TESTIMONY OF PROF. EDWARD D. KLEINBARD

HEARING TITLED

"REDUCING THE DEFICIT BY ELIMINATING WASTEFUL SPENDING IN THE TAX CODE"

U.S. Senate Committee on the Budget

March 5, 2013

Chairman Murray, Ranking Member Sessions, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard and I am a Professor of Law at the University of Southern California's Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress's Joint Committee on Taxation.

I. SUMMARY OF TESTIMONY.

- There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. The CBO projects that the January 2013 fiscal cliff tax deal will triple our deficits over the next 10 years, relative to what deficits would have been had all the 2001-03 tax cuts expired.

- To a surprising extent, our adverse budget deficit picture over the next decade is the result of forgone tax revenues. As a result of the Great Recession, we lost about $2 trillion in revenue over the last few years, relative to our historic rate of tax collections as a percentage of GDP. Looking ahead, the fiscal cliff tax deal will reduce future tax revenues by $4 trillion, relative to what CBO had projected under its 2012 baseline. Together, these past and future forgone revenues amount to a roughly $7 trillion contribution to our deficits from 2008 – 2023 (including interest costs on increased borrowings). To a large extent, both sequestration and the budget caps of the 2011 Budget Control Act are efforts to recoup on the spending side monies that were forgone from the revenue side.

- There is no short-term crisis in financing the national debt; Treasury borrowing rates are at near-record lows. Nor is there a general crisis in the availability or cost of capital for the private sector. The short-term crisis is about jobs; the CBO projects that 2014 will be the first time since the Great Depression that unemployment remains over 7.5 percent for six consecutive years. But deficit reduction through eliminating wasteful tax expenditures can offer little short-term help here.

- The long-term problem is entitlements spending, particularly spending on healthcare. For that matter, healthcare is our biggest *immediate* spending problem as well. The United States today spends much more on healthcare (public and private) per capita than does any other developed economy in the world. *If the United States were to expend per capita what Norway (the second place country) does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some $880 billion/year.*

- While long-term entitlement spending reform is critical, we must "boil the frog slowly," to borrow a phrase from Senate Finance Committee Chairman Baucus. Both our citizens' expectations and our healthcare delivery institutions are built around current policies. Change must follow a predictable path that starts in the near future, phases in slowly, and comes to rest with new institutions that will serve the needs of Americans for decades to come. The requirement that we boil the frog slowly in turn has important implications for tax revenues over the medium term.

- Defense discretionary spending is the other great outlier in U.S. government spending policies. *By one estimate, the United States spends as much on its military as do the next 14 countries combined – 41 percent of the entire world's military expenditures.*

- Current levels of nondefense discretionary spending are modest by world norms. This "spending" includes some items, like infrastructure, that are bona fide investments with long-term economic benefits. And both defense and nondefense discretionary spending already are on downward paths to reach their lowest levels in 50 years. This unrealistically aggressive assumption is baked into the CBO's 2013 deficit projections.

- The number of Americans age 65 or older will increase by more than 1/3 over the next 10 years. This has obvious implications for healthcare, social security and other government spending programs.

- All these points imply that spending cuts cannot by themselves fund all of our deficit reduction requirements in the medium term. Whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.

- The United States is an extraordinarily low-taxed country by world norms – in fact, *in 2012 we were the lowest taxed country in the OECD, as a percentage of GDP*. And even by our own standards we have been collecting historically low levels of tax. This level of revenues cannot be reconciled with our outsized spending on healthcare and defense, and our rapidly aging population.

- By all measures, the United States can afford to increase the total taxes it collects as a fraction of GDP. Just a decade ago, the country ran budget surpluses and enjoyed both a robust economy and job growth, while tax collections exceeded 20 percent of GDP.

- We therefore have no practical choice but to raise the level of tax collections in the medium term to the range of 21 percent of GDP, rather than the 19 percent figure projected by the 2013 CBO baseline.

- Economists prefer to raise additional tax revenues, when necessary, through broadening the tax base, rather than raising marginal rates. Unlike 1986, when the tax system overflowed with unintended tax shelters that could be cleaned up and traded off against lower rates, this means directly tackling some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.

- Of all current law's tax expenditures, the most important to address in tax reform are the personal itemized deductions, such as the deductions for home mortgage interest, charitable contributions and state and local taxes. They are extraordinarily costly subsidies – about $250 billion/year in forgone tax revenues. They are inefficient, in that they lead to major misallocations of economic resources, particularly with respect to housing. They are poorly targeted, in that the government subsidies go to individuals who would have behaved the same without the subsidies. And they are unfair, in that they are "upside down" subsidies – they subsidize high-income Americans more than low-income ones.

- I recommend that we replace the personal itemized deductions (and the standard deduction) with 15 percent tax credits. *My preliminary estimate is that doing so will raise about $1.5 trillion in revenues over the next 10 years* (without taking into account any transition relief).

- My suggestion would still preserve about one-half the aggregate current economic value of personal itemized deductions, but would do so in a way that adds to the progressivity of the tax code. Nonetheless, the scale-back in the value of the personal itemized deductions should be phased in over several years.

- I fully recognize that the home mortgage interest deduction and other personal itemized deductions invariably are described as "sacred cows." *But they are sacred cows that we can no longer afford to maintain.* Either we corral these sacred cows, or we allow them to stampede over us.

II. THINKING ABOUT THE DEFICIT.

A. There is No Immediate Fiscal Crisis.

There is no short-term crisis in financing the national debt; Treasury borrowing rates are at near-record lows. (Indeed, a strong case can be made that this is an ideal time for the federal government to stretch out the average maturity of its debt, to lock in today's very favorable rates.) Nor is there a general crisis in the availability or cost of capital for the private sector.[1] (Of course small or less creditworthy firms may continue to

[1] See, e.g., Bain & Co., Inc., *A World Awash in Money: Capital Trends Through 2020* ("Our

experience difficulties in borrowing at reasonable rates.) We can see the plentiful supply of credit for strong borrowers in the recent boom in debt-financed mergers and acquisitions, such as the recently-announced leveraged acquisition of H.J. Heinz Corporation.

The United States, is, however, mired in an immense jobs crisis. The 2013 edition of the Congressional Budget Office's *Annual Budget and Economic Outlook* points out that the United States is on track to record by 2014 unemployment rates exceeding 7.5 percent for the sixth consecutive year, for the first time since the Great Depression.[2] This topic is desperately important to millions of Americans, but is far afield from my understanding of the purpose of today's hearing, and tax reform would have little immediate impact on this problem.

B. <u>The Long-Term Fiscal Problem is Real</u>.

While the federal government is able to finance its deficits at very low rates today, there is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. The 2013 edition of the Congressional Budget Office's *Annual Budget and Economic Outlook* predicts that, under the CBO's relatively optimistic baseline assumptions, federal debt held by the public will amount to roughly 77 percent of GDP in 2023 (comparable to its 2013 level), and will be trending upwards. Under plausible alternative assumptions, the 2023 ratio would be 87 percent.[3]

The Congressional Budget Office further predicts that our projected deficits over the next 10 years will "lead to lower output and income later in the decade than would have occurred under prior law. The [fiscal cliff] legislation lowers tax rates for many people—thereby boosting output—but it also expands budget deficits—which will reduce

[2] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, at 1 (Feb. 2013).

[3] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, at 4 (Feb. 2013).

national saving and lower the stock of productive capital, thereby reducing output relative to what would have occurred under prior law."[4]

There is no generally-accepted theory in public finance economics of what constitutes a country's optimal debt-to-GDP ratio. Nonetheless, most observers would agree that these projections are troubling, because (i) they leave very little room to absorb unexpected economic or national security calamities in the coming decade, (ii) they imply that even within the next decade the economy will be adversely affected by the crowding out of private investment by government borrowing, and (iii) the adverse projected trend in the debt-to-GDP ratio continues to accelerate in the decades that follow.

Against this background, it is understandable that this Committee would be concerned about the fiscal path on which our country is pointed. I therefore wish to make only a few brief observations about our overall deficit trends. I do so to focus the discussion on the relative contributions to deficit reduction that we should expect from spending cuts, on the one hand, or revenue increases, on the other.

C. Forgone Revenues Tell the Underlying Story.

The CBO's February 2013 10-year deficit projections are much more dire than were those contained in the CBO 2012 baseline, for the simple reason that, as required by law, the CBO 2012 baseline assumed the expiration of all the 2001-2003 tax cuts, as well as the lapse of other temporary tax provisions. The recent "fiscal cliff" tax deal (the American Taxpayer Relief Act of 2012) essentially gives *every* taxpayer an income tax discount relative to what would have been the case had those temporary tax cuts fully expired. (Even the highest-income taxpayer filing a joint return enjoys the benefit of the lower tax rates on his first $450,000 of income.) As a result, the fiscal cliff tax deal is projected to add $4.6 trillion to our accumulated deficits over the next 10 years, which represents a *tripling* in the size of the 10-year projected deficit compared with the 2012 baseline.

Post-fiscal cliff revenues are expected to climb over the next few years to about 19 percent of GDP, and then to stabilize there for the rest of the coming decade. By

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[4] http://www.cbo.gov/publication/43835

contrast, the 2012 baseline, which by law assumed the expiration of all the 2001-03 tax cuts, projected that tax revenues would rise to 21 percent of GDP by 2022. As a result, the 2012 baseline also projected that the country's fiscal crises would be largely resolved, at least for a considerable period. Deficits were projected to average only 1.5 percent of GDP for the entire 2012 – 2022 period, and debt held by the public was projected to decline to 62 percent of GDP by 2022 – a full 15 percentage points lower than the relatively optimistic base case in the 2013 projections.

Forgone revenues also figure into the federal government's deficits looking back over the last several years. The country is slowly climbing out of the worst financial and economic crisis since the Great Depression. To address the crisis required some extraordinary new spending measures and temporary tax reductions. But in addition to these new legislative measures, the Great Recession led to a collapse in existing federal tax revenues and a surge in certain income security spending programs, particularly unemployment insurance and the Supplemental Nutrition Assistance Program (food stamps, colloquially). These consequences are known as "automatic stabilizers" – just by the design of these programs, they operate without any new legislative interventions to mitigate the consequences of a recession, by leading to smaller tax bills and more payments to individuals who qualify for some modest assistance towards meeting current living expenses.[5] Of course, the automatic stabilizers also generate deficits until the economy recovers and the programs in question return to normal levels. Because we have not endured an economic collapse of this magnitude in the living memory of most Americans, we have generally underappreciated the role that automatic stabilizers played in our surge in national debt.

A quick review of tax revenues during the 2008-2013 period illustrates this point. For the decades leading up to the crisis, federal tax revenues averaged 18.3 percent of GDP.[6] (This of course does not mean that revenues approximated this number each year;

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[5] For a discussion of how automatic stabilizers operate, see, e.g., Congressional Budget Office, *The Budget and Economic Outlook, Fiscal Years 2012-2022* (Jan. 2012), Appendix C.

[6] More specifically, using CBO data, I calculated that the unweighted average debt-to-GDP ratio for the 20 years 1988-2007, and for the 30-year period 1978-2007, was 18.3 percent. For the 40-year period 1968-2007, it was 18.2 percent.

revenues topped out at 20.6 percent of GDP at the end of the Clinton administration, for example, and revenues fell significantly in earlier recessions.) During the current crisis years, by contrast, federal revenues have fallen precipitously, to about 15.1 percent of GDP in 2009 and 2010, for example. To be fair, not all of this decline in revenue was the result of the automatic stabilization properties of the income tax, as Congress implemented new temporary tax reductions to stimulate the economy, but a significant portion was attributable to the automatic stabilization function.

To make this more concrete, I calculated what the federal government's tax revenues would have been in the 2008-2013 period, if revenues each year totaled 18.3 percent of that year's GDP, and compared those hypothetical revenue figures to the revenues actually collected (or in the case of 2013, the revenues that are projected to be collected). *The difference is a gap of $2.1 trillion* – without regard to the increased interest costs incurred to finance this contribution to the deficit.

In short, forgone revenues (compared to historical norms) are a large part of the story of where our most recent deficit problems have arisen. In past years (e.g., the 1990's) we used years of strong economic performance to pay back this "missing" revenue, by allowing tax revenues to rise above the long-term average. After all, 18.3 percent of GDP could not have been the average revenues collected over many years if some years fell below that number, and no year rose above it.

Summing up the two streams, and removing any double counting for 2013, leads to the following observation: if the federal government had collected its historic average of 18.3 percent of revenue during the 2008-2012 period, and then switched to the higher revenue levels contemplated by the 2012 CBO baseline (i.e, the expiration in particular of the 2001-03 tax cuts in their entirety) for 2013-2023, total deficits would have been on the order of $7 trillion lower (taking into account debt service savings).[7]

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[7] My calculation of forgone revenues in the 2008-2012 period is not a general equilibrium calculation; that is, it does not take into account the effect on GDP of collecting higher taxes in a recession.

So both looking forward to projected revenues after the fiscal cliff tax deal, and looking back to the revenues forgone through the automatic stabilization function of the income tax (as well as various temporary tax relief measures), we see a consistent story of missing revenues that to a large extent explain our worrisome fiscal trends. And to be clear, the 2012 CBO baseline numbers contemplated revenue collections at levels not very different from those that prevailed at the end of the Clinton administration; these are levels that are not beyond our wildest contemplation. To a large extent, both sequestration and the budget caps of the 2011 Budget Control Act are efforts to recoup on the spending side monies that might have been collected on the revenue side.

D. <u>Explicit Spending</u>.

This section II.D. discusses government spending that is presented as such in standard budget presentations. Section IV, below, discusses disguised government spending baked into our tax code – what specialists call "tax expenditures."

Over a longer horizon than the 10-year window considered above, our country does have a spending problem, driven to a surprisingly large degree by one paramount issue: healthcare spending, and to a much lesser extent by Social Security.[8] The Congressional Budget Office has projected that government spending on Social Security and the major healthcare programs will amount to 11.7 percent of GDP in 2023. In 2007 that figure was 8.2 percent, and in 1970 3.8 percent.

These adverse spending trends reflect among other factors the inescapable demographic fact that our population is growing older, and doing so rapidly.[9] The Congressional Budget Office reminds us that the number of Americans age 65 or older will increase by 1/3 in the next decade. That fact in turn has direct implications for the

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[8] For a recent discussion of some Social Security policy options, see Thomas L. Hungerford, *Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens*, Congressional Research Service publication RL33943 (Feb. 5, 2013).

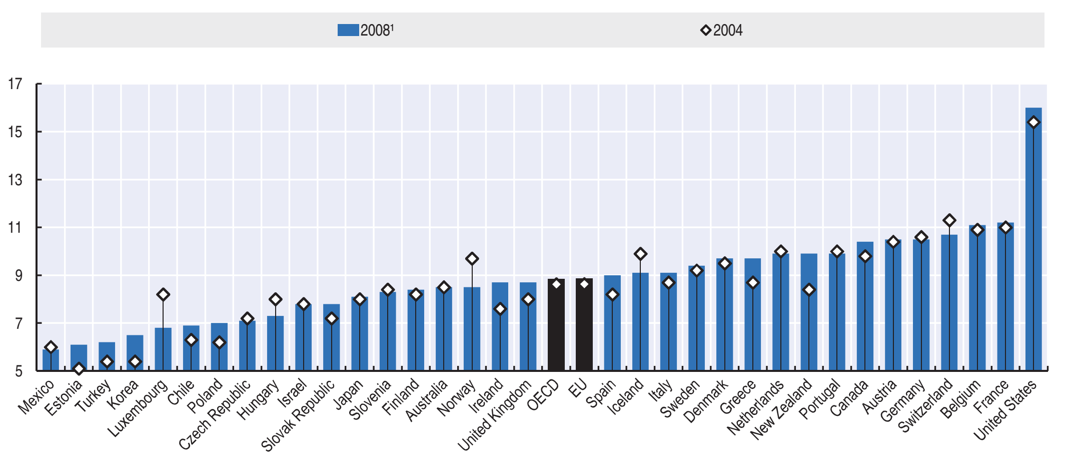
[9] This of course is a universal phenomenon in developed countries. See, e.g., OECD, *OECD in Figures 2009,* at 6-7.

level of tax revenues required to provide basic services to an aging population, and also to the design of these entitlements programs. Phrasing things more directly, it is simply unreasonable to expect that we can maintain tax revenues at pre-crisis average levels while at the same time the number of elderly Americans increases so rapidly.

Healthcare actually is a large-scale current fiscal problem, because our healthcare spending is so large, and so disproportionate to the value we receive, that it imposes large economic efficiency losses on all of us. Here, OECD data are extremely useful in helping us to see just what an outlier the United States is *today* in respect of healthcare costs.

The United States today spends much more on healthcare than does any other developed economy in the world, whether measured as a percentage of GDP or as per capita healthcare spending. Applying consistent OECD metrics, in 2010, the United States spent 17.6 percent of GDP on healthcare; the next most profligate country, the Netherlands, spent 12.0 percent.[10] *If the United States spent the same percentage of GDP on healthcare as did the Netherlands, our total public and private healthcare spending would have been $812 billion lower.*

Figure 3.23. **Health expenditure**
Percentage of GDP



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
1. 2007 for Australia, Denmark, Greece and Japan; 2006 for Portugal.
Source: OECD (2010), *Health Database*.

StatLink http://dx.doi.org/10.1787/888932373514

(Source: OECD, *Economic Policy Reforms: Going for Growth 2011* at 174.)

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10 http://www.oecd-ilibrary.org/social-issues-migration-health/total-expenditure-on-health_20758480-table1

It also is true when measured as dollars spent per capita. In 2010, the United States spent $8,233 per capita on healthcare, by far the highest in the world; the next most profligate country, Norway, spent $5,388 per capita.[11] *If the United States were to spend per capita what Norway does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some $880 billion/year.*

More remarkably, the United States today is second in the world (only to Norway) in *government* spending per capita on healthcare.[12] In 2010, U.S. federal, state and local governments spent more per capita on healthcare than did the governments of Germany, Denmark, Switzerland, France or Canada. Our extraordinary profligacy in government spending on healthcare has nothing whatsoever to do with the Patient Protection and Affordable Care Act, which had no impact on 2010 healthcare spending (the year covered by the data), and which in fact is projected by the CBO to mitigate somewhat the accelerating path of government healthcare spending.

And of course, in return for this profligate spending on healthcare, the United States enjoys poor health outcomes; our life expectancy, for example, is at the bottom end of the OECD, well below that of the countries mentioned above.

In short, the government's long-term *fiscal* health depends directly on grappling much more fundamentally than we have to date with how we provide healthcare services to our citizens.[13] But change in this area will be challenging, and as Chairman Baucus of the Senate Finance Committee has pointed out, in such situations it is important that you "boil the frog slowly."[14] This means that we must rely on long transition periods to move from where we are to where we need to be without unfairly upsetting settled expectations

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[11] OECD Health Data: Health expenditure and financing: OECD Health Statistics (database), *http://dx.doi.org/10.1787/hlthxp-cap-table-2012-2-en*.

[12] http://www.oecd-ilibrary.org/social-issues-migration-health/public-expenditure-on-health-per-capita_pubexhltcap-table-en.

[13] Congressional Budget Office, *2011 Long-Term Budget Outlook* at 45-47 (June 2011).

[14] Cf. http://en.wikipedia.org/wiki/Boiling_frog.

and modes of healthcare delivery systems. *In the meantime, however, the resulting costs must be financed*.

Government discretionary spending has been on a decades-long downward trend, interrupted only by the emergency spending to deal with the Great Recession. Regardless of what one thinks about the efficacy of those programs, they were in fact temporary and will not contribute further to the deficit in future years. As the figure below shows, this downwards trend is true regardless of the application of the sequester and the 2011 Budget Control Act's caps on discretionary spending. As the Congressional Budget Office noted in its 2013 annual *Budget and Economic Outlook*:

> With funding as assumed in the baseline [i.e., including 2011 BCA caps and the sequester], discretionary outlays would fall to 5.5 percent of GDP by 2023, more than 3 percentage points below their average from 1973 to 2012. Specifically, defense outlays in 2023 would equal 2.8 percent of GDP, compared with a 40-year average of 4.7 percent, and nondefense outlays in 2023 would equal 2.7 percent of GDP, compared with a 40-year average of 4.0 percent.[15]

These are wholly unrealistic projected levels of spending. As Martin Feldstein, a prominent conservative economist, recently concluded in an op-ed in the Wall Street Journal that "The truth is that federal finances cannot be stabilized by reducing discretionary outlays alone."[16]

Put another way, the Congressional Budget Office's 2013 annual *Budget and Economic Outlook* projects that the federal government in 2023 will spend 2.7 percent of GDP on all nondefense discretionary spending, but will run a deficit of 3.8 percent of GDP. This means that the federal government would run a significant deficit in that year even if it were to spend *zero* on all nondefense discretionary spending programs.

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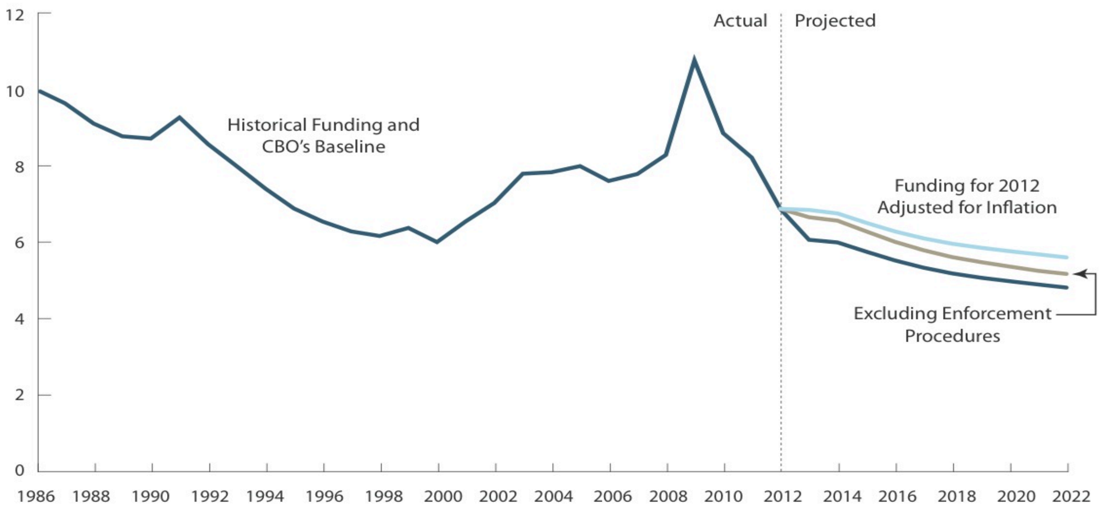
[15] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, at 25 (Feb. 2013).

[16] Martin Feldstein, *A Simple Route to Major Deficit Reduction,* Wall St. J., Feb. 21, 2013, at A-15.

Total Discretionary Budget Authority Excluding War Funding, Disaster Relief, and Program Integrity Initiatives

(Percentage of GDP)

August 2012
http://go.usa.gov/7QY



The caps on discretionary spending—either with the required automatic reductions (as in CBO's baseline) or without them (as in the alternative fiscal scenario)—will necessitate a reduction in the real resources available for many government programs, compared with the funding provided for 2012. If, instead, funding was allowed to grow at the rate of inflation, it would be 17 percent higher in 2022 than the amounts projected in the baseline.

Congressional Budget Office

In general, our nondefense discretionary spending today is modest by world standards.[17] Moreover, our standard budget presentation of discretionary "spending" is a hopeless muddle, because it mixes what in a private business would be treated as current expenses (salary for government employees, for example) with items that a private firm would properly characterize, not as an expense, but as the purchase of an asset. In effect, we confuse income statement and balance sheet items. In doing so, we overstate government nondefense discretionary spending.

By contrast, the U.S. military budget is a discretionary spending outlier. We all are proud of our Armed Forces and are grateful for their work in keeping our country secure, but I nonetheless suspect that it would come as a surprise to many Americans to learn that, by at least one third-party estimate, we spend almost exactly as much on our military services as do the next 14 largest militaries *combined* (in fact, 41 percent of the

[17] This is particularly the case if veterans' benefits and services are properly recharacterized as a component of defense spending, rather than as nondefense discretionary spending (the current budget presentation).

world's total military expenditures), and more per capita than does Israel, for which existential threats are arguably much more immediate.[18]

OECD data that combine *all* national and subnational government spending, both mandatory and discretionary (including social security), confirm that the United States is not the victim of government spending run amok. Of the 31 OECD member countries, the United States ranks 6th from the bottom in total government spending as a percentage of GDP.[19] Given our outsized military and healthcare spending, this implies that the United States is a very parsimonious government spender in all other respects, when compared with our world peers.

Finally, when difficult decisions about taxing and spending must be made, some find it tempting to think that the place to cut back is on government programs designed to alleviate poverty. The federal government's income security programs include the Supplemental Nutrition Assistance Program, Supplemental Security Income, unemployment insurance, the earned income and child tax credits, family support, child nutrition, foster care, and miscellaneous tax credits.[20] Impressive though this list may sound, our government's total outlays for all of these programs combined is much smaller than many observers realize. More specifically, the Congressional Budget Office projections contained in the 2013 annual *Budget and Economic Outlook* contemplate that government outlays for income security programs will decline as a percentage of GDP from 2.0% in 2014 to 1.3% by 2023.[21] I do not believe that, for the largest and most successful economy in the world, this level of support for Americans struggling with unemployment or in poverty can in any way be described as lavish.

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[18] Stockholm International Peace Research Institute, http://www.sipri.org/research/armaments/milex/resultoutput/milex_15/the-15-countries-with-the-highest-military-expenditure-in-2011-table/view, and *Yearbook 2012*, at 183.

[19] OECD Economic Outlook Annex Table 25, available at http://www.oecd.org/eco/outlook/economicoutlookannextables.htm.

[20] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years* 2013 TO 2023, 16, 24 (2013).

[21] *Id.* at 24.

All this suggests to me that further cuts to explicit discretionary spending will make at most only a modest impact on the federal budget deficit in the medium term. And if one further accepts the maxim that one must boil the entitlements spending frog slowly, our worrying fiscal trends over the next decade will not be addressed within that time frame by revisions to mandatory spending programs. That leaves larger tax revenues (which includes eliminating hidden spending in the form of tax expenditures) as the only means of financing the policies to which we largely are committed.

III. WHY TAX REVENUES MUST RISE.

The previous discussion has demonstrated that the gap between projected federal government spending and tax revenues will have measurable adverse consequences in reduced economic output and greater fiscal fragility within a decade. But at the same time, federal government discretionary spending already is projected to reach unsustainably low levels, and reforms to mandatory spending programs (which in some cases may not necessarily be good policy) would in all events require long transition rules.

This leaves tax revenues as the only way to finance our transition from here to there. It is for this reason that bipartisan majorities on deficit reduction panels (for example, the Bowles-Simpson and Rivlin-Domenici commissions), major nonpartisan studies (for example, the Peterson-Pew Commission on Budget Reform's report), the staff of the OECD, thoughtful budget experts like Robert Greenstein at the Center for Budget and Policy Priorities and prominent economists like Alan Greenspan and Martin Feldstein have all agreed that tax revenues must rise from their current levels in order to finance our government.

Bluntly, there is no rational alternative. The need to repay the revenue shortfalls of the Great Recession, the rapid increase in the number of elderly Americans, the continuing needs of the many Americans who are unemployed or in poverty, our oversized and inefficient healthcare system, our large military expenditures, and the costs of supervising the world's largest, most complex and most sophisticated economy collectively require government revenues greater than those we currently are on track to collect.

Fortunately, we begin with such an extraordinarily low level of tax collections in the United States that it is feasible to raise tax collections over the next several years without unduly disrupting the U.S. economy. The United States is an extraordinarily low-tax country by world norms, and of course in recent years the automatic stabilization properties of the income tax have mitigated even those modest levels of tax burdens.

Here OECD comparative data (which combine national and subnational taxes) are again extremely helpful. ***Those data show that for 2012, the United States had the lowest total tax collections as a percentage of GDP of any country in the OECD.***[22]

Yet at the same time, we finance a military as big as that of the next 14 countries combined, and the most expensive and inefficient healthcare system in the world. Why are we then surprised that we are running budget deficits?

Another way of getting a sense of our modest current tax burdens is to look at the "tax wedge" on labor – the difference between what an employer pays (including social security contributions) and what an employee takes home as after-tax wages. Here again OECD data demonstrate that the United States is at the low end of developed country norms:

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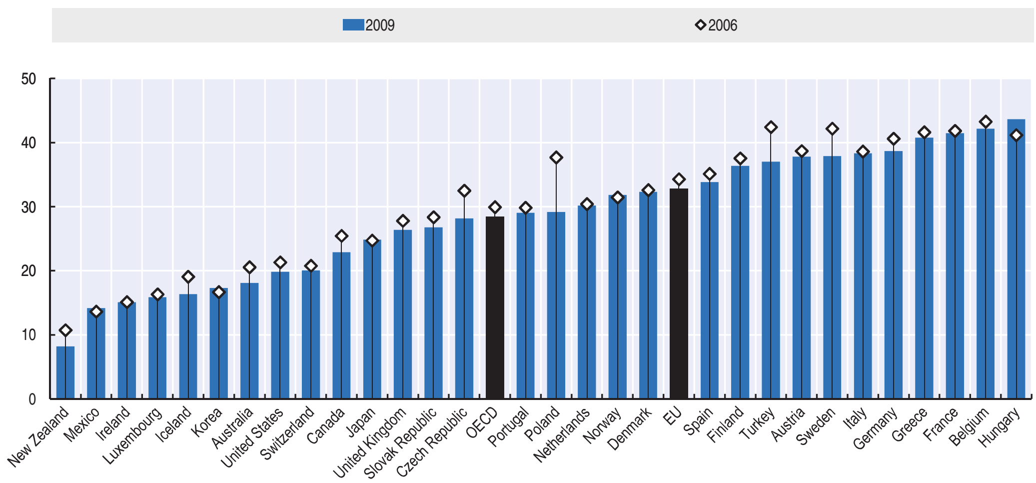
[22] OECD Economic Outlook Annex Table 26, available at http://www.oecd.org/eco/outlook/economicoutlookannextables.htm.

Average Tax Wedge on Labor (As Percentage of Compensation)
(Couple with 100% of Average Earnings and 2 Children)



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.

1. Measured as the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a ratio of total labour compensation. It therefore includes both employer and employee social security contributions.
2. Average of three situations regarding the wage of the second earner.

Source: OECD (2010), *Taxing Wages Database*.

StatLink http://dx.doi.org/10.1787/888932373134

The conclusion that tax revenues must rise sits badly with some. They like to point out that high taxes impede economic growth and job creation. These sorts of nostrums have as much policy utility as the old adage that, all other things being equal, it is better to be rich and healthy than poor and sick. Tax revenues need to increase not because higher taxes are desirable as an independent goal, but because there is no other choice.

Others object that we should look to reducing mandatory spending programs before thinking of raising overall tax revenues. Again, I fully recognize the need to rethink healthcare spending in America, in particular, but whatever the shape of the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.

Realizing that any mention of one Administration can be perceived as politically charged, the undeniable facts are that in the 1992-2000 period the economy grew much faster than it has since that time, and that the economy did so notwithstanding the burdens of tax rates that did not reflect the application of the 2001-03 tax discounts. All other things being equal, lower taxes are better than higher taxes (just as being rich and healthy beats being poor and sick), but whether viewed from the perspective of world norms or our own recent history, it is simply not credible to argue that the U.S. economy cannot sustain higher levels of tax collections than the historically low levels of the last few years, or even slightly higher levels than historical averages.

A close reading of the 2013 CBO annual *Budget and Economic Outlook* in conjunction with the same report for 2012 gives a clear picture of what we need by way of additional federal revenues. The 2013 baseline projection predicts that federal government revenues will reach about 19 percent of GDP during the coming 10 years; as previously explained, this level appears to be too low for optimal fiscal health. Conversely, the 2012 CBO baseline projection contemplated that revenues slowly would climb to about 21 percent of GDP; this level enabled a significant paydown of the national debt.

This is the bid-ask spread, to put things into a Wall Street jargon. The closer we can get over the next 10 years to a revenue base on the order of 21 percent of GDP, the stronger our fiscal health will be. And again, for all the reasons developed above, I do not think it particularly credible to argue that a phased step up to tax revenues at this level will choke our economy or erode our fundamental liberties.

IV. <u>REDUCING THE DEFICIT THROUGH CURBING TAX EXPENDITURES.</u>

A. <u>How Should Revenues Be Raised?</u>

Acknowledging that tax revenues must rise is the first step on the road to fiscal healing, but of course that leaves open how exactly to do so, and to whom should it be done?

Let us consider the second question – on whom should incremental tax burdens fall – first. Here it is important to clarify some widespread confusion about how different taxes relate to each other, because from the perspective of a taxpayer what matters is how many dollars are removed from her personal resources to pay for government, not what the name of the tax is, or even which level of government is doing the removal. For example, it often is observed that 47 percent (or thereabouts) of taxpayers pay no federal income tax. But this is an incomplete and ultimately misleading observation, because it ignores the fact that payroll taxes are paid from the first dollar of wages, and that other taxes (e.g. Federal excise taxes or state sales taxes) also are highly regressive.

Citizens for Tax Justice is the only organization of which I am aware that prepares a comprehensive and regularly updated calculation of the total tax burdens (federal, state and local) imposed on Americans of different income levels.[23] Their analysis shows how important it is to look at the entire suite of taxes to which individuals are subject when making claims about how tax burdens are shared:

Incomes and Federal, State & Local Taxes in 2011

		Shares of		TAXES AS A % OF INCOME		
	Average cash income	Total income	Total taxes	Federal taxes	State & local taxes	Total taxes
Lowest 20%	$ 13,000	3.4%	2.1%	5.0%	12.3%	**17.4%**
Second 20%	26,100	7.0%	5.3%	9.5%	11.7%	**21.2%**
Middle 20%	42,000	11.4%	10.3%	13.9%	11.3%	**25.2%**
Fourth 20%	68,700	18.7%	19.0%	17.1%	11.2%	**28.3%**
Next 10%	105,000	14.2%	15.0%	18.5%	11.0%	**29.5%**
Next 5%	147,000	10.1%	11.0%	19.7%	10.7%	**30.3%**
Next 4%	254,000	14.3%	15.5%	20.6%	9.9%	**30.4%**
Top 1%	1,371,000	21.0%	21.6%	21.1%	7.9%	**29.0%**
ALL	$ 71,600	100.0%	100.0%	17.6%	10.3%	**27.9%**
Addendum: Bottom 99%	$ 58,500	79.1%	78.3%	16.5%	11.0%	27.5%

Notes:
a. Taxes include all federal, state & local taxes (personal and corporate income, payroll, property, sales, excise, estate etc.).
b. For calculations of income shares and taxes as a % of income, income includes employer-paid FICA taxes and corporate profits net of taxable dividends, neither of which is included in the average cash income figures shown.

Source: Institute on Taxation and Economic Policy Tax Model, April 2012

Citizens for Tax Justice, April 2012

(Source: Citizens for Tax Justice, *Who Pays Taxes in America?*, April 4, 2012)

[23] The Staff of the Joint Committee on Taxation has in the past prepared distribution tables showing the distribution of the tax burdens of all *federal* taxes other than the corporate income tax. See, e.g., Staff of the Joint Committee on Taxation, JCX-19-10, Table 11 (March 22, 2010).

From the other direction, and as widely covered in the press, the academic work of Emmanuel Saez and others has demonstrated that income inequality in the United States has risen dramatically in recent decades. I cannot review all the literature here, but a chart from the OECD I think helps to illustrate that, while growth in income inequality is a phenomenon with global reach, the United States is a real outlier in this regard:

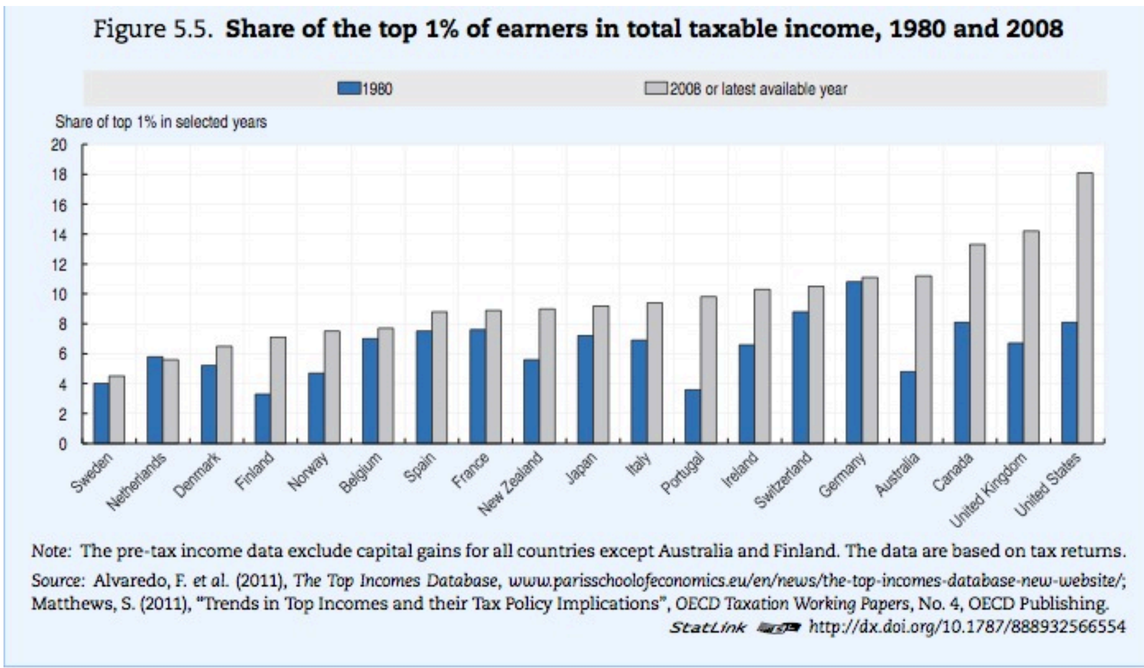


Figure 5.5. **Share of the top 1% of earners in total taxable income, 1980 and 2008**

Note: The pre-tax income data exclude capital gains for all countries except Australia and Finland. The data are based on tax returns.

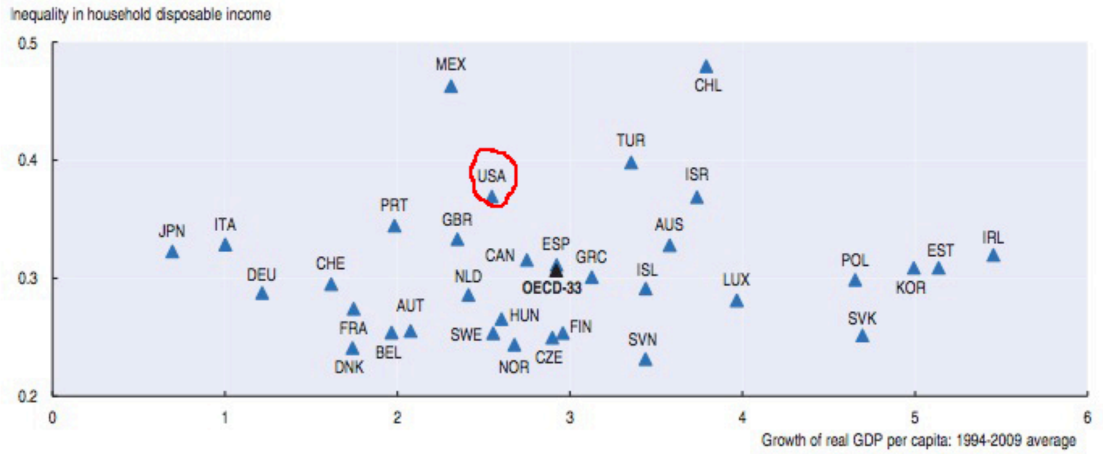
Source: Alvaredo, F. *et al.* (2011), *The Top Incomes Database*, *www.parisschoolofeconomics.eu/en/news/the-top-incomes-database-new-website/*; Matthews, S. (2011), "Trends in Top Incomes and their Tax Policy Implications", *OECD Taxation Working Papers*, No. 4, OECD Publishing.

StatLink http://dx.doi.org/10.1787/888932566554

(Source: OECD, *Economic Policy Reforms 2012: Going for Growth*, at 188.)

What is more, it does not follow that our greater income inequality has fueled faster economic growth, as this OECD chart shows:

Figure 5.9. **There is no simple link between inequality and growth**



Note: Inequality in household disposable income is measured by the Gini index. The inequality measures refer to the late 2000s, except for France and Ireland for which they refer to the mid-2000s.

Source: OECD Income Distribution and Poverty, *OECD Social Expenditure Statistics (Database)*; *OECD Economic Outlook: Statistics and Projections (Database)*.

StatLink http://dx.doi.org/10.1787/888932566611

(Source: OECD, *Economic Policy Reforms 2012: Going for Growth*, at 194.)

I believe that these data support the view that most Americans pay significant taxes, and that additional tax revenues should be raised in a progressive manner. But at the same time, I am sympathetic to the view that the very highest marginal tax rate, once one factors in the new 3.8 percent Medicare tax and the effects of section 68 of the tax code (“Pease”), has reached a level that should not be increased at this time.

It can fairly be argued that certain new taxes (e.g. a carbon tax) can have a long-term positive impact on the country, by addressing “externalities” and the like, but I am not aware of any broad sentiment on this Committee in favor of entirely new taxes. I therefore conclude that the increased tax revenues that we require should come from the income tax, but, for the reasons developed above, should be raised in a way that adds to rather than subtracts from the progressive structure of the Internal Revenue Code.

Finally, I think that significant increases in tax revenues necessarily will come from the personal income tax. The reason is simply that the corporate income tax’s statutory rate of 35 percent is today far outside world norms. The rate needs to come down, but at the same time we cannot afford to lose revenue. I therefore conceive of corporate tax reform as a roughly revenue neutral undertaking, in which the corporate tax base will be broadened through closing business tax expenditures and loopholes, and the resulting revenues used to "pay down" the corporate rate.

The straightforward goals of an incremental reform of the personal income tax should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping marginal tax rates – the tax imposed on your last dollar of income – as low as possible. The intuition here is simple: people are more sensitive to the tax rate imposed on their last dollar of income than to their average tax burden. The deadweight loss of taxation can be minimized by keeping marginal tax rates as low as possible, consistent with the other two goals.

Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-03 tax discounts) requires broadening the tax base. Unlike 1986, the individual income tax today has not been eroded through suspect tax shelters or other schemes to avoid the tax system that Congress anticipated when drafting the tax code. (There are of course exceptions, but they are not significant to the overall revenue picture.) *This means that the only way to raise significant revenues without raising marginal tax rates is to tackle directly some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.*

Tax expenditures, particularly those that can be phrased as "tax subsidies," are a form of government spending, not tax reductions.[24] As such, they are the economic equivalents of cash entitlements programs, but ones that in many cases are poorly targeted, economically wasteful, and awarded to those taxpayers who need subsidies the least. The United States prides itself on being a market-based economy, where market prices, not central planners, determine the allocations of goods and services. All too often, however, tax expenditures undercut this premise, and in fact represent a government thumb on the scale of market prices – with all the inefficiencies that this implies.

[24] The history and theory of tax expenditure analysis is developed at length in the Staff of the Joint Committee on Taxation's publication, *A Reconsideration of Tax Expenditure Analysis,* JCX-37-08 (May 12, 2008).

The magnitude of hidden spending baked into our tax code is staggering: the federal government spends today almost twice as much through tax expenditures as we do through old-fashioned explicit non-defense discretionary spending programs. In fact, we spend more in tax expenditures than we collect in cash through the personal income tax – about $1.2 trillion/year. This spending is divided roughly 90 percent on personal tax expenditures and 10 percent on business tax expenditures. It is as if our tax base were twice as large as it appears, and then we gave half or so of those revenues back through various ersatz subsidies that in many cases are poorly targeted and result in misallocations of economic activity.

Because tax expenditures are so large, and because so many are poorly targeted ersatz subsidies, it is perfectly feasible to envision raising very large sums of money – perhaps on the order of $1.5 to $2 trillion – over 10 years without raising tax rates. I offer a specific suggestion to this effect at the end of this Section IV.

B. The Central Importance of Tax Expenditures.[25]

Tax expenditures dissolve the boundaries between government revenues and government spending. As a result, they reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government. To see how, consider a little example involving the small but self-reliant country of Freedonia. Its economy is comprised of 10 fruit and vegetable growers, each earning $1,000 pre-tax, for a total gross domestic product of $10,000. Each grower pays income tax to support the Freedonian army at a flat rate of 15 percent, for total tax revenues of $1,500.

Freedonia's sole kumquat producer is particularly resourceful. Armed with scientific reports showing the many health benefits of kumquat consumption, he convinces the Freedonian legislature that kumquat production deserves tax incentives, to bring kumquats within the reach of every Freedonian family. The legislature responds by

[25] Some of this subsection is abstracted from Edward Kleinbard, *The Hidden Hand of Government Spending*, Regulation (Cato Inst., pub.), Fall 2010, at 18.

effectively exempting kumquat production from its income tax through an innovative kumquat production tax credit.

But Freedonia is not a profligate state, and it believes in fiscal discipline in the form of pay-as-you-go budget rules. Therefore, to keep the kumquat credit revenue-neutral, the legislature pairs the new preference with an 11.1 percent tax hike on the other producers, to maintain tax revenues at $1,500. (Freedonian tax policy allows for rounding error.) That means that the other fruit and vegetable farmers will each pay $167 (instead of $150) in tax on their $1,000 of income.

In a world without tax expenditure analysis, Freedonian legislators can argue that nothing has changed: government revenues are constant, and there is no increase in government spending or borrowing. But this is plainly wrong; things have changed, in both the private and public sectors.

First, the tax incentive increases kumquat production and consumption. The equilibrium price and quantities sold of kumquats will be different relative to other fruits and vegetables after the tax incentive. Economists believe that, in the absence of some identifiable market failure, markets set prices better than legislatures do, but the kumquat credit alters the quantity of kumquats sold relative to the case in which the tax burden of all fruit and vegetable growers was equal. Unless the health of Freedonians really is improved by the kumquat credit (perhaps due to prior rampant borderline scurvy among the population), the result will be a less efficient allocation of our collective resources.

Second, the introduction of the kumquat credit in an apparently virtuous "revenue neutral" fashion has another profound economic effect: tax rate increases on the incomes of all the fruit and vegetable producers who do not receive targeted tax relief. All taxes, no matter how beautifully implemented, impose "deadweight losses." That is, some transactions that are rational in a world without taxes become too expensive in a world with those taxes and do not take place. And deadweight loss increases faster than the tax rate — in standard presentations, in fact, at the square of the tax rate.

What all this means is that, by virtue of granting "revenue neutral targeted tax relief," the Freedonian government may raise the same aggregate revenues as it did previously, but impose more deadweight loss on the remaining taxable Freedonian private sector. This result is one of the great ironies of many tax expenditures, particularly those that fall into the category of business incentives — once the incentive's impact on tax burdens *for others* is considered, it impoverishes the country even more than it enriches the beneficiaries of the legislative largesse. (Deadweight loss of course cannot be avoided for long by electing "targeted tax relief" without revenue offsets. Unfortunately, recent U.S. tax history has some of this flavor.)

Third, by virtue of its new kumquat credit, the Freedonian government just got bigger, even though aggregate nominal tax revenues remain constant. The best way to analogize the new kumquat credit to a uniform 11.1 percent tax hike on all of Freedonia's fruit and vegetable producers, followed by a $167 kumquat crop farm subsidy payment to the kumquat producer. By recasting the tax expenditure in this way, as a constant tax burden and a separate transfer payment, the two different functions of government are restored to their customary formal presentation, and the words "revenue" and "spending" can be applied consistently to economically identical (but formally different) modes of implementation. As so recast, it is easy to see that Freedonia's economic handprint on the private sector is no longer $1,500 in tax revenues, but rather $1,667 in economic terms. The government is bigger in every meaningful sense of the word.

C. **Tax Expenditures Must Be Evaluated on the Merits**.

Tax expenditures serve many different purposes. Some (the earned income tax credit, the special tax rates on long-term capital gains) might be viewed as adjustments to the tax rate tables; others (the child credit, the refundable portion of the EITC) serve important social and distributional goals; still others (pension plan contributions) can be explained as moves towards a consumption rather than an income tax. But many fall into the category of well-intentioned but ultimately inadvisable instances of Congressional meddling with our market economy, by subsidizing different forms of personal consumption or business activity. These latter sorts of tax expenditures typically introduce economic inefficiencies, miss the target of their intended beneficiaries, and waste a great deal of money.

Every tax expenditure therefore must be evaluated on its own merits. Nonetheless, when one does perform this sort of evaluation, many tax expenditures, including some of the most expensive ones, fail miserably: that is, they represent extraordinarily costly government spending programs that do not deliver commensurate social welfare benefits.

In 2008 the Staff of the Joint Committee on Taxation undertook a comprehensive review of tax expenditure analysis in a pamphlet titled *A Reconsideration of Tax Expenditure Analysis*. Its purpose was to assist policymakers in using tax expenditure analysis "as an effective and neutral analytical tool" to analyze tax proposals.[26] One of the principal contributions of *A Reconsideration of Tax Expenditure Analysis* was to urge that tax expenditures be grouped into different conceptual buckets, so that each could fairly be analyzed in accordance with its overall purpose, and compared to other expenditures serving a similar overall purpose. To my regret, the Staff of the Joint Committee on Taxation later retreated from the presentation recommended in this pamphlet. I think that this reversal unfortunately weakened the utility of tax expenditure analysis in general.

Tax expenditure analysis traditionally has identified "tax expenditures" as those provisions of the tax code that are said to deviate from a hypothetical "normal tax" system. The fundamental problem, however, is that the "normal tax" system is itself a normative assertion, rather than an economic fact. To mitigate the importance of the "normal tax" concept, *A Reconsideration of Tax Expenditure Analysis* recommended that items traditionally labeled as tax expenditures be divided into two main groups: tax subsidies and tax-induced structural distortions. The former category contained the majority of tax expenditures; it comprised those items that a fair reading of the Internal Revenue Code would suggest were exceptions, not to some hypothetical ideal called the normal tax, but rather to the general rules visible on the face of the Code itself. Tax-

[26] Staff of the Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12, 2008). Since that date the Staff of the Joint Committee on Taxation has retreated from the analysis proposed therein to its traditional presentations of tax expenditure analysis. I think that this is a mistake, because reverting to an excessive reliance on a "normal tax" as the analytical starting point weakens the case for bipartisan agreement on the central importance of tax expenditure reform.

induced structural distortions comprised important tax provisions traditionally categorized as tax expenditures, but where the general rules of the Code were not clearly visible, so that it was impossible to say which was the exception and which the rule. The treatment of the international income of U.S. multinational corporations is a perfect example of an economically important tax provision that cannot fairly be described as a simple exception to a general rule of the Internal Revenue Code.

A Reconsideration of Tax Expenditure Analysis further recommended that the world of tax subsidies (which again comprised the vast bulk of tax expenditures) be subdivided into three conceptual buckets: Tax Transfers (refundable credits); Social Spending (tax subsidies unrelated to the production of business income, which are intended to subsidize or incentivize non-business behaviors, such as the subsidy for charitable giving); and Business Synthetic Spending. Tax expenditures that fall into the last category in particular in my view are inherently suspect, as they represent direct Congressional meddling in the operation of our marketplace economy.

A Reconsideration of Tax Expenditure Analysis showed how tax expenditures could be analyzed under traditional tax considerations of equity, efficiency and ease of administration. These considerations weigh differently across the different conceptual buckets described above. For example, one might expect a Business Synthetic Spending tax expenditure to be justifiable primarily on efficiency grounds, while equity considerations in general dominate the design of Tax Transfers.

Finally, *A Reconsideration of Tax Expenditure Analysis* offered some insights into how best to design a tax expenditure, once the decision to offer a tax subsidy had been made through the political process. The pamphlet emphasized the goals of designing subsidies that are transparent (so that costs are easily identifiable, and the identity of beneficiaries made clear), well-targeted (so that the subsidy goes to change behavior in the direction that policymakers intend, and not to reward people who would have engaged in the activity in any event), and certain (so that intended beneficiaries know that they qualify, and can plan accordingly).

Here is an excerpt from the report that applied some of these principles to the vexing question of our very large government subsidies for owner-occupied housing:

To take a well-known example, the Federal income tax today contains several large subsidies (incentives) for home ownership. Most economists would agree that these tax subsidies are welfare-diminishing. The tax expenditures can be described as introducing inequality of after-tax treatment between otherwise similarly-situated home owners and home renters. The incentives can also be seen as introducing inequities in another sense, by virtue of what Stanley Surrey called their "upside down" design – that is, the fact that these tax expenditures, by being structured as tax deductions, give proportionately greater government subsidies to taxpayers with higher incomes (because the value of a tax deduction is determined by the taxpayer's marginal tax rate). Housing tax subsidies can also be viewed as inefficient, in at least three respects. First, they encourage private capital to be diverted into the housing sector from other investments that would have been made in a world without such incentives, thereby raising the cost of capital for the rest of the economy. Second, the revenues forgone by providing these tax subsidies must be made up by raising marginal tax rates, and those higher tax rates by themselves introduce distortions in behavior. Finally, current law's housing incentives certainly add significant complexity to our tax system.

Nonetheless, the political process has concluded that subsidizing home ownership is desirable. This conclusion can be explained as reflecting factors other than efficiency – for example, "externalities" such as the possible advantages to society of having its citizens feel more "invested" in their communities, and committed to the larger political system, that might stem from home ownership. Moreover, a simple application of tax expenditure analysis along the lines summarized above might be criticized in this context (when one is reviewing a longstanding tax expenditure) for assuming a world where decisions had not been distorted for many decades by these incentives; the technical analysis of what to do with those tax expenditures in light of that past history, or in light (in this case) of the market dislocations that this sector of the economy currently is suffering, might be completely different from the analysis that would be applied to a completely new proposed tax expenditure.

To conclude this example, tax expenditure analysis can shed helpful light on the costs (in the broad sense, including, as noted above, environmental costs and similar externalities) of tax subsidies associated with owner-occupied housing, or can propose ways of rethinking the subsidies that might reduce their costs (for example, the replacement of housing-related tax deductions with tax credits). The ultimate decision as to the net societal welfare to be gained by subsidizing home ownership, however, can only be resolved through the political process.[27]

[27] *A Reconsideration of Tax Expenditure Analysis* at 49-50.

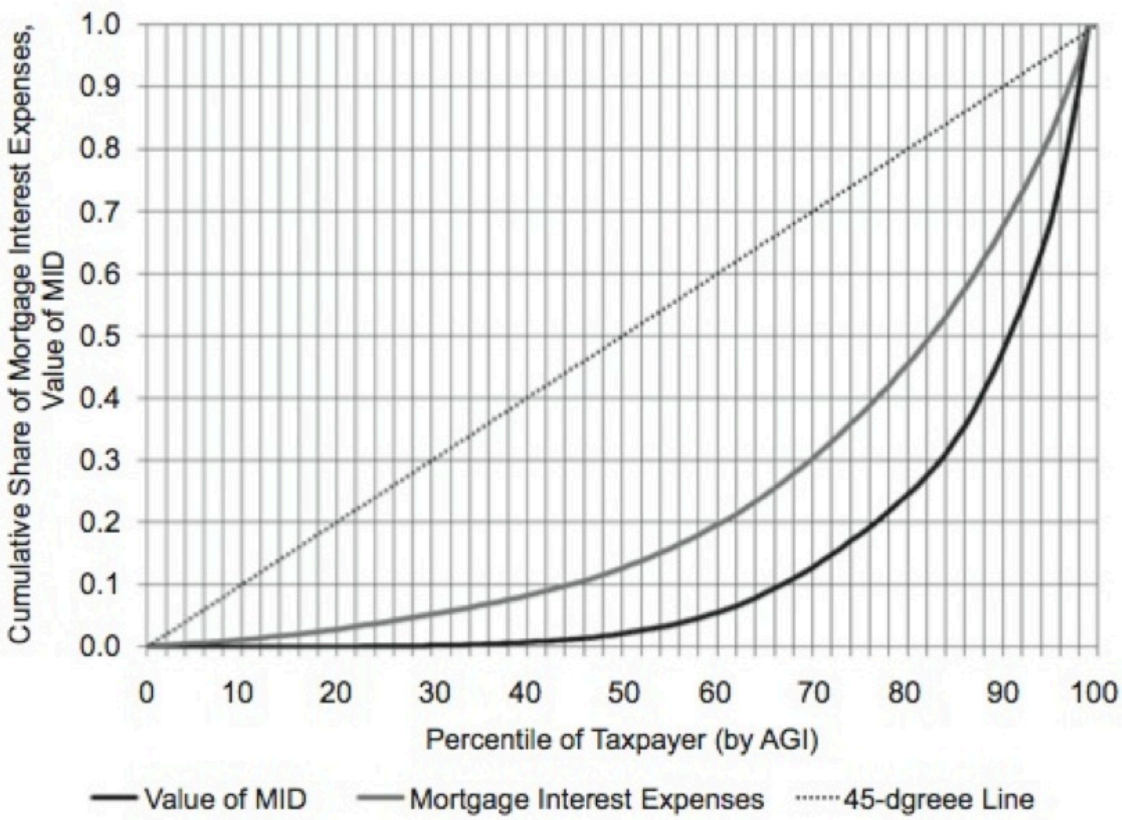
As it happens, I believe that the opponents of this subsidy have by far the better of the argument. The subsidy is inefficient, because it induces Americans systematically to overinvest their capital in homes, rather than in productive business investments; the subsidy is inequitable, in that its benefits go primarily to the highest-income Americans (the "upside down" subsidy problem associated with any subsidy that takes the form of a tax deduction); and the subsidy is poorly targeted, in that its benefits in many cases go to individuals who would have bought a home in any event.

The poor design of our large tax subsidies is neatly captured in the following chart, from an article by Adam Cole, Geoffrey Gee and Nicholas Turner.[28] It shows how the benefits of the home mortgage interest deduction in fact are distributed across Americans of different incomes. What the authors' research tells us is that roughly the top quintile of Americans by income get 80 percent of the value of this government subsidy, and the top 10 percent get over half its value.

[28] Adam J. Cole, Geoffrey Gee and Nicholas Turner, *The Distributional and Revenue Consequences of Reforming the Mortgage Interest Deduction,* 64 National Tax J. 977 (2011).

Figure 3

Cumulative Shares of the Value of the Mortgage Interest Deduction and Mortgage Interest Expenses by AGI Percentile, 2007



Note: Non-filers are excluded from this sample.
Source: Authors' calculations based on data from the SOI Division of the IRS.

(Source: Adam J. Cole, Geoffrey Gee and Nicholas Turner, *The Distributional and Revenue Consequences of Reforming the Mortgage Interest Deduction,* 64 National Tax J. 977 (2011))

Can anyone imagine proposing to Congress in this difficult fiscal environment the creation of a gigantic cash subsidy – totaling *$379 billion* in forgone tax revenues over the next five years, according to the Staff of the Joint Committee on Taxation[29] – the purpose of which is to put roughly $200 billion directly into the pockets of the most

[29] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, Feb. 1, 2013, at 33.

affluent 10 percent of Americans? Yet this is exactly what we have done with this one tax expenditure.

In practice, we do not focus on the enormous expense, the deadweight loss or bizarre targeting of the government's subsidy of home mortgage interest in the same way Congress and the public do when Congress considers the Farm Bill. The reasons are that the home mortgage interest deduction is invisible in our standard government accounts, as just another feature of the tax law that leads to a certain level of tax revenues, and because the deduction functions as an entitlement – a permanent feature of the law that people claim if they are qualified, without annual appropriations by Congress. The home mortgage interest deduction and other similar tax expenditures rely to a large extent on this relative invisibility, not on their economic or equity merits, to survive.

As another quick example of the muddle in which we find ourselves, consider that we use the tax system today both to subsidize alternative energy sources, and to subsidize the fossil fuels that those alternative energy sources are designed to supplant.[30] Together the two efforts counteract each other, by incentivizing production and consumption of what amount to competing products.[31] If the policy behind subsidies for alternative energy is to increase the likelihood of consumers using those sources, the subsidy on fossil fuels is directly in opposition to that policy by incentivizing producers and consumers to continue their existing use of fossil fuels.[32]

It is important to stress that not all tax expenditures are wasteful. The earned income tax credit, for example, is a great success story, to the point where it has been copied in countries around the world, under the general rubric of "making work pay."

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[30] In 2009, tax expenditures supporting fossil fuels totaled $3.2 billion, compared to $1.47 billion for alternative energy. SUBSIDY SCOPE, *Tax Expenditures in the Energy Sector*, PEW CHARITABLE TRUSTS (Sep. 9, 2010), *available at* subsidyscope.org/energy/tax-expenditures.

[31] Diane Cardwell, *Renewable Energy Industries Push for New Financing Options*, N.Y. TIMES (Jan. 30 2013), *available at* dealbook.nytimes.com/2013/01/30/renewable-energy-industries-push-for-new-financing-options.

[32] *Id.*

Over 20 million Americans claim the benefits of the EITC each year. The EITC has lowered the barriers to entry into the job market for these millions of Americans. There are very large costs associated with moving from unemployed status to one's first job – child care, uniforms or tools, commuting expenses, and so on. These are not taxes in a formal sense, but in practice operate effectively as very high marginal taxes on an individual's first dollar of wage income.

The EITC helps to overcome these sorts of barriers, and to enable individuals to develop the skills and work habits that will enable them to move up the income ladder, until they 'graduate' from EITC.[33] For this reason, most EITC recipients in practice receive EITCs only for only one or two years in a row.[34] The EITC thus solves a fundamental economic problem in the labor markets (the very high implicit tax on entering the workforce), thereby increasing the labor supply, our national wealth and our collective social welfare.[35]

Some observers emphasize the possibility of fraud in taxpayers' claiming the EITC, to the exclusion of considering the credit's demonstrated labor market benefits. The IRS is well aware of this risk, and applies much more rigorous vetting procedures to every return claiming the EITC than it does, for example with the home mortgage interest deduction. The IRS checks the social security number of each taxpayer and of each child

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[33] Molly Dahl, Thomas Deleire, and Johathan Schwabish. *Stepping Stone or Dead End? The Effect of the EITC on Earnings Growth*, 62 National Tax J. 329 (2009) (Jobs that single mothers took because of the incentives from the EITC were not dead-end jobs, but rather jobs with the potential of earnings growth).

[34] Tim Dowd and John B. Horowitz, *Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support*, 39 Pub. Fin Rev. 619 (Sept. 2011) (61 percent of taxpayers claiming the EITC do so for no more than two consecutive years). Some taxpayers with children, in particular, receive EITC benefits for longer periods. Id. The authors conclude: "Therefore, for some taxpayers, the EITC acts as a temporary safety net during periods of either anticipated or unanticipated income or family structure shocks. But the EITC also acts as a long-term mechanism of providing assistance to taxpayers with children who are entrenched in the lowest-income brackets."

[35] See e.g. Jeffrey Grogger, *Welfare Transitions in the 1990s: The Economy, Welfare Policy, and the EITC*, 23 J. of Policy Analysis and Management 671 (2004); Timothy Dowd, *Distinguishing Between Short-Term and Long-Term Recipients of the Earned Income Tax Credit*, 58 National Tax J. 807 (2005).

claimed against other government databases. If the IRS finds a problem, it will not give the EITC portion of the refund until after audit. The IRS further uses a variety of automated algorithms to detect suspect EITC filings. And relying in part on section 6695(g) of the Internal Revenue Code, added specifically to increase compliance among paid return preparers, the IRS reviews the returns submitted by commercial tax preparers and looks with more scrutiny at preparers who have submitted erroneous claims in past.

D. <u>Healthcare Tax Expenditures.</u>

The two largest clusters of tax expenditures are those for healthcare and those for owner-occupied housing. Each has had a large and profoundly negative allocative effect on the economy – that is, each has distorted what goods and services we all purchase, by changing relative prices through hidden government subsidies. Each also is poorly targeted, in the sense that the subsidy often goes to taxpayers who would have purchased those goods or services without the help of the subsidy.

The most important healthcare tax subsidy is the treatment of wages paid by an employer in the form of healthcare benefits (whether called insurance or out of pocket reimbursements) as tax-exempt in the hands of an employee. This "exclusion" from employees' incomes of wages paid in the form employer-provided healthcare will cost some $132 billion in forgone income taxes in 2013 alone (and $760 billion over the five years 2013-2017),[36] but even these enormous costs understate the true picture, because they do not include the payroll tax revenues forgone by the exclusion. In 2008, the JCT Staff estimated these payroll tax costs at some $100 billion for one year alone.[37]

In short, the total value of this government subsidy for one mode of healthcare delivery is on the order of $250/billion year. Yet precisely because this subsidy is delivered as an income "exclusion," its recipients are largely unaware that they are the

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[36] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, Feb. 1, 2013, at 38.

[37] Staff of the Joint Committee on Taxation, *Tax Expenditures for Healthcare*, JCX-66-08 (July 2008).

beneficiaries of a hidden government handout. The result is a terrible distortion in public discourse, as seen in the debate surrounding the Patient Protection and Affordable Care Act. Many Americans believed that the Act represented an unprecedented government intrusion into the private sector, but were unaware that the government had long been subsidizing their healthcare (but not necessarily those of other Americans with different employers). This is why in my academic writing I have emphasized the corrosive effects of tax expenditures on our ability to conceptualize the role of government in our lives.[38]

Substantively, the subsidy for employer-sponsored distorts our spending patterns, by encouraging us to take compensation in the form of generous healthcare programs (its allocative consequences), does so inefficiently (by subsidizing higher-income Americans more, since tax-exemption is more valuable to them – the classic "upside down" subsidy pattern of many tax expenditures), and does so unfairly (because its availability depends on the programs offered by your employer, not consistent national standards available to everyone).

For these reasons, every health economist of whom I am aware believes that the tax subsidy for employer-sponsored health insurance is both unaffordable and bad policy. Many I believe were acutely disappointed that the Patient Protection and Affordable Care Act left the subsidy largely intact (except for certain "Cadillac" plans).

The difficulty is not with this ultimate conclusion, but rather with the frog boiling procedure. The tax subsidy for employer-provided healthcare is so deeply engrained in the healthcare delivery system that it cannot be removed except through a carefully thought-out transition to a different system. Whether the Patient Protection and Affordable Care Act is that system, or only a steppingstone to a more comprehensive rewriting of how healthcare is delivered in the United States, is a complex question, but the unwinding of the tax subsidy for employer-sponsored healthcare should take place in the context of a plan that assures Americans that healthcare will not become less available or wholly unaffordable.

[38] E.g., Edward Kleinbard, *The Congress Within a Congress: How Tax Expenditures Distort Our Budget and Our Political Process*, 36 Ohio Northern L. Rev. 1 (2010).

E. <u>The Sacred Tax Cows of Personal Itemized Deductions – It's Them or Us</u>

Employer-provided healthcare is the largest single government subsidy program delivered through the tax system. As a group, however, the personal itemized deductions –in particular, the deductions we claim that subsidize our homes (the home mortgage interest deduction, the deduction for property taxes, etc.), our charitable contributions, our state and local income taxes, and so on – are even larger. *The Staff of the Joint Committee on Taxation has estimated that our tax subsidies for home ownership, charitable contributions, and state and local taxes together will cost $1.2 trillion in forgone federal tax revenues over the next five years.*

Following the recommendations developed in an article I co-authored with Joseph Rosenberg of the Tax Policy Center,[39] I urge that these deductions be converted into nonrefundable tax credits at a 15 percent tax benefit rate: that is, a $100 deduction would be converted into a $15 cash equivalent, in the form of a tax credit.[40] The result will be that these activities still will be subsidized, but to a much smaller degree, and the subsidy no longer will be "upside down." In other words, all taxpayers who itemize will get the same $15 tax benefit from a $100 charitable contribution (or whatever), rather than getting a bigger subsidy if they are in a higher tax bracket. To ease the pain for those taxpayers living in particular at the margin of affordability of their homes, the new principles should be phased in over a few years.

This same principle can even be extended to the standard deduction (with adjustments to deal with the 10 percent tax rate bracket). The standard deduction invariably gets a free pass when tax expenditures are examined, but the standard deduction has all the same ''upside-down" subsidy characteristics that itemized deductions do and no greater justification as a normative income tax matter. Converting the standard deduction to a 15 percent credit (with an adjustment for income in the 10

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[39]Edward Kleinbard and Joseph Rosenberg, *The Better Base Case,* 135 Tax Notes 1237 (2012).

[40] *See also* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stanford L. Rev. 23, 44-48 (2006). Batchelder and her co-authors recommended that credits be refundable; for revenue reasons, I am proposing that they would not be.

percent bracket) raises substantial revenues and addresses the upside down subsidy problem.

I do not have a complete revenue estimate for the revenues that this proposal will raise under the new tax rate brackets adopted as part of the fiscal cliff tax deal, but *my preliminary estimate is that this proposal alone will raise about $1.5 trillion over the 10-year budget window* (ignoring any staged transition rule to minimize the pain of adjusting to the new principles). At the same time, a 15 percent tax credit leaves in place about one-half the aggregate value of the personal itemized deductions, which mitigates some of the transition concerns.

There is a widespread *bipartisan* consensus that the current personal itemized deductions are perverse, inefficient, and unaffordable.[41] In his Presidential campaign, Governor Romney urged that tax expenditures be scaled back, and of course President Obama has proposed a 28 percent cap on the value of personal itemized deductions. The difference between the parties is not, I think, with regard to the merits of scaling back the value of personal itemized deductions, but rather whether the resulting revenues should be used to fund government, or to "buy down" tax rates.

A powerful argument can be made that the personal itemized deductions should be entirely eliminated. My proposal does not go that far, but it is possible to imagine that subsequent Congresses could choose to phase out the personal itemized deductions starting at some later date by reducing the tax benefit of the deductions by, say, 1 percent each year for 15 years.

I recognize that the personal itemized items are frequently described as political "sacred cows," but they are simply unaffordable luxuries in the current environment. Either we eliminate these sacred cows, or they will stampede us.

By scaling back the value of personal itemized deductions, we can not only raise a very large amount of revenue, but we do so efficiently. We can raise this incremental

[41] *See, e.g.*, Michael M. Gleeson and Michael Beller, ''Ryan Budget Calls for Top Tax Rates of 25 Percent,'' *Tax Notes*, Mar. 26, 2012, p. 1595. For example, both Rep. Paul Ryan, R-Wis., and Rep. Patrick J. Tiberi, R-Ohio, have argued that tax expenditures must be scaled back.

revenue *without* raising marginal tax rates. The elimination of the tax preferences for these items also will add to the progressivity of the tax system, because itemizers generally have higher pretax incomes than do taxpayers claiming the standard deduction.[42] (Only about one-third of tax filers itemize their deductions today.)

Moreover, by eliminating these sacred tax cows we directly address a fundamental misallocation of capital in the private sector, which is our overinvestment in single-family homes compared to other forms of capital investment.[43] We also will eliminate the inefficiencies by which we provide these subsidies to those who would have bought their homes (or made charitable contributions, or chosen to live in high-tax states) regardless of the tax incentives.[44]

At bottom, the personal itemized deductions, as the name implies, are all *personal* expenses. Their replacement by a 15 percent credit would make the tax system more progressive, more efficient, less distortive and simpler. Doing so also would raise great deal of money without adding unduly to the deadweight loss from taxation, and raising a great deal of tax revenue in general is something that we have no choice but to embrace.

The reason to convert *all* the personal itemized deductions to a 15 percent credit is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another. Our only practical hope is to round up and eliminate all these tax sacred cows at once.

Martin Feldstein has made a somewhat similar proposal, which he describes as a 2 percent cap on the tax benefits that an individual taxpayer can claim from tax

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42 See, e.g., Testimony of Robert Greenstein Before the Senate Committee on Budget, March 9, 2011, Table 1 (listing distributional consequences of itemized deductions by income quintiles).

43 Robert Carroll, John F. O'Hare and Phillip L. Swagel, *Costs and Benefits of Housing Tax Subsidies*, Pew Charitable Trusts (June 2011); Evridiki Tsounta, *Home Sweet Home: Government's Role in Reaching the American Dream,* International Monetary Fund Working Paper Wp/11/191 (August 2011).

44 For example, Tsounta, supra n. 43, finds (Table 8 at 28) that Canada's tax subsidies for home ownership are perhaps 1/5 as large as a percentage of GDP as those of the United States, yet Canada has a higher rate of home ownership.

expenditures.[45] Feldstein proposes that taxpayers can claim any combination that they wish of the personal itemized deductions and two income exclusions (described below) that are caught by his proposed rule, provided that in doing so taxpayers cannot reduce their tax bills by more than 2 percent of their adjusted gross incomes. (For example, if a hypothetical taxpayer had $100,000 in adjusted gross income, that taxpayer would be limited in claiming deductions and exclusions to an amount that translated into a $2,000 cash tax savings. At a hypothetical flat 25 percent tax rate, this would mean that the taxpayer could claim a total of $8,000 in deductions and exclusions, because 25 percent of $8,000 is $2,000 of cash taxes saved.) Marty and I share a common emphasis on the importance of addressing tax expenditures as the right way to raise revenue, but I do not agree with his specific recommendation.

First, the Feldstein proposal would be extremely complex to implement, much more so than suggested by op-ed I reference in a note. Second, Feldstein proposes to include in his list of tax subsidies subject to the 2 percent cap excludible tax-exempt bond interest. At least as written this does not appear to be economically sensible, because investors in tax-exempt bonds already suffer an implicit tax in the form of lower coupons. (The idea of the exclusion for interest on state and local government debt is not to subsidize investors, but rather the state and local governments that issue the securities.)

Third, whether by design or not, the Feldstein proposal appears to impose very large tax burdens on many middle class Americans. The reason is that he includes in his list of tax subsidies subject to the new 2 percent cap the income exclusion for employer-provided healthcare insurance, subject to an $8,000 allowance. This allowance sounds very generous, and in fact would fully protect most single taxpayers, but if (as I think is intended) Feldstein gives only one $8,000 allowance to a family filing a joint return, then millions of working Americans with employer-provided health insurance would find that much of their previously-excludible health benefits had become taxable. I understand completely the impulse to dismantle the tax subsidy for employer-provided healthcare,

[45] The most recent iteration of this proposal is Martin Feldstein, *A Simple Route to Major Deficit Reduction,* Wall St. J., Feb. 21, 2013, at A-15.

but as I emphasized earlier, we should do so only in the context of a completely secure path to a superior healthcare delivery system that is still affordable.

Fourth, the Feldstein proposal has the odd effect of giving two affluent taxpayers completely different answers, depending on whether their incomes are derived from labor (taxed at the maximum marginal rates) or capital gains taxed at 20 percent. Taxpayers whose income comprised entirely capital gains would get essentially twice as many personal itemized deductions as would high-income wage earners.

Finally, Feldstein excuses charitable contributions from the reach of his proposal. While I understand the impulse to protect charitable giving, I do not agree with this recommendation. Charitable giving is very top-weighted by incomes, and leaving it protected vitiates much of the progressivity of the proposal. Moreover, charitable giving is rife with questionable practices (for example, donor-advised funds or the aggressive use of charitable remainder unitrusts) that have little to do with the eleemosynary purposes for which the charitable contribution deduction was intended.