Dr. Eric Toder

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INTRODUCTION: Dr. Eric Toder is a Senior Fellow with the Urban Institute, who works in the areas of taxation, fiscal policy and retirement policy. He was Deputy Assistant Secretary for Tax Analysis in the U.S. Treasury Dept. from 1993-1996, and Director of the Office of Research at the IRS from 2001-2004, and earlier was Deputy Assistant Director for Tax Analysis at the Congressional Budget Office.

Q You worked at the Congressional Budget Office during the development and enactment of the 1986 Code. What, if any, parallels do you see between that period and the current period, and do you think a rewriting of the Code of that magnitude is likely to occur in the near term, in view of the coming end to surpluses in the Social Security account, growing entitlements, the problems of the AMT and the sunsetting of the Bush tax cuts?

A The one parallel to those times is we are going to need to have some fairly major tax legislation. There are action-forcing events, even if it is just simply extending the Bush tax cuts, or extending most of them, and I doubt that all of them will be extended in their current form. There will be a major tax bill that will happen before the end of 2010. Now, whether that qualifies as tax reform is another issue. So, major tax legislation, yes, but the kind of tax reform that is as fundamental as the 1986 act, which involved sweeping away a whole slew of tax preferences and lowering tax rates a lot, is not likely to happen.

Q What is the role of the surpluses in the Social Security account in masking the deficit?

A Well, that is a very interesting question, and it is clearly a conjectural question. The question is what would other spending and taxes be if we did not have this Social Security surplus. When the Social Security amendments were passed in 1983, there was a massive shift toward a tighter federal fiscal policy. Not only did they solve what was then a short term funding problem for Social Security, which would have been easy to do, but they set off on what they estimated then was a path for 75-year balance for the Social Security system. This means they were for the first time building up very large surpluses in the trust fund against the future retirement of the baby boomers. However, the 75-year old balance disappeared quickly, partly because of inadequate economic assumptions, but mainly for reasons that were predictable at the time. As you move on into later years, you are replacing good demographic years with bad demographic years, years in which there has been a very large percentage of workers to retirees, to years where there will be a smaller percentage. So that was bound to need further adjustment down the road to keep in 75-year balance; but nonetheless it was an enormous shift in the funding of the Social Security program away from pay-as-you-go toward at least a partially funded program.

Whether that increase in the Social Security surplus has actually contributed to a reduction in the federal budget deficit is a conjectural question–you have to ask what else Congress might have done if that trust fund had not been built up. There has been some research and these econometric studies are always subject to interpretation. Some find that basically the build up of the trust fund did not reduce the deficit at all–that essentially it was balanced by increases in the deficit in other parts of the federal budget. So this was really the implication of your question–was the trust fund basically just used to cover other deficits? And at least some studies seem to indicate that is the case.

Again, we can never know that for sure because we do not know what would have been done in the absence of that surplus. But I think a good argument could be made that what Congress has been looking at is the unified deficit in setting policy, not the on-budget deficit, and so when the surplus grows in the Social Security funds, they simply see that as enabling them to avoid having to pay for all the other programs with other tax sources. So while you have had this build up in the trust fund, you have this offsetting build up in federal debt owed to the trust fund. Now, of course, there has also been a build up in the unified debt in the last eight years. But I think arguably there might have been less deficit spending if they could not show in the books these Social Security surpluses to offset it. Actually Senator Moynihan made that point back in 1990 when he proposed reducing the payroll tax so that the payroll tax would only fund current expenses. He felt that basically the payroll tax was being used as a regressive revenue source to fund other federal programs instead of building up a surplus to help pay for the retirement of the baby boomers.

Q In this regard, some have stated or claimed that the special Treasury notes that are held by the Social Security Trust Fund are economically meaningless, that a government with its own bank can only fund itself currently under any circumstances, and to say that the Trust Fund holds notes of the government is simply to say that the government in the future is going to have to raise more money to pay current expenditures. What's your thought

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on the meaningfulness of the special Treasury notes held by the Social Security Trust Fund?

A Well, you know, I think the Social Security Trust Fund is basically a political construct, not an economic construct, and if you are looking at the ability of the federal government to pay its bills in the future, you need to look at all the assets and all the liabilities. To segregate one account from the other is really not telling you much of the story. And the two reasons I say this are, one, I doubt when you get to the year that the Social Security fund runs out of money the Congress is going to sit by and see Social Security benefits cut by 25 or 30% in one year. It is also hard to believe that they are going to feel that they have to be restricted just to raising payroll taxes to cover the deficit. At that point in time they're going to say "How are we going to solve this problem? How are we going to keep retirees mostly whole? How are we going to spread the burden and what's the easiest way to do that?" So at some basic level, the rest of the budget is available for funding Social Security even thought legally under current law it is not. Congress writes the laws and they can change them at any time.

Now, politically it is important for two reasons. One is that it provides a feeling that people have paid into this trust fund so it strengthens their feeling of entitlement to those benefits that they have paid for. And it also basically creates this system where you are funding a program like Social Security through a tax on workers. So in some sense that was the trade off in which past expansions in Social Security were able to take place. It was not being funded by the progressive income tax. Workers were seen to be paying it for themselves. Now, there is some redistribution in that system, but it certainly was part of the political deal by which Social Security was expanded. So in some sense from a conservative point of view, you are using regressive taxes. From a liberal point of view, you are protecting the program. Because as long as there is this surplus coming into the trust fund it is very hard for somebody to make the argument to cut Social Security spending in order to help the rest of the federal budget. It gives a lot of political protection to Social Security.

And if you are being particularly legalistic about your budget projections, you have to say "Well after 2041 we are really not promising Social Security benefits anymore as it says in the law, we are only promising 70-75% of them." But I doubt when you get there, people are going to find it very convincing to say, "Well we never promised you any more money than what was in the trust fund." That is not a politically realistic statement.

I think you need holistic accounting because when you have programs in different buckets, it is really hard to say what is paying for what. For example, you could look at something like the earned income tax credit, which is a refundable tax credit for low income workers and originally started off as refundable only to the extent of payroll taxes. It has since expanded beyond that but if you think of the credit as partly an offset to payroll taxes people are paying, then you have to ask yourself whether people are paying a high payroll tax and getting negative income taxes or are they just not paying so much payroll tax instead of a big income tax rebate. The point being that it has to be looked at in a unified basis.

Q Various official sources have begun to propose substantial code changes, including Chairman Rangel and the President's Tax Reform Panel; the Treasury has indicated it is considering alternatives. From what source or sources of ideas would you expect any real initiative for change to originate?

A Well, there are various proposals. My colleague Len Burman has floated a tax reform plan. Michael Graetz has floated a tax reform plan which would replace part of the income tax with a VAT. I think there will be all kinds of people, like there were in the early 80's, pushing different kinds of plans because I think when you look down the road, you are looking at a situation where there is not enough revenue to fund the government. The Tax Reform Act of 1986 also came about after many years of reform proposals by scholars like Joseph Pechman and David Bradford, some of which were later incorporated in early reform plans offered by political leaders like Bill Bradley, Jack Kemp, and others.

McCain's economic advisor, Douglas Holtz-Eakin, pointed out at a recent Tax Policy Center forum that the income tax revenues are 18½ % of GDP now. That is pretty consistent with historical long run averages. So in his view or Senator McCain's view we do not really have a revenue problem—we have a spending problem. Logically that is a reasonable point of view except for the fact that given the aging of the population, given the increased needs, and given the need to spend more just to keep people close to the same acceptable high standards of medical care and close to being able to get the kinds of replacement rates from the Social Security program that they have had in the past—you are in the situation where it may not be realistic to say that entitlements should forever remain the same share of GDP that they have been in the recent past where we had a very different demographic situation, a very different health care cost situation. It is just not realistic that the public will accept the kinds of cuts or reduced growth in benefits per retiree offered by these spending programs in order to maintain their costs at a constant ratio to GDP. They may accept the idea of spending cuts in the abstract, but when they see what it really involves, that will not be doable.

In fact I think it will be very hard to get any kind of compromise that would work, both with higher revenues and with lower spending. And the spending cuts will be much harder to do politically than the revenue increases. So although I think certainly most of the adjustment is going to have to come on the spending side, I also believe that to say

that this can be done without additional revenues is foolish. We are going to need to look at ways of getting more revenue in the long run.

Another problem we have is the alternative minimum tax, which is a totally unacceptable way of raising revenues and we have managed to keep it off the backs of most people. I hear a bit of grumbling from some of my colleagues who are hit by it, but these are fairly sophisticated high income people who are not going to get confused doing their tax returns in a way that most people will. I do not think anybody wants to allow 23 to 25 million people to all of a sudden have to go on the AMT. Of course what you have in the AMT law is this built in future tax increase. The revenues are built into all the budget projections and in order to get rid of that AMT growth you are going to need to replace the revenue from somewhere else. It is going to get more and more expensive every year to replace AMT revenues. So the sooner something is done about that the better.

My guess is that it is going to be very hard to get rid of things like the lowest income tax bracket, the expansion of the earned income credit, and the child credit expansions that were enacted in 2001. And so you are going to be left with a fight over the high income tax cuts and even getting rid of them is not going to generate enough money to solve the problem. Then you have this incredibly unstable situation with estate taxes where there is the estate and gift taxes, the estate tax is expiring in 2010 and then coming back in 2011 with a $650,000 limit and a 55% top rate. And neither of those will be politically acceptable given the expansion of wealth in recent years and how many people would be hit by the estate tax at that lower limit. So the parties will have to figure out some kind of compromise. In some sense current law had this future time bomb built in going back to 2001. They are going to have to legislate something but I do not think complete elimination of the estate tax is going to be acceptable, certainly not to the Democrats. So, there are a lot of things hanging in the air.

Now, my guess is that given what we have heard from the presidential candidates there will not be anything in the first budget that comes out in 2009 that really addresses any of this stuff realistically, but some adjustments and some negotiation will have to be started in 2010. I cannot pretend to know exactly what the shape of that is going to be. It is going to be fairly messy. They may even try to kick things down the can a little bit, extend the Bush tax cuts for another year, extend the 2009 estate tax rates for another year and push the dates of expiration and then reinstatement to 2001 levels back. There could be in the short term a lot of fooling around with sunsets and extensions. But eventually we will have to face up to it.

Q You have suggested that a reduction in the corporate income tax rate could be desirable to reduce the cost of corporate capital in the U.S. Could such a reduction actually translate into increased spending on capital goods in the U.S., more employment, and related economic benefits, and if so how much of a reduction would be required to get those results?

A I think it is hard to give an exact figure for the right level. The statutory tax rates in the OECD have been creeping down relative to the U.S. tax rates but the effective tax rates that determine the overall burden on investment are not that different. So it is not so much that we are discouraging investment but we are creating incentives for income shifting out of the United States. Over time if those trends continue we might be discouraging investment somewhat as well. I think there is an increasing recognition of the fact that in a world where capital is mobile, taxing capital income on the basis of the residence of the investor, which taxes people on their income no matter where it is earned, makes more sense than taxing capital income on a source basis, that is, taxing income that originates within our borders no matter who owns it. But it is hard to impose a corporate-level income tax on the residence of investors when multinational corporations increasingly issue equity shares and borrow money on international markets. Since the corporate tax necessarily is mostly imposed on a source basis, and it would be quite difficult to change it into a residence based tax, and the individual tax is generally on a residence basis, it seems to me that if you are worried about the double taxation or the excessive taxation of corporate income, the relief should be coming on the corporate side instead of the individual side. In recent years, we have actually moved in the wrong direction by cutting the tax rates on dividends and capital gains and leaving corporate taxation alone.

My inclination therefore would be to bring corporate tax rates down a little bit, broaden the corporate tax base, get rid of a few unjustified preferences, and move the tax rates on dividends and capital gains back up. That is my general view of where those taxes should be imposed and the direction we should be going in, without being very precise about the desirable rate levels.

Generally, I am skeptical about integration. I used to think the classical dividend integration plans that were used in European countries, which was an imputation credit system that essentially treated the corporate tax as a withholding tax and allowed shareholders a credit for corporate taxes associated with their dividends, was the best way to go because it meant the shareholders would be taxed once on their income at the individual level. You would treat the corporate tax on dividends just the way you treat wage withholding, but profits retained by the corporation would still be taxed at the corporate level.

But I think one of the problems with those systems is that when they are in place, they do not give any imputation credits to non-profits for revenue reasons and they do not give it to foreign shareholders. So the extent to which they actually are reducing the cost of

capital if they are not benefiting external sources of finance as opposed to just giving U.S. investors a higher rate of return is not clear anymore to me. I do not think the corporate tax does that much damage as long as we are not too far out of line with our trading partners, but I do think the classical kind of integration program, unless we are doing something to attract the inflow of capital, would not help that much, and will not over time be doing that much, to help the cost of capital. That being said, corporate integration plans that give credit to shareholders for corporate tax paid make a lot more sense than the kind of dividend relief we enacted in 2003, which gives shareholders a special tax break on dividends irrespective of whether the corporation has paid any corporate tax.

There are a lot of imaginative proposals floating around that are interesting, so I think this is an area that requires more thought. Ed Kleinbard has a really interesting proposal to exempt in effect the normal return to capital at the corporate level, while imputing equity returns to individual shareholders. His proposal has been criticized by some people in the legal profession so there is a debate going on. Without commenting on the specific details or criticism, I believe he is going in the right direction by shifting the tax on normal returns to capital from the corporate to the individual level, while retaining the corporate tax as a tax on economic profits or above normal profits. His plan also aims to eliminate the distinction between taxation of debt and equity, which he views as an increasingly artificial distinction in today's world of increasingly complex financial instruments and methods of risk-sharing.

Q Do you think we should move toward consumption taxes and a regime that does not tax capital at all?

A I do not believe we should eliminate the income tax. Although theoretically possible, I do not believe any consumption tax Congress is likely to enact will be effective at maintaining progressivity at the very top of the income distribution and I am concerned about the increased tax shelter opportunities if they fail to follow the consumption tax model to its logical conclusion and eliminate all interest deductibility. I do think, however, that given both the need for more revenues and the difficulty in constructing an income tax that does not excessively burden capital, we should look at what just about every other developed country in the world has done and introduce a value added tax, partly to replace part of the income tax, partly to fund more programs such as universal health care, and maybe for other purposes. I would not go all the way to Michael Graetz's proposals and use it to replace 90% of the income tax and retain the income tax only as something for high income shareholders and corporate income. I do not agree with that for a variety of reasons. But I do think he is right that we need this other revenue source and it is a proven revenue source that works.

Q That would be a credit method VAT?

A I would hope we would do a credit method VAT, yes, I know a lot of the people that have proposed it in the United States have talked about subtraction method, which the experts think is definitely inferior. Retail sales tax is crazy, given the enforcement problems.

Q You have observed that 80% of individuals pay more FICA taxes than income taxes, if you count the employer's portion of the tax as effectively paid by the employee. These FICA payers are taxed on half of the FICA tax and generally are taxed on Social Security benefit payments. Nevertheless, FICA taxes tend to be overlooked in most discussions of fundamental tax changes. How would you integrate the concerns about fundamental tax changes with the FICA tax problems?

A I think the FICA tax has not gotten much attention for two reasons. One is the link to Social Security and Medicare and people do not want to mess around with those funding sources. So without opening up those issues you do not really want to reduce the payroll taxes. Of course, payroll tax has been a big driver historically of changes in the tax system. Between about 1977 and 1990, there were huge increases in payroll taxes and these were documented in a study Frank Sammartino, Rick Kasten and I wrote when we were at CBO. We showed, however, that the federal tax burden of middle class and lower income people had actually fallen a bit over the time period because higher payroll taxes for them were offset by lower income taxes.

At the same time the payroll tax was growing, the earned income tax credit was expanding and personal exemptions were increasing. Congress subsequently introduced child credits and made more of the child credit refundable. So we have been making the income tax more progressive and adding refundable elements to it and that offsets the burden of the payroll tax. So I think again, if you are looking at the tax system holistically you do not really need to change the payroll tax. But again there are all kinds of ideas that are being floated, for example, carbon taxes. And for environmental reasons, how do you offset the burden on low income folks? Well, one possibility is to have a refundable credit against the payroll tax.

Senator Obama has a payroll tax credit as one of his campaign proposals to reduce the burden on low income workers. I think it is definitely the case that you can use the income tax system to offset all these effects. People do not complain about the payroll tax, they do not see it, it does not impose compliance burdens on them because it is a single rate tax with both employee and employer shares collected from employers. But it is now the biggest source of federal taxes we impose on most Americans. ■