Next Round of Deficit Reduction Must Tackle Hidden Spending in the Tax Code

How to Avoid the Sequester and Achieve Truly Balanced Deficit Reduction in the Wake of the Recent 'Fiscal Cliff' Deal

Seth Hanlon January 22, 2013

As Washington heads into the next round of budget negotiations, congressional Republicans are again asserting that every dollar of future deficit reduction must come from cutting government programs and services, not from additional revenue.[1] Congress has already cut spending substantially, however: Three-quarters of the $2.4 trillion in deficit reduction that had been enacted since 2011 has been in the form of spending cuts, and only one-quarter has come from increasing revenue.[2] While Congress raised the top marginal tax rate in the recent legislative deal to avoid the fiscal cliff, it has not even begun to tackle the vast array of tax breaks that disproportionately benefit upper-income Americans, nor has it addressed the many loopholes enjoyed by large corporations. These special tax breaks must be on the table going forward if Congress is committed to a balanced approach to solving our fiscal challenges.

This issue brief identifies about $1 trillion in potential savings over 10 years that can be gained from reducing or reforming tax breaks for high-income individuals and corporations. That amount would be more than enough to replace the so-called sequester, the sudden and indiscriminate cuts to government programs that are now scheduled to take effect starting in March.[3]

These common-sense reductions in tax breaks are far preferable to many of the alternatives: allowing the sequester to kick in; enacting deeper cuts to discretionary spending programs, which have already been cut to the bone; or reducing Social Security, Medicare, or Medicaid benefits.

This $1 trillion by no means comes from an exhaustive list. If Congress is committed to a balanced approach to solving our fiscal challenges and is serious about tax reform, there are even greater potential savings. But the $1 trillion in additional revenue is a reasonable step to take. And although it seems unlikely, if Congress were to achieve the next $1 trillion in deficit reduction solely on the revenue side, the ratio of spending cuts to revenue increases in the major budget deals over the past two years would be about 1-to-1.[4]

In many ways, the distinction between spending cuts and revenue increases is an artificial one. Many tax breaks are simply government-spending programs delivered through the tax code. As economists have emphasized—and as many leading Republicans have acknowledged[5]—the result is the same whether the government spends a dollar directly or delivers a dollar in tax breaks aimed at certain recipients or activities. Yet tax breaks—also known as "tax expenditures"—receive far less scrutiny than direct government spending and, as a result, are often inefficient, outdated, or in need of reform. With this in mind, it makes little sense to leave revenue off the table in the ongoing budget negotiations.

Below, we consider tax code spending that benefits high-income and wealthy individuals, followed by tax code spending that benefits corporations and other businesses.

Note: We have provided links to the sources of the revenue estimates, most of which are from official sources. We note, however, that the estimates were done before the recent tax agreement and could therefore change based on the new tax rates and other factors.

TABLE 1

$1 trillion of special tax breaks on the table

Additional revenue from reducing and reforming tax breaks ($ billions over FY13-22)

Limit extra deductions enjoyed by top-bracket taxpayers	$520
Close international tax loopholes and incentives to move jobs overseas	$168
Eliminate write-offs for corporate meals and entertainment	$140
End special tax breaks for inventory	$67
Eliminate special oil, gas, and coal tax breaks	$25
Close loopholes in the estate and gift taxes	$24
Close the "carried interest" loophole for hedge fund and private equity fund managers	$21
Eliminate the John Edwards-Newt Gingrich "S Corporation" loophole	$11
Deny mortgage deduction for vacation homes and yachts	$10
Reduce the "tax gap" through better enforcement against tax cheats	$10
Close tax loophole for derivatives traders	$3
Eliminate corporate jet loophole	$3
Eliminate special write-offs for horse breeders (Bluegrass Boondoggle)	$0.1 ($126 million)
Total	**$1,003**

Source: Congressional Budget Office, Joint Tax Committee, Treasury Department, Committee for a Responsible Federal Budget, authors' calculations. All estimates preceeded the enactment of the American Taxpayer Relief Act and some may overlap.

Tax breaks for high-income and wealthy individuals

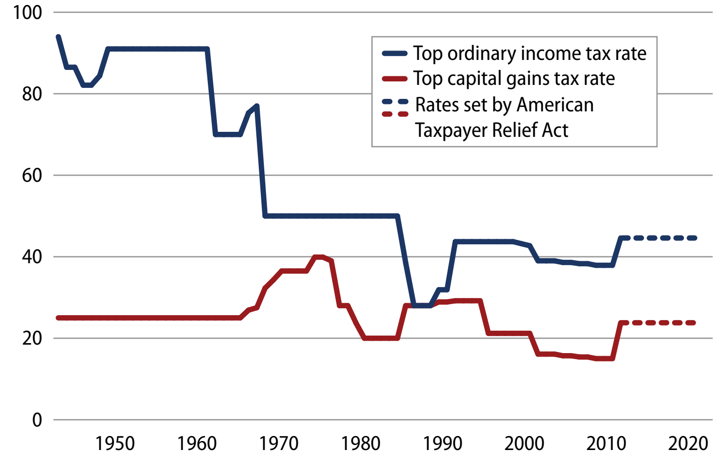
The American Taxpayer Relief Act—the deal passed to avoid the fiscal cliff—allowed ordinary income tax rates to rise to their 1990s levels for families earning more than $450,000 and singles earning more than $400,000 while restoring certain phase-out provisions and modestly increasing tax rates on capital gains and dividends.[6] The top tax rates on ordinary income and capital gains are now about where they were in the 1990s—though still low by historical standards. (see Figure 1) While the tax increases did pass, they are modest: The richest 1 percent of Americans will see their overall tax rates rise by 3 percent in 2013 as a result of the legistlation. That is significantly less than the 5.3 percent increase that would have occurred under President Barack Obama's full revenue proposals and the potential 7.2 percent increase had Congress done nothing and let all tax cuts expire.[7]

To put that 3 percent increase in perspective, keep in mind that between 1979 and 2007, the inflation-adjusted after-tax incomes of the richest 1 percent of Americans rose by more than 300 percent[8]—compounding annually in real terms at an average rate of more than 5 percent per year.[9] Given historic income growth, the wealthiest 1 percent will likely make up for the tax increase in real terms in a short amount of time.

FIGURE 1

Marginal federal tax rates since World War II

Ordinary income (wages, self-employment income, interest, etc.) and capital gains rates



Notes: From 1971 to 1982, the top rate on unearned income other than capital gains (e.g. interest, dividends) was 70 percent. Beginning in 2003, the capital gains rate applied to qualified dividends as well. Top rates include the effect of the Pease limitation for relevant years and Medicare taxes.

Source: Author's calculation based on http://www.ctj.org/pdf/regcg.pdf and H.R. 8, American Taxpayer Relief Act (112th Cong.), as enacted.

The bottom line is that the wealthiest Americans can contribute substantially more to deficit reduction. At this point, the best way to raise the needed revenue is by reducing the hidden spending delivered by tax breaks and tax loopholes. Here are some ways we can do that, as well as how much taking each action could save.

Limit the extra benefit top-bracket taxpayers receive from tax breaks: $520 billion

Most tax benefits and incentives come in the form of deductions or exclusions. Both are provisions that reduce one's taxable income and include many of the most important—and most costly—tax breaks, such as those for mortgage interest, charitable giving, employer-provided health insurance, and retirement savings. One of the unfortunate and largely unintended effects of structuring tax benefits as deductions or exclusions is that they tend to provide much bigger tax benefits to those in the highest tax brackets.

For a wealthy taxpayer in the highest tax bracket—now 39.6 percent—a $10,000 itemized deduction, such as one for mortgage interest, results in $3,960 in tax savings. For a taxpayer in the 15 percent bracket, however, that same deduction is worth only $1,500.

This "upside-down" effect is not only unfair, but it's also inefficient from a budgetary point of view: It gives the largest tax break to the people who are least likely to need it and also least likely to respond to the incentive. High-income people, for example, are already likely to be homeowners, and they would therefore likely use disposable income to save for retirement even without a tax incentive.[10] We would not tolerate it if a federal spending program distributed benefits in such an inefficient way—and we should be equally cost conscious with programs and subsidies that operate through the tax code.

The president has proposed addressing this inefficient "upside-down" effect by limiting tax breaks for the highest-income Americans: People whose high incomes place them in the top tax brackets would be able to claim the same value from deductions that a middle-class taxpayer in the 28 percent bracket gets, but not more. This proposal would make tax breaks fairer and more efficient while raising substantial revenue. In 2012 it was estimated that such a proposal would raise $520 billion over 10 years.[11] (The American Taxpayer Relief Act would reduce this estimate somewhat over the same 10-year budget window. Also, if policymakers create a separate higher limit for charitable deductions—an idea reportedly under discussion in the fiscal cliff talks—the revenue estimate would be further reduced.)

For those concerned about the effect of such a policy on incentives for homeownership, retirement savings, or other areas, it should be noted that the 28 percent incentive under the president's proposal is greater than that of recent House Republican budgets, which cap tax rates at 25 percent, effectively limiting the value of deductions to 25 percent. Twenty-eight percent is also the level that was put in place by the legendary 1986 tax reform, which set the top marginal rate at 28 percent. The incentives retained under the president's proposal are also much stronger and more sensible than the ones retained under proposals to impose a dollar cap on deductions, an idea floated by presidential candidate and former Massachusetts Gov. Mitt Romney (R) and some congressional Republicans.[12]

Of the proposals under consideration, the president's proposal is simply the most progressive and most efficient way to achieve savings from major tax expenditures while also addressing tax code unfairness. The Center for American Progress and others have advocated a more fundamental reform: turning deductions into credits that provide the same benefit for all taxpayers. The president's proposal does not go that far, but it is still a major step toward a more rational tax code.

Close loopholes in the estate and gift tax: $24 billion

The recent tax deal was a boon for heirs of multimillion-dollar estates. Though the highest estate tax rate will rise from 35 percent to 40 percent, the American Taxpayer Relief Act permanently locked in the very high estate and gift tax exemptions approved by Congress two years ago, with those exemption levels rising with inflation in the future. For 2013 the exemption will be $5.25 million per person.[13] That means that the heirs to a couple's estate can inherit $10.5 million of wealth tax free, even without any creative estate planning.

Given the costly extension of estate tax cuts and the fact that the estate tax is now limited to the largest 0.14 percent of estates, it is now even more important that Congress address loopholes in the estate tax that enable the tax-free transfer of even greater sums to heirs.[14]

In a recent op-ed, Harvard economist and CAP Distinguished Senior Fellow Lawrence H. Summers did some simple math to put our "broken" estate tax system in perspective:[15]

> *Assets that are passed to relatives or other personal relations are often badly misvalued relative to what they cost on an open market. The total wealth of American households is estimated at more than $60 trillion. It is heavily concentrated in very few hands. A conservative estimate given the lifespans of Americans would be that 2 percent ($1.2 trillion) is passed down each year, mostly from the very rich. Yet estate and gift taxes raise less than $12 billion, or just 1 percent of this figure each year.*

Estate tax planning strategies come in many different forms.[16] President Obama's budget identifies several reforms to prevent people from undervaluing assets or setting up certain trusts to pass assets to heirs free of tax. The Treasury Department estimated in 2012 that these reforms would raise $24 billion over 10 years, an amount that probably just scratches the surface when it comes to estate tax loopholes.[17]

Close the "carried interest" loophole for hedge fund and private equity managers: $21 billion

Remember Gov. Romney? He may have left the political scene since the November elections, but he continues to benefit from the so-called carried interest loophole to the tune of millions of dollars.[18] This loophole permits the managers of investment funds such as hedge funds and private equity funds to treat the bulk of their compensation—called the "carry"—as capital gain rather than as ordinary income.[19] The carried interest loophole is unfair because for individuals at almost every other job, income from one's efforts is generally taxed at ordinary income rates. In other words, people with regular jobs don't have the opportunity to turn their income into lighter-taxed capital gains. The loophole represents an inefficient and wasteful subsidy for the professions that benefit from it.

The new tax bill let capital gains rates rise, but highly compensated fund managers can still save more than 15 percent in taxes by exploiting the carried interest loophole. In 2011 the Congressional Budget Office estimated that closing the loophole—requiring fund managers to pay ordinary tax rates on their entire compensation—would raise $21 billion over 10 years.[20]

Eliminate the John Edwards-Newt Gingrich "S Corporation" loophole: $11 billion

Certain highly paid professionals sometimes take advantage of a tax loophole made infamous by former Speaker of the House Newt Gingrich (R-GA) and former Sen. John Edwards (D-NC).[21] These professionals—lawyers, accountants, doctors, consultants, and entertainment professionals—form "S corporations," whose profits are not subject to Medicare taxes and who characterize much of their income as profits of the business instead of salaries. Regular wage-earners can't do this, and neither can the owners of other kinds of small businesses. Government watchdogs have flagged the S corporation loophole as an area of rampant abuse.[22] Legislation introduced in the House and Senate in recent years would shut down this loophole, requiring these well-heeled professionals to pay their fair share into Medicare, which would raise $11 billion over 10 years.[23]

Deny mortgage deduction for vacation homes and yachts: $10 billion

The mortgage interest deduction is intended to promote homeownership, but the tax code allows people to claim it not only on one property but two. Moreover, under current Internal Revenue Service rules, a second home doesn't have to be a house—it can be a large boat, too.[24] Under the rules, boats can qualify as second homes eligible for the tax break only as long as they contain sleeping spaces, bathrooms (heads), and kitchens (galleys). In other words, only large boats qualify.

This is a perfect illustration of how a tax break intended to help middle-class people afford homes winds up subsidizing lavish lifestyles and costing more than it should. It makes little sense to maintain tax breaks on vacation properties or yachts while regular homeowners who can't afford such luxuries can claim only a deduction on one home and renters receive no deduction at all, especially at a time when budget constraints have put federal housing programs at risk. We estimate that limiting the mortgage interest deduction to primary residences would raise at least $10 billion over 10 years.[25]

Close tax loophole for derivatives traders: $3 billion

Warren Buffett calls[26] this one of the "extraordinary tax breaks" for the "mega-rich": Due to a special rule in the tax code,[27] certain derivatives traders pay a "blended" rate on their income—60 percent at favorable long-term capital gains rates and 40 percent at ordinary income rates.

Although investors must generally hold onto assets for one year in order to enjoy low-rate capital gain treatment, traders who buy and sell derivatives are eligible for the blended rate even if they buy and sell instantly. The loophole was carved out a generation ago to protect investors in commodities futures whose purpose was to protect long-term profits, not engage in short-term speculation. But financial markets have changed, and as Buffett explains, a trader can "own stock index futures for 10 minutes" and get the favorable tax treatment "as if they'd been long-term investors."

Sen. Carl Levin (D-MI) introduced legislation in the last Congress to close this loophole.[28] The Obama administration estimates that doing so would raise nearly $3 billion over 10 years.[29]

Corporate and business tax breaks

The $2.4 trillion of deficit reduction since 2011 has left corporate taxes untouched even though the corporate tax has been a declining revenue source[30] and special subsidies for businesses abound in tax code. In fact, the American Taxpayer Relief Act included a two-year extension of more than 30 separate corporate and business tax breaks at a cost of $46 billion. It's time to include corporate tax breaks as part of a plan for deficit reduction.

Close international tax loopholes and incentives to move jobs overseas: at least $168 billion

The biggest corporate tax loopholes are found in the tax rules for multinational corporations operating overseas. The U.S. tax code subsidizes offshore investment in myriad ways, stemming from the ability of U.S. multinationals to defer taxes on their foreign income. As a new Congressional Budget Office report explains:[31]

> *The current tax system provides incentives for U.S. firms to locate their production facilities in countries with low taxes as a way to reduce their tax liability at home. Those responses to the tax system reduce economic efficiency because the firms are not allocating resources to their most productive use…The current system also creates incentives to shift reported income to low-tax countries without changing actual investment decisions. Such profit shifting erodes the corporate tax base and leads to wasted resources for tax planning.*

President Obama's proposals to close international tax loopholes would raise a combined $168 billion[32] while helping to level the playing field for investment in the United States. These proposals include:[33]

- Preventing corporations from taking immediate deductions for interest expense related to tax-deferred foreign income
- Determining foreign tax credits on a pooling basis to limit "cross-crediting"
- Cracking down on tax-avoidance schemes involving the transfer of intangible property to offshore locations

- Limiting the ability of certain corporations ("dual capacity taxpayers") such as oil and mining companies to claim foreign tax credits for "disguised royalties" and other nonincome tax items

Eliminate write-offs for corporate meals and entertainment: up to $140 billion

Eating and entertainment are personal expenses. If an individual takes his family out to dinner, he cannot deduct the cost of that meal from his taxable income. If, however, that same individual takes someone out to lunch and claims it is for a business purpose, then IRS rules allow him to deduct half of the cost of the meal. This special exception acts as an unnecessary subsidy for many people who can benefit from expense accounts and their guests while potentially skewing business decision making in inefficient ways.[34] Allowing deductions for business meals and entertainment also results in an unknown quantity of abuse and fraud, with personal expenses classified as "business" expenses and the IRS ill-equipped to police the legitimacy of the deductions.[35]

Entirely eliminating meal and entertainment deductions would raise $14 billion per year, while reducing the deduction to 25 percent would raise $7 billion per year, according to estimates from the Committee for a Responsible Federal Budget.[36]

End special tax breaks for inventory: $67 billion

The tax code allows companies to choose the most favorable method of valuing their inventory and cost of goods sold, and many taxpayers choose the "Last In, First Out," or LIFO, method, which can provide a substantial tax-deferral benefit. LIFO, however, has been described as an inefficient and unnecessary subsidy for certain businesses.[37] Furthermore, International Financial Reporting Standards do not allow the use of the LIFO method, meaning that its use poses an obstacle to conformity with these standards.[38] Phasing out LIFO over a transition period, as well as a similarly flawed accounting method known as "Lower of Cost or Market," would raise $67 billion over 10 years.[39]

End special fossil-fuel tax breaks: $25 billion

The oil and gas industry is one of the most profitable industries on earth. The top five multinational oil and gas companies have reported nearly $1 trillion in profits this decade, and yet the oil and gas industry continues to collect billions in tax subsidies.[40] Two of the major subsidies—expensing of intangible drilling costs and "percentage depletion"—were enacted in 1916 and 1926, respectively. Today the oil and gas industry is a mature, extremely profitable industry enjoying windfalls from oil prices approaching $100 per barrel.[41] The industry simply does not need billions in special tax breaks as an incentive to do what it already does. Moreover, in 2009 the G-20 nations agreed to phase out inefficient and wasteful fossil-fuel subsidies.[42]

Eliminating the following fossil-fuel industry tax breaks would save nearly $25 billion[43] over 10 years:

- Expensing of intangible drilling costs
- Percentage depletion for oil and gas wells
- Two-year geological and geophysical amortization period for independent producers
- Deduction for tertiary injectants
- Exemption to passive loss limitation for working interest in oil and natural gas properties
- Expensing, percentage depletion, and capital gains tax breaks for coal

Eliminate corporate jet loophole: $3 billion

The tax code includes innumerable subsidies that distort the choices made by businesses. One loophole that has drawn intense scrutiny is the tax treatment of corporate jets. Companies can write off the costs of corporate jet purchases over five years, even though passenger jets must be depreciated over seven years and the planes actually last for decades. Closing the corporate jet loophole—that is, simply applying the rule for commercial jets to corporate jets—would raise $3.2 billion over 10 years.[44]

Eliminate special write-offs for horse breeders (the Bluegrass Boondoggle): $126 million

A special tax break[45] slipped into the 2008 farm bill allows horse breeders to write off their investments—the horses—over three years. A report[46] conducted by the Treasury Department determined that racehorses actually have a much longer useful life. A faster, three-year depreciation schedule represents an unwarranted subsidy for the breeders and costs a reported $126 million over 10 years.[47]

Conclusion

All told, this hidden spending through the tax code adds up to roughly $1 trillion in potential budget savings—about enough to turn off the sequester while nearly stabilizing the nation's debt over the next 10 years. And these are nowhere near the full list of areas for potential savings—including loopholes for cruise ship operators,[48] loopholes that allow companies to defer capital gains taxes using "like kind exchanges,"[49] an enormous tax break[50] called "stepped up basis" that is the major reason why about half of all capital gains avoid tax permanently,[51] and many, many more.

We can also recoup billions in lost revenue simply by enforcing the law better and cracking down on tax cheats. The IRS estimates that in 2006, despite enforcement efforts, the United States lost nearly $400 billion in revenue from unpaid and unreported taxes—a number that probably underestimates the revenue loss from offshore activity.[52] Our $1 trillion in revenue includes the $10 billion[53] that the Joint Tax Committee estimates can be raised from several proposals by President Obama to reduce the tax gap. But that is just the tip of the iceberg.

It is likely that the next round of deficit reduction will include a mix of spending cuts and revenues. But even if the entire next round comes from revenues—in other words, if Congress replaces the sequester with roughly $1 trillion in new revenue from reducing tax breaks—the overall ratio of deficit reduction since 2011 would only then approach 1 to 1 between program cuts and revenue.

That is what a truly balanced approach to deficit reduction looks like.

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