USC Gould School of Law

Why Tax Revenues Must Rise

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The Fiscal Cliff Deal - I

- Components:
  - Permanent patch to AMT
  - Makes Bush tax cuts permanent except for high-income txprs
  - Reversion to 39.6% rate (+P&P) for high-income taxpayers
  - 5-year extension of AOTC, Extended EITC, etc
  - Temporary extension of UI benefits
  - Estate tax permanently extended
  - Payroll tax holiday expired
  - ACA’s 3.8% Medicare tax on investment income kicks in

The Fiscal Cliff Deal – II

- Fiscal Cliff deal raised revenues, sort of . . . .
  - Deal raises about $650 billion/10 years compared to 2012 law
  - After debt service, $750 billion/10 years smaller deficits
- But Fiscal Cliff deal also blew a hole in deficit
  - 2012 official CBO "baseline" showed deficits largely disappearing over 10 years ($2.3 trillion total/10 years)
  - New deal adds $4.6 trillion to 10-year deficit
  - *In other words, 10-year deficit now will triple compared to 2012 forecast*
    - *And that forecast is optimistic relative to probable outcomes*

The Fiscal Cliff Deal – Economic Impact

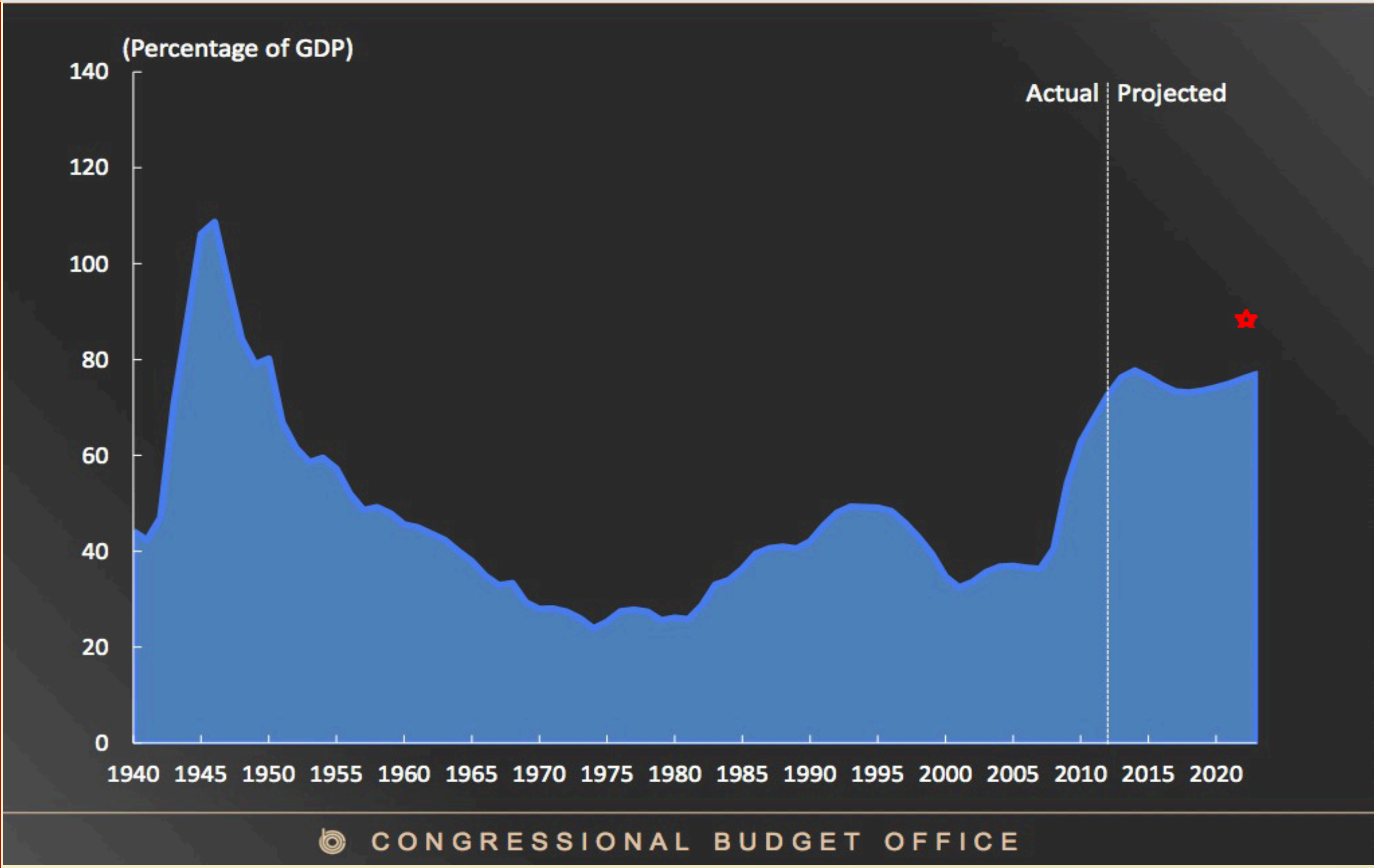
- Avoided 2013 recession from sucking too many $ out of economy too quickly, but at big long-term cost

- 10-year deficit projection = 3.3% of 10-year projected GDP – and upwards trajectory at end of period (3.8% in 2023)

- *"Although we expect that the [deal] will lead to higher output and income in 2013, we also expect that it will lead to lower output and income later in the decade than would have occurred under prior law. The legislation lowers tax rates for many people—thereby boosting output—but it also expands budget deficits—which will reduce national saving and lower the stock of productive capital, thereby reducing output relative to what would have occurred under prior law."*

–Congressional Budget Office 1/2013

Federal Debt Held By Public



CBO Press Briefing 2/5/2013

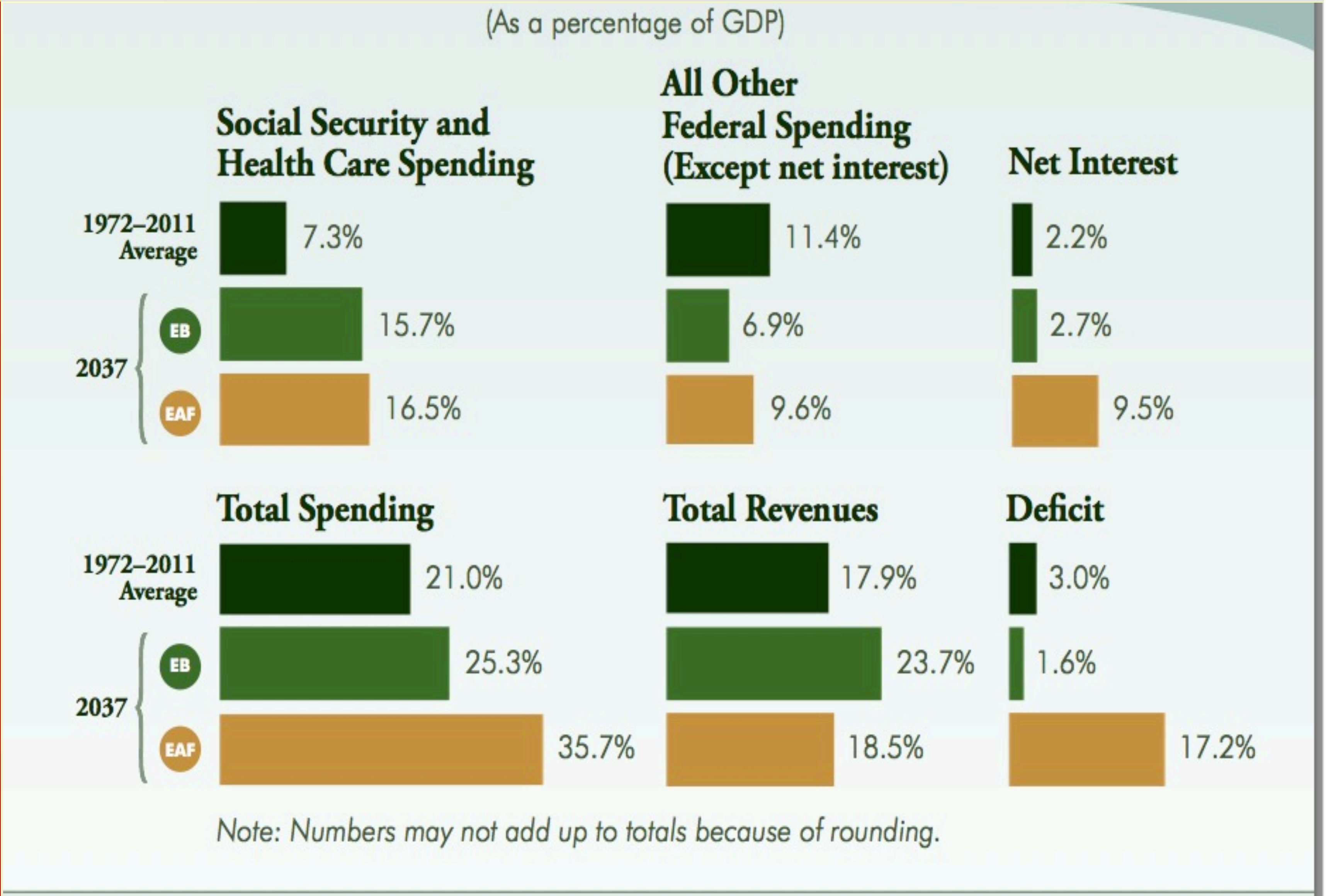
What's With That Asterisk?

- The official "baseline" projections are too optimistic
  - They assume economy at full potential second five years
  - They assume all spending cuts remain and temporary tax cuts (e.g., the "extenders") all expire
  - More probable alternative scenario is much gloomier
    - Tax extenders extended
    - "Doc fix" extended
    - Sequester abandoned (but BCA's original spending caps remain)
- Impact on Debt Held By Public as % of GDP
  - 2007 (Historical) – 36%
  - 2023 Projection (2013 Baseline) – 77%
  - 2023 Projection (2013 Alternative Scenario) – 87%

What Can We Do?

- 2013 post-cliff fiscal policy is unsustainable
  - Closer to 2012 “alternative fiscal scenario” than 2012 baseline
  - And gloomy Debt : GDP projections accelerate after 2023
- It is important to divide time horizons for solutions
  - Short term: underperforming economy addressed in fiscal cliff
  - Long term: implement phased-in entitlements reforms and/or new financing for existing levels of entitlements
  - Medium term: move towards long-term!

Budget Big Picture (CBO 2012)



Long Term: Entitlement Spending

- There are no immediate "bankruptcy" issues, but long-term trend of healthcare spending in particular is unsustainable.

- Mandatory spending (entitlements) reforms are critical for the long term fiscal health of the country
  - More than doubles as % of GDP over next 25 years
  - But any reforms MUST in practice phase in gradually. *In the meantime, the resulting deficits must be financed.*

- In other words, even if you are keen to slash spending, *first* stabilize the patient, and *then* argue about what to amputate

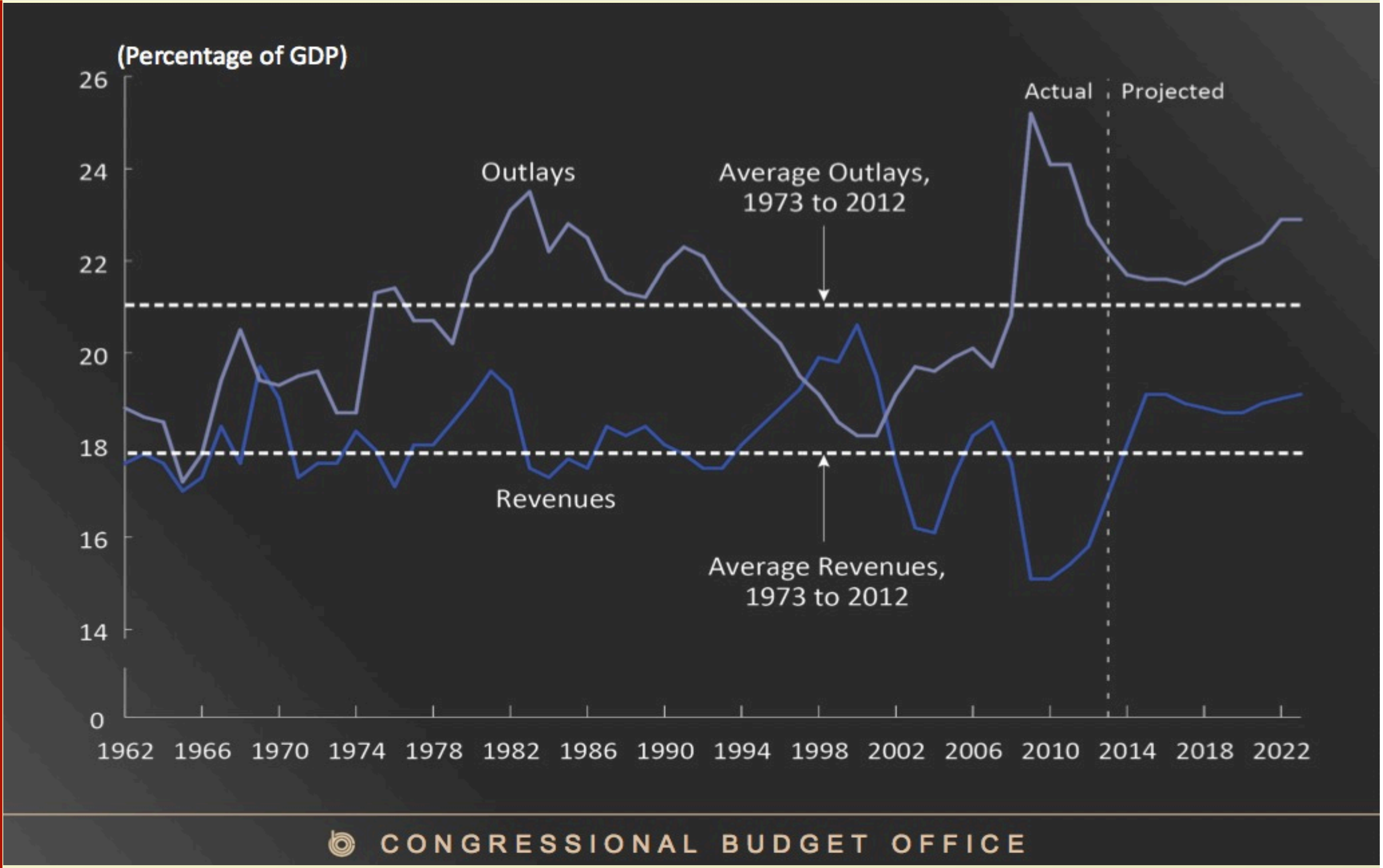
Short Term: Do No Harm

- Fiscal cliff deal a reasonable *short-term* tax and spending regime
- More immediate deficit reduction would have had major impact on economy, reducing tax revenues, increasing deficit, which can end in a negative spiral
- Even IMF now rejects the austerity path to growth
- So let’s try not to screw up too badly in 2013
  - Debt Ceiling
  - Budget
  - Sequestration

The 10-Year Horizon: Filling the Gap

- Here focus shifts to federal Debt/GDP
- How much further deficit reduction do we need?
  - [$1.7 trillion/10 years adopted in 2011 (BCA spending caps)]
  - $4.6 trillion/10 years more to bring Debt/GDP to **2012** Baseline
  - 2012 Baseline Projection of 2022 Debt/GDP was 59%
- And again these numbers assume sequestration, etc.
- 10-year fiscal gap is huge, if we want debt paydown
- *So question is – How best do we fill the gap?*
- *To repeat, rewriting entitlements means long phase-ins, and in the meantime deficits must be financed*

The Gap in a Nutshell



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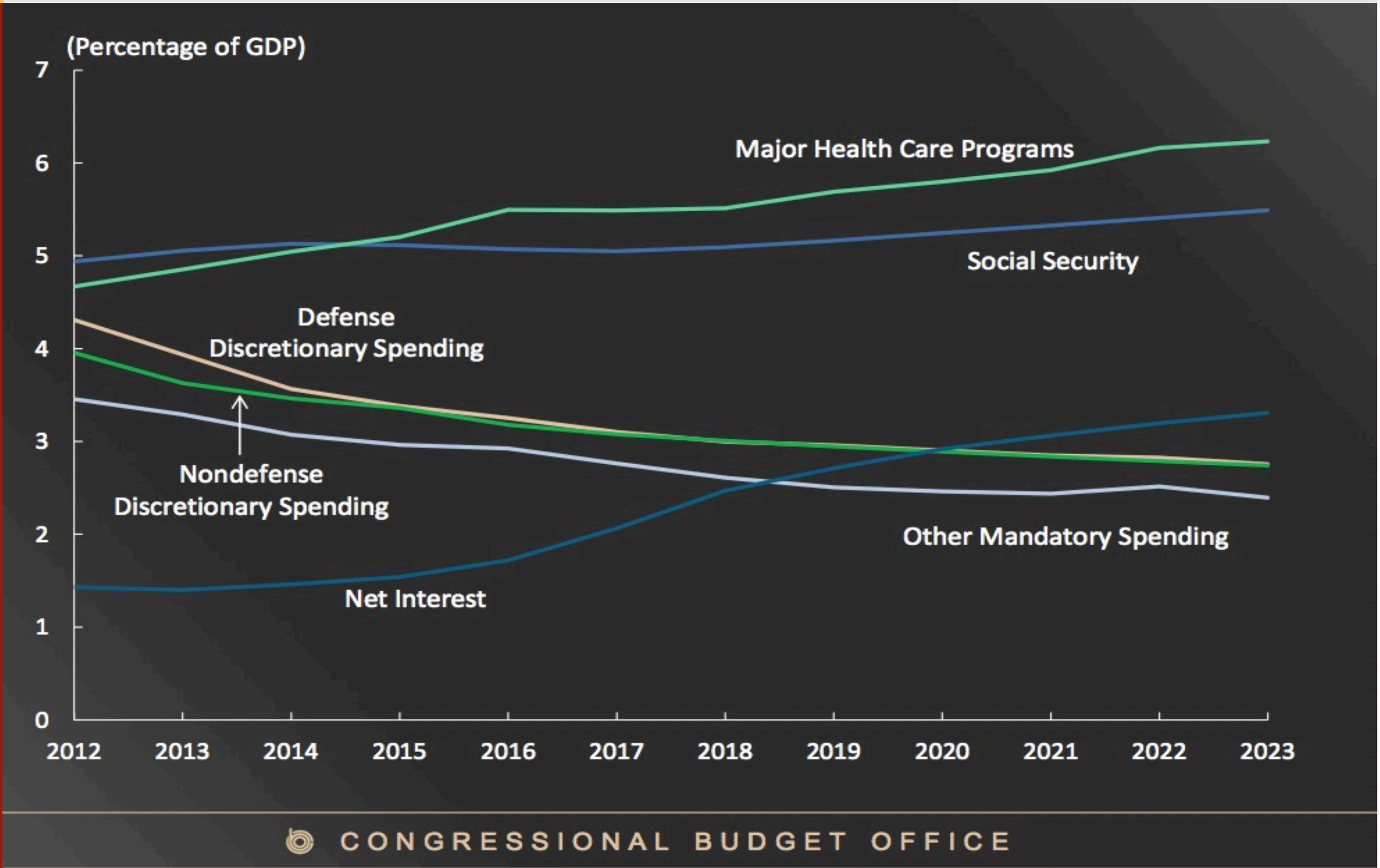
The Spending Side



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Where is the USA a Spending Outlier ?

- **Healthcare!**
  - We're #1 in spending (public + private per capita) (pre-Obama)
  - About $8,000 per person (public + private)
  - If we spent per capita what Norway (#2) does, spending would decline $800 billion/year
  - And we are #2 in world in government healthcare spending
  - Yet our outcomes are mediocre by world standards
- **Military!**
  - Guess who is #1!
  - 42% of world military spending
  - More per capita than Israel
  - 11 nuclear powered aircraft carriers. Rest of world: 1
  - Each carrier ~ 4x bigger than 8 of 10 of rest of world's

50 Shades of Grey . . . Americans

- **Americans age 65+ will increase by 1/3 in next 10 years alone**
- Medicare and Social Security consequences!
  - 2011 = $1.3 trillion cost (+Medicaid $275 billion)
  - 2022 = $2.4 trillion cost (+ Medicaid $600 billion)
  - All mandatory: 13.1% to 14.1% of GDP (2012 to 2023)
- Greying of America *by itself* means that we cannot return to traditional levels of tax revenues as percentage of GDP in medium term
  - Long-term restructuring of programs needs long phase-ins
  - Underfunding Medicare shifts the costs to private citizens, but doesn't address the fundamental problem

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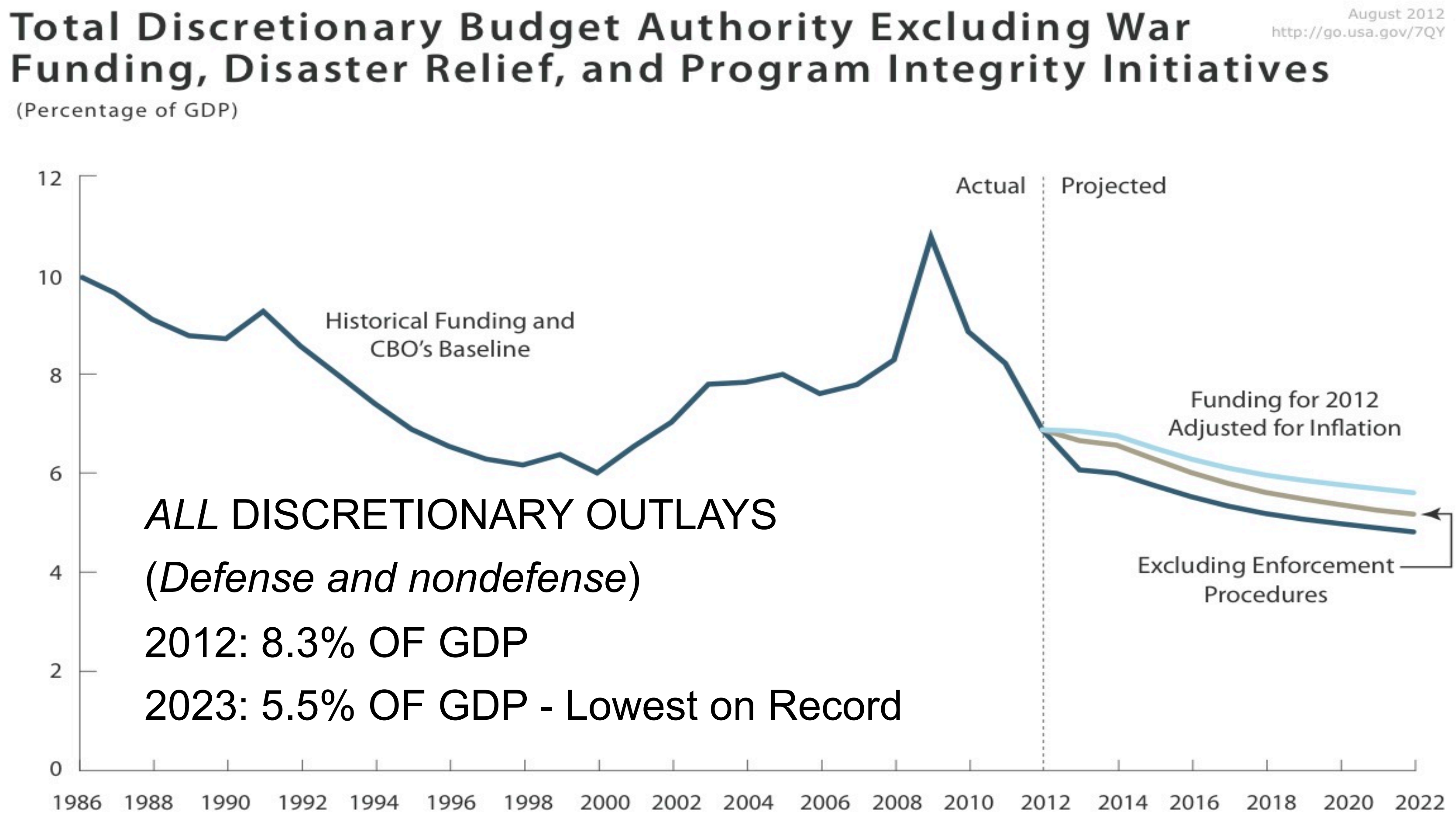
Discretionary Spending Close-Up



The caps on discretionary spending—either with the required automatic reductions (as in CBO's baseline) or without them (as in the alternative fiscal scenario)—will necessitate a reduction in the real resources available for many government programs, compared with the funding provided for 2012. If, instead, funding was allowed to grow at the rate of inflation, it would be 17 percent higher in 2022 than the amounts projected in the baseline.

Congressional Budget Office

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The 10-Year Horizon: Spending

- 2013 Baseline 10-year total outlays = $47 trillion
  - Includes both $1.7 trillion cap and $1 trillion sequestration cuts
  - Note: sequestration ends 2021. CBO assumes full inflation adjustment to discretionary spending thereafter
- Discretionary spending already cut in 2011
  - Sequestration compromise probably will cut some more
- Nondefense discretionary outlays = $6.4 trillion/10yrs
  - In 2022 = 2.7% of GDP (lowest in 50 years)
  - This is just not realistic

Enough With The Tough Love, Already

- Social Security in Application:
  - 90% of Age 65+ receive Social Security
  - Social Security provides 39% cash income of all Age 65+
  - 23% of Age 65+ Marrieds, and 46% of Unmarrieds, rely on it for 90+% of their cash income

  (Source: http://www.ssa.gov/pressoffice/basicfact.htm)

- All Income Security programs (SNAP, SSI, Unemployment, etc.) combined = 1.5% of GDP over next 10 years, and trending down
  - 1.3% in 2023

  (Source: CBO, The Budget and Economic Outlook: Fiscal Years 2013 to 2023)

The 10-Year Horizon: Taxes

- The fiscal cliff deal costs $4.6 trillion in forgone taxes + debt service, relative to CBO 2012 baseline
- *2012* forecast baseline taxes in *2021* = 21.2% of GDP
  - 2013 baseline forecast of 2021 revenue = 18.9% GDP
  - Even Ryan Roadmap 2.0 had target of 19.0%
- The USA today is a *low-tax* country
  - 4th from bottom of the OECD list of total tax as % of GDP
  - And this includes all subnational taxes
- And even by our standards we are collecting historically low levels of federal tax
  - 15.4% Of GDP in 2011, vs 18.4% pre-2008 historic norm

EVERYONE PAYS TAX TODAY

Incomes and Federal, State & Local Taxes in 2011

	Average cash income	Shares of: Total income	Shares of: Total taxes	TAXES AS A % OF INCOME: Federal taxes	TAXES AS A % OF INCOME: State & local taxes	TAXES AS A % OF INCOME: Total taxes
Lowest 20%	$ 13,000	3.4%	2.1%	5.0%	12.3%	**17.4%**
Second 20%	26,100	7.0%	5.3%	9.5%	11.7%	**21.2%**
Middle 20%	42,000	11.4%	10.3%	13.9%	11.3%	**25.2%**
Fourth 20%	68,700	18.7%	19.0%	17.1%	11.2%	**28.3%**
Next 10%	105,000	14.2%	15.0%	18.5%	11.0%	**29.5%**
Next 5%	147,000	10.1%	11.0%	19.7%	10.7%	**30.3%**
Next 4%	254,000	14.3%	15.5%	20.6%	9.9%	**30.4%**
Top 1%	1,371,000	21.0%	21.6%	21.1%	7.9%	**29.0%**
ALL	**$ 71,600**	**100.0%**	**100.0%**	**17.6%**	**10.3%**	**27.9%**
Addendum: Bottom 99%	**$ 58,500**	79.1%	78.3%	16.5%	11.0%	**27.5%**

Notes:
a. Taxes include all federal, state & local taxes (personal and corporate income, payroll, property, sales, excise, estate etc.).
b. For calculations of income shares and taxes as a % of income, income includes employer-paid FICA taxes and corporate profits net of taxable dividends, neither of which is included in the average cash income figures shown.

Source: Institute on Taxation and Economic Policy Tax Model, April 2012

Citizens for Tax Justice, April 2012

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(Citizens for Tax Justice, *Who Pays Taxes in America?*, April 4, 2012)

More Revenue = Personal Tax Hikes

- Corporate income tax is a small fraction of total tax collections (10 – 15% in good years)
- A new tax (VAT, carbon tax, FTT) seems unrealistic
- Corporate statutory rates fall outside world norms
- Corporate tax base can be broadened, but the revenues should go to lower statutory rates.
- So unlike 1986, medium-term tax “reform” logically would mean:
    - Revenue neutral business tax reform
    - Significant income tax hikes on individuals

Tax Expenditures Are Key

- Tax expenditures are government spending by another name
  - Total exceeds revenues collected from personal income tax (roughly $1.2 trillion/year)!
  - 90% personal, 10% business
  - Personal tax expenditures are highly regressive
- So where's the big money in tax expenditures?
  - Employer-sponsored health insurance
    - But we just went through agony on this subject
    - JCT estimate is **$760 billion** over next five years in forgone revenues (not including payroll tax effects, another $500 billion)
  - Personal Itemized deductions!

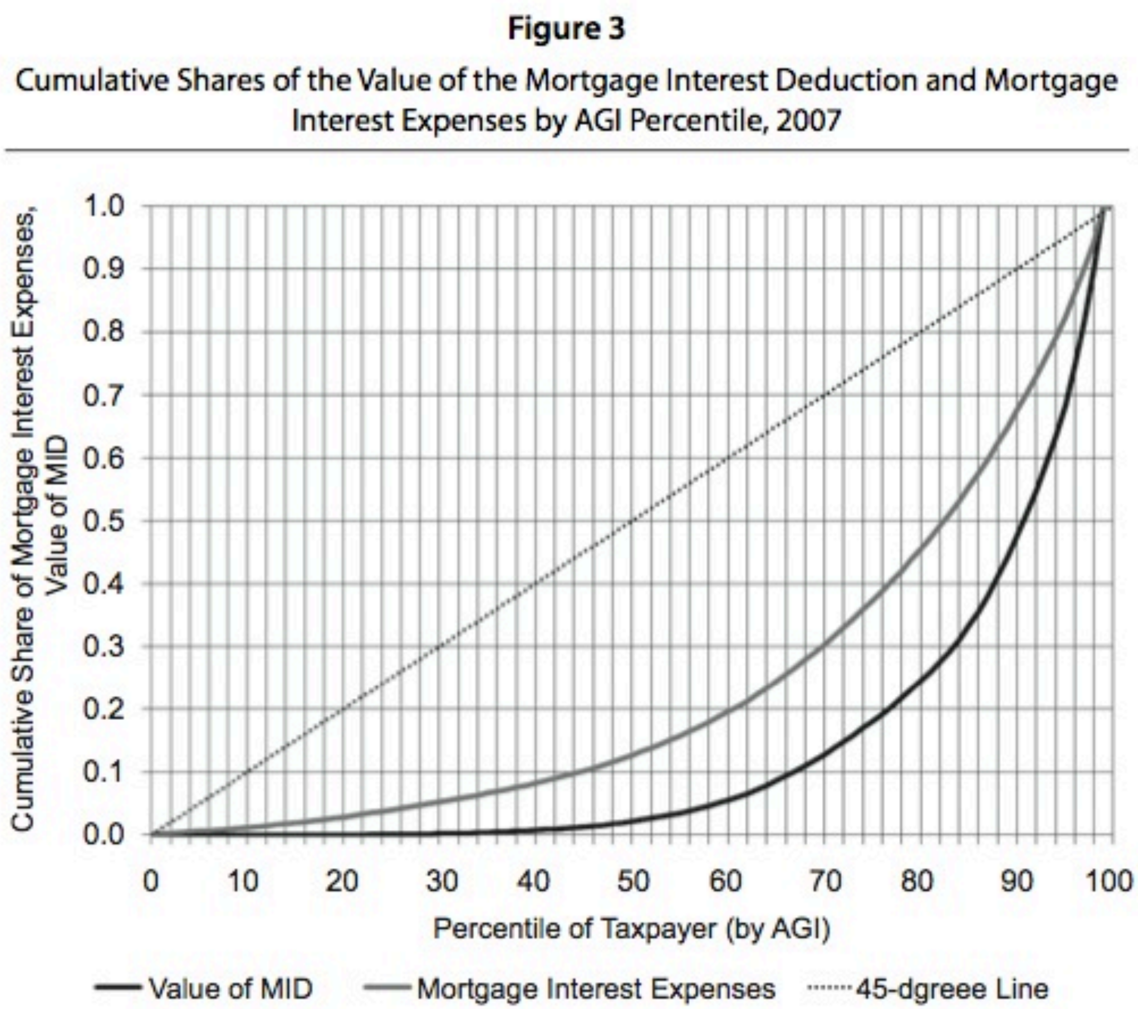
Personal Itemized Deductions by the Numbers

- Home Tax Expenditures: $664 billion/6 years
  - Home mortgage interest + real property taxes + cap gains exclusion
- Charitable Contributions: $239 billion/6 years
- State + Local taxes: $278 billion/6 years
- These 3 itemized deductions = *$1.2 trillion over six years* in forgone revenues
- **These all may be political sacred cows, but it's come down to their survival, or ours**

http://www.huffingtonpost.com/edward-d-kleinbard/sacred-tax-cows-its-them_b_677514.html

(Estimates from JCT annual tax expenditure estimates for 2012-2017)

Itemized Deductions Are Regressive



Note: Non-filers are excluded from this sample.
Source: Authors' calculations based on data from the SOI Division of the IRS.

Source: Cole et al., *The Distributional and Revenue Consequences of Reforming the Mortgage Interest Deduction,* 64 NTJ 977 (2011)