

## **“Working Toward Pro-Growth Tax Reform”**

**Testimony of Diane Lim Rogers, Chief Economist, The Concord Coalition**

**Before the House Budget Committee, September 14, 2011**

Chairman Ryan, Mr. Van Hollen, and Members of the Committee: Thank you for giving me this opportunity to testify before you today on the issue of “pro-growth tax reform.”

I work for the Concord Coalition, a group that’s been dedicated to the cause of fiscal responsibility for two decades now—through both the “thick” and “thin” of federal deficits! As such, I think tax reform should never be considered in isolation of the rest of federal budget policy, and that bias will be clear in my testimony. Nevertheless, the views I express here are my own and do not necessarily represent the official position of the Concord Coalition.

This hearing is titled “The Case for Pro-Growth Tax Reform.” Well, the “case” for pro-growth tax reform is easy and non-controversial—as achieving a stronger economy makes pursuing any other social goals easier (deficit reduction, higher and fairer standards of living, greater investment in higher quality public goods and services, etc).

The disagreement is over what makes a given tax reform “pro-growth.”

Growing the economy through tax policy isn’t as simple as “cutting taxes” to reduce overall tax burdens. Tax cuts all have benefits, but the first thing one learns in an economics class is in a world of scarce resources, we maximize well being by weighing *costs* against benefits, and at the margin starting from where we are right now. Tax cuts that might benefit particular households and businesses don’t necessarily pass society’s cost-benefit test, even based on a narrower and naïve goal of maximizing GDP because:

- (i) If deficit financed, the direct reduction in public saving will typically outweigh any positive response from private saving, so national saving and economic growth falls. This is the biggest factor preventing simple cuts in overall tax rates from being “pro growth” over the longer term.
- (ii) How taxes are cut matters: marginal tax rates are what matters for supply-side growth effects (increases in incentives to work and save), and those responses depend on how large the change in marginal rates (we’re starting from relatively low rates), how large the responsiveness (“substitution effects”) of households and businesses to those rates (often pretty small), and how other factors (such as “income effects”) may swamp those responses to price changes.
- (iii) In an economy still recovering from recession, we have to worry about getting back to “full employment” (where we are putting all of our productive capacity to use) before turning to growing the productive capacity of the economy over the longer term. Tax policies that help increase demand for goods and services (and hence businesses’ *demand* for workers) can be quite different from those that increase the *supply* of labor and capital.

Our experience with the Bush tax cuts has demonstrated each of these challenges, as their major contribution to record-high deficits clearly reduced national saving and economic growth, were not very effective at growing the supply side of the economy (even according to the Bush Administration’s own Treasury Department), and are not the kind of tax cuts that provide high “bang per buck” in a recessionary economy.

Economists agree that the federal budget is on an unsustainable path and that for the continued health of the economy, deficits must eventually come down to levels lower than the growth rate of the economy (allowing the debt/GDP ratio to be stabilized). Even though a sizeable level of deficit spending over the next one or two years can be justified to support the economic recovery, a commitment to bring down deficits to lower, more sustainable levels over the next decade is essential not just for longer-term economic growth but for shorter-term economic stability (via the confidence of global investors in the U.S. economy).

Tax policy has to be part of the solution. It is true that the greatest pressures on the federal budget in the decades to come are in the entitlement programs because of the aging of the population coupled with rising per-capita health costs. But it is hard to see how our society would choose cuts in real, per-capita benefits of the magnitude necessary to both achieve sustainable deficits and keep revenues at the historical average. And even if we would choose to do so, we would never do it very soon; entitlement reforms would have to be phased in much more slowly than tax reforms could take effect.

The historical average level of revenues/GDP has very little bearing on what the right level of revenues is going forward. The right level of revenues is that which is adequate to pay for the government we desire. (And the right size of government is that which we are willing to pay for.) Given the dramatic changes in the structure of our population and the continued growth and evolution of our economy, it is difficult to see how what was right over the past 40 years—and it wasn’t even quite adequate then—could be right over the next 40 years.

Those who oppose raising revenue usually assume higher revenues will lead to larger government. But the holes in our income tax base—the special exemptions, deductions, credits, and preferential rates—amount to over \$1 trillion/year (about 90 percent of this in the individual income tax and 10 percent in the corporate), nearly as much as all of discretionary spending combined<sup>1</sup>. “Filling out” the tax base by reducing these tax expenditures would level out and support lower marginal tax rates (reducing the economic distortions caused by taxes), and reduce both the deficit and the effective size of government, all in a progressive as well as more generally “fair” manner. Thus, this type of tax reform—broadly applicable to both the individual and corporate income tax systems—is consistent with the goals of both Republicans and Democrats and ought to be the easiest area to find bipartisan agreement on policies to reduce the deficit.

Adjusting the CBO current-law baseline to construct the Concord Coalition’s “plausible baseline” (a “business as usual” projection) *triples* the ten-year deficit from \$3.5 trillion to \$10.4 trillion—with \$5.7 trillion of the \$6.9

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<sup>1</sup> Donald B. Marron, “How Large Are Tax Expenditures?”, Tax Notes, March 28, 2011 (<http://www.urban.org/uploadedpdf/1001526-Expenditure-Estimates.pdf>).

trillion difference due to tax policy and the plethora of expiring, deficit-financed tax cuts in current law.<sup>2</sup> The current-law baseline level of revenues achieves an economically-sustainable level of deficits over the next 10-20 years according to CBO. So whatever we do on the tax policy front, we should commit to achieving current-law revenue levels.

There are many tax policies that would be consistent with the current-law baseline level of revenues. I have characterized the three main approaches as: “do nothing” (let the Bush tax cuts expire as scheduled at the end of 2012), “do it big” (broaden the tax base by reducing tax expenditures, paying for lower tax rates), and “do it to the rich” (such as via a surtax on millionaires and/or large corporations). Each approach has different relative advantages regarding their economic effects and political attractiveness. The best economic effects would come from increases in revenue accomplished through progressive base broadening/reduced tax expenditures. We could do any combination of the approaches, and all would be encouraged in practice with a commitment to strict, no-exceptions, pay-as-you-go rules—on new or extended tax cuts and not just spending increases. This commitment is something the debt limit deal’s “super committee” could propose right away to get us on the path to sustainable deficits.

I elaborate on some of these points in the sections that follow, which draw largely from the recurring column I write for Tax Notes magazine, published by Tax Analysts.

### **The Nitty-Gritty on Tax Cuts and the Economy**

Constructing smart tax policy within the broader context of fiscal responsibility requires recognizing the connections and tradeoffs between tax rates, tax bases, revenues, public and private saving, and economic growth. The theory behind supply-side tax policy suggests that reducing tax rates encourages taxpayers to work and save and thus is good for the size of the tax base and for revenues. But in practice, tax cuts rarely pay for themselves, as the more extreme Laffer curve version of supply-side economics would suggest. We experienced higher revenues and budget surpluses following the tax rate increases enacted under the Clinton administration and lower revenues and high deficits following the tax cuts under the George W. Bush administration. In looking for economically efficient ways to raise revenue, there's room to improve the existing income tax base before we play around with the rate structure or add new tax bases. A tax cut needs to do more than provide just some marginal benefit; there must be enough benefit to make the cut worth its cost, relative to competing demands. If reducing tax rates encourages economic activity but doesn't pay for itself (such as with a rate cut that increases the deficit more than it encourages private saving), it's not necessarily good for the economy.

There is no policy area where conservatives and liberals are further apart than tax policy. Conservatives argue that tax cuts that raise returns to saving and investment, or increase the rewards for work, are always good for

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<sup>2</sup> See “The Concord Coalition Plausible Baseline,” updated August 2011: <http://www.concordcoalition.org/concord-coalition-plausible-baseline>.

the economy, in good times and in bad. Liberals argue that tax cuts primarily raise the incomes of the rich and squeeze out benefits for the poor, and are the worst type of fiscal policy when the economy is in a recession. Both sides neglect the adverse long-term economic effects of any type of tax cut that is deficit financed.

The debate is confusing because not all tax cuts are created equal, and the economic effects of those tax cuts differ across three dimensions: (1) the condition of the economy; (2) how the policy affects relative prices (substitution or incentive effects) versus real incomes (income or distributional effects); and (3) how the cost of the policy is paid for. When evaluating the effects of any particular tax cut on the economy, one should ask the following questions.

### **A. Where's the Binding Constraint?**

In a cyclical downturn, increasing aggregate supply (the productive capacity of our economy) won't do any good, because the problem isn't too little capacity, but too much idle capacity. To increase the level of economic activity, or GDP, we need to increase demand for goods and services so that more of current supply is used. Think of the uses or demand side of the GDP equation —  $C + I + G + (X-M)$  — and contemplate what the government's fiscal policy can do to increase consumption (C), investment (I), or net exports (X-M) indirectly via tax cuts and other subsidies, versus increasing direct government purchases of goods and services (G). In terms of the boost to GDP, tax cuts and subsidies are automatically handicapped relative to direct spending, and unless they produce multipliers of greater than 1, they will fall short of the success of dollar-for-dollar direct government purchases.

But in a full-employment economy, fiscal policy is ineffective in increasing demand-side GDP because supply is the limiting factor. GDP can be increased only by encouraging growth in the stock of those productive resources — the supply side of the economy. In this case, we need to ask how we can use fiscal policy to increase incentives to work or to save. How can fiscal policy be reformed to reduce any of the preexisting disincentives and distortions to economic decisions created by current policy?

### **B. What Kind of Tax Cut Is It?**

Tax cuts typically generate two types of effects on the microeconomic decisions of households and businesses: a substitution effect whereby relative prices are changed to encourage substitution into more lightly taxed activities and away from highly taxed ones, and an income effect whereby the higher cash flow to those receiving the benefits of the tax cut generates a change in their economic activity.

**1. Substitution effects and supply-side tax policy.** In a full-employment economy, tax policy's effect on relative prices is more important than it is in a recessionary economy. Marginal tax rates are what affect choices concerning the sources and uses of income. Tax cuts that reduce the marginal tax rates on labor or capital income will encourage substitution into greater labor supply or saving, boosting incomes and GDP. Tax cuts without any effect on marginal tax rates, in contrast, do not improve incentives at the margin. An example of a tax cut that reduces average tax rates and boosts average after-tax returns without reducing the marginal tax

rate is that of raising the contribution or income limits on tax-preferred savings accounts. Because many higher-income taxpayers are already maxed out on the tax-preferred options, and might continue to be even after the higher limits, increasing the availability of the tax subsidy for those households can cause shifting of existing savings (moving money out of taxable accounts into tax-free ones) without necessarily creating any new savings. The policy would generate positive income effects for these taxpayers even without any substitution effects.

Empirical research on the significance of substitution effects shows that higher-income households are more responsive to changes in marginal tax rates than lower-income households, probably because they can fine-tune their work hours more easily, and because the relative price change itself is usually larger at higher income levels given the progressive, graduated rate structure of the federal income tax. In fact, many lower-income households are entirely exempt from the federal income tax and so are completely unaffected by changes in marginal income tax rates. This has encouraged economists to suggest that flat rate tax systems (with a single marginal tax rate above some exemption level of income) would generate positive and sizable supply-side effects on labor supply and saving. But hold that thought, because how much the tax cut would cost in terms of lost revenue and the deficit would affect the supply side of the economy as well.

Increased supply-side incentives can also be achieved by reducing differences across marginal tax rates on different sources and uses of income. Broadening the income tax base by reducing tax expenditures would raise the overall average tax rate but would do so by raising marginal tax rates only on those sources and uses of income that are currently undertaxed in the definition of taxable income. By reducing the tax advantage to those currently undertaxed forms of income, the substitution effects away from higher-taxed income would actually be reduced and that type of income would be encouraged, even as the economy-wide average tax rate rises.

Must one be a supply-side economist to believe in the existence of these supply-side types of responses? No. Economists of all stripes broadly agree in the theory that households and businesses respond to relative price changes when those agents are given the opportunity and have the capacity to do so. Economists also agree that marginal tax rates matter in terms of their incentive effects. The debate over how valuable to the economy supply-side tax policy can be is largely over how large those substitution/incentive effects are in the real world, relative to the other economic effects of tax policy.

**2. Income effects and demand-side tax policy.** In a recessionary economy, the income effects of tax policy matter more. The distribution of the dollar benefits of a tax cut will affect how much the demand for goods and services is stimulated. Tax cuts focused on the top marginal tax rates don't deliver anymore dollars to lower-income households who have the highest propensities to consume. The effect on relative prices matters less than the effect on the levels and distribution of after-tax income. In fact, an economy-wide tax cut isn't a prerequisite of a successful demand-side tax cut. Consider a purely hypothetical and purely redistributive (income-effects-only) Robin Hood policy that increases taxes on the rich and gives the proceeds to the poor. This would increase aggregate demand in the economy by simply shifting income away from savers toward non-savers. Note that this is quite contrary to the optimal strategy in a supply-side tax cut designed to increase labor supply and saving.

Perhaps even more curious, fiscal policies that might seem ineffective or unjustified in terms of incentive effects (such as Social Security cost of living adjustment makeups for seniors, tax breaks for new homeowners, and the "Cash for Clunkers" program) might nonetheless have a high bang per buck in terms of stimulating aggregate demand in a recessionary economy. Even if those policies actually do nothing to encourage the economic activity they're ostensibly designed to, as long as they steer dollars to households with high marginal propensities to consume, they can nevertheless turn out to be pretty effective in stimulating demand.

On the flip side, we shouldn't worry much about higher taxes having large dampening effects on demand if those tax increases are mostly on higher-income households with low marginal propensities to consume. We also shouldn't be too concerned about the potential recessionary effects from tax increases that would take effect only after the economy is back to full employment.

The timing of tax cuts matters. At either the business level or household level, temporary tax cuts are likely to have a greater stimulative effect on the demand for goods and services than permanent tax cuts, because the timing of transactions is relatively easy to change — according to University of Michigan economist Joel Slemrod's hierarchy of responses.<sup>3</sup> A temporary tax cut will generate a large effect as the qualified activity is shifted forward whenever a tax cut has a deadline, even if the same tax cut, because it is only temporary, has a much smaller or negligible long-term effect on the components of aggregate supply.

### **C. How Is the Tax Cut Being Financed?**

**1. Deficit financing sometimes helps and sometimes hurts.** In a recessionary economy, deficit financing will increase the countercyclical stimulative effect of any particular tax cut on aggregate demand by promoting consumption of goods and services in excess of personal incomes. But that doesn't mean any deficit-financed tax cut (or spending) makes for the best stimulus, because there are longer-term economic costs still associated with the deficit — the debt has to eventually be repaid in higher taxes or reduced spending in the future. That puts limits on the amount of deficit-financed stimulus that's economically justified. We want to maximize the economic bang for the buck in deficit-financed stimulus, so fiscal responsibility requires that we determine a level of deficit spending we deem worth it, put high bang-per-buck spending or tax cuts at the front of the line (ranking fiscal policies from most effective to least), and draw the line at the credit limit we've implicitly established.

In a full-employment economy, however, deficit financing represents a dollar-for-dollar decrease in public saving, making it harder for the tax cut to increase national saving unless private saving is encouraged by more than the cost of the tax cut. This is not quite as high a standard as the tax cut paying for itself (as proposed by the Laffer curve) — which is  $1/t$  times as hard ( $t$  being marginal tax rate on private returns to saving). This is why the Bush tax cuts have been evaluated as a net negative for economic growth by William Gale and Peter Orszag

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<sup>3</sup> Joel Slemrod, "Tax Systems" in NBER Reporter, Summer 2002 (<http://www.nber.org/reporter/summer02/slemrod.html>) and "Income Creation or Income Shifting? Behavioral Responses to the Tax Reform Act of 1986," American Economic Review, 85(2), May 1995 (<http://www.jstor.org/pss/2117914>).

within the first few years of the Bush tax cuts, and by Gale more recently.<sup>4</sup> It also explains why increased tax rates during the Clinton administration coincided with higher, not lower, economic growth.

The choice to deficit finance now does not permanently avoid a tougher choice. Deficit-financed tax cuts do not pay for themselves, and they imply inevitably higher taxes or lower spending in the future. This intergenerational redistribution is another economic effect of the tax cut.

**2. On the other hand, paying for the tax cut sometimes hurts and sometimes helps.** In a recessionary economy when the goal is increasing current consumption, offsetting the cost of the tax cut with spending cuts or tax increases will reduce the net stimulative effect on aggregate demand for goods and services. The more the offset affects lower-income households (those most constrained), the larger the negative effect. Paying for a tax cut going to primarily high-income households with a cut in spending that benefits primarily low-income households would likely be contractionary, not stimulative.

In a full-employment economy, however, finding budgetary offsets to the cost of a tax rate reduction is likely to be better for encouraging aggregate supply and boosting GDP than deficit financing. That's because the deficit reduces public saving dollar for dollar, while empirical evidence has shown that the adverse effect of the offsetting policy on private saving is likely to be something less than dollar for dollar.

#### **D. Tax Cuts Matter, but Aren't One Size Fits All**

So are tax cuts good for the economy? It depends. As countercyclical policy during a recession, deficit-financed tax cuts can help stimulate demand, but deficit-financed spending is likely to be even more effective if it is deliberately targeted toward lower-income households. As supply-side policy during periods of full employment, tax cuts are most effective if they increase incentives at the margin to work and save — that is, by reducing marginal tax rates or leveling rates across different forms of income — but any deficit financing is likely to produce a net negative effect on national saving.

That's why a revenue-raising (relative to current policy) tax reform that reduces or levels out effective marginal tax rates and broadens the tax base at the same time is such a win-win-win formula:

**Win #1: It attends to the economy's needs.** In a full-employment setting, revenue-raising tax reform encourages supply-side private-sector economic activity without generating offsetting reductions in public saving. In a recessionary economy, raising revenue primarily from higher-income households

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<sup>4</sup> William G. Gale and Peter R. Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," Tax Notes, October 18, 2004 ([http://www.taxpolicycenter.org/UploadedPDF/1000698\\_Tax\\_Break\\_10-18-04.pdf](http://www.taxpolicycenter.org/UploadedPDF/1000698_Tax_Break_10-18-04.pdf)) and William G. Gale, "Five Myths about the Bush Tax Cuts," Washington Post, August 1, 2010 (<http://www.washingtonpost.com/wp-dyn/content/article/2010/07/30/AR2010073002671.html>).

minimizes any dampening effect on short-term demand for goods and services, while supporting greater levels of high bang-per-buck fiscal stimulus.

**Win #2: It creates the right price incentives and distribution of income.** By focusing on lower marginal tax rates and a broader, more neutral tax base achieved through reducing tax expenditures, it reduces the distortionary effects of tax policy on economic decisions, creating the right kind of substitution/relative price effects to maximize its economic effectiveness, while also generating income effects that can be helpful as countercyclical policy.

**Win #3: It doesn't increase the deficit.** As a deficit-neutral tax cut, it avoids the direct decrease in public saving that is harmful in a full-employment economy, without requiring alternative budgetary offsets that would reduce other and perhaps more stimulative forms of deficit spending when the economy is still recovering from a recession.

Tax cuts are always an attractive option in the political world where budget constraints are often ignored. But in the real world and in real time — where budget constraints bind and opportunity costs matter — policymakers must be mindful of the fact that the effectiveness of any particular tax cut depends on our economic circumstances and goals and how those mesh with the structure of the tax policy.

### **How Reducing Tax Expenditures Would Make for a “Grand Bargain” on Tax Reform**

The most basic role of taxation is to collect funds to pay for publicly provided goods and services, including subsidies for private-sector activities. But we also spend much of those public funds through the tax system via tax expenditures. The special provisions in our federal income tax code — exemptions, deductions, credits, or preferential tax rates — that reduce tax burdens on specific groups are economically analogous to direct spending and have a total cost of about \$1 trillion per year — as much as all discretionary spending combined. If we are to bring greater fiscal discipline to the federal budget, we'll need to carefully evaluate the structure of our tax system in terms of the economic merits of the various provisions, weighing costs against benefits, just as we do when evaluating spending-side programs. Are the tax expenditures justified as having higher net benefits than other spending programs that are being cut? In some cases, are we actually promoting specific activities via tax expenditures that run counter to other fiscal policy goals? If budget analysts started accounting for the longer-term growth of different types of tax entitlements just as we project the growth of different categories of more traditionally defined discretionary and mandatory spending, we would likely find these tax preferences are some of the fastest-growing components of federal spending. And because tax expenditures are created by cutting holes out of a progressive income tax base, their benefits go disproportionately to higher-income households, making them a more palatable target for cuts than most other forms of spending.

Thus, reducing tax expenditures is a strategy that I believe is an essential component of any bipartisan solution to the deficit problem.



Make a Venn diagram of all the specific proposals that the various deficit reduction commissions, study groups, and task forces came up with, regardless of their political leanings, and what does the intersection of the proposals look like? It's big, fundamental, and worth lots of money. That intersection is the proposal to raise more revenue by broadening the tax base. Of all the ways to significantly reduce the budget deficit, base-broadening tax reform has the qualities most likely to appeal to Democrats and Republicans alike.

Reducing tax expenditures is like the fiscal policy version of the old Miller Lite beer commercial: It tastes great *and* it's less filling. Here's why:

**Spending-side blame shouldn't rule out tax-side solutions.** Although the largest projected changes to the federal budget come from rapidly increasing spending on federal entitlement programs, once we consider the reasons for that increase it's unreasonable to think the solution is to just stop it. Given the demographic pressures of an aging population (which we cannot change) and rising per capita healthcare costs (which we don't yet fully understand how to change), a spending-side-only strategy would mean drastic cuts in real, per capita benefits, which I don't believe either political party really wants. Given the level of real entitlement benefits that our society wants to maintain, the problem is as much that revenues can't keep up as it is that spending is growing too fast. That means our historical experience with the level of revenues as a share of our economy (averaging 18 to 19 percent of GDP) is not a guide for what we will need in the future, especially considering that those past levels of revenues haven't even proved adequate to cover spending and have recently sunk to historic lows of just 15 percent of GDP.

**Raising revenue by reducing tax expenditures would shrink, not expand, government.** The Republican pledge on taxes has always been touted as a small-government stance. But some of the most fiscally conservative members of the Republican Party — including Senator Tom Coburn of Oklahoma — now recognize that there's no simple correlation between the level of revenues and the size and reach of government, given the prevalence of tax expenditures. Federal tax expenditures currently total \$1.3 trillion annually — almost exactly as much as all discretionary spending combined.<sup>5</sup> While it's not realistic to imagine eliminating all tax expenditures — or raising that \$1 trillion-plus even if we could because of behavioral responses and the likelihood we'd see some eliminated tax expenditures appear on the direct spending side of the budget — the potential to cut significant levels of subsidies on the tax side of the budget is still huge. President Obama's fiscal commission made that point when it proposed a "modified zero" approach to deficit-reducing tax reform, illustrating the trade-off between a broader tax base (the broadest of which would zero out all tax expenditures) and the marginal tax rates needed to achieve a specified level of deficit reduction.<sup>6</sup>

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<sup>5</sup> Marron, "How Large Are Tax Expenditures?", *op. cit.*

<sup>6</sup>"The Moment of Truth," report of the National Commission on Fiscal Responsibility and Reform, December 2010 ([http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12\\_1\\_2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf)).

**Reducing Tax Expenditures Both:**

<b>"Tastes Great" (Democrats like)</b>	<b>and</b>	<b>"Less Filling" (Republicans like) because it . . .</b>
Reduces deficit on tax side	and	Cuts government subsidies/ "tax entitlements"
Raises revenue	and	Reduces size of government
Enhances progressivity	and	Increases economic efficiency
Avoids cuts in high bang-per-buck, short-term stimulus spending	and	Reduces longer-term deficit to encourage higher saving and economic growth

And tax expenditures don't just imply larger government because of the higher tax rates required to finance the rest of government; they expand government's influence on the economy. Tax expenditures subsidize some economic activities over others. In recasting those tax subsidies in terms of what they would look like if they were run through the spending side of the budget, Donald Marron and Eric Toder of the Tax Policy Center (TPC) estimate that the implied level of government spending rises from roughly 18 percent of GDP to 24 percent.<sup>7</sup> Republicans who continue to claim that any type of revenue increase would expand government are obviously missing this point.

**Reducing tax expenditures is a progressive solution that defies the equity-efficiency trade-off.** Raising taxes progressively (a Democratic priority) does not have to mean raising marginal tax rates on the rich and increasing the distortionary effects of taxes on economic decisions (a Republican concern). A TPC analysis has shown that raising the needed additional revenues to achieve fiscal sustainability from only the top 2 to 3 percent of the population, without any base broadening, would mean that increases in the top federal income tax rates would have to be prohibitively large — getting to Laffer curve levels in excess of 75 percent.<sup>8</sup>

Because tax expenditures poke holes in a progressively structured income tax system (with graduated marginal tax rates), filling in at least a portion of those holes would raise revenue (and cut subsidies) progressively, while

<sup>7</sup> Donald Marron and Eric Toder, "Measuring Leviathan: How Big Is the Federal Government?", presentation for Loyola Law School conference on tax expenditure reform, January 2011 (<http://events.lls.edu/taxpolicy/documents/PANEL2MarronToderSizeofGovernment-presentationFinal01-06-11.pdf>).

<sup>8</sup> Rosanne Altshuler, Katherine Lim, and Roberton Williams, "Desperately Seeking Revenue," Tax Policy Center, January 2010 (<http://www.taxpolicycenter.org/publications/url.cfm?ID=412018>).

smoothing out, instead of exacerbating, the dips and bumps in the tax policy playing field. By reducing tax expenditures, we can achieve a progressive change in tax policy that would avoid the trade-off with economic incentives and growth. Moreover, the progressive rate structure that causes tax expenditures to disproportionately benefit the rich also explains why these tax-side subsidies will grow dramatically in real costs over time as real incomes grow. Just as real bracket creep pushes more and more income into higher marginal tax brackets over time, it will push more and more economic activity into more-tax-preferred status. The single largest tax expenditure in the federal budget, the exclusion of employer-provided healthcare, will grow especially dramatically in cost over time — and the benefits will get more skewed toward higher-income households — as its value rises with the rise in per-capita healthcare costs as well as the growth in real incomes.

Reducing tax expenditures is an inherently progressive policy strategy and can be made as progressive as we want it to be through the use of caps and phaseouts, such as in Obama's proposal to limit the value of itemized deductions to a maximum 28 percent rate. That makes it clear that reductions in tax expenditures are more easily tailored to the progressivity goal if they are modified via the personal income tax, a direct tax on households based on their directly observable levels of income. The healthcare reform bill's approach to paring back the tax expenditure subsidizing employer-provided healthcare — by imposing an excise tax on high-end insurance plans to be paid by the insurance companies (but whose ultimate burden will be felt by households that purchase expensive insurance plans regardless of their income level) — is a prime example of how political concerns can turn good intentions into suboptimal policy.

**Reducing tax expenditures would address both near- and longer-term economic concerns.** There are two sides to achieving fiscal sustainability: the ways we spend, and the means to pay for it. Just mechanically reducing the deficit by cutting spending or raising taxes in any old way is not enough. The policies that reduce the deficit must be thoughtfully crafted to promote a strong economy, both in the short term as we continue to need demand-side stimulus to speed the recovery from an unusually severe recession, and over the longer term, when we should focus on increasing our productive capacity, or the "supply side" of our economy.

It's difficult to find a deficit reduction strategy better suited to addressing both types of economic concerns than reducing tax expenditures. Because tax expenditures disproportionately benefit higher-income households, who are much less constrained and save large fractions of their income, paring back those benefits would be far less damaging to the short-term demand for goods and services than cutting other forms of government spending, which disproportionately benefit lower-income households. And because of the efficiency gains and reduced distortions that come from a broader tax base, reducing tax expenditures is a far better way to raise revenue and reduce the budget deficit (increasing public saving) while minimizing any adverse effects on private sector economic activity (which could come from the alternative of raising marginal tax rates). A base-broadening, tax-rate-leveling, revenue-raising tax reform is a sure thing in terms of boosting national saving and longer-term economic growth through increases in both public and private saving.

**Cutting tax expenditures is the 'tastes great and less filling' approach to solving our fiscal problems.** Even though achieving deficit reduction is naturally unpleasant business, there's something for both sides of the aisle to like about doing it by cutting tax expenditures. Bottoms up!

## Sticking to Pay-As-You-Go Rules to Achieve Sustainable Deficits

For revenues to play any meaningful role in deficit reduction, policymakers will have to set a revenue target somewhere far closer to — ideally, precisely at — current law. The best outcome would be if policymakers agree to strict, no-exceptions, pay-as-you-go rules on expiring tax cuts, which by definition would require current-law levels of revenue. That would allow enough deficit reduction to achieve fiscal sustainability over the medium term of the next 10 to 20 years — long before any entitlement reforms would significantly affect spending levels.

Achieving current-law levels of revenue does not necessarily require letting current law play out — which would be easy, by the way, because Congress and the administration could just go home and do nothing. Here are three broadly different tax policy strategies that could each be consistent with the current-law baseline:

1. *Do Nothing*. Allow all expiring tax cuts to expire as specified under current law. That would mean reverting to Clinton-era marginal tax rates.
2. *Do It Big*. Extend some or all of the marginal tax rates under the Bush tax cuts, but fully offset the costs of extending the low rates by broadening the tax base and reducing some tax expenditures (for example, limiting itemized deductions or reducing the exclusion of employer-provided health benefits). This is the fundamental tax reform approach.
3. *Do It to the Rich*. Extend some or all of the Bush tax cuts — particularly those that affect middle-income taxpayers (lower tax rates, child tax credit, marriage penalty relief) — and fully offset the costs by imposing an extra tax on the very rich, such as a surtax on households with incomes in excess of \$1 million.

How do the three strategies compare in terms of economic effects? Theoretically it seems they would not be as different in their effects on the shorter-term, demand-driven recovery as on longer-term, supply-side growth. Pursuing the second or third option might do less damage to near-term demand than the do-nothing approach. But none of those income tax increases would threaten the recovery as much as the alternatives of spending cuts or letting the payroll tax cut expire.

All three tax policies would achieve the same amount of deficit reduction based on static revenue estimates. But are there potential differences in their dynamic effects on the economy's productive capacity? The higher marginal tax rates under the do-nothing approach are not likely to have much of a disincentive effect on labor supply or saving — as we learned the last time we lived through the Clinton tax rate increases. Those marginal income tax rates, peaking at 39.6 percent, are still relatively low by historical and international standards.

Option 2's fundamental tax reform approach of keeping much of the marginal rate structure while broadening the tax base is best for supply-side effects and overall economic efficiency, because the distortionary effects of taxes on economic decisions would be minimized. Option 3's strategy of raising rates just at the very high end of the income distribution means marginal rates at the top would have to go up substantially more, but it's unclear that the economic incentives of the rich to earn more income would be changed that much as long as their marginal tax rate were still far from 100 percent. Warren Buffett certainly disputes this worry.<sup>9</sup>

Combining all three approaches is possible, too, and makes the revenue target easier to achieve without having to take any one option to an extreme. For example, we could let the top tax rates expire or at least come up a bit (rather than letting all rates expire), reduce some tax expenditures in progressive ways (without eliminating them), and even add a new top bracket around the millionaire level, as suggested by Bruce Bartlett,<sup>10</sup> without having to raise the top rate to the problematic levels suggested by the Tax Policy Center's "Desperately Seeking Revenue" analysis.<sup>11</sup> Increasing the capital gains tax rate to something closer to that on ordinary taxable income could represent a combination of options 2 and 3 — reducing a tax expenditure (the preferential rate) that disproportionately benefits the rich. In fact, various bipartisan deficit reduction groups, including both the Bowles-Simpson (President's) commission and the Rivlin-Domenici (Bipartisan Policy Center) task force, have suggested raising capital gains and dividend tax rates under the individual income tax as a way of paying for lower marginal rates under the corporate income tax.<sup>12</sup> This sounds like raising some tax rates to lower other tax rates, but in fact, it's another application of the guiding principle of economically-efficient, fundamental tax reform: broadening the tax base—in this case by bringing more capital gains and dividend income into the definition of "ordinary" taxable income—to allow reductions in the highest marginal tax rates (here, the top corporate rate, now at 35 percent).

What are the potential differences among those paths politically? Of course, option 1 emphasizes a do-nothing Congress (so why bother keeping them on their job?); option 2 (fundamental tax reform) means policymakers will have to work much harder at actual policymaking and requires more public education, engagement, and support of those efforts; and option 3 is susceptible to the class warfare and redistribution criticisms and partisan battles. I think the politics suggests that some combination of all three ways of getting to current-law baseline revenue levels is probably best.

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<sup>9</sup> Warren Buffett, "Stop Coddling the Super-Rich," *New York Times*, August 14, 2011 (<http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html>).

<sup>10</sup> Bruce Bartlett, "Buffett May Be Right But the Top Tax Rate Is Wrong," *The Fiscal Times*, August 19, 2011 (<http://www.thefiscaltimes.com/Columns/2011/08/19/Buffett-May-Be-Right-but-the-Top-Tax-Rate-is-Wrong#page1>).

<sup>11</sup> Altshuler, Lim, and Williams, *op. cit.*

<sup>12</sup> Howard Gleckman, "Should We Cut Corporate Taxes By Raising Rates on Investors?" Tax Policy Center, TaxVox blog, March 29, 2011 (<http://taxvox.taxpolicycenter.org/2011/03/29/should-we-cut-corporate-taxes-by-raising-rates-on-investors/>).

Must we go all the way to the current-law revenue baseline? Achieving the grand bargain on deficit reduction and going bigger than required with revenues would give us more of a cushion to allow for future waivers of pay-as-you-go rules for truly stimulative tax policies (or spending) that would better qualify as emergency spending. We need to change the question from, "Do we want the Bush tax cuts?" to, "Are the Bush tax cuts the best way to spend \$2.5 trillion over 10 years — for any purpose, be it short-term stimulus or to encourage longer-term economic growth?"

Whichever way we get there, setting our revenue standards to the current-law baseline would get us the more balanced approach to deficit reduction that Americans desire, bring revenues high enough to keep deficits at an economically sustainable level over the medium term (while we continue to work on gradual entitlement reforms), and leave us more flexibility in tax and spending policy to better address and not worsen the ailments in the near-term economy.

Note that revenue levels have huge potential in deficit reduction but aren't the most important factor in determining tax policy's role in stimulating (or contracting) the economy. Big overall revenue losses don't necessarily translate into big increases in the demand for goods and services (and hence the creation or maintenance of jobs in a recessionary economy), if the tax cuts go disproportionately to high-income households and businesses that are least likely to immediately spend their tax cuts. Setting a goal of boosting revenues to current-law levels to be achieved by increasing the overall progressivity of the tax system is therefore likely to both reduce the deficit and provide more effective support for the still-fragile economy. In fact, if some combination of the different approaches to getting to the current-law baseline were taken, we could easily gain enough revenue to be able to apply it to both reducing deficits to economically sustainable levels and temporarily providing more stimulative deficit-financed tax cuts or spending.

Thus, sticking to the current-law revenue baseline really isn't that hard to do, and there are lots of opportunities for our policymakers to actually make better tax policy while doing it. It starts with a simple commitment to strict pay-as-you-go rules on expiring tax cuts, something very easy for members of the debt deal's "super committee" to do right away.

### **Conclusion: Improving Tax Policy and the Fiscal Outlook at the Same Time**

Politically arbitrary labels such as the choice of budget baselines matter a lot, because politicians need these simple metrics to demonstrate their success as policymakers. Republicans will always want to be known as the tax cutters, while Democrats will always push for more progressive taxation. Setting a goal of sticking to the current-law revenue baseline, which is achieved by base broadening rather than higher rates, is a way of honoring the seemingly inconsistent tax policy goals of both parties. It seems reasonable that policymakers should start from a current-law standard, because making changes relative to current *law* is their legislative responsibility, after all, even if the policy-extended baseline is a more accurate reflection of "business as usual."

Economically, however, it doesn't matter if we view such tax policy as raising revenue relative to a current-policy baseline or as keeping revenue constant relative to a current-law baseline. All that matters is that the policy raises enough revenue to keep deficits at an economically sustainable level — where the economy's growth has a chance to keep up with the growth of the debt — while minimizing the distortionary effects of taxation.

No matter how one might choose to interpret it — as a policy change consistent with Republican goals of reducing tax rates and government's interference with market decisions, or as one consistent with Democratic goals of reducing the deficit by progressively raising revenue as a share of our economy — this type of bipartisan tax reform will be crucial to achieving fiscal sustainability. Admittedly, a couple decades from now when the results of any entitlement reforms begin to materialize, we might discover that revenue neutral relative to current law still won't be enough revenue for the long term. But for now I think it's a big enough goal for the tax side of the budget to aspire to, while holding the spending side of the budget to a tight enough constraint to require and inspire some significant progress there, too.