

## The Better Base Case

By Edward D. Kleinbard and Joseph Rosenberg



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The most recent Congressional Budget Office forecast for the federal budget estimates that the deficit will decline to about 1 percent of GDP a decade from now. But that essentially rosy forecast is predicated on the expiration of all temporary tax policies — in particular, the 2001 and 2003 personal income tax cuts — and a reversion to pre-2001 tax law. Kleinbard and Rosenberg argue that revenue collections of the same magnitude as those projected by the CBO are necessary over the medium term. But some aspects of tax law are problematic, and the efficiency and equity of the scheduled post-2012 tax system can easily be improved.

The authors have developed an alternative post-2012 personal income tax regime: the “Better Base Case.” Their proposal contemplates modifying current law by limiting personal itemized deductions to a 15 percent tax rate benefit and then spending the resulting incremental revenues to (1) permanently patch the alternative minimum tax, (2) tax dividends at the same preferential rates as net capital gains, (3) restore the estate tax to 2009 rates and exclusion, and (4) restore the child credit to its current levels. Using the Tax Policy Center’s microsimulation model, the authors demonstrate that this package of reforms is revenue neutral compared with current law and is slightly more progressive in its distribution of tax burdens. The authors consider the political economy implications of the proposal and conclude that the Better Base Case is a logical and feasible next step in the evolving debate over the size and financing of the federal government.

The authors would like to thank Dan Baneman for expert assistance with the tax model simulations. The views in this report are theirs alone and do not represent the views of the Urban Institute, its board, or its funders.

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### I. Crises of Our Own Design

We are paralyzed by false fiscal crises. Over the next decade, at least, the nonpartisan Congressional Budget Office has calculated that federal budget deficits will shrink to reasonably small levels, without recourse to selling our national parks, shutting

down Pell Grants or similar programs, or abandoning Medicaid. That CBO baseline projection does, however, assume that two conditions are met: first, that there are no extraordinary developments (new wars, for example) that would severely stress the U.S. economy; and, second, that Congress keeps its hands off fiscal policy and allows current law to operate as scheduled. In particular, the CBO baseline projections contemplate that the scheduled \$1.2 trillion spending sequester will go into effect and, much more important, that all temporary tax policies expire as scheduled (amounting to about \$5.4 trillion over 10 years<sup>1</sup>).

<sup>1</sup>CBO, “Updated Budget Projections: Fiscal Years 2012 to 2022,” at 5 (Mar. 1, 2012), *Doc 2012-5304*, 2012 TNT 50-26.

The CBO baseline budget projection shows the federal government running deficits in the range of 1 percent of GDP by the end of the 10-year period and publicly held Treasury debt at declining but still relatively high levels compared to historical norms (around 61 percent of GDP in 2022). That might suggest that the baseline does not include enough cushion for unknown future economic shocks. But much more important is the CBO's conclusion that continuing temporary tax policies — in particular, the 2001 and 2003 personal income tax cuts — will lead to wholly self-inflicted but genuine fiscal crises, with annual deficits running at more than 5 percent of GDP and publicly held debt climbing to levels 50 percent higher than those projected in the baseline (about 93 percent of GDP).<sup>2</sup>

It is possible that Congress will remain paralyzed on all significant tax legislation until the new one sits in January 2013. But ironically, paralysis here is better than the alternative, which is for Congress to surrender to its bad bipartisan impulse to reflexively continue its temporary tax policies, and thereby precipitate an authentic fiscal crisis in a few years' time.

In other words, if Congress is a doctor charged with restoring our fiscal health, then its first imperative must be to do no harm. Congress can do so here by just taking a break and walking away — by allowing the fiscal policies (by which we mean simply the overall levels of projected revenues and outlays) already embedded in law to take effect. The resulting inaction will lead to an imperfect but sustainable fiscal path for the next decade.

This report therefore proposes that policymakers view the inevitable expiration of the temporary personal income tax cuts as an opportunity, not a looming disaster. More particularly, we envision the following:

1. The temporary personal income tax cuts expire as scheduled at the end of this year. (We allow for the possibility that the path to the current-law revenue baseline be phased in, rather than take effect all at once.)
2. Recognizing that the reversion to circa-2000 tax law would bring back some highly undesirable tax policies, Congress adopts the simple revenue-neutral (relative to the current-law baseline) reform package that we outline in Section II.
3. Policymakers then use the relative calm of a stable medium-term fiscal path to reach con-

sensus on strategies to address our unsustainable long-term entitlements spending problems.

Congress needs to focus on long-term fiscal pressures, which arise primarily from the issue of U.S. medical care.<sup>3</sup> The United States is by far the most profligate healthcare spender in the world per capita, and in return we have both mediocre health outcomes and tens of millions of uninsured Americans.<sup>4</sup> But we must stabilize the patient first. We then can have a more productive conversation about long-term spending policies and design appropriately long transition rules to whatever those new spending policies might be.

Section II presents the "Better Base Case." Section III briefly addresses the political economy implications of the scenario we envision. Section III considers, for example, whether it really is necessary to raise revenues relative to the current-policy (as opposed to current-law) baseline, whether the expiration of the temporary personal tax policies would be too great a shock for the economy to bear, and whether a reversion to circa-2000 personal income tax rates will have a material adverse effect on work effort.

All things being equal, lower taxes are better than higher taxes, and lower marginal tax rates are better than higher marginal tax rates. But those are truisms along the lines of the observation that as a rule of thumb, it is better to be rich and healthy than poor and sick. If we as a country can agree on government spending reductions that make sense to us, then taxes can be lower. But to argue for lower taxes because that will lead to lower spending is like arguing that by buying clothes that are too small, one is sure to lose weight.<sup>5</sup>

Section III returns to some of those themes. But unless and until government spending reductions materialize, we should assume that the CBO baseline represents a necessary base case for the level of federal government revenues that are required to fund a government that fulfills the functions that we collectively demand of it.<sup>6</sup> The point of the

<sup>3</sup>Alan J. Auerbach and William G. Gale, "The Federal Budget Outlook: No News Is Bad News," Brookings Institution (Apr. 2012). Auerbach and Gale report fiscal gaps of between 2 and 4 percent of GDP through 2085, even under CBO baseline budget assumptions.

<sup>4</sup>Edward D. Kleinbard, "The Role of Tax Reform in Deficit Reduction," *Tax Notes*, Nov. 28, 2011, p. 1105, *Doc 2011-21341*, 2011 TNT 229-6.

<sup>5</sup>For an empirical rejection of the hypothesis that tax cuts can drive spending reductions, see Christina D. Romer and David H. Romer, "Do Tax Cuts Starve the Beast? The Effect of Tax Changes on Government Spending," *Brookings Papers on Economic Activity* (Spring 2009), at 139-200.

<sup>6</sup>See *supra* note 4, at 1112-1113.

<sup>2</sup>*Id.*

scenario we outline above is that we need first to stabilize the fiscal patient before bickering over which limb to amputate.

This report does not address business tax reform. We agree with many other observers that business tax reform is needed and that the U.S. statutory corporate income tax rate is too high. We believe, however, that business tax reform should be seen for the moment as on a separate track from the personal income tax revenue base that is the focus of this report. In particular, we see business tax reform as a roughly revenue-neutral exercise, with lower corporate tax rates paid for through (1) reductions in business tax expenditures (for example, depreciation), (2) an international business tax system that is more resistant to the depredations of the systematic underreporting and arbitrage that plague it today, and (3) greater consistency between corporate and noncorporate business tax burdens. Business tax reform and the personal tax issues discussed in this report intersect principally at only one point, which is the concern that in the new rate environment the closely held corporation will become a tax shelter. There are, however, solutions to that technical problem.<sup>7</sup>

## II. The Better Base Case

The CBO's current-law baseline projection of federal tax revenues over the next 10 years represents an inescapable, if mildly discomfiting, base case for the level of tax collections required to stabilize the patient — to fund the federal government over the medium term. But there are good reasons beyond a simple aversion to higher taxes to be unenthusiastic about the return of the tax system that was in place in 2000. That tax system had several conspicuous defects. The individual AMT was one; by (perverse) design, it was not indexed to inflation, and so applied to more and more taxpayers with every passing year. But there were other major flaws as well.

We do not believe that one can stabilize the fiscal patient and simultaneously subject the fundamental design of our tax system to major transplant surgery through the addition of VATs or similar ideas. Those sorts of fundamental reform proposals should be considered, but the right time to debate them is in an environment in which we do not confuse their rationales with solutions to artificial fiscal crises of our own making.

<sup>7</sup>Cf. Kleinbard, "An American Dual Income Tax: Nordic Precedents," 5 *Nw. J.L. & Soc. Pol'y* 41 (2010) (discussing how Nordic dual income taxes used deemed rate of return mechanisms to distinguish labor from capital income in the case of closely held businesses).

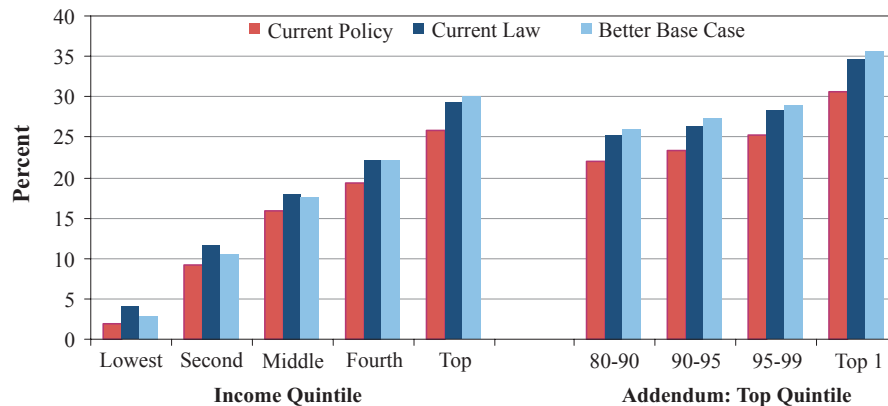
Nonetheless, we believe that it is possible to raise the same level of revenues as that contemplated by the CBO's 10-year baseline projection in a far fairer and more efficient manner: by making a few targeted surgical alterations to the current personal income tax system. We set out our proposal — the Better Base Case — below. It was developed using the Tax Policy Center's state-of-the-art microsimulation tax model, similar to those used by government agencies. All calculations reflect plausible behavioral responses to the changes we propose, just as do the revenue estimates of the Joint Committee on Taxation.

Very simply, the Better Base Case contemplates raising the same federal personal income tax revenues as would the CBO's current-law baseline. It introduces one revenue-increasing change and then spends those revenues elsewhere through four important tax reductions that improve the fairness and efficiency of the tax system.

Specifically, the Better Base Case contemplates the following:

1. *Limit the value of personal itemized deductions to a 15 percent tax benefit*, and simultaneously repeal the Pease overall limitation on the ability to claim itemized deductions.<sup>8</sup> This would raise almost \$1.3 trillion between 2013 and 2022, over and above the expiration of the 2001 and 2003 tax cuts, assuming a January 1, 2013, effective date.
2. *Permanently patch the AMT*, by providing for an inflation adjustment of the AMT exemption amount from its 2011 level. Also, the patch would allow nonrefundable tax credits to offset AMT liability. This would cost a little less than \$600 billion over the nine-year period, measured after imposing the 15 percent cap on itemized deductions.
3. *Retain the child credit at its 2012 level*. This would cost \$300 billion over nine years. It is an important element of our proposal because it maintains some of the progressivity at lower income levels that was one of the desirable features of the Bush tax cuts.
4. *Keep the tax rate on qualified dividend income at the same 20 percent tax rate that applies to long-term capital gains* (technically, net capital gain), rather than allowing the tax rate on dividends to jump to the maximum marginal tax rate on labor income. This would cost about \$160 billion over the nine-year period. One of the virtues of the 2001 and 2003 tax cuts was the

<sup>8</sup>Section 68.

Average Effective Federal Tax Rates<sup>a</sup> by Income Percentile, 2015

<sup>a</sup>Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income. Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

elimination of the enormous tax planning efforts that went into converting dividend income into capital gains and the attendant distortions in economic behavior. Moreover, the charge that prior law imposed an inexplicable double tax on dividend income had merit, particularly when nonpublic firms could organize as passthrough entities and avoid that double tax entirely.

5. *Reinstate 2009 estate tax rules* — a \$3.5 million exclusion (permanently indexed for inflation from 2009) and 45 percent tax rate. This would cost about \$240 billion over the nine-year period. In our view, this represents a reasonable compromise among competing proposals and avoids returning to the \$1 million exclusion and 55 percent rate contemplated by pre-2001 law. By raising the exclusion to \$3.5 million, our proposal will exempt all but the very largest estates from estate tax liability.

The year-by-year revenue estimate for the Better Base Case package, along with tables showing the distribution of tax changes in 2015, measured against both the current-law baseline and current policy, are set out in Appendix A. As shown in the figure, the distribution of tax burdens under the Better Base Case is slightly more progressive than the current-law baseline, particularly at the lowest income levels.

We believe that policymakers of all political persuasions should find the Better Base Case superior to simply reverting to pre-2001 law. The Better Base Case permanently patches the AMT and limits the impact of the estate tax to only the very largest estates. It preserves two of the most important policy initiatives of the 2001 and 2003 tax cuts: the reduction in dividend tax burdens to the same rate

as capital gains and tax relief for lower-income working families through the expanded child credit. And it does all that with inframarginal tax increases elsewhere — that is, without further raising marginal tax rates on anyone. Economists of all political persuasions agree that inframarginal tax increases have the lowest impact on fundamental incentives to work and earn income.

There is a widespread consensus that the current personal itemized deductions are perverse, inefficient, and unaffordable.<sup>9</sup> The Better Base Case addresses the upside-down nature of the current deduction structure by capping those personal deductions at a 15 percent tax rate benefit, so that wealthy Americans are not subsidized disproportionately compared to middle-income taxpayers.<sup>10</sup> At the same time, the Better Base Case leaves in place a substantial fraction of the aggregate value of the personal itemized deductions, which minimizes transition concerns.<sup>11</sup>

A powerful argument can be made that the personal itemized deductions should be entirely

<sup>9</sup>See, e.g., Michael M. Gleeson and Michael Beller, "Ryan Budget Calls for Top Tax Rates of 25 Percent," *Tax Notes*, Mar. 26, 2012, p. 1595. Both Rep. Paul Ryan, R-Wis., and Rep. Patrick J. Tiberi, R-Ohio, have argued that tax expenditures must be scaled back, but neither has made specific proposals. See *supra* note 4, at 1113-1117, for a summary of some of the relevant policy arguments.

<sup>10</sup>Cf. Lily L. Batchelder et al., "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stanford L. Rev.* 23, 44-48 (2006).

<sup>11</sup>Slightly more than half of the aggregate value of itemized deductions would be preserved under our 15 percent benefit cap.

eliminated.<sup>12</sup> The Better Base Case does not go that far, but it is possible to imagine that subsequent Congresses could choose to phase out the personal itemized deductions starting at some later date by reducing the tax benefit of the deductions by, say, 1 percent each year for 15 years.

Similarly, the standard deduction invariably gets a free pass when tax expenditures are examined, but the standard deduction has all the same “upside-down subsidy” characteristics that itemized deductions do and no greater justification as a normative income tax matter. The Better Base Case does not change the tax treatment of the standard deduction, but we note that if the standard deduction also were limited to a 15 percent tax rate benefit, that would raise an additional \$215 billion between 2013 and 2021, over and above the nearly \$1.3 trillion raised by the 15 percent tax rate benefit cap on personal itemized deductions. If desired, this additional change could be used to offset the revenue loss from eliminating the AMT altogether.

The Better Base Case can fairly be criticized for leaving untouched the largest single personal consumption tax expenditure: the exclusion of the value of employer-provided healthcare benefits from both the personal income tax base and the payroll tax base of an employee. Our reason for doing so is that this tax expenditure is an integral part of the overall healthcare system, and Congress just went through a gut-wrenching process of reforming how we finance and deliver healthcare in this country. The decision to retain the exclusion for employer-sponsored healthcare was not one to which we are particularly sympathetic, and the resulting healthcare financing and delivery system has the quality of something that even Rube Goldberg might find embarrassing. But our goal in developing the Better Base Case is to stabilize the fiscal patient, not to address the longer-term structural policy issues facing the country. The right time to reconsider the tax treatment of employer-sponsored healthcare is in the context of debating the long-term crisis in healthcare spending. Section III returns to that theme.

Finally, although outside the main thrust of our thesis, we observe that the Better Base Case can be argued to obviate the need for a “Buffett rule.” The

combination of higher tax rates on capital gains and dividends, higher effective (not just marginal<sup>13</sup>) tax rates on the highest levels of labor income, and reduced tax advantages to personal itemized deductions work together to raise the effective tax rate on most Americans with very high incomes.

### III. Political Economy Considerations

#### A. Why Tax Revenue Must Rise

The Better Base Case rests on an assumption that is difficult for some policymakers to swallow, which is that the federal fiscal patient’s condition cannot be stabilized over the next decade without accepting that tax revenues must rise to the levels implied by the lapse of the Bush tax cuts (roughly 21 percent of GDP 10 years from now). One of the authors of this report made the case for that mildly discomfiting reality check in an earlier *Tax Notes* report, and it is worth summarizing very briefly.<sup>14</sup>

In a nutshell, the U.S. government is a spending outlier in two important respects. First, we operate a military that is as expensive as that of the combined budgets of the next 14 or so countries. We have about 5 percent of the world’s population and spend about 42 percent of global military expenditures. We can finance those outsized military expenditures as well as homeland security programs only through tax revenues.

Second, we have by far the world’s most expensive healthcare — about 50 percent more expensive per capita than the next most profligate country (Norway). (By itself, government spending on healthcare in the United States is second to Norway’s.) If the United States were to spend per capita on healthcare what Norway spends, our total healthcare costs (public and private) would decline by some \$800 billion per year. Those outsized government costs must be financed, and tax revenues are how we do so.

At the same time, the population of the United States is aging much more rapidly than most observers appreciate. The CBO projects that the number of Americans over the age of 65 will increase by about one-third by 2022.<sup>15</sup> That demographic trend,

<sup>12</sup>See, e.g., National Commission on Fiscal Responsibility and Reform, “The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform,” at 25 (Dec. 1, 2010), *Doc 2010-25486*, 2010 TNT 231-35 (“The Commission proposes tax reform that relies on “zero-base budgeting” by eliminating all income tax expenditures (but maintaining the current payroll tax base, which should be modified only in the context of Social Security reform), and then using the revenue to lower rates and reduce deficits”).

<sup>13</sup>The Obama administration’s fiscal 2013 budget contemplates retaining the lower tax brackets introduced by the 2001 and 2003 cuts. It is sometimes overlooked that those lower rates are inframarginal tax discounts to high-income taxpayers. The return to pre-2001 tax brackets thus raises the effective tax rate on high-income taxpayers over and above the impact of the marginal tax rate increases that receive the greatest public attention.

<sup>14</sup>See *supra* note 4.

<sup>15</sup>CBO Director Douglas Elmendorf, Presentation to the National Association for Business Economics (Mar. 26, 2012), at 6.

along with the long-term trend of medical costs increasing more rapidly than GDP, has inevitable large fiscal implications because of the claims that older Americans will make on Social Security, Medicare, and other government programs.

As a result, the CBO projects that by 2022, federal government spending on Social Security and government healthcare programs will amount to 12.8 percent of GDP — a 5.5 percentage point increase over the average of the past 40 years.<sup>16</sup> The problem does not disappear by repealing the Affordable Care Act (which in any event was self-funding, so that repeal would generate no net revenues for other purposes), because the problem is more fundamental: It is a sad but inescapable attribute of the human condition that old people are sicker and less productive than are young ones, and therefore make more claims on healthcare and safety net systems.

Against the inescapable demands on government revenues posed by a rapidly aging population and our extraordinary commitment to military expenditures, U.S. federal and subnational governments today collect in tax revenues the lowest percentage of national GDP of any major advanced economy in the world.<sup>17</sup> Our revenue base is simply mismatched with the demands that we place on it today and that we can expect to continue to place on it over the next decade. The government simply cannot operate by collecting the same revenues as a percentage of GDP that might have sufficed 40 years ago when we had a younger, healthier population, while at the same time spending 42 percent of the world's military budget.

For those and similar reasons, we see as unavoidable an increase in tax revenues roughly commensurate with the lapse of the temporary personal tax policies (chiefly, the 2001 and 2003 tax cuts) in their entirety. Fortunately, if there is any good fortune to be seen here, the end of those temporary tax discounts is the default. By agreeing on nothing, by accomplishing nothing, Congress through its inaction will improve the condition of the federal fiscal patient. Our Better Base Case further stabilizes the patient in ways that should satisfy different political points of view.

We are not naïve, and we fully appreciate that the two political parties have very different perspectives on the role of government in the lives of U.S. citizens. That issue can and should be fully debated. But the right way to do that is not by bickering over the right rehabilitation program while the fiscal patient bleeds to death. First, stabilize the patient.

<sup>16</sup>*Id.*

<sup>17</sup>See *supra* note 4, at 1109-1111.

Then, reconsider the larger issues of the role of government. History demonstrates that the patient demonstrably has the strength of constitution to stomach the medicine we have in mind, and the larger debate will need time to play out, followed by years of transition to whatever the new order might be.

The Better Base Case is not a Trojan horse for permanently higher taxes. To the contrary, once the fiscal patient is stabilized, proponents of small government have a clear pathway to communicating their vision because every spending cut they propose can be paired with a promised tax reduction. To us, at least, the current strategy of those advocates seems perverse, as they pair unchanged tax revenues with painful spending cuts.

Throughout this report, we have described the Better Base Case as stabilizing the fiscal patient. We need to emphasize, however, that the Better Base Case does not address the longer-term fiscal imbalance in this country. Those longer-term issues are driven almost entirely by entitlements spending, particularly healthcare spending. We can and should debate (again) how we deliver and finance healthcare in this country so that it does not swallow up the rest of our economy, but that dialogue will be a long and painful one. By design, the Better Base Case does not address that fundamental long-term problem, but it does give Americans sufficient time to reach a new consensus and (equally important) to implement that consensus through sufficiently gradual transition rules so as not to be unfair to settled expectations.

## B. Too Much, Too Quickly?

Many commentators have expressed concern that the lapse of all temporary tax policies at the end of this year is too great a shock for the U.S. economy to absorb in one blow. More than four years since the Great Recession officially began, the U.S. economy is still grappling with stubbornly high unemployment and insufficient growth. The strong revenue medicine that the fiscal patient requires might be too great a stressor if administered in one dose.

The CBO's baseline budget projections do reflect the short-term macroeconomic impact of the jump in tax revenues. The CBO's annual budget and economic outlook, of which the current-law revenue baseline is part, is partly derived through a full general equilibrium macroeconomic model of the economy, which takes into account the effect of tax collections on consumer demand. (A good example of the CBO's method is its recent analysis of President Obama's fiscal 2013 budget, in which the CBO explains the models it uses and how the president's proposed tax policies would affect the

overall economy over the next decade.<sup>18</sup>) In a recent report, the CBO has suggested that a full revision of tax and spending policies might in fact result in a contraction of the economy in the first half of 2013 and lower overall growth by four percentage points.<sup>19</sup> But that same report also warns that indefinitely avoiding necessary tax increases is even more damaging to long-term growth prospects. There is never an ideal time to raise taxes; in the end, the disagreeable medicine must be swallowed.

We are sympathetic (but only up to a point) to the concern that a one-time revenue shock of the magnitude contemplated by the current-law CBO baseline could cause the fiscal patient to suffer relapse, especially when conventional monetary policy is constrained by the zero bound on interest rates and there is little political appetite for providing additional fiscal support on the spending side. The argument proves too much when it is used to justify never allowing any of the existing temporary tax cuts to expire. We believe that it is possible to stabilize the patient by phasing in tax increases over two or three years — especially those that would provide the biggest short-term impact on aggregate demand.<sup>20</sup>

For simplicity, the revenue estimates in Appendix A do not reflect any phase-in of the higher tax revenue levels, but appropriately designed, such support would not have a material adverse effect on the health of the fiscal patient at the end of the nine-year period our estimates cover. As a practical

<sup>18</sup>CBO, “The Economic Impact of the President’s 2013 Budget” (Apr. 2012), *Doc 2012-8733*, 2012 TNT 80-18. For example, the CBO concludes:

CBO estimates that the President’s budgetary proposals would boost overall output initially but reduce it in later years. For the 2013-2017 period, under most of the estimates CBO produced using alternative models and assumptions, the President’s proposals would increase real (inflation-adjusted) output (relative to that under current law) primarily because taxes would be lower than those under current law, and, therefore, people’s disposable income and their demand for goods and services would be greater. Over time, however, the proposals would reduce real output (relative to that under current law) because the deficits would exceed those projected under current law, and the effects of increasing government debt would more than offset the favorable effects of lower marginal tax rates on labor income.

<sup>19</sup>CBO, “Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013” (May 2012), *Doc 2012-11046*, 2012 TNT 100-32.

<sup>20</sup>Peter Orszag has recently outlined an alternative approach that would allow temporary tax cuts to expire, while supporting the economy in the short term with further temporary reductions in payroll taxes. See “Surviving ‘Taxmageddon’ Without Maiming Economy,” Bloomberg News, Apr. 24, 2012, available at <http://www.bloomberg.com/news/2012-04-24/surviving-taxmageddon-without-maiming-economy.html>.

matter, we envision that this sort of very short-term transition to the current-law revenue baseline would be enacted retroactively in early 2013, along with the principles of the Better Base Case.

### C. Will We All Go to the Beach?

Some argue that current law’s projected future revenue collections will crush the souls of high-ability taxpayers in particular, leading them to retire to the beach (no doubt to read *The Fountainhead*). But arguments of that nature often border on the preposterous.

The fictional Gordon Gekko in the movie *Wall Street* celebrated the thought that “greed is good,” even though he faced 28 percent capital gains tax rates — not the 20 percent rate baked into current law for years after 2012.<sup>21</sup> And the highest marginal tax rates on labor income will simply return to the same rates that applied in the 1990s, when the economy was booming and high-ability individuals swarmed the canyons of Wall Street and the corridors of the first Internet start-ups. As pointed out earlier, when compared with other jurisdictions, the United States is a low-tax country and will remain so even after the 2001 and 2003 tax cuts expire.<sup>22</sup> High-ability U.S. taxpayers will not be taxed at high rates by worldwide norms.<sup>23</sup>

An extensive body of economic research suggests that the lapse of the temporary personal income tax policies would have only a modest effect on the decisions and effort level of taxpayers.<sup>24</sup> The literature considers two related questions. First, how would the reversion to pre-2001 tax rates affect labor effort and similar real-world decisions — particularly of high-ability taxpayers? And second, would an increase in tax rates in fact collect much revenue from high-ability taxpayers, or would those higher rates just lead to offsetting tax sheltering activities?

In determining the overall effect of a change in tax rates on labor supply (particularly the labor

<sup>21</sup>Beginning in 2013, an additional 3.8 percent tax on net investment income enacted as part of the 2010 healthcare reform legislation will take effect for some high-income taxpayers.

<sup>22</sup>Martin A. Sullivan, “Busting Myths About Rich People’s Taxes,” *Tax Notes*, Apr. 16, 2012, p. 251, *Doc 2012-7723*, or 2012 TNT 73-1; see *supra* note 4, at 1108-1113.

<sup>23</sup>Phil Gramm and Steve McMillin recently argued to the contrary in *The Wall Street Journal* (“The Real Causes of Income Inequality,” Apr. 6, 2012, at A-13) but Sullivan has demonstrated the inaccuracies and logical fallacies in their arguments. Sullivan, *supra* note 21.

<sup>24</sup>For a very recent and accessible summary of the economic literature, see Chye-Ching Huang, “Recent Studies Find Raising Taxes on High-Income Households Would Not Harm the Economy: Policy Should Be Included in Balanced Deficit-Reduction Effort,” Center on Budget and Policy Priorities (Apr. 24, 2012), *Doc 2012-8735*, 2012 TNT 80-28.

supply of high-ability taxpayers, who might plausibly be in a position to buy more leisure through reduced labor effort), economists analyze whether the “substitution effect” (the urge to chuck it all and head for the beach) in fact would outweigh the “income effect” (the urge to work even harder to restore one’s after-tax income to its pretax increase level). In general terms, most research suggests that labor effort (particularly of the primary wage earner in a household) is relatively inelastic to changes in tax rates of the magnitudes we are discussing when crossing from 2012 to 2013.<sup>25</sup>

Some recent literature has urged as a more comprehensive metric the elasticity of taxable income, which measures the responsiveness of a taxpayer’s taxable income as reported on her tax return (not her labor effort) to changes in tax rates.<sup>26</sup> The elasticity of taxable income is an important concept, because it is simple, relatively easy to measure, and captures in one number all possible sources of deadweight loss resulting from responses to changes in tax rates — not just reductions in labor effort or choice of intangible amenities (like choosing a job in a pleasant climate over higher cash income), but also tax minimization or evasion strategies, such as taking more compensation in tax-advantaged forms, or taking out a larger home mortgage.

Research suggests that there might be a meaningful response to moderate tax rate increases when measured by that metric, although not one so large that it negates the positive revenue implications of those measures.<sup>27</sup> Yet because results predicted

through the metric of elasticity of taxable income deliberately mangle consequences attributable to the porosity of a tax system with any real labor (or investment) responses, the tool’s actual policy implications may be occluded. The code is an overflowing fountain of lawful tax minimization strategies in the form of tax expenditures; as a result, a meaningful taxable income response to modest tax rate increases can plausibly be described in large measure as evidence of the structural defects of the tax system itself. But it is possible to address the porosity of the tax system head-on. For example, by limiting the value of itemized deductions, the Better Base Case reduces the incentive to use itemized deductions when faced with higher tax rates, thereby reducing the elasticity of taxable income.<sup>28</sup>

To give the debate specific context, imagine that a high-ability taxpayer who today enjoys a 35 percent marginal tax rate finds that in 2013 her marginal tax rate has jumped to 40 percent. She will now keep \$60 of every \$100 earned, rather than \$65.<sup>29</sup> That \$5 difference represents a 7.7 percent reduction in after-tax income on the taxpayer’s last dollar of income.<sup>30</sup> (Her effective tax rate will be affected even less.) Perhaps that decrease in after-tax returns from her last hour of labor will lead her to chuck it all, or even somehow to negotiate a life in which she works only 92.3 percent as hard, but given the volatility in pretax returns to labor (and to capital) that we have endured in our roller coaster economy over the last 15 years, that would seem in general to be an extreme reaction.<sup>31</sup>

<sup>25</sup>*Id.*; Peter Diamond and Emmanuel Saez, “The Case for a Progressive Tax: From Basic Research to Policy Recommendations,” 25 *J. of Econ. Persp.* 165, 172 (2011) (“A number of studies have shown large and quick responses of reported [taxable] incomes along the tax avoidance margin at the top of the distribution, but no compelling study to date has shown substantial responses along the real economic responses margin among top earners”).

The Diamond and Saez study concludes that under plausible assumptions, the optimal highest marginal tax rate should be greater than 70 percent (Optimal tax theory seeks to “maximize a [given] social welfare function subject to a government budget constraint, taking into account that individuals respond to taxes and transfers. Social welfare is larger when resources are more equally distributed, but redistributive taxes and transfers can negatively affect incentives to work, save, and earn income in the first place. This creates the classical trade-off between equity and efficiency which is at the core of the optimal income tax problem.” *Id.* at 165).

<sup>26</sup>Saez et al., “The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review,” 50 *J. of Econ. Lit.* 3 (2012). That line of analysis began with Martin Feldstein, “The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act,” 103 *J. of Pol. Econ.* 551 (1995).

<sup>27</sup>It is often overlooked that the JCT directly takes those sorts of tax minimization strategies into account when it estimates the

(Footnote continued in next column.)

revenue consequences of proposed changes in tax law, so that its revenue estimates are not overstated by virtue of being “static” in this dimension.

<sup>28</sup>Jon Gruber and Saez, “The Elasticity of Taxable Income: Evidence and Implications,” 84 *J. of Public Econ.* 1 (2002). They find substantially smaller elasticities for a broader measure of income that does not include itemized deductions. We recognize that the Better Base Case does not solve every predictable response to higher tax rates. For example, as labor tax rates go up, executives might seek to take more compensation in the form of nontaxable fringe benefits — for example, to accept in lieu of cash compensation a revised company travel policy that permits executives to fly on company business in first class rather than coach. Those sorts of issues require more fundamental tax reform.

<sup>29</sup>For the sake of clarity, this mental experiment ignores other taxes; the basic point is unaffected, however, by including them.

<sup>30</sup>Similarly, a jump in the capital gains tax rates from 15 to 20 percent will reduce the after-tax returns to capital gains by only 5/85, or 5.9 percent.

<sup>31</sup>Conversely, if marginal tax rates were 65 percent, the same 5 percentage point increase in marginal tax rates to 70 percent would reduce the after-tax return to a taxpayer’s last dollar of income from \$35 to \$30, a 14.3 percent reduction — close to double the dollar effect when compared with 2012 tax rates as the starting point.



Finally, many readers who today are active participants in the labor markets were active participants in 2000. We invite those readers to recall their past selves and reflect on how their approach to supplying labor to the markets was affected by taxes then, or how those behaviors changed following the large personal income tax cuts in 2001 and 2003. We suspect that most readers who conduct the thought experiment honestly will conclude that their labor efforts were not much affected in either case.<sup>32</sup>

#### IV. Conclusion

Regardless of political persuasion, we all know that the government's fiscal policies are unsustainable over the long term, but our fiscal panic attacks have left us paralyzed by the seeming insolubility and indivisibility of the issues. We argue that taxes are too low, or insufficiently progressive — or perhaps the opposite. We maintain that we should slash government spending, unless perhaps we should increase it. But our tax debates cannot be separated from our views on the size of government — and how can we decide which should determine the other? Overlaying all those thoughts is the paralyzing fear that keeping to our current course will lead to fiscal collapse in the foreseeable future, so that something dramatic must be done immediately.

Those debates are dominated by abstract disagreements over income tax rates, or how progressive the tax system should be, as if those are goals in themselves. But taxes are means, not ends. Collecting tax is not the point of government; taxes are simply how we divide up the bill for the goods and services we collectively deliver to ourselves through the medium of government. Government spending is the logical predicate to taxation, not the other way around.

At the same time, we do not engage in rational discourse about the desired size of government because we allow those discussions to loop rapidly into debates about how to finance that government spending — that is, our tax policies. And those debates play out against the backdrop of the unsustainability of the net consequences of our current spending and tax policies — that is, our budget deficits. And so the circular arguments repeat themselves. As a result, we are unable to see that our fiscal problems are not insurmountably large — and

that there is a logical order in which the issues might be teased apart — to enable our political discourse actually to reach rational conclusions.

We have argued that the critical first step on the path to fiscal stability is to stabilize the patient. To do so, tax revenues must rise to the levels contemplated by the budget baseline. But the current-law revenue system is a mess, featuring, for example, the return with a vengeance of the individual AMT, the estate tax, and high tax rates on dividend income.

The report therefore has made a specific proposal — the Better Base Case — to rationalize the current-law revenue system, by making five straightforward strategic moves that radically improve that baseline tax system that applies to individuals, while leaving intact its aggregate level of revenues. The result is a sensible and sustainable tax system, which in turn can be improved further in a more orderly way by attention to a great many details that are not immediately relevant to stabilizing the patient.

Once the patient is stabilized, policymakers and citizens can turn their attention to the fundamental questions, which are the size and roles of government. Those are questions of government spending, not taxing. In the course of those debates, proponents of small government can offer future tax reductions to lessen the pain of their proposed spending cuts. To us, that ironically is a more effective message than the current strategy of offering taxpayers today the continuation of tax policies against the promise of painful future scale-backs of popular government programs.

Those larger discussions will be painful, but the consensus that emerges will shape America for a generation or more. We should hold those debates in a rational environment, not with the panicked sense that the patient's pulse is slipping away. The Better Base Case gives us time to debate, to reach whatever consensus might emerge, and to implement the resulting new regimen in a responsibly phased-in manner.

*(Appendix tables begin on the next page.)*

<sup>32</sup>In conducting that thought experiment, one must reconstruct one's younger, presumably hungrier, self; it is not fair to the experiment to respond that in light of one's 2012 age and wealth, the lapse of the 2001 and 2003 cuts will lead one now to head for the beach.

COMMENTARY / SPECIAL REPORT

Proposal	Fiscal Year										
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
(1) Limit the value of itemized deductions to 15 percent and repeal overall limitation on itemized deductions (PEASE)	0	88.5	124.1	132.5	141.1	148.9	157.0	165.6	174.5	184.1	1,316.3
(2) Index the parameters of the alternative minimum tax to inflation after 2012 and allow nonrefundable credits against tentative AMT	0	-21.9	-33.1	-40.2	-48.0	-57.9	-69.8	-83.9	-100.2	-119.1	-574.1
(3) Retain the child tax credit at its 2012 limits — \$1,000 credit with a \$3,000 earned income refundability threshold	0	-26.1	-34.6	-34.5	-34.4	-34.3	-34.1	-33.9	-33.6	-32.9	-298.4
(4) Tax qualified dividends at long-term capital gain rates and repeal special rates (3/18 percent) for capital gains held more than five years	0	-12.3	-16.2	-16.0	-16.7	-17.6	-18.4	-19.1	-19.7	-20.0	-156
(5) Reinstate 2009 estate tax law — 45 percent top rate and \$3.5 million exclusion amount (indexed from 2009)	0	0	-19.2	-20.4	-25.2	-28.3	-31.2	-35.1	-38.8	-43.1	-241.3
<b>Total</b>	<b>0</b>	<b>28.2</b>	<b>20.9</b>	<b>21.4</b>	<b>16.8</b>	<b>10.9</b>	<b>3.5</b>	<b>-6.4</b>	<b>-17.8</b>	<b>-31.2</b>	<b>46.4</b>
<p><i>Source:</i> Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).</p> <p><sup>a</sup>Fiscal years. Revenue changes measured relative to a current-law baseline. Estimates include a microdynamic behavioral response; assume that taxpayers adjust their investment portfolio and pay down their mortgage balance if their tax benefit from the mortgage interest deduction is reduced; and assume that taxpayers adjust charitable contributions in response to changes in the tax price of giving. Proposal effective January 1, 2013. Fiscal year estimates assume a 75-25 split for individual income tax provisions and a 0-100 split for the estate tax.</p>											

Table A2. The Better Base Case Distribution of Federal Tax Change by Cash Income Percentile, 2015<sup>a</sup>

Cash Income Percentile <sup>b</sup>	Panel A. Baseline: Current Law						Average Federal Tax Rate <sup>d</sup>	
	Tax Units With Tax Increase or Cut			Percent Change in After-Tax Income <sup>c</sup>	Share of Total Federal Tax Change	Average Federal Tax Change (dollars)	Change (percentage points)	Under the Proposal
	With Tax Cut	With Tax Increase	Average Tax Increase					
Lowest quintile	13.1	0.1	-981	32	-18.7	-129	-1.1	2.8
Second quintile	28.0	0.8	-1,150	99	-40.8	-321	-1.0	10.6
Middle quintile	33.8	15.6	-1,310	1,001	-29.0	-263	-0.5	17.6
Fourth quintile	37.6	42.8	-2,224	1,762	-3.9	-42	0.0	22.2
Top quintile	22.0	72.7	-7,082	5,095	193.2	2,370	0.8	30.1
All	25.9	20.9	-2,164	3,323	100.0	179	0.2	24.2
Addendum								
80-90	21.6	70.8	-3,113	2,665	54.1	1,319	0.9	26.1
90-95	19.5	76.9	-4,448	3,349	36.2	1,808	0.9	27.3
95-99	26.8	70.9	-10,122	6,121	35.0	2,139	0.6	29.0
Top 1 percent	19.5	78.4	-46,567	31,350	67.9	16,361	0.9	35.5
Top 0.1 percent	25.2	73.3	-147,853	150,035	31.0	72,643	0.9	38.9
Panel B. Baseline: Current Policy								
Cash Income Percentile <sup>b</sup>	Tax Units With Tax Increase or Cut						Average Federal Tax Rate <sup>d</sup>	
	With Tax Cut			Percent Change in After-Tax Income <sup>c</sup>	Share of Total Federal Tax Change	Average Federal Tax Change (dollars)	Change (percentage points)	Under the Proposal
	With Tax Cut	With Tax Increase	Average Tax Increase					
Lowest quintile	0	22.1	0	433	1.0	95	0.8	2.8
Second quintile	0	71.5	0	608	3.8	434	1.4	10.6
Middle quintile	0	93.0	0	1,044	7.3	969	1.7	17.6
Fourth quintile	0	98.2	0	2,768	17.1	2,713	2.8	22.2
Top quintile	0	99.4	0	12,975	70.9	12,739	4.2	30.1
All	0	70.9	0	3,723	100	2,615	3.3	24.2
Addendum								
80-90	0	99.4	0	6,230	17.3	6,164	4.1	26.1
90-95	0	99.4	0	8,567	11.7	8,580	4.0	27.3
95-99	0	99.3	0	14,039	15.3	13,673	3.6	29.0
Top 1 percent	0	99.4	0	96,108	26.7	94,020	4.9	35.5
Top 0.1 percent	0	99.0	0	456,540	13.0	445,980	5.3	38.9

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

Number of AMT payers (millions). Baseline: 27. Proposal: 0.8.

<sup>a</sup>Calendar year. Current-policy baseline assumes that all temporary provisions in place for calendar year 2011 are extended, with the exception of the payroll tax cut.

<sup>b</sup>Includes both filing and nonfiling units but excludes those that are dependents of other tax units. Tax units with negative cash income are excluded from the lowest income class but are included in the totals. The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2011 dollars): 20% \$19,342; 40% \$39,862; 60% \$69,074; 80% \$119,546; 90% \$169,987; 95% \$242,597; 99% \$629,809; 99.9% \$2,868,534.

<sup>c</sup>After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

<sup>d</sup>Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.