

Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction

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Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for inviting me to appear today to discuss the need for fundamental tax reform.

America's tax system is broken. It's needlessly complex, economically harmful, and often unfair. It fails at its most basic task, raising enough money to pay our government's bills. And it's increasingly unpredictable, with large, temporary tax cuts not only in the individual income tax, but in corporate, payroll, and estate taxes.

For all those reasons, our tax system cries out for reform. Such reform could follow many paths. Some analysts recommend the introduction of new taxes—such as a value-added tax, a national retail sales tax, or pollution taxes—to supplement or replace our current system. Those ideas are worth serious discussion, but in today's testimony, I will focus on a more traditional approach to reform: redesigning our income tax.

My message is simple: the income tax is riddled with tax preferences. These preferences narrow the tax base, reduce revenues, distort economic activity, complicate the tax system, force tax rates higher than they would otherwise be, and

* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its funders, or its trustees.

are often unfair. By reducing, eliminating, or redesigning many of these preferences, policymakers can

- Make the tax system simpler, fairer, and more conducive to America’s future prosperity;
- Raise revenues to finance both across-the-board tax rate cuts and deficit reduction; and
- Improve the efficiency and fairness of any remaining preferences.

I elaborate on these points in the remainder of my testimony.

1. Tax preferences pervade the tax code.

The individual and corporate income taxes together contain almost 200 tax preferences—credits, deductions, deferrals, exclusions, exemptions, and preferential rates. These preferences total more than \$1 trillion annually, almost as much as we collect from individual and corporate income taxes combined (Office of Management and Budget 2010).¹

Of course, identifying provisions as tax preferences is not without controversy. Doing so requires a benchmark notion of an “idealized” tax system. Experts differ on the best benchmark. Government analysts use a comprehensive income tax, with a few adjustments to reflect the practical realities of administering the tax system. But other analysts believe a broad-based consumption tax would be a better benchmark. In that case, several important tax provisions—including accelerated depreciation,

¹ This figure comes with several caveats. First, it reflects only reductions in income taxes; some preferences reduce other taxes. Second, each preference is estimated individually; interactions among the preferences may increase the overall revenue loss (Burman, Toder, and Geissler 2008). Third, the estimates are static—they do not account for how taxpayers might respond if the preferences were eliminated; such responses would likely lower any potential revenue gains. Finally, estimates of how much revenue could be gained from eliminating preferences that change the timing of tax payments—such as accelerated depreciation or deferral of tax on contributions to retirement accounts—differ from the tax expenditure estimates, which assume an alternative tax system was permanently in effect.

lower rates on some capital gains and dividends, and many retirement provisions—would not be identified as tax preferences.

This disagreement reflects a fundamental debate about tax policy, but it does not undermine the larger point that tax preferences are enormous. Most provisions that are preferences relative to a comprehensive income tax are also preferences relative to a broad-based consumption tax.²

2. The first step in any income tax reform should be to broaden the tax base by reducing or eliminating tax preferences.

Tax preferences often distort economic behavior. Taxpayers naturally undertake more of those activities that qualify for preferences and cut back on those that don't. Such responses can be beneficial if they serve a larger social goal—for example, encouraging donations to charity. But that often isn't the case. The mortgage interest deduction, for example, encourages taxpayers to purchase larger homes and to take out bigger mortgages, but does little to increase homeownership.³ It is hard to believe a tax preference that encourages people to go deeper into debt and directs capital into larger homes is socially beneficial.

Tax preferences are also a primary reason that the tax system is complex, costly to administer, and difficult to comply with. Every preference requires extra paperwork and creates new opportunities for error or fraud.

By reducing or eliminating many tax preferences, policymakers could help level the playing field for different economic activities, reduce the degree to which taxes distort economic behavior, and make taxes simpler to file and administer.

² In preliminary work, Eric Toder and I (2011) estimate, for example, that in dollar terms 70 percent of the tax preferences identified by government analysts for fiscal year 2009 would also be preferences relative to a consumption tax benchmark.

³ Toder and colleagues (2010) provide a helpful review of this literature.

3. Policymakers can then use the resulting revenue to lower tax rates, reduce future deficits, or both.

An aggressive effort to trim tax preferences could increase federal revenues by several hundred billion dollars each year. Policymakers should use that money to lower tax rates and reduce future deficits.⁴ Lowering tax rates would further reduce the economic distortions the tax system creates and would encourage economic growth. Reducing future deficits would help tame our federal debt, which threatens to rise to unsustainable levels in coming years.

President Obama's National Commission on Fiscal Responsibility and Reform (2010) and the Bipartisan Policy Center's Debt Reduction Task Force (2010) (on which I served) both endorsed this strategy in their recent deficit reduction proposals. The fiscal commission's "Illustrative Tax Plan" would scale back and redesign many of the largest tax preferences (e.g., mortgage interest, employer health insurance, and retirement saving), eliminate many others (e.g., state and local interest), and use the resulting revenue to

- Cut individual tax rates, bringing today's six brackets (10, 15, 25, 28, 33, and 35 percent) down to three (12, 22, and 28 percent);
- Repeal the alternative minimum tax (AMT), the personal exemption phase-out (PEP), and the phase-out of itemized deductions (Pease);
- Cut the corporate income tax rate from 35 to 28 percent; and
- Reduce the deficit by \$80 billion in 2015 and more in later years.

⁴ There are two ways to reduce tax rates on businesses. The one that has recently received the most attention is reducing statutory tax rates on business income (the corporate rate for most large businesses and individual rates for pass-through businesses). Another approach would be to move toward full expensing of business investment (while eliminating the deductibility of interest); that would lower what's known as the effective tax rate on business investment.

The Bipartisan Policy Center task force recommended a similar reform, eliminating many preferences and fundamentally redesigning those that would remain. Like the fiscal commission, the BPC would then cut individual tax rates (to just two brackets, 15 and 27 percent); eliminate the AMT, PEP, and Pease; and cut the corporate rate to 27 percent—all as part of a larger package that would cut future deficits and bring the federal debt under control.⁵

4. Many tax preferences are effectively spending programs run through the tax code; that poses a challenge for how we talk about tax reform and the size of government.

Tax preferences are often called “tax expenditures.” That moniker reflects the fact that many of these provisions—but not all—resemble government spending programs in their economic and budget impacts. The tax exemption for interest on state and local bonds, for example, provides a subsidy for municipal borrowing. The federal government could accomplish the same goal through an explicit subsidy to state and local issuers, paid out of general revenues. The exclusion for employer-sponsored health insurance could be recast as an explicit subsidy for insurance coverage. The domestic production credit could be replaced with explicit payments to companies engaged in domestic manufacturing. And similarly for scores of other preferences.

These spending-like tax preferences pose a challenge for how we think about the size of government. Analysts usually invoke official budget measures—revenues and outlays—when trying to measure the federal government. For example, we often hear that federal revenues have averaged about 18.1 percent of gross domestic product (GDP) over the past four decades, while outlays have averaged about 20.7

⁵ The Bipartisan Policy Center proposal would also introduce new taxes, most notably a value-added tax.

percent. But those measures are incomplete—and potentially misleading—if some tax breaks are effectively spending programs.

In some preliminary research, my Tax Policy Center colleague Eric Toder and I (2011) have tried to estimate how large the government is when we recognize that many (but not all) tax preferences are effectively spending programs. For fiscal 2007, we estimate that spending-like tax preferences amounted to 4.1 percent of GDP. Adding that to official outlays yields a broader definition of spending, 23.7 percent of GDP in 2007, about a fifth larger than the official 19.6 percent. Similarly, our broader definition of revenues—official revenues plus revenues foregone through spending-like tax preferences—is 22.6 percent of GDP rather than the official 18.5 percent.

These figures illustrate that conventional budget measures understate the extent to which federal fiscal policy affects economic activity. They also suggest that some policy proposals that increase revenues, as conventionally measured, may nonetheless reduce the size of government. If policymakers reduce the tax preference for employer-provided health insurance, for example, that would increase federal revenue but reduce the government's role in private insurance markets.

Advocates of smaller government are often skeptical of proposals that would increase federal revenues. When it comes to paring back spending-like tax preferences, however, an increase in revenues may actually mean that government's role is narrowing.

5. Other tax preferences, however, are not effectively spending programs.

Many observers have recently embraced the idea that tax preferences resemble spending through the tax code. That's a promising development. Unfortunately, that enthusiasm has sometimes led to the misconception that all items identified as tax

preferences are akin to spending. That's understandable given that these items are often called "tax expenditures." But it is not correct. Some items identified as tax expenditures really are tax provisions, and should be viewed and evaluated as such.

As I noted earlier there is a long-standing debate whether the best approach to taxation would be a comprehensive income tax, a broad-based consumption tax, or some combination of the two. Several important features of our tax system are effectively compromises within that debate. Accelerated depreciation, for example, allows businesses to write off their investments faster than under a comprehensive income tax, but slower than the full expensing a consumption tax provides. Accelerated depreciation is flagged as a "tax expenditure" because government analysts use a comprehensive income tax as their benchmark. But that does not mean that accelerated depreciation is a spending program in disguise. Instead, it is a compromise between different visions of taxation.

A related issue arises with the lower tax rates on long-term capital gains and qualified dividends. In this case, the debate is not only between income and consumption taxation, but also about the best way to implement a comprehensive income tax. The lower capital gains and dividend tax rates provide one way to limit the double taxation that can occur when investment income is subject to both personal and corporate taxes. Analysts continue to debate the merits of these lower rates and the extent to which they may allow income to avoid taxation. But, again, those disagreements reflect different visions of taxation, not disputes over hidden spending programs.

6. Many tax preferences provide benefits to millions of taxpayers; they aren't just "tax breaks for special interests."

When discussing the opportunity to pare back tax preferences, commentators often describe them as "tax breaks for special interests," "loopholes," or, more recently, "tax earmarks." Some narrow provisions certainly warrant those names. But the

reality is that many of the largest, most economically relevant tax preferences affect millions of taxpayers:

Table 1. The 10 Largest Income Tax Preferences in 2009 (\$ Billions)

| | |
|--|-----|
| Employer-sponsored health insurance | 144 |
| Employer pensions and retirement plans | 85 |
| Mortgage interest | 79 |
| State and local taxes (property, income, etc.) | 74 |
| Accelerated depreciation | 57 |
| Capital gains | 53 |
| Earned income tax credit (includes outlays) | 49 |
| Child credit (includes outlays) | 45 |
| Capital gains step-up at death | 41 |
| Charitable contributions | 37 |

Source: Office of Management and Budget (2010)

Note: These figures are only for income taxes. Some preferences also reduce payroll taxes; the health insurance exclusion, for example, reduced payroll revenues by \$97 billion in 2009.

As Nina Olson, the national taxpayer advocate (2011), recently put it:

Tax complexity doesn't occur just because of "big money" special interests. It occurs because of the tax provisions that benefit each one of us. We are the special interests. And until we acknowledge that, tax reform discussions will deteriorate into shouting matches and finger pointing about cutting "their" special tax breaks and not "ours."

The road to true tax reform requires each and every one to be willing to stop protecting our own tax breaks long enough to begin a dialogue about what we want our system to look like, so we remain a vibrant nation with a tax system that is transparent to its taxpayers—one that is simpler to understand and comply with. If we want to run business incentives or social programs through that system, then we need to have a way to evaluate those programs so we can describe to their taxpayers what is being done and how effective those programs are.

Americans should understand that to get the benefits of tax reform—lower rates, simpler taxes, and a more vibrant economy—they will need to give up some popular tax breaks.

7. Policymakers should re-evaluate the design of any tax preferences that they decide to keep.

Policymakers will likely want to maintain some current tax preferences. Some preferences may be the most efficient way to accomplish widely shared social goals (e.g., the earned income tax credit). Others may be sufficiently popular that it isn't politically practical to eliminate them entirely (e.g., preferences for homeownership).

In these cases, policymakers should look for opportunities to improve the tax preferences that remain.

Some preferences are needlessly complex and should be simplified. The preferences for low-income workers and families, for example, are notoriously complex; that weakens their effectiveness and imposes unnecessary costs on intended beneficiaries. Analysts have developed various proposals to consolidate these preferences into streamlined provisions for work, children, and child care (Bipartisan Policy Center 2010; Maag 2010; President's Advisory Panel on Tax Reform 2005; President's Economic Recovery Advisory Board 2010)

Other preferences should be redesigned as credits rather than deductions or exclusions. If policymakers want to continue to support homeownership through the tax system, for example, a more effective approach would be to replace the mortgage interest deduction with a mortgage interest credit. The president's fiscal commission suggested one way to do this: a 12 percent, nonrefundable credit on interest on a first mortgage up to \$500,000. This approach would provide a fairer, more uniform incentive for homeownership than today's mortgage interest

deduction, which is available only to itemizers and whose value is larger for taxpayers in higher tax brackets. Other options would make such a credit refundable (thus making it even more uniform) or link the credit to homeownership rather than interest payments (thus avoiding an incentive for greater debt). Similar ideas apply to other preferences structured as deductions or exclusions.

Conclusion

Tax policy experts have long known that high tax rates disproportionately harm the economy. A rough rule of thumb is that doubling a tax rate increases the resulting economic harm by a factor of four. The best tax systems thus keep tax rates low and apply them to a broad base.

America's income tax system violates that principle. Widespread tax preferences narrow the tax base, distort economic activity, and force rates higher than they need to be. That has real economic costs.

At the same time, America faces large deficits as far as the eye can see. Unless Washington demonstrates unprecedented spending restraint in coming years, the pressures of an aging population and rising health care costs will require greater revenues to avoid an unsustainable build-up of debt.

Well-designed tax reform can help address these challenges. By reducing or eliminating many spending-like tax preferences and using the resulting revenue for a mixture of rate cuts and deficit reduction, policymakers could enhance U.S. economic performance and slow the build-up of debt.

Thank you again for inviting me to appear today; I look forward to your questions.

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