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# IF YOU'RE GOING TO DO SOCIAL POLICY THROUGH THE TAX CODE, DO IT RIGHT

By Jason Furman[1]

The most contentious issues in tax policy are not going to be settled in the next two years. President Bush and the Democratic Congress are unlikely to come to a sustainable, long-term agreement on the level of revenue — debates on extending the tax cuts or letting some of them expire are likely a matter for the next president and the next Congress. The proper level of progressivity of taxes and the doctrinal debate over consumption and income taxes are unlikely to be settled in the next two years either. But views on one tax issue are rapidly approaching a consensus, at least among tax wonks of various stripes: If you're going to do social policy through the tax code, do it right. And generally that means using credits rather than deductions. Building bipartisan trust for tax reform may require eschewing a grand vision and instead first focusing on a major change that is ripe for the picking: reforming tax expenditures.

The tax code has a profound effect on housing, healthcare, charitable giving, saving, and many other aspects of life. In the last budget, Treasury listed a total of $911 billion of tax expenditures in fiscal 2006.[2] That total approaches the total amount of discretionary spending ($1.025 trillion in fiscal 2006) and mandatory spending ($1.418 trillion in fiscal 2006). Unlike discretionary or mandatory spending, most of those tax expenditures are in the form of tax deductions. As is well known, those tax deductions are larger for households in higher tax brackets or with higher deductible expenses -- and may be nonexistent for households that take the standard deduction or have no income tax liability.

Many in the tax community have had a long-standing suspicion of tax expenditures, preferring to get the IRS out of the business of administering hundreds of billions of dollars worth of social programs. While many tax expenditures are poorly thought out and serve goals of dubious value, it is unlikely that they will disappear anytime soon. And if we are going to subsidize activities like housing and healthcare, it is far from clear that those goals would be better served by moving the programs out of the tax code. Converting tax expenditures to spending programs would reduce the administrative burden on the IRS and reduce the complexity families face in filling out tax returns.

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[2] Note that those totals are indicative of the extent of tax expenditures but are not an estimate of the revenue that would be raised by repealing those tax expenditures because they ignore behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.

But all of that complexity would simply be shifted to another government agency. Duplicative paperwork would, in fact, likely increase the overall administrative burden for the government, not to mention families struggling to provide duplicative information on multiple forms to multiple government agencies. Also, centralizing many social expenditures in the tax code makes their phaseout rates more transparent and makes it easier to harmonize the phaseout rates to prevent the marginal rates in excess of 50 percent or even 100 percent that are often observed in the tax and transfer system.

But to accept — or even embrace — tax expenditures is not to defend how they are structured. For years, a wide range of tax analysts from Gene Steuerle to Kevin Hassett to Bill Gale have written about the benefits of shifting from deductions to uniform, refundable tax credits. Recently Lily Batchelder, Fred Goldberg, and Peter Orszag laid out the most comprehensive case for the efficiency benefits of using credits rather than deductions to address externalities or encourage desired behavior.[3] They point out that the goal of tax expenditures is often to encourage people to consume more of something, for example, health insurance. But deductions reduce the after-tax price more for high-income families than low-income families — generally producing too much added consumption by high-income households and too little by low-income households. In the absence of evidence on elasticities by incomes, Batchelder, Goldberg, and Orszag suggest that credits should be uniform. In reality, it's likely more economically efficient to provide larger subsidies to lower-income households. For example, a uniform credit might be too little to encourage a lower-income family to purchase health insurance while being more than is needed for a high-income household that would have purchased the insurance in any case.

But that is not just a cause for ivory tower theorists. The President's Advisory Panel on Federal Tax Reform proposed to convert the personal exemption and the mortgage interest deduction into credits. The panel's mortgage credit would have expanded tax benefits to more than 20 million middle-income families, a fact that was lost in the uproar over the smaller group of families who would have been affected by the lower cap. Rep. Rahm Emanuel, D-Ill., proposed a similar plan to unify the various child tax benefits, in the process rolling the personal exemption into a tax credit. And the "Fair Flat Tax" proposed by Sen. Ron Wyden, D-Ore., would convert the deduction for state and local taxes to a credit and have Treasury study the possibility of making similar changes to the exclusion for employer contributions to health insurance premiums.

So what should the president and Congress do? At a minimum, any new tax expenditures with a behavioral motivation should be implemented as credits rather than deductions. House Democrats campaigned on "making college tuition tax deductible," but the details of their plan wisely would implement that rhetoric in the form of a tax credit. But the big gains come only from taking on the existing system of tax expenditures. Ideally that process would contribute toward reducing the nation's large fiscal gap and toward making the tax system more progressive, helping to offset some of the increase in inequality in recent decades. But even a revenue- and distribution-neutral reform of tax expenditures would have substantial dividends, making the tax code more fair and efficient while helping promote goals policymakers have identified, like increasing the prevalence of health insurance, college, and homeownership.

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[3] Batchelder, Lily, Fred T. Goldberg, and Peter Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stanford Law Review* 23 (Oct. 2006).

Converting the dependent exemption, mortgage interest deduction, health exclusion, and savings incentives from deductions to credits would be a major step. Also, in many cases those credits would be more efficient if they were capped, so more of our limited resources go into encouraging people to own a home or have health insurance and less goes into subsidizing more generous homes or health insurance. Finally, those new credits — together with existing credits — should be bundled together and phased out in a uniform fashion.

That process would not be easy — nothing in tax reform is. But it is one of the few areas in tax reform in which the appropriate resolution of the major issues is relatively settled and agreed to by analysts across the political spectrum. That makes it a good place to start our tax reform efforts.