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Tax Expenditures Deserve Scrutiny, Panelists Say

By Eric Kroh — ekroh@tax.org

The federal government must reexamine and reduce tax expenditures to avert a fiscal crisis and put the country's budget on a sustainable course, speakers said at a roundtable in Washington hosted by Tax Analysts and moderated by Tax Analysts President and Publisher Christopher Bergin.

"One way or the other we can raise taxes on the vast majority of us or we can radically change our thinking about the size of government, and that in turn requires putting tax expenditures front and center," said Edward D. Kleinbard, former chief of staff of the Joint Committee on Taxation.

Raising taxes on only the rich would not be sufficient to solve the country's financial problems, and middle-income earners will have to be tapped as a source of revenue, Kleinbard said. That could be accomplished by raising marginal tax rates through a VAT or some other means or by reducing spending such as tax expenditures, he said.

The United States has the fourth lowest taxes of any OECD country, yet the nation has an "appetite for spending" akin to that of a country with high taxes, Kleinbard said, noting that spending on tax expenditures as a fraction of GDP has accelerated in recent decades. Capping expenditures at the same percentage of GDP as in 1974 would save \$450 billion per year, he said. "We'd be done. We win. Thanks for coming. Drive home safely," Kleinbard said.

Capping expenditures at the same percentage of GDP as in 1974 would save \$450 billion per year, Kleinbard said.

But achieving a significant reduction in tax expenditures would require a herculean political effort, because legislators are loath to cut "sacred cows" such as the employer deduction for health-care plan contributions or the homeowner mortgage interest deduction, Kleinbard said.

Eric Toder, codirector of the Urban-Brookings Tax Policy Center, said refusal to sacrifice those provisions amounts to a significant loss of revenue. About \$1.2 trillion in revenue will be lost to tax expenditures in 2011, Toder said. According to his analysis, the 12 largest tax expenditures accounted for about two-thirds of the revenue lost over a five-year period. The largest tax expenditure, the



Edward D. Kleinbard

Tax Analysts/Derek Squitres

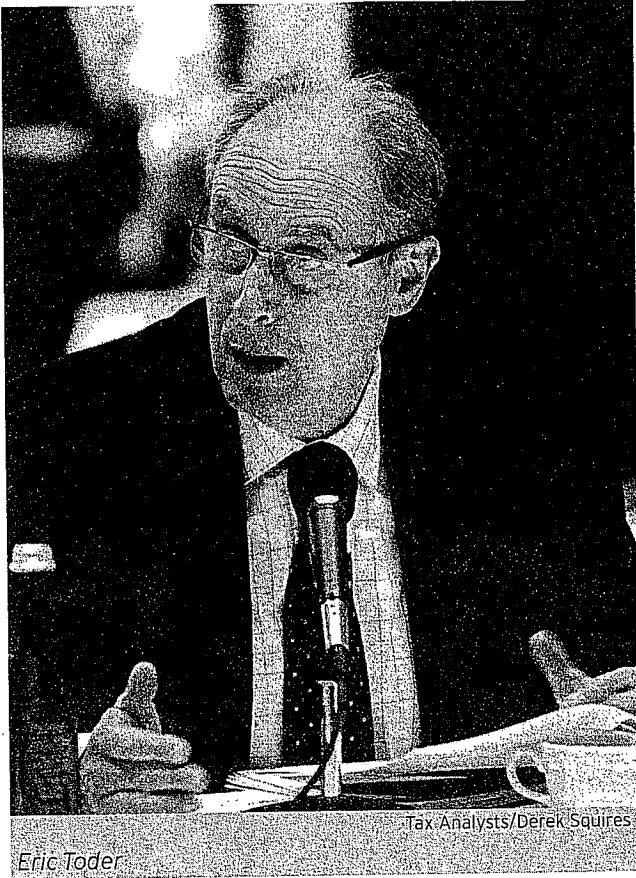
employer healthcare deduction, accounted for a loss of \$1 trillion in revenue over five years, he said.

Kleinbard praised a tax reform proposal offered by Senate Finance Committee member Ron Wyden, D-Ore., and Senate Budget Committee ranking minority member Judd Gregg, R-N.H., as a step in the right direction to reduce tax expenditures and simplify the tax code. (For prior coverage, see *Tax Notes*, May 24, 2010, p. 866. For S. 3018, the Bipartisan Tax Fairness and Simplification Act of 2010, see *Doc 2010-3973* or *2010 TNT 36-47*.)

"All we can do as a country is force our elected representatives to appreciate how important these issues are to us," Kleinbard said. Comprehensive state programs to examine the benefits of tax expenditures in place in Oklahoma and Washington state are also worthy of emulation, Kleinbard said.

Cameron Arterton, tax counsel to House Ways and Means Committee member Lloyd Doggett, D-Texas, mentioned a provision authored by Doggett in the recent tax extenders legislation that would have required the JCT to analyze the worth of each tax expenditure in the bill. (For the extenders bill (H.R. 4213) as passed by the House, see *Doc 2010-12324* or *2010 TNT 107-35*.)

Senate leaders decided to abandon the extenders legislation in part because they could not gain the



Eric Toder

support of some senators who objected to the spending in the bill. (For prior coverage, see *Tax Notes*, June 28, 2010, p. 1416.)

Martin Lobel of Lobel, Novins & Lamont LLP, and chair of the Tax Analysts board agreed that tax expenditures should be justified before they are included in the code.

"They ought to be justified on a regular basis just like appropriated funds are, because these are appropriated funds," Lobel said. He praised the program in place in Oklahoma for including sunsets for all tax expenditures and forcing lawmakers to prove the expenditures, worth before they are renewed.

The money saved by reducing tax expenditures could be used to simplify the code and lower rates across the board, Lobel said. "I think that would be far more stimulative than giving tax subsidies to the steel industry, to the auto industry, to the oil industry, to Wall Street," he said.

Toder said three questions should be asked of every tax expenditure to justify its effectiveness: Does the activity addressed by the provision merit special subsidies? Would a direct spending program make more sense administratively? And if a tax expenditure is needed, is the provision designed the way it should be?

Andrew Schulz, vice president for legal and government affairs at the Council on Foundations, said the government does not have a good system for evaluating the merits of tax expenditures. There should be a single set of questions used to examine every tax expenditure to understand its efficiency and return on investment, Schulz said.

There should be a single set of questions used to examine every tax expenditure to understand its efficiency and return on investment, Schulz said.

"If you forgo a dollar in tax revenue, what are you getting out of the other side?" Schulz asked, adding that lawmakers have no way to find the answer. "That's a significant weakness in how we evaluate these expenditures."

Brian Flahaven, director of government relations at the Council for Advancement and Support of Education, agreed that a reliable method of examining expenditures was necessary. If tax expenditures are not evaluated for their effectiveness before a fiscal crisis occurs, it could lead to a "target-rich environment" in which expenditures are slashed



Andrew Schulz



Tax Analysts/Derek Squires

Brian Flahaven

pell-mell, Flahaven said. In that case, the expenditures that are most likely to survive would be the ones that have the most lobbying dollars behind them rather than the ones that provide the most benefit.

Eileen O'Connor, former head of the Justice Department's Tax Division and now a partner at Pillsbury Winthrop Shaw Pittman LLP, said a proper reexamination of tax expenditures would involve questioning the role of government. While the economic impact of expenditures should certainly be evaluated, their use as a political tool should also be taken into account, O'Connor said.

Lawmakers often propose tax benefits to try to win over a constituency, O'Connor said. That application of expenditures "doesn't belong in our tax system," she said.

Mortimer Caplin, former IRS commissioner and founder of Caplin & Drysdale, said lawmakers' conduct on tax policy is "shocking" and that more leadership on Capitol Hill is necessary to face the fiscal crisis. Caplin agreed with several others at the forum that some form of a VAT is inevitable. He recommended an approach that would apply a VAT to employment taxes along with a simplified income tax.

But James White, director of tax issues at the Government Accountability Office, contended that a VAT would not solve the problem of tax expenditures. The VAT in place in Europe is riddled with tax expenditures, he said. "Large chunks of the consumption tax base in Europe are either exempt from the European VAT, subject to zero rates, or subject to special rates," White said.

'Large chunks of the consumption tax base in Europe are either exempt from the European VAT, subject to zero rates, or subject to special rates,' White said.

Diane Lim Rogers, chief economist at the Concord Coalition, said legislative efforts to reform tax expenditures would be useless without a campaign to educate the public. "The American people can't call on the politicians to do the right thing in terms of tax expenditures because the American people don't understand how tax expenditures work," Rogers said.

Rogers said political activist groups such as the tea party movement that advocate lower taxes don't understand that they would have to give up something in return for lower rates. "That is a big problem," Rogers said. "We'll never get anywhere . . . unless we start with the American people and explain to them that these things have a cost." ■