Your Loophole Is My Noose

By Editor Test *Wed, Aug 11, 2010*

Tax breaks, when seen as passive spending programs, are a form of government waste. So raising taxes might shrink the size of government. Or not.

"Here we are in August," Donald Marron told 300 or so retirement researchers at the National Press Club last week, "and the federal government is still deciding what the tax policy for the current year will be."

That's a big obstacle to decision-making by businesses, individuals, and the financial industry. "The future is always uncertain," said Marron, a veteran inside-the-Beltway wonk and blogger who is now director of the Tax Policy Center at the liberal-leaning Urban Institute. "But now it's particularly uncertain."

The fate of the Bush tax cuts is only one of the uncertainties. So is the issue of the whether the estate tax will be enforced retroactively for 2010, and whether Congress will continue the "patch" that has prevented the Alternative Minimum Tax from hurting the upper middle class, and whether the "tax extenders" bill will pass.

Uncertainty even lingers over the impact of health care and financial regulation, he said. Although "historic" bills have been signed into law, their precise effect won't be known the bureaucracy writes regulations, if then.

But Marron's main beef was with tax policy, or the lack of it. "We don't have a well-defined tax policy in the U.S.," he said. "This creates uncertainty in private business and in the policy community."

The current imbalance between federal expenditures and tax revenues cries out for a more coherent policy, he said. Tax revenues are down to about 15% of GDP, down from a long-term average of about 18%. Meanwhile, government expenditures have reached about 26% of GDP, up from a more familiar 20%. That imbalance, a result of the financial crisis, is unsustainable. But Marron doesn't see anyone in government working on a timetable to end it.

"You can't have debt growing faster than the economy," he said.

"The financial crisis has brought the 'long-run future' closer by about a decade," he figures, simply because it raised the deficit. Putting it another way, "we lost about a decade of response time for dealing with the deficit.

Even if no budget problems existed, we would still have to reform the tax system, which he described as "unfair, inefficient, anti-growth and too complex."

What's needed—that is, what's lacking—is a "vision of where we want to go," Marron said. "The political process needs to replace the arbitrary and uneven trajectory of tax policy with a coherent plan."

That will involve “resurrecting firm budget restraints,” as opposed to the “soft”—he intended that to be an understatement—restraints that exist today. PAYGO restraints that require new expenditures to be offset by cuts or new revenue are only a superficial remedy.

“The question is, how big a government do you want?” Marron said. But he pointed out that this question won’t be easy to answer because the word “big” can be very ambiguous.

Some people regard the repeal of tax preferences—such as agricultural or mortgage or oil exploration subsidies, or the Bush tax cuts—as akin to raising taxes and increasing the size and reach of government.

Others regard tax preferences as spending programs by another name and see their removal as tantamount to a reduction in spending and in the size of government.

“You can have a debate over whether you’re growing or shrinking government by closing or keeping loopholes,” Marron said. He did not mention that the recipients of political pork are unlikely to regard it as such, and vice-versa.

Marron said his own “quixotic goal” is to advocate the removal of the tax break for employee health care costs. That would free up $200 billion a year and could single-handedly eliminate Social Security’s long-term funding problems. It would also make individuals more sensitive to the cost of medicine and thereby dampen its overuse. “That might bend the curve” of rising costs, making it less steep.

Speaking of Social Security—Marron disagreed with the conventional wisdom that it’s the “easy” problem to fix.

On paper, that might be true, he said. But there are lots of messy ethical or equity issues complicating Social Security reform, he said, such as whether the pain of raising the retirement age would fall disproportionately on those least able to bear it. (See “The Downside of Upping the Retirement Age,” in the August 11, 2010 issue of RIJ.)