

Two Issues Not on the Current Tax Radar Screen

C. Eugene Steuerle

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When it comes to tax cuts, most of the attention focuses on big items and big numbers. Is the tax bill going to be \$1.6 trillion or \$1.2 trillion over 10 years? How much is the top rate going to be cut? Will the child credit be doubled? And so on. Much less attention is paid to some of the maneuvering that takes place to meet lesser objectives and to get the tax bills to fit within a limited budget.

Here are two items that seem to be just below the radar screen of most of those following the debate. First, in the House- passed rate reduction bill, the taxation of social security benefits for income tax purposes is adjusted to try to prevent any loss of money to the social security and Medicare trust funds, which are credited with those income taxes. While the mechanical adjustment can be made in a simple bill, it really can become quite complex when there are multiple bills and multiple provisions over time. Second, child credits are increased but in a way that keeps the nominal amount of the credit unadjusted for inflation. Effectively over the long run, the increase in the credit is only temporary.

Taxing Social Security Benefits

Under current law a portion of social security benefits may be subject to income taxation. The amount depends primarily on the taxpayer's income, although most social security benefits remain immune from this provision. For years the Treasury Department has by law estimated the amount collected under this provision in the most generous fashion possible. The economists in the Office of Tax Analysis essentially run a model and calculate roughly the total income tax collected under current law and the total amount that would be collected if no social security benefits were to be subject to income tax. The difference between the two calculations is credited to the social security and Medicare trust funds.

The procedure "stacks" social security benefits as the last dollars of income and therefore imputes a rate of tax on those benefits at the taxpayers' highest marginal rates. For example, suppose a person pays zero percent on the first dollars of income, an average tax rate of 14 percent on all income, but a 28 percent tax rate on the last dollars of income. Social security, rather than other income, would be credited with taxes at the 28 percent rate. If social security were "stacked" as the first dollars of income, it would be credited at about a zero percent tax rate.

When tax rates go up generally, as happened in 1993, the social security and Medicare trust funds gain. For example, a taxpayer who before might have been subject to a 31 percent rate on his last dollars of income might now pay a 36 percent rate. When tax rates go down, however, the social security and Medicare trust funds could be credited with less money . . . unless something is done. Accordingly, in the rate reduction bill passed by the House, social security and Medicare would be credited as if all other proposals in the bill were not enacted.

This action supposedly protects the trust funds. But project out a few years and it is easy to see that this type of protection technically will be impossible to calculate. Treasury simply will not be able to estimate every minute change in the law over time while factoring out the change in 2001, partly because some changes cannot easily be modeled. Imagine after a number of years there has been another tax rate increase, then a new child credit, then the research tax credit induces higher business income in exchange for lesser individual income, then 535 special provisions for each member of Congress are enacted one year to get another bill through, then a rate cut, then a base-broadening bill with difficult accounting provisions involved . . . well, you get the picture.

Congress operates under procedures that generally do not allow it to reduce the social security and Medicare trust funds. In truth, the rules are violated all the time because every single tax and expenditure change enacted has some effect, directly or indirectly, on the trust funds. For instance, even a small excise tax

reduces the amount of income subject to tax and, therefore, the amount likely to be credited to the trust funds.

The True Size of the Child Credit

Fixating on the size of the child credit ignores how small that credit is going to be over time. The existing child credit is a flat amount that does not change as inflation and income increase in the economy. Neither is the additional amount of child credit proposed by the House to be adjusted. After enough years pass, therefore, the real credit available eventually approaches zero as inflation erodes its value. Relative to the size of the economy, even a credit indexed for inflation would decline.

Treasury and the Joint Committee on Taxation sometime estimate what they call a "fully phased-in" tax law. They must assume some ultimate level of the proposed credit as it is increased in nominal terms from \$500 currently to \$600 in 2002 and eventually \$1000 in 2006. But assuming an inflation rate of 3 percent, the new credit in real dollars would equal \$582 in 2002, \$863 in 2006, \$744 in 2011, \$554 in 2021, \$412 in 2031, and so on. Thus, the true fully phased-in value equals zero.

Relative to the size of the economy, the decline is even steeper. This particular way of adjusting values is how the cost of the so-called family-style provisions in the code are often constrained over time. Note, by the way, that this does not occur with other items (rates, deductions, credits) if they are stated as a percent of income. The contrast reveals in part the preferences Congress has for various types of tax cuts.

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