

**The Role of Tax Reform in Deficit Reduction  
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**Edward D. Kleinbard**

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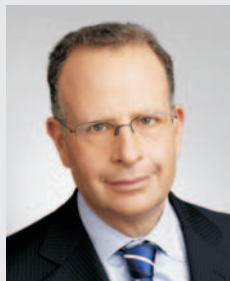


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## The Role of Tax Reform in Deficit Reduction

By Edward D. Kleinbard



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Income tax reform discussions too often are exercises in tax nostalgia. The Tax Reform Act of 1986 was revenue neutral because it could afford to

be. (It also was preceded and followed by major tax increases.) The fact that we must raise revenues today means that a contemporary incremental income tax reform effort will look different, not that it is impossible.

Unlike in 1986, when the tax system overflowed with unintended tax shelters that could be cleaned up and traded off against lower rates, modern tax reform must tackle some of the deliberate congressional subsidy programs baked into the tax code, which is to say, tax expenditures. Of those, the most

important to address are the personal itemized deductions. They are extraordinarily costly — about \$250 billion a year in forgone tax revenues. And they are inefficient, poorly targeted, and unfair.

The personal itemized deductions invariably are described as political sacred cows. But they are sacred cows that we can no longer afford to maintain. Either we eliminate these sacred cows or we allow them to stampede over us.

Incremental income tax reform also must address the corporate income tax, but here there is no choice but a revenue-neutral approach, because the U.S. corporate rate is now a global outlier. A corporate tax reform package should be designed along the following lines: eliminate business tax expenditures; reduce the corporate tax rate to the 25 to 27 percent range; and tax multinationals on their worldwide income through worldwide tax consolidation. The resulting corporate tax system would represent a huge competitive boost for American domestic firms, attract inward investment, and provide a fair tax environment for U.S.-based multinationals.

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This report is based on testimony prepared for a hearing held by the Senate Finance Committee's Subcommittee on Fiscal Responsibility and Economic Growth on September 13. The report explores technically straightforward incremental reforms to the individual and corporate income tax systems that respond to the country's immediate fiscal imperatives. It does not address new revenue sources, such as VATs.

### I. Summary

There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. By contrast, there is no consensus about the role of incremental tax revenues in redressing those unsustainable policies, or the design of the federal taxes that might be employed if Congress were to seek to raise additional tax revenues. This report argues that the country has no

choice but to accept significantly higher tax revenues. In light of the need to respond promptly to the federal fiscal crisis, and the technical difficulties associated with designing and implementing large-scale tax reform packages, the report ignores radical revisions to the suite of federal taxes on which the government currently relies; instead, the report identifies incremental reforms that are technically feasible and that are as economically efficient as possible, given the country's revenue constraints.

America's long-term fiscal problem is entitlements spending, particularly spending on healthcare. The United States today spends much more on healthcare per capita than does any other developed economy in the world. If the United States were to expend per capita what Norway (the second-place country) does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some \$800 billion/year.

Current levels of non-defense discretionary spending are moderate by world norms, especially if one discounts for the temporary crisis-related spending programs. This "spending" includes some items, like infrastructure, that are bona fide investments with long-term economic benefits. Defense discretionary spending, by contrast, is the other great outlier in U.S. government spending policies. By one estimate, the United States spends as much on its military as do the next 14 countries combined — 42 percent of the entire world's military expenditures.

Unless we completely rethink our defense policies and reinvent our healthcare system overnight, spending cuts cannot by themselves fund all our deficit reduction requirements in the medium term. Whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turn means higher tax revenues than those we currently collect. Tax reform and tax policy thus are highly relevant to the medium-term horizon. This period must serve as the bridge from where we are to the more sustainable package of government spending and taxing that we need to reach.

Congressional Budget Office projections show us running deficits (albeit relatively small ones) 10 years from now, even with the assumptions that (i) we enjoy uninterrupted growth over those 10 years and (ii) the "Bush tax cuts" (more neutrally, the "2001-2003 temporary individual tax discounts") will all expire at the end of 2012. By contrast, extending these tax discounts indefinitely will add some \$4.6 trillion to our cumulative deficit over the next 10 years.

We therefore have no practical choice but to raise the level of tax collections in the medium term when compared with current rates. Fortunately, the

United States today is an extraordinarily low-taxed country by world norms — the fourth lowest in the OECD. And even by our own standards we are collecting historically low levels of tax — below 15 percent of GDP for 2009-2011. This level of revenues cannot be reconciled with our outsized spending on healthcare and defense.

The CBO baseline effectively must serve as the tax reform revenue collection base case. This implies federal tax collections in the range of 20 percent of GDP, to finance our gradual transition to more sustainable long-term entitlement policies. Discretionary spending cuts also will be useful, but they cannot handle the entire burden if we are to maintain even minimum levels of developed country government services.

We can do better than this base case. We should assume the lapse of the 2001-2003 temporary individual tax discounts and the other points summarized above, and ask, how can we raise about the same amount of revenue, or maybe a little more, but in a smarter way?

This means that we must abandon our nostalgia for the Tax Reform Act of 1986. That tax reform effort was revenue neutral because it could afford to be. (It also was preceded and followed by major tax increases.) The fact that we must raise revenue today means that this tax reform effort will look different, not that it is impossible. We should not hold ourselves prisoners to tax nostalgia.

Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-2003 tax discounts and the new very-high-income bracket proposed above) requires broadening the tax base. Unlike in 1986, when the tax system overflowed with unintended tax shelters that could be cleaned up and traded off against lower rates, this means directly tackling some of the deliberate congressional subsidy programs baked into the tax code, which is to say, tax expenditures.

Of all current law's tax expenditures, the most important to address in tax reform are the personal itemized deductions, such as the deductions for home mortgage interest, charitable contributions, and state and local taxes. They are extraordinarily costly subsidies — about \$250 billion a year in forgone tax revenues. They are inefficient, in that they lead to major misallocations of economic resources, particularly regarding housing. They are poorly targeted, in that the government subsidies go to individuals who would have behaved the same without the subsidies. And they are unfair, in that they are upside-down subsidies — they subsidize high-income Americans more than low-income ones.

The Tax Policy Center has estimated that eliminating the subsidies for personal itemized deductions would increase tax revenues in the neighborhood of 1.5 percent of GDP, over and above the lapse of the 2001-2003 temporary tax discounts. This is an enormous revenue pickup; it could be used for deficit reduction or to mitigate the tax rates implicit in the base case.

Tax reform also should address the corporate income tax. Its 35 percent rate is much too high by current world norms. At the same time, U.S. multinationals have become extremely adept at gaming the current U.S. system, and those of other high-tax countries around the world, through the production of what I call “stateless income” — income that is taxed essentially nowhere. The U.S. corporate tax base is being systematically eroded through these stateless income tax planning strategies. A revenue-neutral corporate tax reform package must address both our high marginal rates and the corrosive effects of stateless income tax planning.

## II. Thinking About the Deficit

There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. This report therefore makes only a few brief observations about our overall deficit trends.

First, the passions of our fractious political dialogues often make it difficult for us to think objectively about our problems. Like a couple with marital difficulties, we might sometimes benefit from considering the perspective and advice of dispassionate outside professionals. In this regard, the OECD — a supranational organization of more than 30 member countries, most of which have developed economies with at least some similarities to that of the United States — and other international organizations such as the IMF have done a great deal of useful work showing how the United States is doing in comparison with other countries, and drawing from that work some straightforward advice. By concentrating on cross-country comparisons, this work supplements the nonpartisan and enormously valuable analysis provided by the CBO, the Congressional Research Service, and the staff of the Joint Committee on Taxation.

Second, in grappling with the enormity of our adverse budget deficit trends, it is extremely helpful to divide our problems into three time buckets: the short-term (perhaps the next two years), the medium-term (years 2 through 10), and the long-term (the next several decades).

### A. Short Term

The short-term fiscal crisis is not a crisis in financing the national debt; Treasury borrowing rates are at near-record lows. Nor is there a crisis in

the availability or cost of capital for the private sector, except perhaps in some continued difficulty in access to bank borrowings by small or less creditworthy firms.<sup>1</sup> Instead, we face an immediate jobs crisis. This topic, however, is far afield from the focus of this report, and tax reform would have little immediate impact on this problem.

### B. Long Term

The long-term fiscal crisis confronting our country is in large measure a spending problem, driven to a surprisingly large degree by one paramount issue — healthcare spending — and to a much lesser extent by Social Security. The CBO has projected that government spending on Social Security and healthcare will amount to 12 percent of GDP in 2021. In 2007 that figure was 8.2 percent, and in 1970, 3.8 percent.

These adverse spending trends reflect to a significant extent the inescapable demographic fact that our population is growing older.<sup>2</sup> That fact in turn has direct implications for the level of tax revenues required to provide basic services to an aging population and also to the design of these entitlements programs.

OECD data are extremely useful in helping us see just what an outlier the United States is today regarding healthcare costs. The United States spends much more on healthcare than does any other developed economy in the world. This is true when measured as a percentage of GDP. (Figure 1.) It also is true when measured as dollars spent per capita.

In 2009, for example, the United States spent \$7,960 per capita on healthcare, by far the highest in the world; the next most profligate country, Norway, spent \$5,352 per capita.<sup>3</sup> If the United States were to expend per capita what Norway does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some \$800 billion per year.

More remarkably, the United States today is second in the world (only to Norway) in *government* spending per capita on healthcare.<sup>4</sup> Our federal, state, and local governments today spend more per capita on healthcare than do the governments of Canada, Denmark, Germany, or Switzerland. Our extraordinary profligacy in government spending

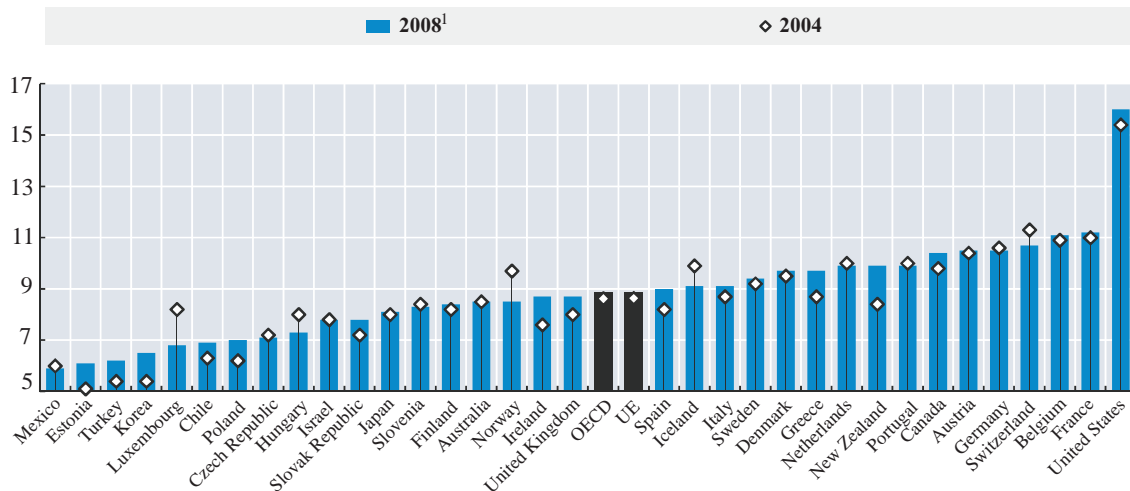
<sup>1</sup>See, e.g., Richard Bravo, “Bank Loans to Companies Defying U.S. Slowdown,” Bloomberg News, Sept. 7, 2011.

<sup>2</sup>This, of course, is a universal phenomenon in developed countries. See, e.g., OECD, *OECD in Figures 2009*, at 6-7.

<sup>3</sup>OECD Health Database 2011, Table: Total expenditure on health, /capita, US\$ purchasing power parity, available at [http://www.oecd.org/document/16/0,3746,en\\_2649\\_37407\\_208520\\_0\\_1\\_1\\_1\\_37407,00.html](http://www.oecd.org/document/16/0,3746,en_2649_37407_208520_0_1_1_1_37407,00.html).

<sup>4</sup>*Id.*

**Figure 1. Healthcare Expenditure (percentage of GDP)**



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.  
<sup>1</sup>2007 for Australia, Denmark, Greece, and Japan; 2006 for Portugal.  
 Source: OECD, *Health Database* (2010).

on healthcare has nothing whatsoever to do with the Patient Protection and Affordable Care Act (PPACA), which was not even enacted in 2009 (the year covered by the data), and which in fact is projected by the CBO to mitigate somewhat the accelerating path of government healthcare spending.

And, of course, in return for this profligate spending on healthcare, the United States enjoys poor health outcomes. Our life expectancy, for example, is at the bottom end of the OECD, well below that of the countries mentioned above.

In short, the government’s long-term *fiscal* health depends directly on grappling much more fundamentally than we have to date on how we provide *physical* healthcare services to our citizens.<sup>5</sup> But change in this area will be challenging, and as Sen. Baucus has pointed out, in situations like this it is important that you “boil the frog slowly”<sup>6</sup> by relying on long transition periods to move from where we are to where we need to be, without unfairly upsetting settled expectations and modes of healthcare delivery systems. *In the meantime, however, the resulting costs must be financed.*

**C. Medium Term**

Tax policy and tax reform are most directly relevant in the medium term (years 2 through 10,

for example), as we begin the transition from unsustainable long-term government entitlement program spending patterns to more efficient ones. The medium term is the critical budget reform time frame because it can function as the bridge from where we are to a fundamentally different package of government services and revenues. By developing and implementing sensible long-term policies today with appropriate transition periods, we can reorient public thinking to accept this different long-term environment, demonstrate congressional commitment to making hard choices, and address the concerns of the financial markets.

Government discretionary spending has been on a decades-long downward trend, interrupted only by the emergency spending to deal with the Great Recession.<sup>7</sup> Regardless of what one thinks about the efficacy of those programs, they were in fact temporary and will not contribute further to the deficit in future years.

In general, our non-defense discretionary spending today is modest by world standards.<sup>8</sup> Moreover, our standard budget presentation of discretionary “spending” is a hopeless muddle, because it mixes what in a private business would be treated as

<sup>5</sup>CBO, “CBO’s 2011 Long-Term Budget Outlook” (June 2011), at 45-47, *Doc 2011-13600*, 2011 TNT 121-21.  
<sup>6</sup>Cf. [http://en.wikipedia.org/wiki/Boiling\\_frog](http://en.wikipedia.org/wiki/Boiling_frog).

<sup>7</sup>See, e.g., CBO, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021” (Jan. 2011), Figure 3-3 at 79, *Doc 2011-1753*, 2011 TNT 18-16.

<sup>8</sup>This is particularly the case if veterans’ benefits and services are properly re-characterized as a component of defense spending, rather than as non-defense discretionary spending (the current budget presentation).

current expenses (salary for government employees, for example) with items that a private firm would properly characterize not as an expense, but as the purchase of an asset — for example, investment in infrastructure. In effect, we confuse income statement and balance sheet items. In doing so, we overstate government non-defense discretionary spending.

By contrast, the U.S. military budget is a discretionary spending outlier. We all are proud of our Armed Forces and are grateful for their work in keeping our country secure, but I nonetheless suspect that it would come as a surprise to many Americans to learn that, by at least one third-party estimate, we spend more on our military services than do the next 14 largest militaries *combined* (in fact, we account for 42 percent of the world's total military expenditures) and more per capita than does Israel, for which existential threats are arguably much more immediate.<sup>9</sup>

This suggests to me that with the possible exception of our defense spending, discretionary spending cuts can make at most only a modest impact on the federal budget deficit in the medium term. And if one further accepts the maxim that one must boil the entitlements spending frog slowly, that leaves larger tax revenues as the only means of financing the policies to which we already are largely committed.

In this connection, an OECD Economics Department Working Paper from a year ago that reviewed the U.S. federal budget trajectory offered a useful suggestion for our medium-term fiscal goals. That study suggested that our medium-term goals should be a budget deficit of 3 percent by 2015 and zero by 2020; to do so, the report concluded, will require some “modest” increases in tax revenues.<sup>10</sup>

To be clear, both the American people and the financial markets want to see that the United States has reoriented itself to long-term fiscal sustainability, but that does not mean that we have to reach budget surplus in three years or that we have to rip out our healthcare system overnight. What we do need in the medium term is to establish a coherent long-term plan, demonstrate a commitment to stick with the plan, and be willing to finance our transition to that plan.

<sup>9</sup>Stockholm International Peace Research Institute, *Yearbook 2011*, at 183.

<sup>10</sup>Patrick Lenain et al., “Restoring Fiscal Sustainability in the United States,” OECD Economics Department Working Paper 806 (Oct. 25, 2010), at 12-14.

### III. Tax Collections and Deficit Reduction

Bipartisan majorities on the recent deficit reduction panels (for example, the Bowles-Simpson and Rivlin-Domenici commissions), major nonpartisan studies (for example, the Peterson-Pew Commission on Budget Reform's report), the OECD, and thoughtful budget experts like Robert Greenstein at the Center on Budget and Policy Priorities, Alan Greenspan, and Martin Feldstein have all agreed that tax revenues must rise from their current levels in order to finance our government. Bluntly, there is no other alternative.

The most recent CBO “baseline” projections show the United States continuing to run federal budget deficits over the next 10 years, albeit at levels that decline substantially, especially after 2012, so that by the end of the period, deficits will be in the neighborhood of 1.2 percent of GDP per annum (assuming the effectiveness of the deficit reductions to come from the Joint Select Committee on Deficit Reduction) — a level at which federal debt held by the public (in effect, the cumulative tally of past deficits) will start to decline.<sup>11</sup> Given the uncertainty associated with all budget projections, and in particular their great sensitivity to unpredictable economic developments, these baseline projections can be understood as at best sounding a note of cautious optimism. Many observers no doubt would argue, to the contrary, that projections of any deficits at all 10 years in the future are wholly unsatisfactory, given that the projections assume continuous economic growth for the next 10 years.

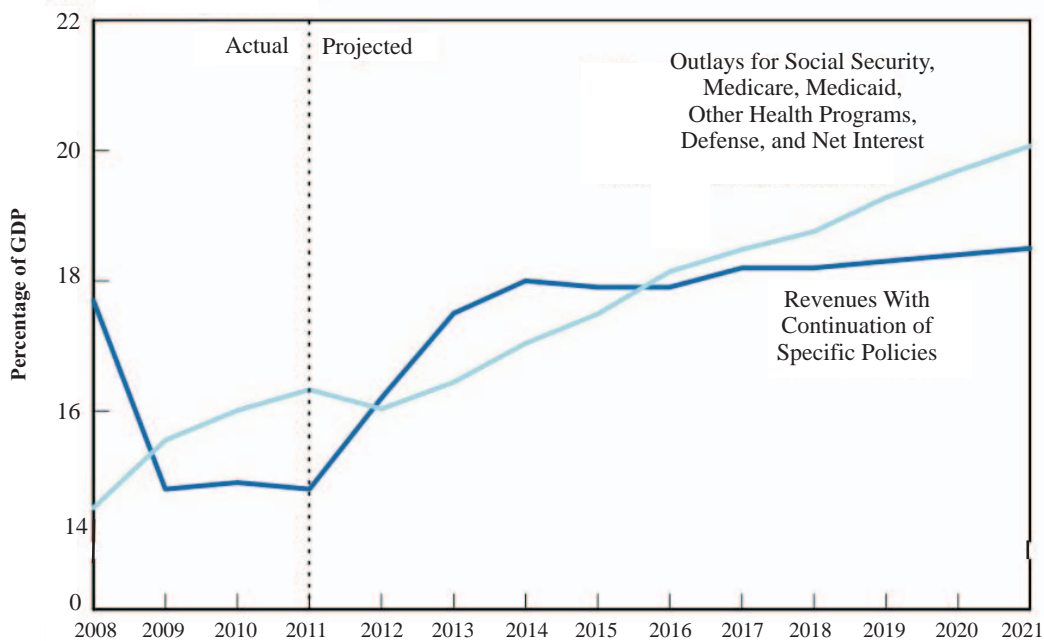
These baseline projections assume the expiration of the 2001-2003 temporary tax discounts. As a result, the baseline projections predict that federal tax revenues will rise to just below 21 percent of GDP by 2021. This level of tax revenues is significantly higher than the historic average of the last several decades up to the Great Recession, of about 18.4 percent.

The prospect of tax revenues running at the rate of about 21 percent of GDP is plainly unpalatable to many. But to put matters starkly, extending the 2001-2003 individual tax discounts indefinitely by themselves would add an additional \$4.6 trillion to the CBO's baseline deficits over the next 10 years.<sup>12</sup> And if the 2001-2003 temporary tax discounts and other associated current policies were all extended indefinitely, deficits at the end of the 10-year period would basically revert to levels approaching 5 percent of GDP per annum, and federal debt held by

<sup>11</sup>CBO, “The Budget and Economic Outlook: An Update” (Aug. 2011), Summary Table 1-2, at 4-5, *Doc 2011-18102*, 2011 TNT 165-18.

<sup>12</sup>*Id.* at 26.

Figure 2



Source: Congressional Budget Office (data does not reflect August 2011 update).

the public would spiral upward.<sup>13</sup> No one would recommend that the country set out to follow this budget trajectory.

Put another way, CBO projections demonstrate that the continuation of current revenue and entitlements policies would mean that the federal government would run a deficit in the coming decade even if it were to spend *zero* on all non-defense discretionary spending programs. (Figure 2.)

This means that whatever the long-term world we transition to, we will need to finance the costs of getting there; that in turn means higher tax revenues than those we currently collect.

This conclusion sits badly with some. They like to point out that high taxes impede economic growth and job creation. These sorts of nostrums have as much policy utility as the old adage that, all other things being equal, it is better to be rich and healthy than poor and sick. Tax revenues need to increase not because higher taxes are desirable as an independent goal, but because there is no other choice as part of a transition from current policies, which in turn have been shaped by both political parties over many decades.

Fortunately, we begin with such an extraordinarily low level of federal tax collections in the United

States that it is feasible to raise tax collections over the next several years without unduly disrupting the U.S. economy. The CBO and the JCT predict that for fiscal 2011, revenues will equal only 14.8 percent of GDP; fiscal 2009 and 2010 were also below 15 percent. Over several decades leading up to the collapse in revenue collections during the Great Recession, revenue collections averaged about 18.4 percent of GDP; in 2000, when the United States last produced a budget surplus, revenues were well in excess of 20 percent of GDP, yet the economy was robust and job creation was strong. If in fact we collected tax revenues for this year at the historic rate of 18.4 percent of GDP, this year's budget deficit would be some \$538 billion smaller than we currently expect.<sup>14</sup>

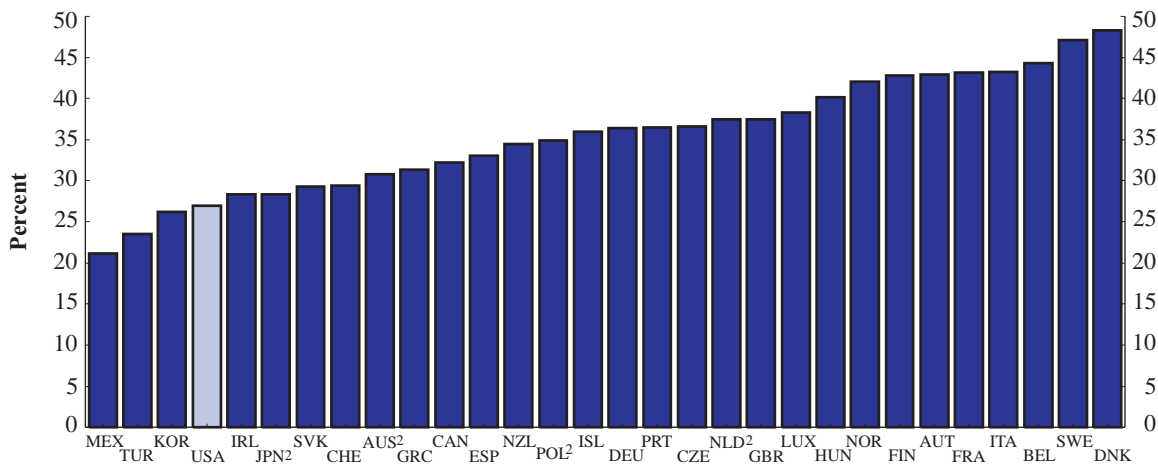
More generally, and without regard to the current collapse in tax revenues, the United States is an extraordinarily low-tax country by world norms. Here OECD comparative data (which combine national and subnational taxes) are extremely helpful. (Figure 3.)

As described earlier, at the same time that the United States imposes tax burdens close to those of Turkey or Mexico, we finance a military bigger than

<sup>13</sup>*Id.*, Summary Figure 1 at xii.

<sup>14</sup>Obviously the text assumes that GDP would be unaffected.

**Figure 3. The U.S. Tax-GDP Ratio Is Low by OECD Standards<sup>1</sup>**  
(in percent of GDP, 2008)



<sup>1</sup>The Revenue Statistics database contains data provided by the national tax authorities, which are generally based on standard national accounts definitions and methods. However, divergences with the national accounts exist in some areas. The differences are small for most countries and in most years, but they are substantial in some cases. The most frequently used measure of the tax burden is shown in the figure (total taxes plus Social Security contributions as a percentage of GDP).

<sup>2</sup>2007 final data (provisional data not available).

Source: Revenue Statistics database.

the next 14 countries combined and the most expensive healthcare system in the world. Why are we then surprised that we are running budget deficits?

Another way of understanding our current levels of tax burdens is to look at the “tax wedge” on labor — the difference between what an employer pays (including Social Security contributions) and what an employee takes home as after-tax wages. Here again OECD data demonstrate that the United States is at the low end of developed country norms. (Figure 4.)

For these reasons, the recent OECD “report card” on the United States concluded: “Given that the tax-to-GDP ratio in the United States is among the lowest in the OECD area, even including taxes at the levels of state and municipalities, modest tax increases could be made while keeping the overall tax burden at a relatively moderate level.”<sup>15</sup>

Finally, and realizing that any mention of one administration can be perceived as politically charged, the undeniable facts are that in the 1992-2000 period, the economy grew much faster than it has since that time, and it did so notwithstanding the burdens of tax rates that did not reflect the application of the 2001-2003 tax discounts. All other things being equal, lower taxes are better than higher taxes, but whether viewed from the perspec-

tive of world norms or our own recent history, it is simply not credible to argue that the U.S. economy cannot sustain higher levels of tax collections than the historically low levels of the last two years. Given that our “baseline” budget projections already have baked into them the lapse of the 2001-2003 tax discounts, and that those baseline projections restore us only to deficits in the range of 1.2 percent at the end of the estimating horizon, the only reasonable question to debate is what form those tax increases should take.

#### IV. Immediate Structural Tax Reform

##### A. The Tax Nostalgia Industry

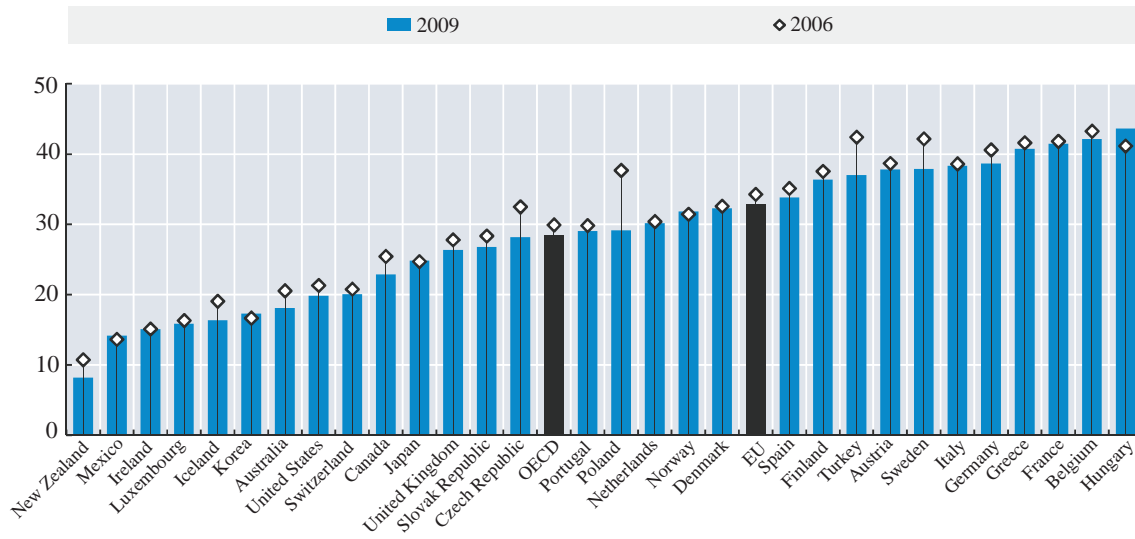
In recent years, several participants in TRA 1986 have published essays recounting their roles in the legislative process and drawing from that one piece of legislation lessons that purportedly should govern current tax reform efforts. Chief among these is the observation that because the TRA 1986 was designed to be revenue neutral, so too must contemporary tax reform legislation. Other corollaries include the assertion that tax expenditures that survived the 1986 reform have by that fact alone become impregnable to future reform efforts.

These exercises in tax nostalgia are unhelpful and generally lead to bad advice. The TRA 1986 was fashioned at one moment in time, now a full generation in the past, through a complex process

<sup>15</sup>Lenain et al., *supra* note 10, at 14.



**Figure 4. Average Tax Wedge on Labor<sup>1</sup> (as percentage of compensation)  
(couple with 100 percent of average earnings and two children<sup>2</sup>)**



*Note:* Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.  
 1. Measured as the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a ratio of total labour compensation. It therefore includes both employer and employee Social Security contributions.  
 2. Average of three situations regarding the wage of the second earner.  
*Source:* OECD, *Taxing Wages Database* (2010).

that reflected economic, political, and demographic factors that no longer are relevant.

In contrast to the environment surrounding the TRA 1986 (itself preceded and followed by major revenue-raising legislation), tax revenues need to rise from their current depressed levels. Moreover, the economy is very different from what it was in 1986 (for example, in the rise of cross-border business activity and the creation of whole new industries). At the same time, tax policy analysis has advanced substantially in the last 25 years, and we have a better understanding of the tradeoffs between different policies than we did in 1986. We therefore should put to one side our nostalgic impulses and focus instead on the problems we face today.

**B. The Baseline as the Base Case**

As previously noted, CBO baseline budget projections assume that the 2001-2003 individual tax discounts will lapse. Some observers think that the budget deficits reflected in those baseline projections (in the range of 1.2 percent of GDP by the end of the 10-year horizon, assuming the effectiveness of the new provisions relating to the Joint Select Committee on Deficit Reduction) are still too high. Extending the 2001-2003 individual tax discounts

indefinitely would add an additional \$4.6 trillion to those baseline deficits over the next 10 years.<sup>16</sup>

For all the reasons developed earlier, I believe we need to accept the CBO baseline as the tax reform base case: Tax revenues will need to rise to levels in the neighborhood of 20 percent of GDP, or even a bit more, over the medium-term horizon. Our current entitlements and defense programs, particularly the trajectory of healthcare spending, require this level of funding, and it will take years of substantial revenues both to pay down the debt hangover from the Great Recession and to fund the transition to some as-yet-unspecified package of less expensive entitlements programs and/or reduced defense spending.

I further submit that the most pragmatic way of reaching tax revenues in line with the CBO baseline is in fact to follow the baseline, more or less. Specifically, I recommend that tax reform begin by postulating the following individual revenue package:

1. In general, allow the 2001-2003 individual tax discounts to lapse at the end of 2012.

<sup>16</sup>See CBO, *supra* note 11.

2. Restore the estate and gift taxes to their 2009 levels, preferably as of January 1, 2012. (This actually has a roughly \$260 billion cost relative to the CBO baseline.<sup>17</sup>)

Tax reform should build on this tax revenue base case. That is, we can appropriately talk about “revenue-neutral” tax reform, as long as revenue neutrality is measured against this revenue base. The goal should be to see whether through other reforms we can improve the distributional fairness or economic efficiency of the individual tax system while preserving revenue neutrality, *all relative to this base case*.

For example, I would propose two modifications to this base case, designed to be a revenue-neutral pairing:

1. Maintain current policy’s prescription that corporate dividends should be taxed at the same rates as long-term capital gain. (This proposal is discussed below; it loses revenue relative to the CBO baseline but has a strong policy justification.)
2. Add a new top marginal tax rate of, say, 42 to 44 percent for incomes above \$2 million. (The idea would be to find the income level that would raise revenues sufficient to fund the dividend tax proposal.)

Others might have their own pet reform ideas, but again the rule should be that they must be revenue neutral relative to the base case described above.

### C. The Central Importance of Tax Expenditures<sup>18</sup>

The straightforward goals of any incremental reform of the personal income tax (and I put TRA 1986 into this category) should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping marginal tax rates — the tax imposed on your last dollar of income — as low as possible. The intuition here is simple: People are more sensitive to the tax rate imposed on their last dollar of income than to their average tax burden. The deadweight loss of taxation can be minimized by keeping marginal tax rates as low as possible, consistent with the other two goals.

Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-2003

tax discounts) requires broadening the tax base. Unlike 1986, the individual income tax today has not been eroded through suspect tax shelters or other schemes to avoid the tax system that Congress anticipated when drafting the tax code. (There are of course exceptions, but they are not significant to the overall revenue picture.) This means that the only way to raise significant revenues (perhaps enough to “buy back” some of the tax increases contemplated by the base case summarized earlier) without raising marginal tax rates is to tackle directly some of the deliberate congressional subsidy programs baked into the tax code, which is to say, tax expenditures.

Tax expenditures, particularly those that can be phrased as “tax subsidies,” are a form of government spending, not tax reductions.<sup>19</sup> Tax expenditures dissolve the boundaries between government revenues and government spending. They reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government.

Tax expenditures serve many different purposes. Some (the earned income tax credit, the special tax rates on long-term capital gains) really function as adjustments to the tax rate tables; others (the child credit, the refundable portion of the EITC) serve important social and distributional goals; still others (pension plan contributions) can be explained as moves toward a consumption rather than an income tax.<sup>20</sup> But many fall into the category of well-intentioned but ultimately inadvisable instances of congressional meddling, by subsidizing different forms of personal consumption or business activity. These latter sorts of tax expenditures typically introduce economic inefficiencies, miss the target of their intended beneficiaries, and waste a great deal of money.

The magnitude of tax expenditures is staggering: The federal government spends today almost twice

<sup>19</sup>The history and theory of tax expenditure analysis is developed at length in the JCT staff publication “A Reconsideration of Tax Expenditure Analysis,” JCX-37-08 (May 12, 2008), Doc 2008-10450, 2008 TNT 93-21. Since that date the JCT staff has retreated from some of the modes of analysis proposed therein to its traditional presentations of tax expenditure analysis. I think that this is a mistake, because reverting to an excessive reliance on a “normal tax” as the analytical starting point weakens the case for bipartisan agreement on the central importance of tax expenditure reform.

<sup>20</sup>One of the principal contributions of “A Reconsideration of Tax Expenditure Analysis,” *supra* note 19, was to urge that tax expenditures be grouped into different conceptual buckets, so that each could be fairly analyzed in accordance with its overall purpose. The JCT staff’s retreat from this mode of analysis unfortunately weakens the utility of tax expenditure analysis in general.

<sup>17</sup>CBO, “Reducing the Deficit: Spending and Revenue Options” (Mar. 2011), at 216 (“Alternative 2”), Doc 2011-5145, 2011 TNT 48-18.

<sup>18</sup>Some of this subsection is abstracted from Edward D. Kleinbard, “The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes,” 36 *Ohio No. L. Rev.* 1 (2010).

as much through tax expenditures as it does through old-fashioned explicit non-defense discretionary spending programs. In fact, we spend more in tax expenditures than we collect in cash through the personal income tax. It's as if our tax base were twice as large as it appears, and then we gave half or so of those revenues back through various ersatz subsidies that in many cases are poorly targeted and result in misallocations of economic activity.

Tax expenditures dissolve the boundaries between government revenues and government spending. As a result, they reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government. To see how, consider a little example involving the small but self-reliant country of Freedonia. Its economy comprises 10 fruit and vegetable growers, each earning \$1,000 pretax, for a total GDP of \$10,000. Each grower pays income tax to support the Freedonian army at a flat rate of 15 percent, for total tax revenues of \$1,500.

Freedonia's sole kumquat producer is particularly resourceful. Armed with scientific reports showing the many health benefits of kumquat consumption, he convinces the Freedonian legislature that kumquat production deserves tax incentives to bring kumquats within the reach of every Freedonian family. The legislature responds by effectively exempting kumquat production from its income tax through an innovative kumquat production tax credit.

But Freedonia is not a profligate state, and it believes in fiscal discipline in the form of "pay as you go" budget rules. Therefore, to keep the kumquat credit revenue neutral, the legislature pairs the new preference with an 11.1 percent tax hike on the other producers, to maintain tax revenues at \$1,500. (Freedonian tax policy allows for rounding error.) That means that the other fruit and vegetable farmers will each pay \$167 (instead of \$150) in tax on their \$1,000 of income.

In a world without tax expenditure analysis, Freedonian legislators can argue that nothing has changed: Government revenues are constant, and there is no increase in government spending or borrowing. But this is plainly wrong; things have changed, in both the private and public sectors.

First, the tax incentive increases kumquat production and consumption. The equilibrium price and quantities sold of kumquats will be different relative to other fruits and vegetables after the tax incentive. Economists believe that in the absence of some identifiable market failure, markets set prices better than legislatures do, but the kumquat credit alters the quantity of kumquats sold relative to the case in which the tax burden of all fruit and vegetable growers was equal. Unless the health of

Freedonians really is improved by the kumquat credit (perhaps because of prior rampant borderline scurvy among the population), the result will be a less efficient allocation of their collective resources.

Second, the introduction of the kumquat credit in an apparently virtuous revenue-neutral fashion has another profound economic effect: tax rate increases on the incomes of all the fruit and vegetable producers who do not receive targeted tax relief. All taxes, no matter how beautifully implemented, impose deadweight losses. That is, some transactions that are rational in a world without taxes become too expensive in a world with those taxes and do not take place. And deadweight loss increases faster than the tax rate — in standard presentations, in fact, at the square of the tax rate.

What all this means is that by virtue of granting "revenue-neutral targeted tax relief," the Freedonian government may raise the same aggregate revenues as it did previously but impose more deadweight loss on the remaining taxable Freedonian private sector. This result is one of the great ironies of many tax expenditures, particularly those that fall into the category of business incentives — once the incentive's impact on tax burdens *for others* is considered, it impoverishes the country even more than it enriches the beneficiaries of the legislative largesse. (Deadweight loss of course cannot be avoided for long by electing "targeted tax relief" without revenue offsets. Unfortunately, recent U.S. tax history has some of this flavor.)

Third, by virtue of its new kumquat credit, the Freedonian government just got bigger, even though aggregate nominal tax revenues remain constant. The best way to analogize the new kumquat credit is to a uniform 11.1 percent tax hike on all of Freedonia's fruit and vegetable producers, followed by a \$167 kumquat crop farm subsidy payment to the kumquat producer. By recasting the tax expenditure in this way, as a constant tax burden and a separate transfer payment, the two different functions of government are restored to their customary formal presentation, and the words "revenue" and "spending" can be applied consistently to economically identical (but formally different) modes of implementation. As so recast, it is easy to see that Freedonia's economic handprint on the private sector is no longer \$1,500 in tax revenues, but rather \$1,667 in economic terms. The government is bigger in every meaningful sense of the word.

#### D. Healthcare Tax Expenditures

The two largest clusters of tax expenditures are those for healthcare and those for owner-occupied housing. Each has had a large and profoundly negative allocative effect on the economy — that is, each has distorted what goods and services we all

purchase, by changing relative prices through hidden government subsidies. Each also is poorly targeted, in the sense that the subsidy often goes to taxpayers who would have purchased those goods or services without the help of the subsidy.

The most important healthcare tax subsidy is the treatment of wages paid by an employer in the form of healthcare benefits (whether called insurance or out-of-pocket reimbursements) as tax-exempt in the hands of an employee. This “exclusion” from employees’ incomes of wages paid in the form of employer-provided healthcare will cost some \$117 billion in forgone income taxes in 2011 alone (and \$161 billion in 2014, when the economy is projected to be more robust),<sup>21</sup> but even these enormous costs understate the true picture, because they do not include the payroll tax revenues forgone by the exclusion. In 2008 the JCT staff estimated these payroll tax costs at some \$100 billion for one year alone.<sup>22</sup>

In short, the total value of this government subsidy for one mode of healthcare delivery is on the order of \$250 billion per year. Yet precisely because this subsidy is delivered as an income exclusion, its recipients are largely unaware that they are the beneficiaries of a hidden government handout. The result is a terrible distortion in public discourse, as seen in the debate surrounding the PPACA. Many Americans believed that the healthcare act represented an unprecedented government intrusion into the private sector but were unaware that the government had long been subsidizing their healthcare (but not necessarily those of other Americans with different employers). This is why in my academic writing I have emphasized the corrosive effects of tax expenditures on our ability to conceptualize the role of government in our lives.<sup>23</sup>

Substantively, the subsidy for employer-sponsored health insurance distorts our spending patterns by encouraging us to take compensation in the form of generous healthcare programs (its allocative consequences), does so inefficiently (by subsidizing higher-income Americans more, because tax exemption is more valuable to them — the classic upside-down subsidy pattern of many tax expenditures), and does so unfairly (because its availability depends on the programs offered by your employer, not consistent national standards available to everyone).

<sup>21</sup>JCT, “Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014,” JCS-3-10 (Dec. 2010), *Doc 2010-27177*, 2010 TNT 245-12.

<sup>22</sup>JCT, “Tax Expenditures for Healthcare,” JCX-66-08 (July 2008), *Doc 2008-16755*, 2008 TNT 148-11.

<sup>23</sup>See, e.g., Kleinbard, *supra* note 18.

For these reasons, every health economist of whom I am aware believes that the tax subsidy for employer-sponsored health insurance is both unaffordable and bad policy. Many I believe were acutely disappointed that the PPACA left the subsidy largely intact (except for some “Cadillac” plans).

The difficulty is not with this ultimate conclusion, but rather with the frog boiling procedure. The tax subsidy for employer-provided healthcare is so deeply engrained in the healthcare delivery system that it cannot be removed except through a carefully thought-out transition to a different system. Whether the PPACA is that system, or only a steppingstone to a more comprehensive rewriting of how healthcare is delivered in the United States, is a complex question, but the unwinding of the tax subsidy for employer-provided healthcare should take place in the context of a plan that assures Americans that healthcare will not become less available or wholly unaffordable.

### E. Sacred Personal Itemized Tax Cows

Employer-provided healthcare is the largest single government subsidy program delivered through the tax system. As a group, however, the personal itemized deductions — in particular, the deductions we claim that subsidize our homes (the home mortgage interest deduction, the deduction for property taxes, etc.), our charitable contributions, and our state and local income taxes — are even larger. These three tax subsidies alone are projected to cost at least \$240 billion in forgone revenues for just the current fiscal year, and that cost will climb as the economy recovers.

I propose that we phase out the tax subsidies for these activities over the five years from 2013 to 2017. The most elegant way to do so would be to convert the deductions into tax credits and then phase down the credit rate to zero ratably over that five-year period.

I recognize that all these items are political sacred cows, but they are simply unaffordable luxuries in the current environment. Either we eliminate these sacred cows, or alternatively they will stampede over us.

The elimination of the personal itemized deductions, together with the lapse of the 2001-2003 tax credits, will by themselves yield enough revenue to address our deficit concerns for the medium term and thereby buy us the time we need to develop and gradually implement long-term entitlement spending reforms. Moreover, their elimination would largely remove the need for an alternative minimum tax patch, because it is these deductions that drive most taxpayers into the AMT in the first place.

**Figure 5. Revenue Consequences of Eliminating Personal Itemized Deductions, Assuming Lapse of 2001-2003 Tax Discounts and No Transaction Relief**

	2013	2014	2015	2016	2017
GDP*	\$16,705	\$17,760	\$18,630	\$19,508	\$20,398
Total deficit*	-\$525	-\$438	-\$507	-\$585	-\$579
Eliminate all itemized deductions effective Jan. 1, 2013**	\$253	\$268	\$283	\$297	\$311
<b>Revised deficit</b>	<b>-\$272</b>	<b>-\$170</b>	<b>-\$224</b>	<b>-\$288</b>	<b>-\$268</b>
Memorandum					
Baseline deficit as percentage of GDP	-3.1%	-2.5%	-2.7%	-3%	-2.8%
Revised deficit as percentage of GDP	-1.6%	-1%	-1.2%	-1.5%	-1.3%
*CBO projections (Aug. 2011). Reflects expiration of all 2001 and 2003 tax cuts.					
**Tax Policy Center (Dec. 30, 2010). Estimates are static; they do not include a behavioral response.					
Source: Tax Policy Center.					

In December 2010 the Tax Policy Center was kind enough to produce some estimates for me of the revenue impact of repealing the personal itemized deductions. (Figure 5.)

These figures admittedly are imperfect. They are a year old, and they are static, in the sense that they do not account for any behavioral responses. Moreover, the figures do not incorporate any transition relief along the lines I propose. They do, however, reflect “tax form behavior,” which is to say they reflect the fact that affected taxpayers will switch from itemizing their deductions to the standard deduction. Nonetheless, the data do capture the order of magnitude of these public subsidies for personal consumption decisions.

That we are today forgoing revenue on the order of 1.5 percent of GDP per annum for these government subsidies of personal expenses suggests to me that whatever their political appeal, they are simply luxuries we cannot afford. And as I noted already, their repeal largely resolves the current crisis over what to do with the individual AMT, because it is these deductions that drive most taxpayers into the AMT in the first place.

By phasing out the deductibility of personal itemized deductions, we not only raise a very large amount of revenue, but we do so efficiently. We raise this incremental revenue *without* raising marginal tax rates. The elimination of the tax preferences for these items also will add to the progressivity of the tax system, because itemizers generally have higher pretax incomes than do taxpayers claiming the standard deduction.<sup>24</sup> (Only about one-third of tax return filers are eligible to claim itemized deductions today.)

Moreover, by eliminating these sacred tax cows, we can directly address a fundamental misalloca-

tion of capital in the private sector, which is our over-investment in single-family homes compared with other forms of capital investment.<sup>25</sup> We also will eliminate the inefficiencies by which we provide these subsidies to those who would have bought their homes (or made charitable contributions, or chosen to live in high-tax states) regardless of the tax incentives.<sup>26</sup>

At bottom, the personal itemized deductions, as the name implies, are all *personal* expenses. Their elimination would make the tax system more progressive, more efficient, less distortive, and simpler. Doing so also would raise a great deal of money without adding unduly to the deadweight loss from taxation, and raising a great deal of tax revenue in general is something that we have no choice but to embrace.

The reason to eliminate *all* the personal itemized deductions is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another. Our only practical hope is to round up and eliminate all these sacred tax cows at once.

The incremental revenues that would result from eliminating personal itemized deductions can be used to speed the transition to a different set of long-term government spending and tax policies, or to pay down the federal debt, or to “buy back” some of the tax increases contemplated by the base case I posited earlier. Regardless, closing down these inefficient, poorly targeted, and unfairly top-weighted government subsidy programs would constitute a major achievement in tax reform.

<sup>25</sup>Robert Carroll et al., “Costs and Benefits of Housing Tax Subsidies,” Pew Charitable Trusts (June 2011); Evridiki Tsounta, “Home Sweet Home: Government’s Role in Reaching the American Dream,” IMF Working Paper Wp/11/191 (Aug. 2011).

<sup>26</sup>For example, Tsounta, *id.*, finds (Table 8 at 28) that Canada’s tax subsidies for home ownership are perhaps one-fifth as large as a percentage of GDP as those of the United States, yet Canada has a higher rate of homeownership.

<sup>24</sup>See, e.g., Testimony of Robert Greenstein Before the Senate Budget Committee (Mar. 9, 2011), Table 1 (listing distributional consequences of itemized deductions by income quintiles), *Doc 2011-4974*, 2011 TNT 47-35.

Martin Feldstein has an even more ambitious proposal, which he describes as a 2 percent cap on the tax benefits that an individual taxpayer can claim from tax expenditures.<sup>27</sup> Feldstein and I share a common emphasis on the importance of addressing tax expenditures as the right way to raise revenue, but I do not agree with his recommendation.

First, the Feldstein proposal would be extremely complex to implement, much more so than suggested by Feldstein's article referenced in note 27. This follows from the iterative calculations required first in respect of tentative itemized deductions, and again employing the standard deduction.

Second, whether by design or not, the Feldstein proposal would impose very large tax burdens on many lower-income working Americans. The reason is that Feldstein effectively would reverse the current tax subsidy for employer-provided healthcare and the child credit, except to the very limited extent of his 2 percent cap. That is, both current law's healthcare exclusion and the child credit would be treated as tax expenditures subject to the 2 percent cap.

By his own calculations (in a *Washington Post* op-ed, not in the *Tax Notes* article), 54 percent of all taxpayers who today claim the standard deduction would pay higher taxes under his proposal. A single mother of two working full time at the minimum wage would lose more than \$1,400 of her \$2,000 child tax credit under the Feldstein proposal — more than 80 percent of her current credit. Meanwhile, a family of four earning \$60,000 would lose about \$800 of their \$2,000 child tax credit, or 40 percent of it.<sup>28</sup>

By contrast, the elimination of personal itemized deductions by definition would affect only taxpayers who today itemize their deductions, not those who claim the standard deduction. That is why the elimination of personal itemized deductions not only is an efficient reform from an economic perspective, but it also increases the progressivity of the tax code.

I understand completely the impulse to dismantle the tax subsidy for employer-provided healthcare, but as I emphasized earlier, we should do so only in the context of a completely secure path to a superior healthcare delivery system that is still affordable. I also am concerned that any tax reform legislation not burden the poorest Ameri-

cans. For both those reasons, I think that the Feldstein proposal goes too far.

## F. Business Tax Reform

As noted earlier, one important exception that I would make to my general base case of allowing the 2001-2003 individual tax discounts to lapse relates to the tax burden on dividend income. Keeping that tax at the same rate as the rate on long-term capital gains, rather than allowing it to revert to the tax rate on ordinary income, is highly desirable for the simple reason that it will not distort corporate dividend policy (because otherwise, investors would insist on taking their returns through stock sales). A great deal of corporate tax planning in the past was devoted to converting dividend income into long-term capital gain; failing to maintain tax rate parity will simply invite tax lawyers to dust off those old planning stratagems. Moreover, dividend income and long-term capital gains on corporate stock can plausibly be linked as the only two cases of genuine double taxation in the tax code; there is merit in mitigating that phenomenon in both cases.

The U.S. statutory corporate tax rate today is too high and should be lowered. Here is an area where roughly revenue-neutral tax reform makes sense: Broaden the business tax base and lower the rate. The business sector also is riddled with government subsidies in the form of tax expenditures. In the income tax area, those subsidies amount to roughly \$100 billion per year, of which about 80 percent are captured by corporations and the remainder by noncorporate businesses. Also, there are numerous excise tax subsidies that are not even scored in the annual tax expenditure roundups. These subsidies, with all their poor targeting and allocative distortions, should be exchanged for lower corporate tax rates.

Implicit in this suggestion is the idea that to some extent, noncorporate businesses will pay more in tax so that corporations will pay less. I believe this is appropriate, for several reasons. First, as mentioned, most business tax expenditure benefits are claimed by corporations, not passthrough entities. Second, noncorporate businesses today generally enjoy lower rates on capital income than do corporations.<sup>29</sup> For example, gain on sale of a noncorporate business generally is taxed as long-term capital gain, even though there is no double taxation of the firm's earnings the purchaser can obtain a step-up in tax basis without further cost, and those long-term capital gains in fact often relate to the labor

<sup>27</sup>See Martin Feldstein et al., "Capping Individual Tax Expenditure Benefits," *Tax Notes*, May 2, 2011, p. 505, *Doc 2011-7166*, or 2011 TNT 86-8.

<sup>28</sup>Tax calculations kindly provided by the CBAP, based on 2011 tax law.

<sup>29</sup>CBO, "Taxing Capital Income: Effective Rates and Approaches to Reform" (Oct. 2005), Table 1 at 8, *Doc 2005-21274*, 2005 TNT 202-16.

contributions of the owner-operator. Third, small noncorporate businesses in general have had a long and troubled tax compliance history, including mingling of personal and business expenses and non-reporting of cash income.

Recently I have written extensively about our international corporate tax regime.<sup>30</sup> The long and the short of it is that I believe U.S.-based multinational firms have vastly overstated the “uncompetitiveness” of the U.S. system for taxing foreign direct investment. On the contrary, sophisticated U.S. multinationals have succeeded in effectively gaming both the U.S. tax system and those of other high-tax jurisdictions through their adroit production of income taxed nowhere — stateless income. At the same time, the real competitiveness story, which is the tax burden imposed on U.S. *domestic* corporations, has largely escaped attention.

For all the reasons developed in my papers on the subject, the right answer here is to tax U.S. firms on their worldwide income but at much lower tax rates. I believe tax rates in the neighborhood of 25 to 27 percent are easily achievable. Rates at this level would provide U.S. multinational firms a “competitive” tax environment while substantially improving the tax environment for domestic firms and encouraging inbound cross-border investment. These arguments are developed at much greater length in the papers referenced in note 30.<sup>31</sup>

There is understandable concern that at some point, if individual marginal rates go up and corporate rates go down, the corporation will become a “tax shelter,” in that individuals will prefer to earn income through a corporation to take advantage of its lower tax brackets. There are awkward technical solutions to this problem already in the tax code; the better answer, however, lies as part of a more ambitious long-term tax overhaul, as outlined below.

### V. Long-Term Structural Tax Reform

If Congress were to allow the 2001-2003 temporary tax discounts to lapse, phase out personal itemized deductions, and engage in revenue-neutral business tax reform along the lines outlined above, it would have done enough. It could then turn its attention to the difficult issues of long-term entitlements spending reform, in particular the structure of our healthcare delivery system.

Nonetheless, it is possible to imagine even more fundamental tax reforms. One direction, of course,

would be to reorient the tax system more toward consumption taxes. There are economic efficiency arguments that support a preference for consumption over income taxes, but of course there also are difficult transition and design issues.

In my research I focus instead on the income tax, which I believe is much sprier than do many of its critics. I believe that it is possible to imagine a much more economically efficient income tax than our current system — that is one that would impose more consistent tax burdens on economically similar items of income, regardless of their legal labels, and would tailor those burdens to the different kinds of income in question.

Policy discussions about fundamental income tax reform usually are highly fragmented. We debate capital gains policy, the corporate tax rate, small business taxation, or carried interest as independent concepts, but this ultimately is silly. Notwithstanding the generations of law students who have been taught to the contrary in Tax 1 courses around the country, as a practical matter, income really is derived from labor, from capital, or from the two combined.<sup>32</sup> Roughly, about two-thirds of our GDP is contributed by (a “return to”) labor and one-third by capital.<sup>33</sup> Capital income includes interest and rental income, dividend income and capital gains, and also corporate income, because a corporation (at least a large publicly held one) compensates its labor factor of production directly in the form of tax-deductible wages.

The corporate income tax in the first instance is thus a tax on capital income. It is a different (but of course important) question whether the incidence of that tax (the ultimate economic burden) is shifted to labor, in the way that the excise tax on gasoline actually is borne by consumers.

Our policy debates, overinfluenced by the tax ideologies reflected in TRA 1986, tend to see an ideal income tax as one that taxes returns to labor and returns to capital on a single progressive tax rate schedule, but there is no reason this should be so. On the contrary, the economic evidence suggests that labor and capital have different sensitivities, or if you prefer, aversions, to taxation. The only reason to insist on a common tax rate schedule as the ideal is because it is difficult to distinguish between returns to capital and returns to labor. For example, the local restaurant owner who invests her life

<sup>30</sup>See, e.g., Kleinbard, “Stateless Income’s Challenge to Tax Policy,” *Tax Notes*, Sept. 5, 2011, p. 1021, *Doc 2011-14206*, or 2011 *TNT* 172-5, and the longer papers cited in n.1.

<sup>31</sup>*Id.*

<sup>32</sup>Treasure-trove — the lucky fan who catches the record-setting home run baseball, and the purchase of an old piano that turns out to be stuffed with cash — important only for law school exams, not for tax revenues.

<sup>33</sup>Recent CBO data would put the split at 60/40. CBO, *supra* note 11, Figure 2-13, at 56.

savings and all her working hours into her restaurant obtains economic returns in the form of business profits from the combination of her labor and her capital, but all that we see is a single bottom-line profit.

It turns out, however, that good research and even real-world experiments have been done on this question of distinguishing labor income from capital income, which in turn opens up the question of what the tax burden should look like on each. I group this work under the general rubric of “dual income taxes.”<sup>34</sup> (They are “dual” in that they have two rate schedules, one for labor income and one for capital income.)

At the same time, we also have learned a great deal about how to think conceptually about capital income. We now understand that it can usefully be broken down into three categories: normal returns (the bread-and-butter risk-free returns from waiting, or, if you prefer, the return on marginal investments in competitive markets), risky returns (the compensation we demand for taking on uncertain projects), and economic rents (the supersized returns from owning some especially valuable asset that cannot simply be reproduced, like a valuable patent).<sup>35</sup>

In a nutshell, it is possible to use these new insights and techniques to design an income tax system that first separates income into two buckets — capital income and labor income (which latter category would include a treasure-trove and all the other marginalia that animate tax law professors) — and then applies coherent but separate rules to each. I call the core component of this re-imagining of our income tax the business enterprise income tax.<sup>36</sup>

The capital income side is the more difficult one. But one can imagine a feasible and administrable capital income tax system that is much superior to our current approach, including along the following margins:

1. It would eliminate the tax preference for debt over equity financing.<sup>37</sup> It is an interesting insight into the limitations of traditional tax expenditure analysis that this enormously distortive tax subsidy is not even scored as a tax expenditure, because it is thought to be inherent in any income tax. But that is not correct.
2. It would achieve tax integration — that is, the elimination of double taxation on business earnings.
3. It would tax all business entities identically, rather than having different rules for different legal forms, and similarly would tax all forms of capital investment identically.
4. It would move the taxation of much business income (more specifically, “normal” returns) to the level of the individual rather than that of the firm. This has very important technical benefits both for the measurement of capital income and for practical international tax “competitiveness” concerns.
5. It would ground the taxation of capital gains on some principled basis, rather than our current instinct either to overtax or to under-tax those instances of capital income, and would apply a single consistent tax rate to all forms of capital income, whether earned over time or as a lump sum through a sale.
6. By providing a single tax schedule for all instances of capital income, it would greatly reduce the distortions arising from the collision of current tax law’s fixation with out-of-date legal constructs and commercial realities.

I find all this to be an exciting prospect for my academic research and hope one day to see it implemented into law. But none of this should detract from what should be the immediate focus, which is raising sufficient revenues as painlessly as possible to enable the country to buy the time required to revise its entitlement spending programs in a way that is fair to settled expectations and to our shared vision of what it means to be Americans.

<sup>34</sup>See, e.g., Kleinbard, “An American Dual Income Tax: Nordic Precedents,” 5 *Nw. J.L. & Soc. Pol’y* 41 (2010).

<sup>35</sup>See, e.g., Kleinbard, “Designing an Income Tax on Capital,” in *Taxing Capital Income* (2007).

<sup>36</sup>For early iterations of the idea, see Kleinbard, *supra* note 34; and Kleinbard, *Rehabilitating the Business Income Tax* (May 2007).

<sup>37</sup>Ruud A. de Mooij, “Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,” IMF Staff Discussion Note SDN/11/11 (May 2011).