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The Role of Tax Reform in Comprehensive Deficit Reduction and Fiscal Policy

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Thank you, Mr. Chairman. I am very pleased to have this opportunity to testify on this important subject.

Our nation faces an enormous fiscal problem, with budget deficits that are projected, on overly optimistic assumptions, to be heading toward 100 percent of GDP. Preventing this explosion of our national debt is critical for our country's economic health.

Putting the deficits and debt on a declining path would create the confidence among households and businesses that is now needed to increase spending and jobs. Reducing the future government debt would also lower future tax rates and would contribute directly to capital formation and growth. I have discussed this subject extensively in a recent paper that I will submit for the record.[1]

Although this hearing focuses on tax reform, I must emphasize that tax reform is not a substitute for the fundamental reform of Social Security, Medicare and Medicaid, the main sources of the future growth of government spending. Unless those programs are changed, they will eventually force a doubling of our tax rates, with very adverse effects on economic activity and growth.

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* Testimony of Martin Feldstein to the Senate Subcommittee on Fiscal Responsibility and Economic Growth, September 13, 2011. Martin Feldstein is Professor of Economics at Harvard University.

[1] "Preventing a National Debt Explosion," NBER Working Paper 16451 (2010). forthcoming in NBER Tax Policy and the Economy, volume 25, 2011. Available as http://www.nber.org/papers/w16451.pdf

The key to those reforms is to reduce gradually the growth of the projected government benefits and to supplement those government benefits with universal investment-based annuities and health spending. Doing that would protect the future incomes and health care of older Americans without requiring higher future tax rates.[2]

Fundamental tax reform can strengthen the economy and improve the incentives that affect the behavior of households and businesses. I will focus this testimony on improving the individual income tax but will conclude with some remarks on corporate tax reform.

<u>The Individual Income Tax</u>

The tax code is full of special features that reduce tax revenue and that hurt the economy by distorting the way that individuals spend their time and their income. These tax rules lead to excessive household debt, overspending on housing, the high cost of health care, and other economic problems.

Many of these features of the tax code are substitutes for direct government spending. The law provides special tax breaks instead of government checks to encourage certain forms of household behavior. That's why they are called "tax expenditures" or "government spending through the tax code." They are wasteful in the same way that direct government spending would be.

The key to favorable tax reform is to limit the revenue lost because of these tax rules and to use the resulting extra revenue to reduce current and future marginal tax rates. Today's marginal tax rates are typically close to 50 percent for a middle income family because of the combined impact of the income tax, the payroll tax, and state taxes. Those high marginal tax rates reduce the incentive to work, to acquire more skills, to start or expand small businesses, to save, and to invest. They also induce individuals to seek compensation in nontaxable forms and to spend money in wasteful ways that generate tax deductions.

[2] See section 3 of "Preventing a National Debt Explosion."

Limiting tax expenditures and using the resulting revenue to lower marginal tax rates would produce a double win: it would reduce wasteful behavior directly and it would strengthen incentives for increased economic growth. And that can be made a triple win by using some of the resulting revenue to reduce budget deficits.

Although limiting tax expenditures produces additional revenue, it is really a way of cutting government spending. The effect shows up in the revenue side of the budget but it is really a cut in spending. The accounting rules make it look like a tax increase but the economic effect is the same as any other reduction in government outlays.

I know that limiting tax expenditures is politically difficult. Every form of tax expenditure has some justification – just as every form of direct government spending has its justification. But reducing spending through the tax code is the key to better incentives and lower budget deficits.

Tax reform can reduce the revenue loss from tax expenditures without actually eliminating any of the tax expenditures or even putting limits on specific tax expenditures (like the size of the deductible mortgage). A better and fairer way to reduce the revenue loss caused by tax expenditures is to allow individuals to use all currently available tax expenditures but to limit the total tax benefit that each individual can get from those tax expenditures to a percentage of that individual's adjusted gross income.

Limiting the revenue loss from the itemized deductions and the exclusion of employer payments for health insurance to two percent of each individual's adjusted gross income would raise more than $275 billion at current income levels and more than $3 trillion over the next decade.[3]

This tax expenditure limit does not apply to the tax rules that encourage saving and investment, like the deduction for IRA contributions, the exclusion of the earnings in IRA and 401k accounts, and the lower tax

[3] For more details, see Martin Feldstein, Daniel Feenberg and Maya Macguineas, "Capping Individual Tax Expenditure Benefits," Tax Notes, May 2, 2011. Available at http://www.nber.org/feldstein/TAXNOTES-may2011.pdf

rate on capital gains. Although these features are counted as "tax expenditures" in the official government analyses, they have favorable effects on saving and investment and should therefore be preserved without limits.

The size of the cap could of course be started with a higher rate and gradually reduced to a two percent cap. Even a five percent cap would generate more than $100 billion of additional annual revenue at the current income levels.

Using the revenue from a two percent cap to reduce marginal tax rates would allow a 25 percent across the board reduction in rates – the current 35 percent rate could be cut to 27 percent and the 25 percent rate could be cut to 19 percent. Or some of that extra revenue could be used to strengthen saving and investment incentives by greater rate reductions on interest, dividends, and capital gains. And of course some of it should be used to reduce budget deficits, as the Bowles-Simpson commission proposed, thus reducing the national debt and the future tax burdens of paying interest on that debt.

A key point to stress is that the two percent cap in this proposal is applied to the tax expenditure <u>benefit</u> and not to the total amount deducted or excluded. For example, for someone with a 30 percent marginal tax rate who pays annual mortgage interest of $5,000, the related tax expenditure benefit would be $1,500.

There is a further benefit of capping tax expenditures – simplification. A two percent cap on tax expenditure benefits would cause nearly 75 percent of individuals who now itemize their deductions to shift to the standard deduction, an enormous tax simplification for tens of millions of taxpayers.

<u>Corporate Tax Reform</u>

Although I have focused this testimony on reforming the individual income tax, current corporate tax rules should also be reformed to strengthen the economy, increasing employment and growth. The two key features of desirable corporate tax reform are to lower the existing tax rate (now higher than that in every other country but Japan) and to shift the form of taxation of foreign source income to the "territorial" system used in virtually every other industrial country.

I have discussed these reforms in a recent Wall Street Journal article[4] and in the report on tax reform options prepared for President Obama's Economic Recovery Advisory Board.[5]

I look forward to your questions.

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[4] "Want to Boost the Economy? Lower Corporate Tax Rates." WSJ February 15, 2011 available at http://www.nber.org/feldstein/wsj02152011.pdf)

[5] The Report on Tax Reform Options, President's Economic Reform Advisory Board, 2011, Parts IV and V