Testimony Prepared for the Hearing:
"Supporting Broad-Based Economic Growth and Fiscal Responsibility through Tax Reform"
Senate Committee on the Budget
May 22, 2013

By Adam Looney
Senior Fellow
The Brookings Institution

Chairman Murray, Ranking Member Sessions, and Members of the Committee: Thank you for inviting me to share my views on the role of tax reform in supporting broad-based economic growth and fiscal responsibility.

The United States faces a daunting outlook for budget deficits, an increasingly challenging global economy for many American workers and businesses, and rising income inequality.

Improvements in tax policy could help address these challenges by making our tax system more fiscally sustainable, more efficient, and more fair. Indeed, any tax reform will be evaluated based on how it affects each of those three criteria.

But improving on all three dimensions simultaneously is increasingly difficult because of tradeoffs between competing goals of efficiency, revenues, and equity.

Today's long-term budget outlook means that we're likely to need higher tax revenues in the future. And rising inequality means that changes in policy will be increasingly scrutinized for how they affect the progressivity of the tax schedule. But a tax reform that devotes revenues to deficit reduction and retains our progressive system would have much more difficulty achieving other goals—such as lowering tax rates.

In my testimony today, I want to describe some of these tradeoffs and some potential paths forward.

Tax Reform and the Budget

Much of the energy surrounding tax reform focuses on the model of the Tax Reform Act of 1986. In that reform, tax rates were lowered substantially and the lost revenue was restored by cutting tax breaks, deductions, exclusions, and other so-called tax expenditures. That reform enhanced economic efficiency without increasing the deficit. In the 27 years since then, however, the economic context has changed, making such a reform harder to achieve.[1]

[1] For a further discussion see: Greenstone, Michael, Dmitri Koustas, Karen Li, Adam Looney, and Leslie B. Samuels. "A Dozen Economic Facts About Tax Reform," The Hamilton Project (May 2012).

First, we face a dire long-run budget outlook; most believe that putting the budget on a sustainable path will require contributions from both spending cuts and revenue increases. Many hope that tax reform can help produce those revenues.

This makes tax reform more difficult because revenues allocated to deficit reduction are revenues that cannot be used to reduce rates, and vice versa.

Moreover, raising revenues and cutting rates at the same time is a tall order. At first glance, the list of tax expenditures is projected to add up to $1.4 trillion in 2015.[2] But that figure dramatically overstates the revenue gains that are available from cutting expenditures.

Some expenditures, including obscure items like imputed rent, would be difficult to eliminate for practical or administrative reasons; others, like credits and deductions for working families with children are integral to combating poverty and encouraging employment. These categories account for roughly one quarter of all tax expenditures.[3] An additional one-third of the tax expenditures arise from the preferential treatment of savings and investment. And the largest non-savings-related expenditures include those for health insurance, mortgage interest, state and local taxes, and charitable contributions. These, and many others, tend to serve substantive goals, remain on the books because they were too difficult to eliminate in 1986, and, as you well know, are backed by popular constituencies.

In addition to political difficulties, there are basic practical issues to consider. Certain tax expenditures exist for the purposes of simplifying the tax system, to reduce record keeping, or to minimize the filing burden on taxpayers. Eliminating those provisions or scaling back others could make the system more complicated and onerous.

Because of such considerations, the Congressional Research Service warns that "it may prove difficult to gain more than $100 billion to $150 billion" each year from reducing tax expenditures.[4] And those estimates are based on a 35 percent top rate; if marginal tax rates were reduced, eliminating a dollar's worth of deductions would raise proportionately less revenue. In other words, if eliminating a dollar of mortgage interest today raised 39 cents, under a top rate of 25 percent, it would raise only 25 cents—37 percent less.

To put these numbers in perspective, in order to be revenue-neutral, the tax plan included in House Budget Committee Chairman Ryan's budget would require eliminating roughly $450 billion worth of tax expenditures each year just to balance out the individual income tax rate cuts targeted in his plan.[5] The plans initially developed by the Domenici–Rivlin Task Force

[2] Marron, Donald B. "How Large are Tax Expenditures? A 2012 Update," Tax Notes (April 9, 2012): 235.
[3] For a description of these expenditures, see Nguyen, Hang, James Nunns, Eric Toder, and Roberton Williams. "How Hard Is It to Cut Tax Preferences to Pay for Lower Tax Rates?" Tax Policy Center (July 10, 2012): Table 1.
[4] Gravelle, Jane G. and Thomas L. Hungerford. "The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening," Congressional Research Service (March 22, 2012): 3.
[5] Tax Policy Center Table T13-0110

and the Bowles–Simpson Commission, which reduce rates and contribute to deficit reduction, likely require reductions in tax expenditures of a similar or larger magnitude.

The gap between the reductions in tax expenditures required by such plans and those that could be agreed upon illustrates the challenge of formulating a plan that achieves both lower rates and higher revenues.

Tax Reform in a Progressive System

A second consideration is the issue of rising income inequality and its relationship to the tax code. Earnings have risen dramatically at the top—by more than 250 percent over the past 30 years for households in the top one percent of the income distribution. At the same time, many households at the middle and bottom have experienced stagnating or even declining earnings. Changes in the tax system over the past 30 years have exacerbated these problems; the very people who have received the biggest income gains in the past three decades have also seen the largest tax cuts. A progressive tax code is perhaps the most significant and powerful tool available to counteract income inequality. Indeed, there are increasing calls for policymakers to use the tax code for that purpose.

Such concerns were much less salient the last time we did tax reform. In 1986, the phenomenon of rising inequality had yet to be fully discovered or understood, and the technical expertise to measure how the tax system affected inequality had yet to be developed.

Today not only are concerns about the progressivity of the tax schedule heighted, but so is our ability to measure how tax changes affect different groups. That raises the level of scrutiny directed to reform and also reveals a substantive tradeoff: that any changes in rates and tax expenditures must balance out within income groups in order to retain a progressive tax structure.

In a series of papers, colleagues at the Tax Policy Center and I analyzed these tradeoffs by examining a hypothetical reform with the stated goals of maintaining tax revenues, lowering marginal tax rates, while at the same time ensuring a progressive tax system.[6] We took as an example a plan that lowered the top rate from 35 to 28 percent and continued the low rates that apply to savings and investment. These rate reductions are roughly the same levels specified in earlier plans from Bowles–Simpson and Domenici–Rivlin, but are substantially smaller than those specified in Chairman Ryan's plan. We asked what it would take to achieve other goals of revenue and progressivity.

[6] Brown, Samuel, William Gale, and Adam Looney. "On the Distributional Effects of Base-Broadening Income Tax Reform," Tax Policy Center (August 1, 2012); Brown, Samuel, William Gale, and Adam Looney. "TPC's Analysis of Governor Romney's Tax Proposals: A Follow-Up Discussion," Tax Policy Center (November 7, 2012); Marron, Donald. "Understanding TPC's Analysis of Governor Romney's Tax Plan," Tax Vox (August 8, 2012); and Nguyen et al. (2012).

In that analysis, we estimated the revenue losses due to lower rates, and then tried to pay for those revenue losses by eliminating tax expenditures. We assumed that certain tax expenditures were off the table because of the administrative difficulty of closing certain breaks; others were off the table because they provided preferential treatment for savings and investment.

Overall, the available tax breaks were enough to offset revenue losses from lower rates. But this resulting tax schedule, we found, was less progressive. Even when we implemented the most progressive way of reducing the remaining tax breaks, there was simply not enough revenue from these breaks in the top brackets to offset the revenue losses from lower marginal tax rates.

This result—that this sort of base-broadening reform led to a less progressive tax system—was true even when we incorporated revenue feedback, not just according to the standard dynamic effects used by Tax Policy Center, Treasury, and the Joint Committee on Taxation, but also additional feedback effects from optimistic estimates of potential economic growth, drawn from theoretical models.

The implication is that such a tax reform must give up on at least one of its stated goals: either higher-income taxpayers would receive a tax cut and middle- and lower-income taxpayers a tax increase; the deficit would go up; preferences for savings and investment would have to be reduced; or marginal tax rates would need to be higher.

Prospects for Reform

Of course, these considerations don't rule out tax reform; indeed, many experts have put forward plans that provide more incremental reforms that simultaneously achieve efficiency gains, higher revenues, and a more progressive tax system. But such plans require substantial compromises.

For instance, certain plans proposed by the Domenici–Rivlin Task Force and the Bowles–Simpson Commission achieve their distributional goals by eliminating preferential rates for capital gains and dividends and curtailing other savings and investment-related tax breaks.

A host of other incremental reforms propose improving the efficiency of the tax system not by reducing rates but by reducing inefficient or wasteful tax expenditures. For example, deductions and exemptions—like for mortgage interest, that currently provide tax savings of up to 39.6 percent—could be replaced with flat credits of, say, 15 percent, providing continued support for homeowners but in a less-costly and more progressive way.[7] An overall limit on the value of tax expenditures at 2 percent of income would provide an across-the-board reduction in costly tax expenditures.[8] The President's Budget includes a provision to limit the amount that certain tax deductions and preferences can reduce tax liability by to 28 percent. And at a meeting

[7] Batchelder, Lily L., Fred T. Goldberg, Jr., and Peter R. Orszag. "Reforming Tax Incentives into Uniform Refundable Tax Credits," The Brookings Institution Policy Brief 156 (August 2006).
[8] Feldstein, Martin, Daniel Feenberg, and Maya MacGuineas. "Capping Individual Tax Expenditure Benefits," NBER Working Paper 16921 (April 2011)

convened by the Hamilton Project last February, a bipartisan group of tax experts presented proposals to reduce benefits from the mortgage interest deduction, subsidies for fossil fuels, preferences for retirement savings, and the overall value of deductions.[9] A common thread is that all of these proposals enhance economic efficiency, raise revenues, and increase progressivity.

Beyond economic appeal, proponents of this approach hope for political appeal. To paraphrase Harvard Professor Martin Feldstein: if Republicans want to reduce the deficit by cutting spending and Democrats want to increase revenues, by focusing on tax expenditures we should find a middle ground.[10]

---

[9] See Alan Viard, "Replacing the Home Mortgage Interest Deduction," Joseph E. Aldy, "Eliminating Fossil Fuel Subsidies," Karen Dynan, "Better Ways to Promote Saving through the Tax System," and Diane Lim "Limiting Individual Income Tax Expenditures" in *15 Ways to Rethink the Federal Budget*, The Hamilton Project (February 2013).

[10] Feldstein, Martin. "A Simple Route to Major Deficit Reduction," The Wall Street Journal (February 20, 2013).