Embargoed Until 2pm
March 23, 2010

Statement of

Leonard E. Burman
Daniel Patrick Moynihan Professor of Public Affairs
Maxwell School
Syracuse University

Before the
Subcommittee on Select Revenue Measures
House Ways and Means Committee

Taxes and the Budget

March 23, 2010

Chairman Neal, Ranking Member Tiberi, Members of the Subcommittee: Thank you for inviting me to share my views on taxes and the federal budget. I applaud the subcommittee for looking at the role of tax policy in dealing with our long-term budget problems.

In summary, I'd like to make three main points:

- Continuing the current course of enormous and growing deficits is not an option. Ignoring budget constraints could produce an economic calamity of unprecedented proportions. And when the budget catastrophe occurs, it will mean confiscatory taxes and an eviscerated government—a nightmare scenario whatever your political orientation.

- The budget cannot be tamed by spending cuts or tax increases alone. The retirement of the baby boomers combined with growing healthcare costs will require revenue increases if we are not to renege on our promises to seniors. But spending cannot be allowed to grow on its current path without crippling the economy.

- The best way to increase tax revenues is through tax reform—making the tax system fairer, simpler, and more conducive to economic growth. This means base broadening—and subjecting the nearly 200 spending programs that are run through the tax code to the same scrutiny applied to direct spending programs.

Avoiding Catastrophic Budget Failure

It has become a cliché to say that current budget trends are unsustainable, and to cite Herb Stein's dictum that if something can't go on forever, it will stop. Stein was clearly correct, but *how* our debt stops growing matters. The best outcome is that it stops growing because policymakers make the hard choice of cutting programs and raising taxes before the economy has suffered any real damage.

A slightly more painful option is that interest rates start to increase to reflect the increasing riskiness of government securities—because higher debt brings with it a risk that the US will either default on some of its debt or be forced to print money to avoid a default, triggering inflation or even hyperinflation. Higher interest rates would bring increasing political pressure to reduce the deficit from businesses that can't afford to invest and consumers who can't afford to borrow to buy a home or car. The downside is that the higher interest rates would also increase government's debt service costs, making the required fiscal adjustments even more painful. And higher interest rates could precipitate a recession (or stifle a nascent recovery).

The worst outcome is that interest rates show no perceptible effect from the US borrowing binge for a long time. Rates may stay low because our foreign lenders have an incentive to keep enabling our borrowing habit. The money they lend us fuels our giant trade deficit, which in turn props up their economies. If they pulled the plug, the dollar would collapse in value and US demand for foreign goods would slow to a trickle. So, in part, our debt habit simply reflects a very dangerous codependency between us and our foreign enablers.

We might hope that financial markets would save us from catastrophe by demanding higher interest rates on Treasuries, but that would require a degree of foresight that we haven't seen lately. Despite some saber rattling from bond rating agencies, our lenders have clearly calculated that Treasuries are a safe investment at low interest rates because as long as we can roll over maturing debt at low rates, we can easily pay the interest our lenders demand.

This dynamic is eerily similar to the bubble logic that overtook the housing market. Lenders concluded that as long as housing prices were growing at double digit rates, almost any borrower was worthy of a mortgage because, under the worst case scenario, the lender could foreclose and sell the house at a profit. Cheap and easy credit boosted demand for homes and kept prices soaring, fulfilling the expectations of lenders—for a while. The problem was that prices couldn't rise forever, and when they stopped, the bubble burst.

The analogy in the government bond market is that at some point investors will decide that lending to the US government is risky and demand a higher interest rate. The higher rate increases default risk as debt service becomes more burdensome, and the higher risk pushes the required interest rate up further. This vicious cycle pushes interest rates ever higher. When the dust settles, the government may only be able to borrow at exorbitant interest rates—or possibly not at all.

That is, the market for government bonds might be a classic bubble. But when this bubble bursts, the government won't have the option to borrow to prop up financial markets if its borrowing caused the crisis.

Unable to borrow, the government will have to cut spending to the bone—including potentially devastating cuts in Social Security, Medicare, and Medicaid—and have to raise taxes to levels never before seen in this country. And even that may not be enough for forestall default. In October 2009, more than $2.5 trillion of debt had a maturity of less than one year. If the government could not roll over that debt, there is no way that it could cut spending or raise taxes fast enough to avoid default. (CBO projected total income tax revenues in 2010 to be about $1.1 trillion, so doubling the income tax—which is neither feasible nor desirable—would not close even half the gap.) As the debt grows, the amount of debt coming due each year—and the size of the potential crisis—will grow as well.

Thus, the Federal Reserve would have to serve as the "lender of last resort" for the US government, massively expanding the money supply. If the bubble burst tomorrow, the Fed might be able to plausibly commit to tightening the money supply in the near future as the federal government ran surpluses to buy back the debt. If investors believed this, we might avoid hyperinflation. But even in this case, investors might be skeptical of any promise of fiscal responsibility from the government that precipitated the crisis. And if the debt were twice as big when the bubble bursts, the government would have no credibility at all.

The consequence would likely involve a long and severe recession or depression and hyperinflation. In their survey of financial crises through the ages, Carmen Reinhart and Ken Rogoff (2009) reported that the average debt crisis of the sort we're likely to experience came with inflation of 9000 percent. That is, after the crisis, a dollar might be worth a little more than a penny.

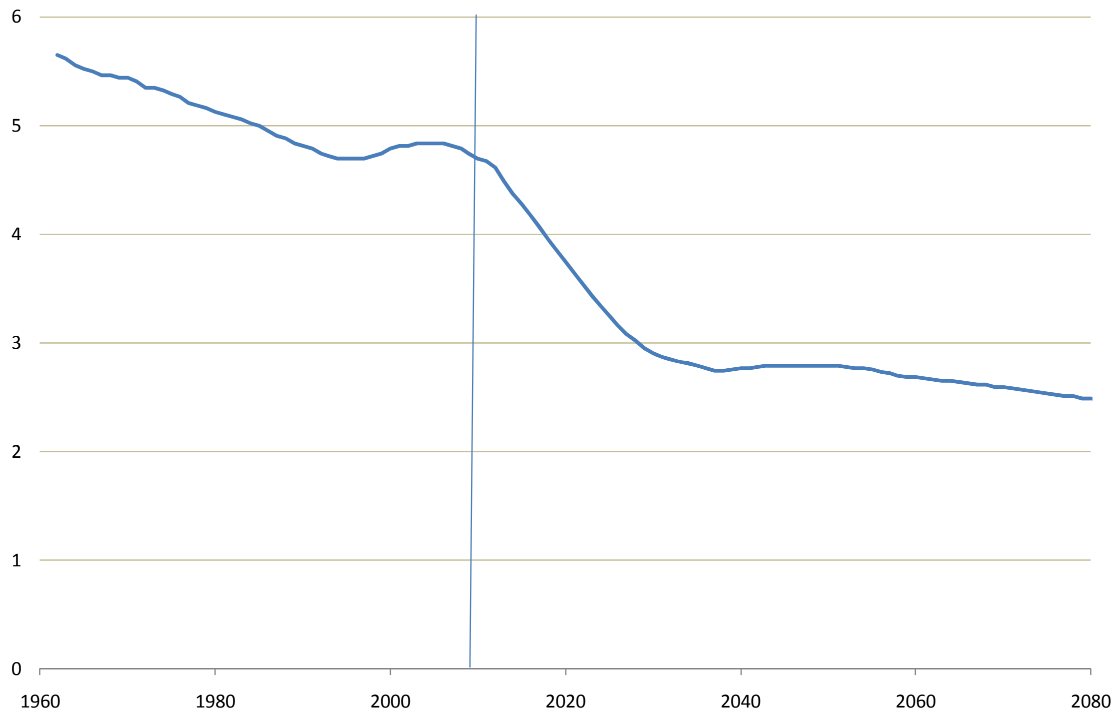
Bottom line: catastrophic budget failure would involve hyperinflation, an eviscerated public sector, taxes that would make a Scandinavian revolt, and a crippled economy. Avoiding that fate should be your highest priority.

<u>Tax Increases are Inevitable</u>

Nobody likes to pay taxes, but there is no practical way to tame the debt without higher taxes unless you are willing to renege on promises made to seniors. Figure 1 summarizes the demographic challenge facing the nation. There are currently about 4.7 working age individuals (ages 20-64) for every person of retirement age (65 and older). But, as the baby boomers reach retirement age, that number plummets to 4.0 in 2018 and just 3.0 in

2028. Some refer to the inverse of this ratio as the "dependency ratio"—a measure of how many retirees depend on Social Security and Medicare for each person working and paying into the system. Even if health care costs weren't growing faster than the rest of the economy, the swelling dependency ratio would require the dwindling share of workers to shoulder larger burdens.

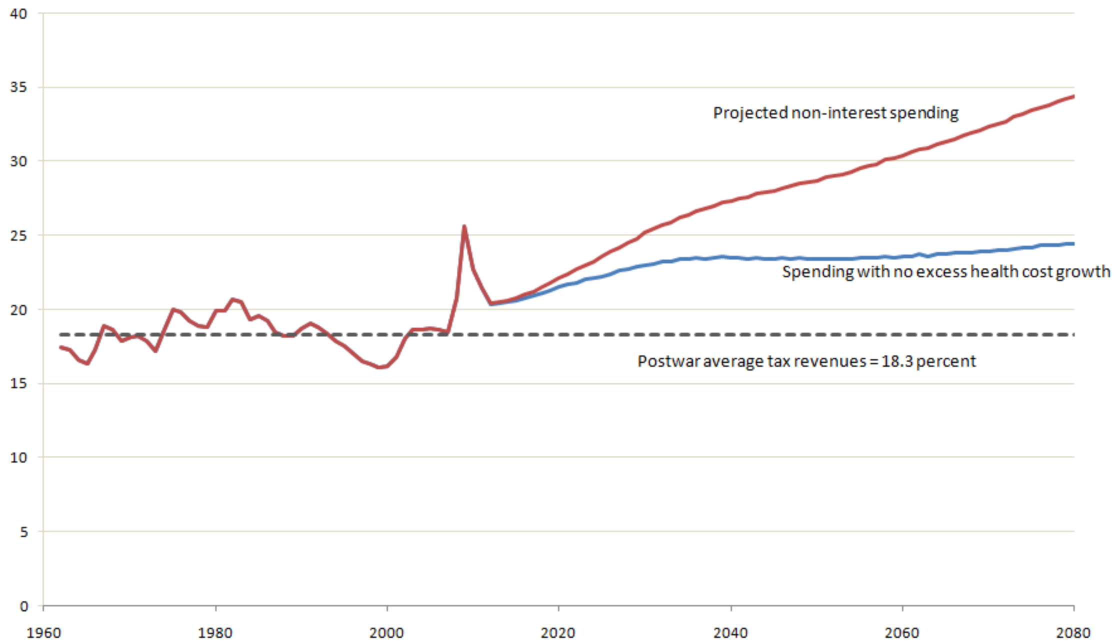
Figure 1. Ratio of Working Age Individuals to Retirees, 1962-2080



Source: Congressional Budget Office, 2009.

The consequence is that either taxes must increase significantly above historic levels to prevent enormous accumulations of public debt, or that government services, especially those benefiting the elderly, must be cut substantially below current levels. Figure 2 shows that even if health care costs grew at the same rate as the economy from 2009 on (rather than the historical average of 2.5 percent per year faster than GDP), primary spending—excluding interest on the debt—would still escalate rapidly from 20 percent of GDP in 2012 because of the demands of aging baby boomers. By 2030, spending would reach 23 percent of GDP. If revenues were kept at their post-war average level of 18.3 percent of GDP, deficits, the debt, and interest payments on the debt would soar.

Figure 2. Projected Non-Interest Federal Spending with and without Excess Health Costs, as Percent of GDP, 2062-2080



Source: Congressional Budget Office, 2009.

In reality, healthcare spending has grown much faster than GDP for decades—by an average of 2.5 percentage points. If it continues to follow that path, spending will increase dramatically. CBO projects that total federal primary spending will exceed 25 percent of GDP by 2030 and top 27 percent by 2040.[1] Clearly, healthcare spending will have to slow or households and governments at all levels will be bankrupted. It is highly unlikely, however, that we can hold the rate of growth of health costs below that of the economy. One reason is that a significant share of healthcare spending has paid for valuable innovations that have improved the quality and length of life. Artificial joint replacements that preserve pain-free mobility for older people are the classic example. Cutler (2005) argues that, given the potential benefits, we are not spending enough on healthcare. Cohen *et al* (2008) argue that spending on preventive care is far below optimum, and Liebman and Zeckhauser (2008) explain why human foibles (procrastination and the tendency to undervalue future benefits relative to current costs) lead people to consume too little healthcare.

Thus, while it is essential that healthcare costs be restrained over the long term, it may be neither feasible nor desirable to shrink healthcare spending as a share of the economy.

[1] As alarming as these estimates are, they assume that discretionary spending both for defense and non-defense purposes will decline as a share of GDP. If that is not true, for example, because of the costs of addressing future security threats or maintaining our crumbling infrastructure, spending could be even higher. The estimates also do not include the effects of healthcare legislation currently being considered by Congress, which could add to or reduce deficits depending on the ultimate design.

Furthermore, tremendous uncertainty exists about future health technology and spending patterns, but past experience is not encouraging. It is highly likely that health spending will compound the long-term budget problem.

It is tempting to wish that we will grow out of the problem, but that is implausible. Most of the factors that have boosted output over the past few decades are unlikely to repeat. For example, the tremendous increase in women's labor force participation was a one-time event.[2]

The greater risk is that swelling national debt will slow economic growth. Reinhart and Rogoff (2010) calculated that countries with debt above 90 percent of GDP grow by an average of 1.3 percentage points per year slower than less debt-ridden countries. (The debt-to-GDP ratio is currently about 60 percent of GDP; CBO projects it will reach 90 percent around 2020 under current policies.) If growth slows, all of the economic challenges that we face will worsen.

Taxes and Economic Growth

With few exceptions, taxes entail economic costs.[3] Some supply-siders have even contended that cuts in marginal tax rates could pay for themselves because the economy would grow faster and generate more tax revenues. Serious analyses of supply-side tax cuts, even by those very sympathetic to the premise that tax cuts can boost economic growth, have all concluded that deficit-financed tax cuts do not pay for themselves over the long run.[4] In fact, if the resulting deficits are ultimately offset by higher tax rates, the ultimate effect is likely to be lower GDP.

This occurs because the cost of taxation grows disproportionately with the tax rate. Thus, if top tax rates are cut from 40 percent to 35 percent for a while, but then raised to 45 percent to pay back the resulting debt, the 5 percentage point increase in rates reduces growth by much more than the temporary 5 percentage point rate cut boosted it.

As a general rule, stable tax rates impose less economic cost than volatile ones. For that reason, it would be far better to raise taxes soon to reduce or eliminate the deficit (after the economy has recovered from the economic downturn) than to postpone action for many years. The longer we wait, the higher tax rates would have to be to restore balance.

[2] For an excellent discussion of this issue, see Minarik (2010).

[3] The exceptions are where taxes mitigate a market failure, such as pollution. The scope for raising revenue from such taxes is not insignificant, but not anywhere near enough to eliminate the long-term fiscal gap.

[4] The Congressional Budget Office, Joint Committee on Taxation, and the Treasury all conducted studies in the early 2000s. They concluded that tax rate cuts could boost the economy in the short-run, but not by nearly enough to offset the direct revenue loss. The long-run effect depended on how the deficits were closed. If the deficits ultimately led to higher tax rates, GDP would be lower than without the tax cuts. If the deficits ultimately led to spending cuts, GDP would increase permanently. In all cases, the effects were small. See Gravelle (2007) for an excellent survey.

And income tax rates of 50 or 60 or 70 percent would entail huge economic costs compared with a 40 percent rate.[5]

Taxing the Rich Won't be Enough

While supply-siders hold out hope that tax cuts can somehow pay for themselves, liberals also cling to their own version of wishful thinking—that tax increases on the rich would suffice. President Obama has repeatedly promised not to raise taxes on households earning less than $250,000 per year. Rosanne Altshuler and colleagues at the Tax Policy Center (2010) estimated how much income tax rates would have to increase—assuming the rest of the Obama budget were enacted—to get the deficit down to an average of 2 percent of GDP from 2015 to 2019. They concluded that rates would have to increase by almost half: the 10-percent bracket would increase to almost 15 percent and the top bracket would increase to 52 percent—a level not seen since enactment of the Tax Reform Act of 1986.

Table 1. Rates Required to Reduce Deficit to Two Percent of GDP from 2015 to 2019

Current Tax Rates	Raise All Rates	Raise Top Three Rates	Raise Top Two Rates
10.0	14.9	10.0	10.0
15.0	22.3	15.0	15.0
25.0	37.2	25.0	25.0
28.0	41.7	60.8	28.0
33.0	49.1	71.7	85.7
35.0	52.1	76.1	90.9

If tax increases are limited to those with higher incomes, the top rates would have to become truly exorbitant to hit the 2-percent deficit target. Raising only the top 3 rates would require a top rate of 76 percent; and raising only the top 2 rates—the policy most consistent with the President's promise to spare the middle class—would require a top rate of almost 91 percent, a level not seen since the Kennedy Administration.

As Altshuler *et al* (2010) point out, those estimates do not account for the increased tax avoidance that high rates would engender. Accounting for such behavioral responses would require even higher rates. It is thus infeasible that the deficit target could be met with tax increases on the rich alone. And, given that the deficit grows ever larger, the target would grow more elusive over time.

[5] CBO estimates that allowing the Bush tax cuts to expire (raising top income tax rates to 40 percent) would reduce the primary deficit (excluding interest) to less than 2 percent of GDP until after 2030. Over the long term, further spending cuts or tax increases would be necessary, but CBO's calculations show that a top rate of about 40 percent could be consistent with a much improved fiscal situation.

Base Broadening and Deficit Reduction

Tax rate increases harm the economy and cannot, by themselves, close the budget gap. In contrast, base broadening can boost tax revenues and make the income tax more efficient, fair, and comprehensible.[6] Loopholes and preferences in the income tax complicate tax preparation and create opportunities for tax avoidance and evasion. For example, long-term capital gains face a 15-percent top rate compared with a 35 percent rate for ordinary income. The capital gains preference has created a whole tax shelter industry designed to convert highly taxed ordinary income into lightly taxed capital gains. The lower rate can distort investment and occupation choices. For example, finance experts who work in the private equity arena are taxed at less than half the rate of bond traders who may work down the hall and do very similar work. Taxing capital gains at the same rate as other income would eliminate those distortions.[7]

The numerous tax preferences in the Code and reduce tax revenues by an enormous amount—over $1 trillion a year.[8] Like healthcare expenditures, they are growing faster than the rest of the economy. Over the next 5 years, so-called "tax expenditures" will reduce federal revenues by over $9 trillion, or 74 percent of income tax revenues. Subjecting tax expenditures to the same level of scrutiny we apply to direct spending programs could improve the efficiency of the government and help tame the budget deficit. And, arguably, since tax expenditures are really just spending programs in disguise, limiting tax expenditures could be seen as consistent with the President's promise to spare the middle class from tax increases. Indeed, the President has proposed to limit cap the growth of discretionary spending. It would make sense to apply the same budget discipline to the far larger category of spending programs run through the tax system.

The concept of tax expenditures is controversial, but it has been around for decades, since Treasury Assistant Secretary Stanley Surrey proposed that deviations from the normal tax rules that serve to benefit a particular group or activity should be considered spending. The basic notion is that a $100 tax reduction for undertaking a particular activity is identical to a $100 cash grant for the subsidized activity in terms of its effect on the deficit and resource allocation.

Conservatives have objected to the notion of a tax expenditure since long before Surrey coined the term. William Gladstone, a Tory member of the British parliament, argued in

---

[6] Saez *et al* (2009) conclude that rate increases entail significant economic costs while base broadening reduces the cost of taxation. Conservative icon Martin Feldstein (2009) made the same argument in a *Wall Street Journal* op ed, arguing that additional revenues are needed and eliminating tax breaks would be far better than raising tax rates.

[7] Numerous other arguments are made for a lower tax rate on capital gains. See Burman (1999) for a discussion and critique.

[8] The estimates in this paragraph are based on the sum of the tax expenditure estimates reported in the *Analytical Perspectives* volume of the federal budget. Adding tax expenditures ignores potentially significant interactions among the different tax subsidies. Burman *et al* (2008) found that including interactions would increase the total by 5 to 8 percent. Thus, the $1.1 trillion sum of tax expenditures in 2010 is likely an underestimate of the total cost.

1863 that the government should monitor the uses of the charitable deduction allowed under the income tax, just as it would any other spending program. The rebuttal from Sir Strafford Northcote could be lifted from the modern ultraconservative's critique of tax expenditures: "The right hon. Gentleman, if he took £5 out of the pocket of a man with £100, put the case as if he gave the man £95…" (Quoted by Neil Brooks, 1986)

For some reason, modern conservatives find this talking point compelling, but I have a hard time understanding why. Virtually any spending program could be converted into a tax expenditure. Why does that sleight of hand inoculate a spending program from scrutiny? The late Princeton economist David Bradford—one of the intellectual forebears of the "flat tax"—used to quip that he could fund the Pentagon with tax expenditures (by, for example, providing refundable tax credits in lieu of cash to arms manufacturers), reducing the size of the recorded defense budget without hurting national security one bit.

To take another example, suppose we offered individuals eligible for Medicare the option of buying their insurance for an actuarially fair premium from the government, in exchange for a tax credit equal to 110% of the premium. Higher-income seniors with sufficient tax liability to use the credit would presumably take advantage of this great deal. It would cut Medicare spending, and cut taxes by even more. Government would appear to be smaller and taxes lower, but in reality, we'd only have complicated tax compliance for seniors and increased the deficit.

The growth of tax expenditures has been fueled by a political environment that favors "tax cuts" over spending, even when a spending program might be more effective. But tax expenditures strongly resemble entitlement programs and can be just as detrimental to the budget over the long term. And they often make the tax system more complex.

Monitoring tax expenditures would require a significant change in the budgeting process as most tax subsidies are now virtual entitlements, continuing (and growing) unless Congress legislates change or repeal. Former JCT chief of staff George Yin (2009) has proposed sunsetting all tax expenditures and requiring periodic reauthorization as for discretionary programs. A less radical approach would be to include the value of tax expenditures with direct expenditures and subject the totals to caps as part of the Congressional budget process. This obviously would create some jurisdictional challenges for Congress (between appropriating committees and the tax-writing committees), but it is, in my view, the only way to get total spending under control. It makes no sense to exempt more than $1 trillion of spending from budget scrutiny.

I'm certainly not proposing to eliminate all tax expenditures. It makes sense to run some programs through the tax system instead of setting up another bureaucracy. I just think we ought to subject these expenditures to the same fiscal constraint and scrutiny that the President wants to apply to other domestic spending programs.

Conclusions and Recommendations

Taming the budget will require both spending cuts and new tax revenues. The best way to raise revenues would be to broaden the base—eliminate or reform tax expenditures that are not serving their purpose with the goal of making the tax system simpler, fairer and more conducive to economic growth. As part of that process, other more efficient sources of revenue such as a VAT should be considered.

The President has signaled that his deficit reduction panel may consider tax reform as part of a package of revenue increases and spending cuts. That's a good idea. However, if Congress makes most of the Bush and Obama tax cuts permanent, as the President proposes, tax reform would become much more difficult. A better approach would be to extend the tax cuts for two or three years and commit to a real process of tax and expenditure reforms to eliminate the primary deficit by a certain date.

References

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

Burman, Leonard E., *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed,* Washington, DC: The Brookings Institution Press, 1999.

Burman, Leonard E., Eric Toder, and Christopher Geissler, "How Big are Total Individual Income Tax Expenditures and Who Benefits From Them?" Tax Policy Center Discussion Paper No. 31, 2008.
http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf

Brooks, Neil, "Review of Surrey and McDaniel,"*Canadian Tax Journal*. Vol. 34, no. 3, pp. 681-694, 1985.

Cohen, Joshua T., Peter J. Neumann, and Milton C. Weinstein, "Does Preventive Care Save Money? Health Economics and the Presidential Candidates," *New England Journal of Economics*, February 14, 2008.

Cutler, David M., *Your Money or Your Life: Strong Medicine forAmerica's Health Care System*, New York: Oxford University Press, Inc., 2005**.**

Feldstein, Martin, "ObamaCare's Crippling Deficits," *Wall Street Journal*, September 7, 2009.

Gravelle, Jane, "Issues in Dynamic Revenue Estimating," CRS Report for Congress RL31949, U.S. Congressional Research Service, 2007.

Liebman, Jeffrey, and Richard Zeckhauser, "Simple Humans, Complex Insurance, Subtle Subsidies," in Henry Aaron and Leonard Burman, eds., *Using Tax Breaks to Reform Health Insurance: Pitfalls and Promises*, Washington, DC: Brookings Institution Press, 2008.

Minarik, Joseph, "Why the Debt Problem Can't Be Solved by Economic Growth Alone," Bipartisan Policy Center (video), 2010. http://bipartisanpolicy.org/news/multimedia/2010/03/18/318-video

Reinhart, Carmen M., and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Foll*y. Princeton University Press. 2009.

Reinhart, Carmen M., and Kenneth S. Rogoff, "Growth in a Time of Debt," *The American Economic Review Papers and Proceedings*. 2010 (forthcoming)

Saez, Emmanuel, Joel B. Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," NBER Working Paper 15012, 2009. http://www.nber.org/papers/w15012

Yin, George K., "Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint," *New York University Law Review*, Vol. 84, 2009