would increase after-tax income for ordinary workers and retirees.

Another way of thinking about this is that under the "progressive price indexing" proposal, the percentage reduction in Social Security benefits for workers making $60,000 a year would be nearly as large as the percentage reduction in benefits for those making a $1 million a year. (The benefit reductions for those who make $90,000 — the maximum amount of wages subject to Social Security payroll taxes — would be *fully as large* as the benefit cuts for those making $1 million.) But the average *tax-cut* benefits that workers at $60,000 or $90,000 would receive from the types of tax cuts that Reps. Thomas mentioned would generally be only a small percentage of the handsome tax-cut benefits that those at very high income levels would reap.

Finally, while the tax cuts that Reps. Thomas and McCrery appear to be contemplating may be deficit-financed now, eventually they would have to be paid for. Enacting such tax cuts in the face of the staggering deficits that lie ahead would only increase the likelihood that deep cuts ultimately would be made in basic programs and services for low- and middle-income American families, such as programs that provide health care or education.