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**PENSIONS, TAXES AND THE  
BUDGETARY PROCESS**

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## Pensions, Taxes and the Budgetary Process<sup>1</sup>

Peter Diamond<sup>2</sup>

I appreciate the high honor of receiving the John R. Commons award, and take great pleasure in joining the list of very distinguished past winners.

1978 saw the publication of The Structure and Reform of Direct Taxation, the report of a committee headed by James Meade.<sup>3</sup> To consider the design of a tax system for the UK, the Meade Report, as it came to be called, analyzed the elements that should be considered when designing a tax system. Chapter 2 of the Meade Report, 'The Characteristics of a Good Tax Structure', is divided into six sections: Incentives and economic efficiency, Distributional effects, International aspects, Simplicity and costs of administration and compliance, Flexibility and stability, and Transitional problems. To consider direct taxation in the UK, the Meade Committee examined each of these issues separately and then combined the insights into a policy recommendation. It seems to me, as it seemed to Alfred Marshall, that this is an appropriate way to proceed.<sup>4</sup> While the capacity of computers to find equilibrium in complex models has grown greatly since the Meade Report, the models available for analysis, like much of the underlying theory, are still quite limited in the ability to address the allocation issues that they incorporate and are still too far from reality to proceed in any other fashion than that followed by the Meade committee, by addressing multiple issues separately.

The part of Chapter 2 in the Meade Report on which I focus is Flexibility and stability. Although tax legislation can have an open-ended horizon, it is expected that taxes will change as circumstances develop and governments change. Moreover, governments do not articulate, much less commit to, a complete (contingent) set of future policies. Individuals making decisions that affect their future tax liabilities (such as investments and education) are faced with uncertainty about future circumstances, future governments and their possible tax reforms, and any transition rules the government may include in tax legislation. Recognizing the ongoing process of the adaptation of tax policies to economic and demographic developments as well as to changes in normative perceptions and in political balance, the Meade Report expressed its concern for both flexibility and stability:

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<sup>1</sup> This lecture was presented at the Allied Social Science Association Meetings, in January 2012, on presentation of the John R. Commons Award by Omicron Delta Epsilon. It is part of a continuing exploration of this topic, drawing on three previous papers, Banks and Diamond (2010) and Diamond (2009, 2011).

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<sup>3</sup> The Structure and Reform of Direct Taxation, Report of a Committee chaired by Professor J. E. Meade, London: George Allen & Unwin, 1978.

<sup>4</sup> it [is] necessary for man with his limited powers to go step by step; breaking up a complex question, studying one bit at a time, and at last combining his partial solutions into a more or less complete solution of the whole riddle. ... The more the issue is thus narrowed, the more exactly can it be handled: but also the less closely does it correspond to real life. Each exact and firm handling of a narrow issue, however, helps towards treating broader issues, in which that narrow issue is contained, more exactly than would otherwise have been possible. With each step ... exact discussions can be made less abstract, realistic discussions can be made less inexact than was possible at an earlier stage. [Alfred Marshall, *Principles of Economics*, eighth edition. New York: The Macmillan Company. 1948, page 366.]

A good tax structure must be flexible for two rather distinct purposes, the first being primarily economic and the second primarily political.

In the former category there must be recognition of the need to be able to adjust total tax burdens reasonably rapidly and frequently in the interests of demand management.

Until the recent crisis, discretionary fiscal policy was not in high favor among academic economists (Auerbach, 2002). The length and depth of the slow recovery from the financial crisis has been a very different environment than the short recessions experienced in the US previously since the Great Depression and, together with the zero bound on nominal interest rates, has put discretionary fiscal policy back in a central place of policy discussion. In today's economic environment of high unemployment in many countries and high vulnerability to the risk of significant further shocks, shocks that have sizable probabilities, fiscal policy has a far more important role to fill than in the earlier post-war US recessions. Indeed, the failure to take further fiscal steps to help the recovery is viewed as a major political shortcoming in the eyes of many analysts, including me.

Built-in stabilizers, while not getting much active attention in recent years, have still been viewed positively (Auerbach and Feenberg, 2000).<sup>5</sup> It seems appropriate to incorporate their role along with the usual arguments about income tax rates in the design of the tax schedule. Social insurance institutions also play a built-in stabilization role, along with that of the income tax. Indeed, unemployment affects claims of Social Security retirement benefits and applications for disability benefits, providing both a social insurance role and a built-in stabilizer role. From this perspective, beyond the usual tradeoff between encouraging later retirement and recognizing that some people ought to retire early, there is an added element in selecting the age at which retirement benefits can first be claimed along with the rate at which initial benefits increase with a delay in their start. Awareness of that role should be incorporated into the design of policies.

Beyond issues of short-run demand management, there are changes in long-run fiscal needs that are likely to occur from trend developments in economic and demographic circumstances, as well as the spreading over the future of short-run changes in fiscal needs (e. g., after a war).

The Meade Report continues:

In a healthy democratic society there must be broad political consensus – or at least willingness to compromise – over certain basic matters; but there must at the same time be the possibility of changes of emphasis in economic policy as one government succeeds another. ... But at the same time there is a clear need for a certain stability in taxation in order that persons may be in a position to make reasonably far-sighted plans. Fundamental uncertainty breeds lack of confidence and is a serious impediment to production and prosperity. (Meade, 1978, Page 21.)

There is always uncertainty about future taxes, although more so currently than has been typical. Tax design needs to recognize that individual expectations about future taxes are endogenous to the policy framework that is created.

While the Meade Report was addressing taxation, analysts take a somewhat similar view toward social security issues. Systems need legislated changes in light of economic, demographic and

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<sup>5</sup> It is odd that there was not discussion of built-in stabilizers in the Meade Report.

social developments; but for pension systems to serve well as a foundation for retirement preparation, changes should be infrequent and with significant lead time for workers to adapt. This essay considers the issues of flexibility and stability in the way that the US political process addresses both Social Security and the federal personal income tax. It is interesting that the political process and the legislative history are different between retirement benefits on the one hand and taxation of earnings on the other. In addition, the assumptions commonly made in economic analyses of these policy areas also differ.

## I. Social Security

Social Security plays a large role in the lives of Americans and in the federal budget. For 2011:

- about 55 million people were receiving benefits at year end:
  - 38 million retired workers and dependents,
  - 6 million survivors of deceased workers,
  - 11 million disabled workers and dependents
- 158 million people paid payroll taxes during the year.
- Total expenditures were \$736 billion.
- Total income was \$805 billion
  - \$691 billion in non-interest income
  - \$114 billion in interest earnings,
- Trust Fund assets (U.S. Treasury securities) grew to \$2.7 trillion.<sup>6</sup>

In 2009 Social Security benefits made up at least half of income of two-thirds of couples and nonmarried individuals over age 65 and at least 90 percent of income for one-third of such units.<sup>7</sup> Social Security tax revenues come primarily from the Social Security payroll tax of 12.4 percent of earnings up to a cap, equal to \$110,100 for 2012. Following the same pattern as in 2011, while workers will not pay the full payroll tax this year, the Treasury will make up the missing amount so that the Trust Fund is not affected by the temporary tax cut. Thus, while Social Security is being used as part of the fiscal stimulus, it is not bearing the long-run financial consequences of that use.

In light of the importance of national retirement systems to workers and retirees, analysts of national pension systems conclude that a well-run system should have infrequent legislated changes, and any benefit reductions should be phased in slowly, having small effects on retirees and those near to retirement as part of creating an environment where individuals can prepare for retirement with limits on the risks coming from the mandatory retirement system.<sup>8</sup>

Social Security revenues and expenditures are included in reports of the unified federal budget, which is the depiction of the budget primarily referred to by politicians and the press.

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<sup>6</sup> Source: Board of Trustees, 2012, p. 2.

<sup>7</sup> Source: Social Security Administration, 2011, p. 7.

<sup>8</sup> See, e. g., Barr and Diamond, 2008, 2010.

Nevertheless, Social Security is normally treated differently from other spending and receipts in the federal budgetary process. Central to this process are the annual 75-year projections of the finances of Social Security done by the Office of the Actuary of Social Security (and also done by the Congressional Budget Office).

The last significant changes in Social Security came in 1983, when the system was on the verge of needing to cut benefits without a legislated change.<sup>9</sup> At the time of the reform, the legislation was projected to cover expenditures for 75 years, with years of annual surpluses to build up the Trust Fund to help with the retirement of the baby boom followed by years of annual deficits, during and after their retirements. Without any automatic changes in light of demography, this implied structure of annual flows was bound to generate a sequence of 75-year forecasts that became steadily worse as additional calendar years with deficits were added to maintain a rolling 75-year horizon.

According to its 2012 projection, shown in Figure 1, Social Security does not have sufficient resources to pay all of the benefits given by the benefit formula (referred to as scheduled benefits). Under current law, Social Security cannot borrow from the Treasury – benefit payments are limited to the resources which Social Security commands through the ongoing flow of tax revenue and the accumulation of past surpluses, which is held in the Trust Fund.<sup>10</sup> Thus the projection shows a drop in payable benefits from 2033 on. The projected inadequacy of resources for paying full benefits is not new, but has been a feature of projections for a number of years. Indeed, there have been calls for changes to address the long-term problems for many years, including serious efforts by both the Clinton and following Bush administrations.

The ability of Social Security, and retirement systems elsewhere, to go for extended periods without legislated changes comes from a number of factors. A central one is the presence of a dedicated revenue source and the accumulation of any surpluses also dedicated for future benefits. Indeed, central to its stability is keeping Social Security largely outside the annual budget process, even though it is part of the annual budget reporting. For example, the 2 percentage point reduction of the employee portion of the payroll tax for 2011 did not lower Social Security revenues, as the Treasury was charged with making up the lost revenues.<sup>11</sup> The combination of limited spending ability, from the inability to borrow from the Treasury and recognition of past surpluses for financing benefits, has tended to limit benefit increases (based

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<sup>9</sup> Social Security is not allowed to borrow. Thus, under then-current law, inadequate resources to pay full benefits would have required benefit cuts. This is still the governing law.

<sup>10</sup> Nevertheless, in its long-term forecasts, the Congressional Budget Office assumes full payment of scheduled benefits under the benefit formula, ignoring the actual structure of current law.

<sup>11</sup> Some proposals floated by members of the “supercommittee” did include a reduction in the cost-of-living adjustment rules of Social Security. This change was paired with a similar change in the automatic adjustment for inflation of the income tax bracket limits. It is an open question whether such legislation would have had long-run consequences for the politics of Social Security, to its detriment.

on attention to the ability to finance them over the traditional 75-year horizon) and to limit benefit decreases (based on attention to the presence of the assets in the Trust Fund).

Supporting the process of infrequent adjustment is the automatic indexing of the system for prices and wages. Benefits in payment are adjusted annually for price inflation; the benefit formula for newly-eligible beneficiaries is adjusted annually for wage growth, as is the maximum level of earnings subject to the payroll tax. Some other countries also have automatic adjustments of benefits for demographic factors – Sweden adjusts newly eligible benefits for life expectancy and Germany adjusts all benefits for a dependency ratio.

As with the overall federal budget, Social Security is on an unsustainable trajectory. In light of the current tension between high unemployment and long-run unsustainability of the federal debt trajectory, restoring actuarial balance to Social Security with slowly phased in changes, along with separate short-run stimulus, could be an excellent policy combination. Arguing for this approach is considerable understanding of how to restore sustainability to Social Security while maintaining its social insurance role, including a sizable literature informing the impacts of parameter changes on workers and retirees. This stands in contrast with possible reforms of Medicare and Medicaid, where the complexity of the provision of medical care makes it difficult to legislate current reforms that will reliably address costs without harming the provision of medical care. Successful reform of health care seems to me to require much more of a trial and error process than reform of the retirement income system. Moreover, should Social Security be restored to actuarial balance, it is unlikely that such a reform would be undone – making for a level of commitment that exceeds that with many other fiscal actions under consideration.

## II. Federal income taxation of earnings

In contrast to the treatment of Social Security, income tax revenue is a central part of the annual budget process. Legislated tax rate and tax base changes happen more frequently than changes to Social Security. For example, the legislated marginal income tax rate on the highest level of earnings has changed repeatedly, although the size of the changes has not been as large since 1986 as in the earlier 80s.

<u>Years</u>	<u>Tax Rate, in percent</u>
1965-1981	70
1982-1986	50
1987	38.5
1988-1990	28
1991-1992	31
1993-2000	39.6
2001	39.1
2002	38.6
2003-2012	35

While the Congressional Budget Office does long-run projections of the entire federal budget, they play a different role in the budget process than do the projections for Social Security. In particular, the focus is on a ten-year horizon, not a 75-year horizon.

### III. Program structures

With that background on programs, let us look at differences in program structure.

<u>Social Security Benefits</u>	<u>Income Taxation of Earnings</u>
· Dependent on a long earnings history	· Tax base focused on a single year
· Dependent on age	· Little variation with age
· Dependent on date of birth	· Varies by year
· Indexing for prices and wages	· Indexing for prices

Social Security benefits are based on the best 35 of wage-indexed earnings,<sup>12</sup> while each year's income tax is based on earnings in a single year. Eligibility for retirement benefits for a worker is based on reaching age 62, the earnings test is only present before the age for full benefits, and the level of benefits depends on the difference between the age at which they are first claimed and the age for full benefits. In contrast, there are only small differences in the income tax based on age. During the phase-in of the 1983 Social Security reform, the age for full benefits was set to vary with the worker's date of birth. Legislation of future tax rates depend on the year of applicability without these distinctions across ages.

#### Age to Receive Full Social Security Benefits

(Called "Full Retirement Age" or "Normal Retirement Age")

<u>Year of Birth</u> <sup>13</sup>	<u>Full Retirement Age</u>
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66

<sup>12</sup> The indexing does not extend to all years.

<sup>13</sup> If you were born on January 1st of any year you should refer to the previous year.

1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

For good reason, the balance between stability and change differ between the two programs, and the political process has been largely effective in achieving a difference over the last 30 years, even though neither has been ideal.

#### IV. Economic analyses

While a few analyses of Social Security focus on tax payments and benefit receipts within a year, the bulk of academic analyses take a lifetime perspective. In contrast, much analysis of the taxation of earnings is based on modeling of a single year. The taxation of capital income, on the other hand, like the analysis of retirement benefits, naturally has an intertemporal perspective, although much discussion focuses on a single year, particularly discussion of the relative taxation of labor and capital incomes.

But even within lifetime perspectives, there remains a significant difference in that many Social Security analyses are built around the perception that many workers do not save enough for their own good. In contrast, tax models looking at lifetimes typically rely on the standard life-cycle model. Social Security analyses are more likely to recognize systematic evolution in work preferences over a lifetime than do income tax analyses, where it is common to treat each year as having the same preferences. Social Security analyses are frequently in an overlapping generations setting, although consideration of a single cohort is also common. Some tax analyses go beyond single lifetimes and consider a dynasty model, while others do overlapping generations modeling.

To see another perspective on differences in analyses, consider the common analysis of reasons for a mandatory retirement benefit system. Apart from free riding, these items make little or no appearance in tax modeling (apart from analysis of tax-favored retirement savings – IRAs and 401ks).

Should there be a mandatory retirement pension system?

- free riding
- too little savings
- poor investing
- high cost of investing



– too little annuitization – both individual and joint-life

Going back to the methodological stance with which this essay started, there is a need for multiple models of different aspects of the effects of policies. It is appropriate that the models should focus on the issues that seem likely to matter the most for the policy implications. Nevertheless it would be good to keep in mind the role of the assumptions being made in the Social Security realm when thinking about taxation. I note a growing interest in modeling the role of age-dependent taxes.<sup>14</sup> The issue of tax-favoring retirement savings is an interesting hybrid of the two areas and would benefit from considerably more analysis. So too would be further analysis of the automatic stabilization effects played not just by the income tax, but also by the presence of social insurance programs.

#### V. Today's issues

Currently we have an unemployment crisis and a debt problem, although some in Washington appear to think we have a debt crisis and an unemployment problem. Unemployment has been high for an extended period, leading to large numbers of people out of work for a long time and large numbers having trouble getting started on their careers. Unemployment is high today and projected to stay high for an extended period. The cost of unemployment is not just in foregone earnings and productivity, but the lasting impact on those with long-term unemployment and those with delayed starts on their career trajectories.

While the projection of the federal budget shows an unsustainable path, I think we have considerable time to adjust that path, as is also the case with Social Security. A debt problem turns into a debt crisis when the need to repeatedly rollover parts of the debt occurs with high and rising interest rates out of concerns about the ability to eventually pay the debt. Thus debt held by the public plays a different role than debt internal to the government, which is part of the accounting system and comes from a pattern of political decisions designed to affect future outcomes. Thus the debt held by the Social Security Trust Fund is likely to have some effect on the future levels of benefits and taxes, but is not part of the process of rolling over the debt held by the public, although there is a partial and indirect role by affecting projections of future budget balance. Actions today that credibly lower future publicly-held debt projections have a particularly valuable role while there remains a need for current fiscal stimulus. Restoring actuarial balance to Social Security may be an ideal tool for this, as good reforms, and politically viable reforms, will do little or nothing to affect short-run conditions, while having a potentially significant impact on long-run debt held by the public. For example, the reform proposal I made with Peter Orszag in 2004 was projected to reduce debt held by the public by 25 percent of GDP by 2050, compared with simply paying benefits (which is the basis of CBO projections). It is also worth noting that we have considerable understanding of how to restore actuarial balance and the impacts of changes in system parameters on the economy, much more so than our

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<sup>14</sup> See, for example, Weinzierl 2011, Gervais, 2012.

understanding of how to reduce the trend increases in medical expenses without harming medical outcomes.

Starting in the 1980s, there have been repeated calls for using some of existing payroll tax revenues to finance defined contribution individual pension accounts as part of Social Security. As Social Security is only partially funded, this raises the issue of how to continue to finance traditional benefits while part of payroll tax revenue is not available for this use. Many of the proposals call for transfers from the Treasury to Social Security. In the absence of a link to further budgetary changes, such transfers would require additional borrowing from the public, adding to the risk of an eventual debt crisis. That is, use of existing payroll tax revenues to finance asset purchases for individual accounts increases the debt held by the public, which, in turn, needs to be rolled over. Analysis of the proposals for Social Security reform during the Bush administration calculated the extent of increased debt held by the public that would follow from different proposals.<sup>15</sup> It was projected that some of these increases would eventually result in very large increases in the debt, for example, over 90 percent of GDP by 2050 for the proposal by Congressman Paul Ryan and then-Senator John Sununu.

In light of the growing concern about US debt, one might think that Social Security proposals would no longer include extended periods with payments from the Treasury to cover the purchase of assets for the individual accounts during the transition. However, that thought would be incorrect, as a few members of Congress continue to put forth proposals calling for such transfers. On the web page of the Office of the Actuary, <http://www.socialsecurity.gov/OACT/solvency/index.html>, are evaluations of recent proposals including such transfers by Representative Jeffrey Landry (R, LA), Representative Thaddeus McCotter (R, MI), and (again) Representative Paul Ryan (R, WI). Restoration of actuarial balance to Social Security in a way that reduces debt held by the public should be high on the political agenda.

As to the taxation of earnings, future increases should be part of a response to the projection of an unsustainable budget trajectory.<sup>16</sup> In addition one could make a package of tax increases that have small impact on current aggregate demand with tax or spending changes that have a larger impact per dollar of current budget balance. Indeed, the history of decades of reduced levels of investment in infrastructure and research (relative to GDP) is a strong reason for increased investment at the current time, when the social cost of such investment is relatively low.

## VI. Concluding remarks

This essay has recognized the role of stability in light of an expectation of future government changes. In addition, given the difficulty of radical change, the existing basic structure of Social Security and taxation influences the political process when circumstances call for change.

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<sup>15</sup> Horney and Kogan, 2005.

<sup>16</sup> See, e. g., Diamond and Saez, 2011.

Indeed, links between the form of public pension design and anticipated future legislation has been part of the debate in the United States between defined benefit and defined contribution mandatory public systems.<sup>17</sup> Similarly, implicit in a focus on the tax base, separate from tax rates, is an assumption that tax rates are to be optimized for given tax bases, thereby ignoring the political linkage that may well be present between an ongoing tax base and legislated tax rates.<sup>18</sup> It is incomplete to say that a suitable choice of tax rates can make a different tax base have comparable overall progressivity if that suitable choice will not happen. Recognition of the link between the form of tax institutions and the perceptions and salience that then influence policy making is important.

Taxes and pensions are both very important for the functioning of the economy. Cross-fertilization of these research areas as well as further analyses of the interaction between politics and policy design could be very helpful.

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<sup>17</sup> For example, see Diamond, 1999, chapter 3.

<sup>18</sup> It is common to pair a widened tax base with across the board reductions in marginal tax rates. Yet any change in tax bases will alter the responses of taxable incomes to tax rates, and so should be accompanied by altered progressivity. This would plausibly include increased marginal tax rates on top earnings (Diamond and Saez, 2011).

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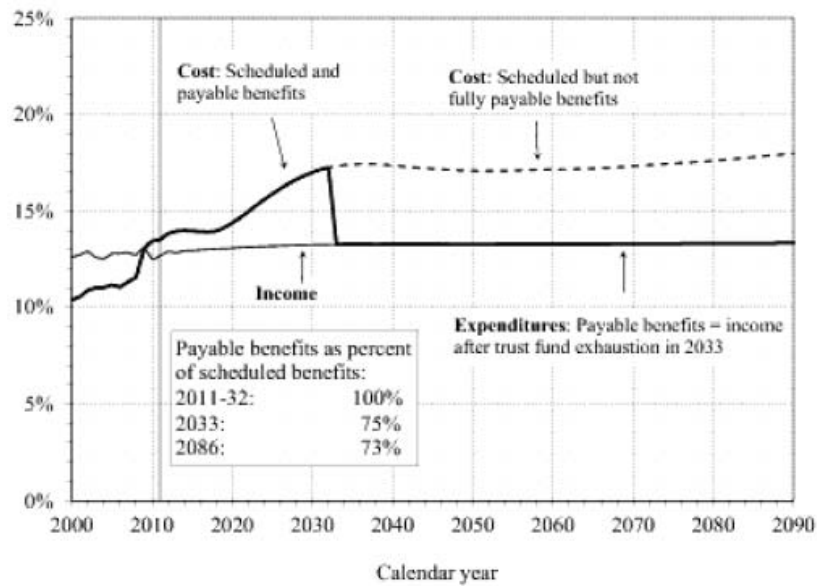
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Figure 1. OASDI Income, Cost, and Expenditures as Percentages to Taxable Payroll (under Intermediate Assumptions)



Source: The 2012 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds. Social Security Administration, The 2012 Annual Trustees Report. P. 11.