Jobs, Deficit Reduction, Revenues, and Fundamental Tax Reform

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Jobs, Deficit Reduction, Revenues, And Fundamental Tax Reform

By Stephen E. Shay

Stephen E. Shay is a professor of practice at Harvard Law School. He thanks Herbert Bass, Robert Shay, and Patrick Nash for their comments on earlier versions of this article.

In this article, Shay argues that flat opposition to revenue increases has contributed to U.S. economic vulnerability and has had unintended effects, including contributing to increased deficits instead of smaller government. Shay also distinguishes fundamental income tax reform from raising revenues from tax expenditures. He urges President Obama to have Treasury spearhead fundamental income tax reform, within the context of an overall budget framework that includes revenue increases, and to develop detailed proposals to make the individual and corporate income taxes fairer, simpler, and more efficient.

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Two topics promise to dominate American politics in 2012: increasing the number of jobs and reducing the federal deficit. The two are related: Increased employment, aside from its other benefits, would contribute to economic growth and increased tax revenues for the federal government, while the maintenance — let alone the increase — of aggregate demand on which increased employment and economic growth depend will surely be affected by policy choices aimed at reducing the deficit. There is debate whether short-term stimulus would help accelerate growth, but there is a reasonably broad consensus on the need for agreement on long-term policies to achieve fiscal sustainability. Any agreement on sustainable long-term fiscal policies must address questions of the future role and size of government (taking into account commitments already made) and how to raise the requisite revenue.

Some would take one policy — revenue increases — off the table. That is both unwise and arbitrary. Unwise in part because the political inability to use revenue increases has contributed


2A recent study by the Federal Reserve Bank of New York highlights the current failure of aggregate demand and the adverse effect it has had on small business job creation. Aysegul Sahin et al., “Why Small Businesses Were Hit Harder by the Recent Recession,” 17 Current Issues in Economics and Finance 4 (2011).


Our economy is suffering today from an extraordinarily high level of long-term unemployment, with nearly half of the unemployed having been out of work for more than six months. Under these unusual circumstances, policies that promote a stronger recovery in the near term may serve longer-term objectives as well. In the short term, putting people back to work reduces the hardships inflicted by difficult economic times and helps ensure that our economy is producing at its full potential rather than leaving productive resources fallow. In the longer term, minimizing the duration of unemployment supports a healthy economy by avoiding some of the erosion of skills and loss of attachment to the labor force that is often associated with long-term unemployment... Although the issue of fiscal sustainability must urgently be addressed, fiscal policymakers should not, as a consequence, disregard the fragility of the current economic recovery. Fortunately, the two goals of achieving fiscal sustainability — which is the result of responsible policies set in place for the longer term — and avoiding the creation of fiscal headwinds for the current recovery are not incompatible. Acting now to put in place a credible plan for reducing future deficits over the longer term, while being attentive to the implications of fiscal choices for the recovery in the near term, can help serve both objectives.
to economic vulnerability and reduced U.S. policy flexibility. Federal spending is paid for with taxes, fees, and, if the budget is not in balance, federal debt. Federal debt ultimately must be paid with taxes. In other words, federal spending (not paid for with user fees) will be paid for with taxes sooner or later.

A fixed commitment to forgo revenue increases also is unwise because it materially reduces, rather than enhances, the likelihood of reaching agreement on a sustainable fiscal policy for the long term. To date, the leading credible nonpartisan or bipartisan fiscal plans include material revenue increases. Successful post-World War II solutions to major budget shortfalls (each smaller than currently required) all have relied on revenue increases. And a long-term budget solution that does not include increased taxes, even if one could be adopted, likely would lack credibility in the markets.

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Congress’s apparent inability to agree on raising revenues was an important factor in Standard & Poor’s (S&P) downgrade of the U.S. credit rating. The S&P downgrade report cites as one factor “our view of the difficulties in bridging the gulf between the political parties over fiscal policy,” including “containing growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues.” See S&P, “Research Update: United States of America Long-Term Rating Lowered to AA-,” available at http://www.standardandpoors.com/ratings/us-rating-action/en/us/. Irrespective of one’s views on the correctness of the downgrade, the perceived political inability to resort to revenue increases as part of a long-term deficit solution clearly increases the perceived risk of a default and unsettles the markets.

Limitations on revenue increases as a way to address the financing of government programs constrains U.S. policy alternatives. Perhaps most immediately, U.S. fiscal policy is constrained in its ability to respond aggressively to anticipatable potential future fiscal shocks. Also, other policy objectives are constrained, such as U.S. defense and security commitments, as evidenced by proposed reductions in defense spending. Other recent examples of constraint include the range of potential response to unexpected international developments and the size of resources available for disaster relief.


This will be true whether one starts from the current-law or extended policy baseline. See CBO update, supra note 1. The (Footnote continued in next column.)

Flat opposition to revenue increases is an arbitrary policy with unintended consequences. It has encouraged reliance on tax incentives, rather than more transparent government appropriations, to provide government support for an extraordinary range of activities, from oil and gas exploration to borrowing to buy a home (if you have enough deductions to warrant itemizing deductions). Those government subsidies are referred to as tax expenditures. Although a tax expenditure is in form a reduction in tax liability, it is nonetheless an off-budget, indirect expenditure that contributes to the deficit to the same extent as an equal cash expenditure. Moreover, tax expenditures are not subject to the same scrutiny as spending and have grown so much that estimated fiscal 2012 tax expenditures exceed $1 trillion for one year.

Opposition to taxes generally, and to tax increases in particular, is attractive politically. A large number of senators and representatives have pledged not to increase federal income taxes. The objective of the pledge is to stop the growth of government under a “starve the beast” theory, which is premised on spending being restrained within a reasonable period to avoid debt financing getting out of hand. In the United States, limitations on taxes clearly have failed to restrain federal spending. Federal on-budget expenditures have current-law baseline assumes that the Bush tax cuts will not be extended a second time, so it “bakes in” tax increases from current law. The more realistic extended policy baseline assumes extension of those tax cuts and therefore presents a far more daunting deficit challenge.


Office of Management and Budget, “Budget of the United States, Fiscal Year 2012, Analytical Perspectives Table 17.3 Income Tax Expenditures Ranked by Total, Fiscal Year 2012-2016 Projected Revenue Effect.”

As of June 1, 236 representatives and 41 senators, most of whom are Republicans, had signed the pledge. See http://www.atr.org/federal-taxpayer-protection-questions-answers-a6204.

grown from $807 billion (18.3 percent of GDP) in 1986\textsuperscript{15} to $2.9 trillion (20 percent of GDP) in 2010.\textsuperscript{16}

The “no new taxes” pledge sounds like a small government commitment and avoids confronting Americans with the need to limit spending on popular programs. But by failing to impose discipline on the spending side (even while enacting the massive 2001 and 2003 tax reductions), the pledge has become a commitment to deficits and increased federal debt. Debt held by the public climbed from $1.74 trillion (39.5 percent of GDP) at the end of 1986 to $9.02 trillion (62.2 percent of GDP) at the end of 2010.\textsuperscript{17}

It is unrealistic to believe that our need for job growth in the short run and deficit reduction in the long run can be addressed by continuing current tax policies (including extension of current individual tax rates) and relying on spending cuts alone.\textsuperscript{18}

Spending cuts of the size required necessarily would extend beyond discretionary spending categories and would require larger shifts of Medicare costs and reductions in other entitlement benefits than is politically plausible.\textsuperscript{19} The public response to the House fiscal 2012 budget resolution is evidence that there are practical limits on where sus-

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tainable spending reductions can be found.\textsuperscript{20} Republicans should drop their unyielding opposition to using tax increases, including by eliminating tax expenditures and rationalizing the income tax base, as part of an overall plan to restore a sustain-

able fiscal policy.\textsuperscript{21}

President Obama has not been immune to the siren call of limiting options on taxes, having pledged in 2008 not to raise taxes on Americans with incomes under $250,000. He has acknowled-
edged a need for new revenues, but limiting shared sacri
cifice to those with incomes of $250,000 and above is inconsistent with rationalizing many wasteful tax expenditures that benefit middle-
income earners as well as the very wealthy. In exchange for job-creating stimulus, Democrats should open to sharing sacrifice more broadly, but without sacrificing a fair distribution of overall tax burden.\textsuperscript{22}

Importantly, no one is proposing tax increases in the short term. Consistent with Federal Reserve Board Chair Ben Bernanke’s observations, flexibility on including revenue increases as part of a deficit solution does not require nor imply that taxes be increased before the economy recovers.

Much has been said about the prospect of tax reform in the context of deficit reduction efforts. Deficit reduction that repeals inefficient and unfair tax breaks can be consistent with, but should not be
confused with, fundamental income tax reform. That type of reform involves more than looking for revenue offsets in tax expenditures to reduce tax rates. Not all tax expenditures are bad; indeed, many are worthwhile. Moreover, many targeted tax breaks are not labeled as tax expenditures, yet they contribute to the deficit as much as items labeled tax expenditures and actual spending.23

Fundamental income tax reform should not only build the capacity of the income tax to raise revenue, it should make the income tax code a fairer and more efficient instrument suitable for the economy of today and the future, while staying within what is politically practical. The objective of fundamental tax reform should be a more comprehensive income tax base that is simpler and fairer and does not make losers of domestic manufacturers and winners of video game companies with offshore intangibles. Special tax rules for business income should be limited to what is necessary to correct market failures. Individual tax expenditures should address important social objectives that are not better addressed through a spending program. The tax code raises more than $2 trillion a year and affects every part of our $15-trillion-plus economy. Fundamentally changing the tax code is too important and complicated to base on catchy sound bites and lobbyists’ policy prescriptions. And fundamental reform cannot simply be delegated to Congress, because it requires leadership from the president and his Treasury secretary. President Obama should ask Treasury to begin a process that will result in a detailed proposal for fundamental income tax reform — to improve and simplify the individual and business income taxes to raise the revenue needed under an agreed budgetary framework, along with an analysis of its budgetary, economic, and distributional effects.24 It is critical for both the executive and legislative branches to invest the time, resources, and open processes necessary to get it right.25

More immediately, there needs to be leadership in fiscal policymaking, or the direct and indirect costs of lack of growth and increased debt will be borne by future generations of Americans. It is time to put everything on the table, including revenue increases, and for our leaders to have the courage to make decisions on the budgetary framework for the coming decade. That effort can provide a framework within which Treasury can develop detailed proposals to rehabilitate the individual and corporate income tax system so that it is fairer, simpler, and more efficient.


24It simply does not make sense to reform the corporate tax without also addressing shareholder taxation and business income earned by business owners through passthrough entities.

25The president should delegate that task to the Treasury secretary and Treasury’s Office of Tax Policy. The relevant tax policy expertise exists nowhere else in the administration. Congressional leadership should use the expertise of the tax-writing committees and the Joint Committee on Taxation.

The Tax Reform Act of 1986 was the product of three years of work, starting with a year of work by the Office of Tax Policy in 1984 to develop a proposal after several tax reform plans had been proposed. (One-year commissions that are fully staffed (Footnote continued in next column.)