COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Let's Get Specific: Tax Expenditures
October 2010

The *Let's Get Specific* series is intended to help focus the national discussion on specific policies that could help to reduce the deficit and create a better understanding of the types of policy changes that will be required. The policies recommended in this series are not necessarily endorsed by all the members of the Board of the Committee for a Responsible Federal Budget.

Tax Expenditure Reform Framework

- **Step One**: Reform Large Tax Expenditures
- **Step Two:** Consolidate and Simplify Overlapping Tax Expenditures
- **Step Three:** Review and Eliminate Other Tax Expenditures
- **Step Four:** Incorporate Tax Expenditures in the Budget Process

Fig. 1: Summary of Recommendations to Reform Large Tax Expenditures

	10-Year Savings ($billions)
Replace Employer Provided Health Insurance Exclusion with a Credit	$600
Gradually Reduce the Mortgage Interest Deduction	$50
Eliminate the Deduction for State and Local Taxes	$850
Put a Floor on the Charitable Deduction at 2% of Income	$200
TOTAL SAVINGS	**$1,700**

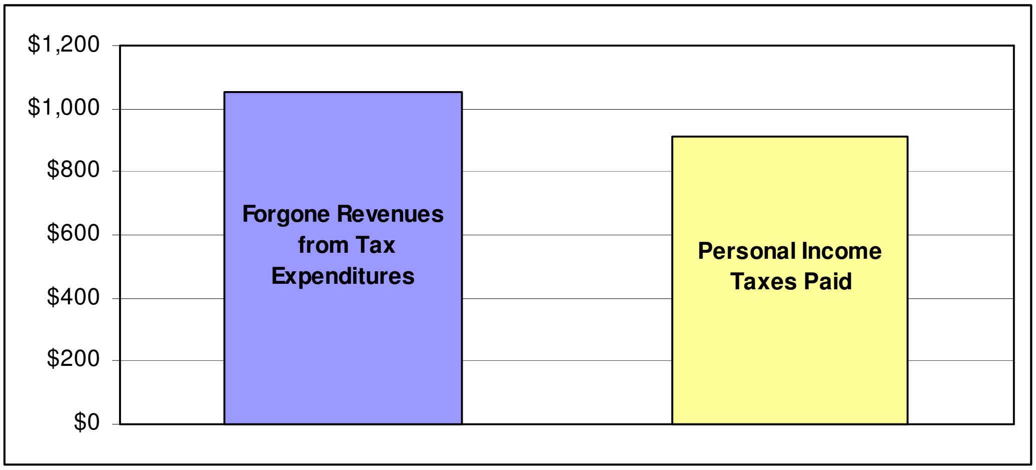
Source: Congressional Budget Office.

Reforming tax expenditures—the diverse collection of tax exclusions, deductions, exemptions, and credits targeted at certain groups—should be at the top of the budget reform agenda. Many tax expenditures often are called "tax loopholes" or "special tax breaks", but most of them bear a far greater resemblance to government spending than taxes. They result in more than $1 trillion in forgone revenue a year – more than 6 percent of GDP. These revenue losses were larger than all income taxes paid by individuals last year. (See Figure 2)

One of the problems—indeed, the great political appeal—of tax expenditures is that they are not subject to annual budget review: they are created without the same level of scrutiny received by other areas of the budget, and then run open-ended with little review. Because they escape the normal budget process, policymakers have found them particularly attractive, and the tax expenditure budget has grown tremendously.

The tax code contains around 250 tax expenditures, double the number from only a few years ago. Adoption of these deductions, credits, exemptions, exclusions, and other tax preferences has undercut the effectiveness, efficiency, transparency, and fundamental fairness of the tax system. The result is a Swiss-cheese tax base filled with rifle-shot tax breaks which, much like entitlement programs, are on automatic pilot and do not receive sufficient scrutiny as part of the budget process.

Fig. 2: Forgone Revenues from Tax Expenditures versus Income Tax Revenues ($billions, 2009)



Sources: Joint Committee on Taxation; Congressional Budget Office.

Revenues will likely have to be part of a plan to rebalance the budget. However, before we consider raising tax rates or introducing a new tax, we should scrub the tax base for unaffordable, outdated, redundant, and inefficient programs running through the tax code, in an effort to improve and simplify the tax code while raising more revenues in a manner that would damage the economy as little as possible.

The last time fundamental base broadening was adopted, tax expenditure reform was the centerpiece of the 1986 Tax Reform Act. Base broadening was also at the heart of recommendations by the President's Advisory Panel on Federal Tax Reform in 2005.[1] The difference this time is that money raised from broadening the base will have to help close the fiscal gap rather than to pay for lower tax rates.

The Tax Expenditure Reform Plan

Step One: Reform Large Tax Expenditures

Four of the largest tax expenditures—the exclusion on employer provided health care, the mortgage interest deduction, the deduction for state and local taxes, and the

[1] The President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, pp.61, 89-93.

deductions for charitable giving—account for nearly half of the lost revenue from all tax expenditures. Additionally, they distort economic activity, which hurts future growth and living standards.

Economists have been recommending for years that we curtail these tax expenditures. Done right, we could raise about $1.7 trillion in additional revenue over the decade. We suggest:

- **Replacing the employer provided health insurance exclusion with a refundable credit.** Many employers provide contributions for health care premiums, which are not counted as income. The tax subsidy means that the price and supply of health care services do not reflect real market demand. As a consequence, market discipline is undercut, which drives up health care costs. The recent health care legislation takes a small first step in limiting effects of the exclusion by placing a 40 percent excise tax on high cost plans beginning in 2018, but it does not go far enough.

  We recommend replacing the current exclusion with a refundable credit that would be phased out for high-income individuals. This strategy would reduce the incentive for employers to offer "gold plated" insurance plans. It would be advisable to wait until 2014 to start this policy, when individuals would have the option of entering the new health exchanges. Levels for credits could also vary based on state-level exchanges to account for geographic differences in health care prices.

- **Reducing the home mortgage interest deduction.** The home mortgage interest deduction allows homebuyers to deduct up to $1 million in borrowing. The policy is regressive (providing larger tax breaks to those well-off enough to purchase more expensive homes), promotes homeownership over other productive investments, and costs the government roughly $100 billion a year in lost revenues. In fact, this deduction certainly contributed to the current housing crisis by both inflating the value of homes and by encouraging over-borrowing. However, phasing down the tax break is tricky, given the current weakness in the housing market.

  We recommend that, beginning in 2013, we gradually reduce the $1 million ceiling to $500,000, while also eliminating the deduction for second homes. If the housing market were not currently so weak, we would recommend much more aggressive changes. Once the housing market has more fully stabilized, policymakers should find ways to further limit the deduction.

- **Eliminate the deductions for state and local taxes.** Individuals who itemize their deductions can deduct state and local income, property, and sales taxes. This state and local tax expenditure is a subsidy for state and local governments, with important distributional implications as well (some states and localities have higher taxes). There is an additional fairness issue: this deduction is more valuable to the wealthy, who itemize more than others. We recommend eliminating this deduction, although a gradual phase-down might be advisable until state and local finances and the economy are on more stable footing.

- **Put a floor on charitable deductions at 2 percent of income.** Individuals who itemize deductions to determine their taxable income can subtract qualified charitable donations. Although this encourages charitable giving, in some cases, it also serves as a windfall to many high income individuals who would have given anyway. By allowing deductions only if contributions exceeded 2 percent of income, the tax break balance would shift in a positive direction: this plan would still provide an incentive to donate, but the government would be able to capture additional revenue. Over the longer term, we would also recommend reevaluating the current definition of charitable activity, which equates organizations that are very different from a public policy point of view.

Step Two: Consolidate and Simplify Overlapping and Inconsistent Tax Expenditures

It is not enough to reform some of the largest tax expenditures. Our tax code has become contradictory and overly complex, and our tax base has dramatically narrowed over the years. The piecemeal adoption of tax expenditures during the past 20 years has contributed significantly to these problems, particularly as policymakers have increasingly relied on tax expenditures to escape normal budget discipline. Unfortunately, with no fundamental tax reform since 1986, we face a maze of often incoherent and competing provisions which may not be the best use of the public purse.

Policymakers need to consolidate and make more consistent the tax expenditures that reflect our top priorities without diminishing much-needed support for our priorities:

- **Improve incentives for savings.** Increasing the national saving rate is an important national priority. While there are several important reasons why people do not save more (including our tax system, which favors consumption), an area for improvement is tax incentives for savings, which are mind-numbingly complex.

  There are currently more than 20 provisions in the tax code which provide incentives for directed saving. For a start, savings accounts for retirement and education could be consolidated, and rules for eligibility, contribution, withdrawal and taxation harmonized - or at least made more consistent.

The recent report of the President's Economic Recovery Advisory Board (PERAB) chaired by Paul Volcker presents eight options along these lines.[2] Examples include consolidating employer-based retirement accounts and simplifying eligibility and contribution rules; or consolidating and separating non-retirement savings. The 2005 President's Advisory Panel on Federal Tax Reform also put forward recommendations for improvement, including broad measures to increase basic savings incentives.

- **Improve the effectiveness of fiscal support for families and children.** While many families can, in principle, claim multiple tax expenditures in a single year depending on their circumstances (such as the dependent exemption, Child Tax Credit, and the Earned Income Tax Credit or EITC), each tax expenditure has a different and complex set of rules. Definitions are often different, too. These tax expenditures should be simplified and redesigned to be more coherent. For example, experts have proposed consolidating family benefits by replacing the EITC with the "Work Credit" and combining the dependent exemption, standard deduction, and child tax credit into the "Family Credit".[3] Simplification of rules is critical, but brings with it challenges in maintaining the right balance among simplicity, targeting, and progressivity. We support consolidation and simplification of these provisions after a thorough review in 2011 when some of them are scheduled to expire, as the Volcker report has just recommended.

- **Improve incentives for education.** In addition to tax expenditures for education savings, there are more than a dozen tax expenditures to encourage educational investment. The myriad of tax expenditures is not the best way to encourage education as a national priority: they are inconsistent, overlapping, and often confusing to taxpayers. Compliance is a problem. Moreover, the subsidies may actually increase the cost structure for education. Replacing the large number of education-related tax expenditures with a smaller number of credits would increase efficiency and effectiveness. With appropriate consolidation and simplification, taxpayer and school paperwork and compliance burdens will diminish, and incentives will become clearer.

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[2] The President's Economic Recovery Advisory Board (PERAB), *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation,* August 2010, pp.23-55.
[3] PERAB, *op.cit.*, pp.8-9; and The President's Advisory Panel on Federal Tax Reform, *op.cit.*, pp.60-61.

Step Three: Review and then Eliminate Other Tax Expenditures

To reform tax expenditures, we also must tackle smaller revenue provisions that have slipped through the tax policy radar screen. While considerably smaller than the worst offenders noted earlier, these tax expenditures still have costs for the economy and our future: they distort marketplace efficiency by tilting economic behavior toward tax-favored activity; they make the tax code overly complex for taxpayers; and they raise fairness issues, all of which can discredit any tax system. In some ways they are like appropriations earmarks: they are not where the real money is, but they need to be cleaned up to build faith that the government is not misallocating taxpayer resources.

There are many other tax expenditures for individuals and companies that could be modified or eliminated, and a thorough review is needed. We recommend setting hard savings targets, engaging in rigorous performance reviews, and then eliminating a sufficient number of tax expenditures to reach theses targets. Figure 3 illustrates the range of unrelated and often puzzling activities for which we give tax breaks. In some instances, it is hard to figure out the public policy principle involved.

Fig. 3: Review and Eliminate Other Revenue Losers

	Estimated Revenue Effects in 2011
End exemption from passive loss rules for rental income	$7 billion
End tax exclusion of individual's income earned abroad	$6 billion
End exclusion for interest on state and local bonds for hospital construction	$3 billion
End tax exclusion, employee parking reimbursement	$3 billion
End oil and gas tax subsidies	$3 billion
End exclusion for interest on state and local bonds for private nonprofit educational facilities	$2 billion
End tax exclusion, employee group term life insurance premiums	$2 billion
End special Blue Cross/Blue Shield treatment	$700 million
End coal tax subsidies	$110 million
End tax exclusion of sports sponsorship payments to colleges	$18 million

Sources: Congressional Budget Office; Office of Management and Budget.

Step Four: Impose the Annual Budget Framework on Tax Expenditures to Improve Fiscal Governance

The fiscal governance of tax expenditures must be improved. For far too long, tax expenditures have received a free pass from the budget process. We recommend placing an immediate moratorium on new tax expenditures, pending the reform of the entire system. Or, as an alternative to a moratorium, Congress and the Administration could create a separate tax expenditure pay-as-you-go regime, so that any new tax expenditures would be paid for by reductions in other tax expenditures, thereby keeping policymakers from further expanding tax expenditures.

Additionally, once policymakers have reviewed and reformed the trillion dollars of individual tax expenditures, they should put hard caps on this area of the budget. This will limit the growth of tax expenditures, along the lines of what needs to be done to other areas of the budget. Finally, tax expenditures should be included in the regular annual budget process and treated more similarly to other spending programs.

Other Possible Reform Options

There are other options for reforming tax expenditures, including:

- Shifting the home mortgage interest deduction into a credit, available to all taxpayers, with the mortgage limited to the average regional price of housing.

- Replacing the income tax exclusion for employment-based health insurance with a deduction. This change would at least start the process of including the fringe benefit as taxable compensation.

- Starting the phase down of the mortgage ceiling for the home mortgage interest deduction later in the decade, when the housing market is on even firmer footing so that we do not add to stabilization problems.

- Limiting all itemized deductions to 15 percent of taxable income.

Alternatively, broader reforms can also be considered. For example, if we cut tax expenditures for individuals on a large scale (by 2 percent of GDP from the current 6.4 percent of GDP), we would lower our national debt by around $4 trillion in 2020, and reduce our debt-to-GDP from 90 percent to 72 percent.[4] Other possibilities are to adopt a multiyear revenue path to reduce tax expenditures as a percent of GDP or to phase-in an across-the-board reduction for all or the largest tax expenditures as a percentage of GDP.

Most of the options discussed apply primarily to individual taxpayers. Tax expenditures for companies also must be reviewed in order to raise revenue, increase economic efficiency, and provide fairness, though it is likely they will be used to pay for revenue-neutral reform of the corporate income tax.

Conclusion

Reforming tax expenditures could go a long way toward closing the fiscal gap. Moreover, the changes would improve the complex and inefficient tax system. Plus, as a matter of fiscal governance, transparency, and consistency, the murky world of tax

[4] Martin Feldstein, "The 'Tax Expenditure' Solution for Our National Debt," *Wall Street Journal*, July 20, 2010.

expenditures needs to be brought into the central budget process. Tax expenditures should be subjected to the same annual scrutiny and discipline as the rest of the budget. In this context, Congress should immediately adopt a moratorium on the creation or expansion of new or current tax expenditures and undertake a thorough review, with the goal of reducing tax expenditures significantly over the next decade. Achieving this goal would enhance our economic efficiency and help us meet the nation's fiscal challenges.