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The $1.1 Trillion Tax Hike

By Kerry Pechter *Wed, Nov 17, 2010*

The "Zero Plan" proposed by the co-chairs of the National Commission on Fiscal Responsibility and Reform last week calls for the end of $1.1 trillion in tax breaks. The co-chairs would save Social Security through a combination of reduced benefits and higher taxes.

The most provocative idea in the PowerPoint slides released last week by the co-chairs of the National Commission on Fiscal Responsibility and Reform was “Option 1: The Zero Plan.” It was buried so deeply in the document, however, and was couched in such bureaucratic language, that not everyone noticed it.

Option 1, on page 23, says that the government should “eliminate all $1.1 trillion of tax expenditures” and apply the new revenue to reduce the deficit and tax rates. It would add back any particularly desirable tax expenditures and increase the tax rate to pay for them.

This modest proposal—assuming that it’s more than a bluff or a bargaining chip—obviously isn’t so modest.

First, it suggests that Americans already give themselves a generous $1.1 trillion in tax breaks every year. Second, it implies that every exemption, deduction, exclusion, credit and deferral in the IRS code—from the mortgage interest deduction to corn syrup price supports—is a form of government spending.

Third, and most importantly for anyone in the retirement income industry, it knocks the legs out from under the employer-sponsored retirement savings industry and the insurance industry, which are predicated on tax deferral and exemptions.

Some observers recognized right away what the Zero Option meant. One of the first to attack it last week was Brian Graff, CEO of the American Society of Pension Professionals and Actuaries (ASPPA), which represents thousands of third-party retirement plan administrators and others.

“The proposed ‘Zero Option Plan’ would decimate the savings rate by eliminating tax incentives for contributing to employer-sponsored retirement plans, such as 401(k) plans, likely triggering mass terminations of company retirement plans—directly impacting a worker’s ability to save for retirement,” Graff said in a press release.

“The 401(k) acts as the primary savings vehicle for most Americans and eliminating these tax incentives would strip them of critically important benefits and protections provided by the Employee Retirement Income Security Act of 1975 (ERISA). Simply put, the retirement security of American workers will greatly suffer if the Deficit Reduction Commission’s recommendations are enacted.”

Another first-responder was blogger Michael Cannon at the Cato Institute website. For Cannon, the use of scornful expressions like “tax expenditure” and “backdoor spending in the tax code” in the Proposal when referring to tax breaks was a sure sign that someone’s hand was about to reach into his pocket.

“To call them ‘tax expenditures’ or ‘tax subsidies’ or ‘backdoor spending in the tax code’ is to claim that when the government *fails to take* a dollar from you, it is *spending* that dollar,” Cannon fumed. “It implies that your dollar actually belongs to the government, which is graciously letting you keep it. And it implies that eliminating a tax loophole is not a tax increase, because that dollar already belonged to the government anyway. The government has simply decided to spend its money somewhere else. When you hear a politician use the terms *tax expenditure*, *tax subsidy*, or *backdoor spending in the tax code*, beware. He’s about to raise your taxes.”

The Zero Option was so audacious that some people gave it little chance of being taken seriously. (After reading the Deficit Commission’s PowerPoint last week, I e-mailed a prominent figure in the 401(k) industry. “I think it’s a trial balloon or a negotiation ploy, rather than a serious threat,” I wrote. “They’re just saying ‘Everything is on the table.’” “Agreed,” he wrote back.)

Others felt the same way. In an e-mail to a LinkedIn discussion group, Boston-based consultant Leslie Prescott wrote, “The implications would be enormous. Aside from any company matches, there would be little incentive for employees to participate. Their proposal is completely at odds with the efforts of other areas of the government to increase retirement savings, and the industry’s lobbyists will be furiously trying to squash it. I believe this measure has 0% chance of being implemented.”

That may be why more people focused on the Social Security section of the draft proposal. It suggested a wide range of partial fixes for the old age insurance program, including raising the retirement age, adopting a more conservative COLA index, and gradually increasing the wage base for payroll taxes to about $175,000 from $106,000 over the next 40 years.

Steven Sass of the Center for Retirement Research at Boston College, who has written a history of the private pension system in the U.S. and recently helped produce a Social Security Claiming Guide, was generally positive about the Bowles-Simpson recommendations.

“Raising the retirement age is sensible. The change in the CPI makes sense. It makes Social Security work the way it ought to work, with two caveats. The chained CPI is based on notion that people change their shopping habits when prices go up. But older people don’t necessarily change habits as easily as younger people, so chain linking isn’t a good measure for them,” Sass said.

“The basic issue for social security—it’s largely a matter of what the young want,” he continued. “People approaching retirement won’t be affected by the increase in the retirement age, so a lot of reform is based on [changing Social Security for] young people. Ultimately, they will have to decide whether they want to pay less tax or get more benefits. It would be great to hear from them. The current proposal is weighted more toward benefit cuts than tax increases, and I don’t know if that would be their choice. It’s hard for them to appreciate the difference. I’d love to have someone set up a national vote on it.

“For Social Security, the shift in the dependency ratio is the underlying problem. If we move the retirement age out five years, we can get back to a three-to-one ratio of workers to retirees. But the more you raise the retirement age, the more people you get on disability. That’s a mess,” Sass said.

“My real fear is that we’ll quickly slip into a means-tested system. Pretty soon you have half the population on means testing. Means-testing makes people hide their means or it discourages work. There’s pain coming, and we’ve got to take our medicine. We’ve known for over 20 years that Social Security had a long-term financing problem, but liberals don’t want to cut benefits and conservatives want individual accounts and we haven’t been able to deal with that.

“But the solution is not look for scapegoats or nostrums. We have to find a better way than, ‘We don’t want to take our medicine.’ People tend to overestimate the utility of money and underestimate the utility of not being surprised by financial problems or not having to worry about money.”