



LET'S FACE IT—WE'RE FAR FROM BROKE

America's Real Spending Problem and How to Fix It

BY **THOMAS L. HUNGERFORD**

The relationship between tax policy and spending policy in the United States has changed dramatically over the past 200 years (Ippolito 2012). Kimmel (1959, 7) notes that for the first 140 years, “federal budget policy was concerned mainly with the money costs of government and raising the revenues to meet them.” In recent years, only one of the two major political parties continued to view fiscal policy this way. Democratic proposals for spending increases or tax cuts have routinely been “paid for” with new revenue sources or by offsetting spending reductions.¹ For Republicans, however, tax and spending decisions appear to be developed in isolation from one another and with little regard to any impact on deficits and federal debt, with both tax cuts and spending increases unaccompanied by financing sources undertaken during Republican administrations. When Republican policy makers do pay attention to deficits, they tend to focus only on the spending side of the budget. For example, House Speaker John Boehner (R-Ohio), speaking for many in the GOP, argues,

“Washington has a spending problem. Let’s face it—we’re broke” (Boehner 2012).

This is clearly wrong. While the federal government is projected to run deficits far into the future, the U.S. economy is projected to generate substantial amounts of income growth far into the future. This means the real fiscal challenge is simply the political problem of raising revenues that are sufficient to meet our spending needs. Indeed, the Constitution (Article I, Section 8) provides Congress with the power to raise revenue “to pay the debts and provide for the common Defense and general Welfare of the United States.” This issue brief examines our nation’s fiscal situation and identifies what the real challenges on the spending and revenue sides are.

The principal findings are:

- Our genuinely pressing spending problem is a decline in spending on public investments relative to

our needs, which can reduce future economic growth and contribute to growing inequality.

- The nation is considerably richer today than it was 50 years ago, and it is expected that significant growth in income and wealth will continue for the foreseeable future. There is nothing about current spending commitments that are “unaffordable” relative to the projected income generation of coming decades. Instead, these spending commitments are only “unaffordable” given current political choices about how much revenue to raise.
- At the same time that income and wealth have been growing, the distribution of income and wealth has become more unequal—the richest 1 percent receives a growing share of income and owns a growing share of wealth. This is a challenge for distributing the fruits of economic growth, and could also pose a political barrier to raising sufficient revenue for future spending needs.
- There are several ways to increase tax revenues needed for public investment and strengthening the social insurance system by both broadening the federal tax base and raising tax rates. Examples include reducing the gap in tax rates between labor and capital incomes, limiting the value of tax expenditures, closing loopholes in the corporate income tax code, or even introducing new revenue sources like a wealth tax or a value-added tax. To be clear, not all of these solutions are equally desirable, but the scope for revenue increases is much larger than recognized in conventional budget debates.

The real spending problem

Federal spending is generally divided into three broad categories: discretionary spending, mandatory or direct spending, and net interest payments. Discretionary spending is controlled by the annual appropriations process and accounts for about one-third of federal spending. Mandatory spending refers to budget outlays

that are controlled by laws outside of the annual appropriations acts and accounts for almost 60 percent of federal spending. Net interest on federal debt is the only category of federal spending that is not directly controlled by legislative action, although Congress enacts the spending and revenue laws that create the deficits leading to debt.

This categorization, however, sheds little light on the purpose and importance of federal spending. One pundit described the federal government as “an insurance conglomerate protected by a large, standing army,” which is not far from the truth (Klein 2011). Indeed, federal spending is better examined by what it does rather than by how it is decided.

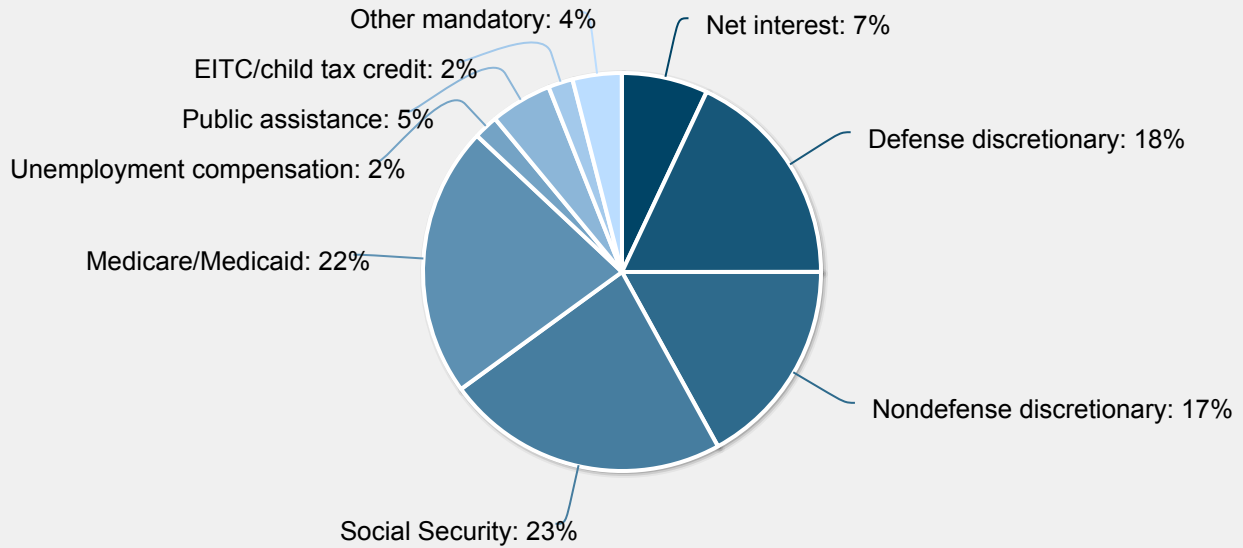
The changing composition of federal outlays

Figure A displays the composition of federal outlays in fiscal year 2013. The single largest function of government can best be described as social welfare, which accounts for 52 percent of the total. Social welfare spending includes: (1) monetary benefits such as Social Security benefits, Unemployment Compensation and cash public assistance (e.g., Temporary Assistance to Needy Families and Supplemental Security Income); and (2) in-kind benefits such as Medicare and Medicaid as well as nutrition public assistance (e.g., the Supplemental Nutrition Assistance Program or food stamps). Social welfare benefits have traditionally been classified as either social insurance or public assistance, but this artificial division is not particularly helpful.

Social insurance benefits are generally considered an earned right based on an individual’s work history. Workers pay taxes on wages (which can be thought of as premiums) and if they experience an insured event (such as unemployment, disability, or retirement), they receive a benefit. Social insurance can be considered a transfer from good times (that is, employment) to bad times (that

FIGURE A

Composition of federal outlays in fiscal year 2013



Source: Office of Management and Budget data (OMB 2015, tables 8.5 and 8.7)

ECONOMIC POLICY INSTITUTE

is, loss of wage income), although done in a progressive manner.

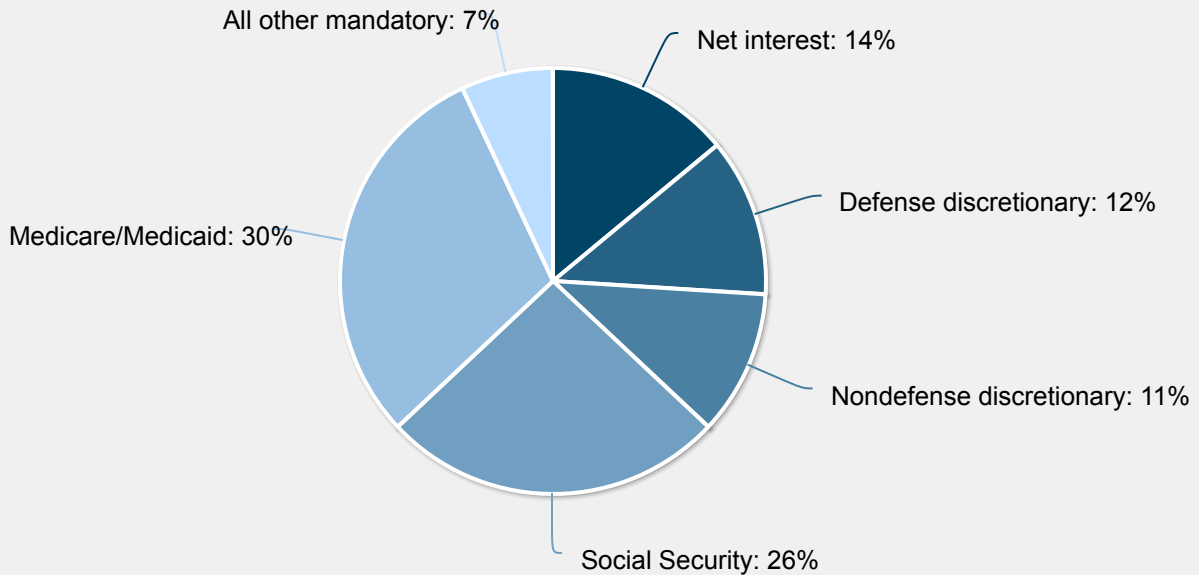
Public assistance benefits, on the other hand, are means-tested and generally considered a transfer from the “haves” (taxpayers) to the “have nots”; public assistance is pejoratively referred to as “welfare.” Public assistance, however, can also be thought of as insurance. By the age of 65, a majority of Americans have experienced at least some poverty and have received public assistance benefits (Rank 2004). But for most of these Americans, the bout of poverty and public assistance receipt is fairly short-lived (typically less than five years). In these cases, the “insurance premiums” are often paid after the benefit is received rather than before—for many, it is just a transfer of income from good times to bad. Kleinbard (2014) argues that the whole social welfare system (social insurance and public assistance) should be considered as the insurance function of government.

The refundable part of two tax credits—the earned income tax credit (EITC) and the child tax credit—comprises about 2 percent of total federal outlays. The EITC provides an effective incentive to enter the workforce, especially for single mothers. These two credits are effective in increasing the after-tax incomes of targeted groups, reducing poverty among families with children, and reducing income inequality (Hungerford and Thiess 2013).

Other mandatory spending accounts for about 4 percent of federal outlays. This category includes spending for federal employee pensions, veteran benefits, and various agriculture programs. It also includes “negative” outlays—undistributed offsetting receipts (e.g., Medicare premiums) and income from various federal credit programs—that reduced mandatory spending by \$172.8 billion in 2013.

FIGURE B

Projected composition of federal outlays in fiscal year 2024



Source: Congressional Budget Office, baseline projections (CBO 2014a, tables 1-1 and 1-2)

ECONOMIC POLICY INSTITUTE

Net interest payments or interest on publicly held debt account for about 7 percent of total outlays. These payments depend on both the amount of federal debt (which is determined by past congressional decisions regarding spending and revenues) and interest rates. Defense discretionary spending is the support of our “large, standing army,” and accounts for about 18 percent of total federal spending.

The final broad category—nondefense discretionary spending (NDD)—fits with neither the insurance function nor the defense function of government. It can best be thought of as the investment function of the federal government. NDD spending accounts for about 17 percent of total federal spending.

Discretionary spending (defense and nondefense) was cut back as a result of the Budget Control Act of 2011 (BCA)

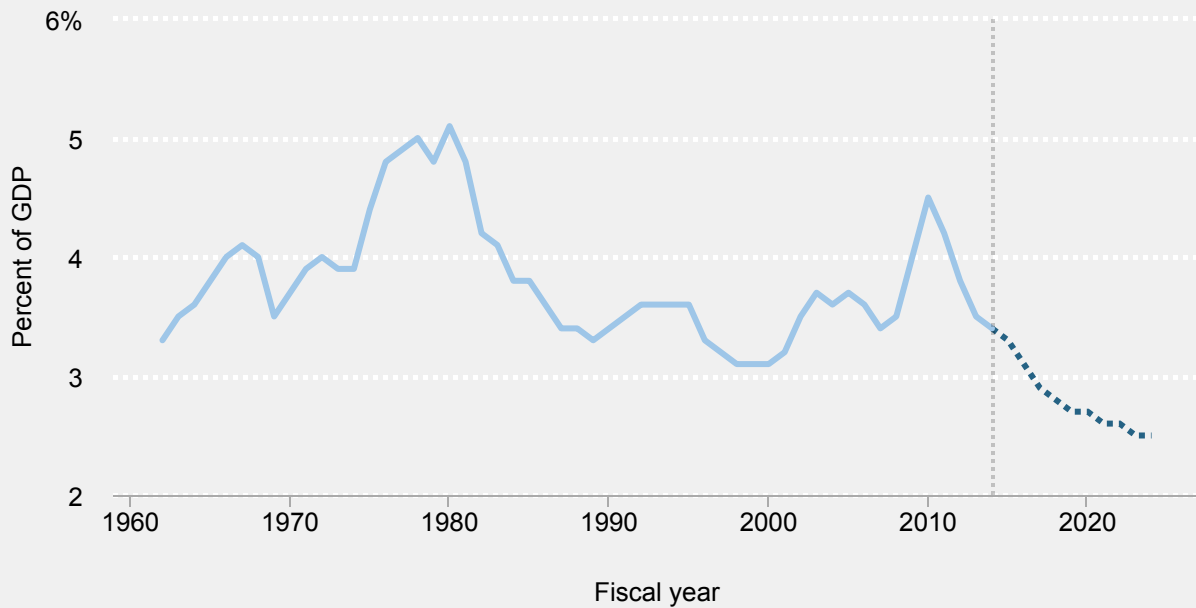
sequester. As a result of the BCA, NDD as a percent of GDP was smaller in 2013 than in 2007.

Figure B displays the projected fiscal year 2024 composition of federal spending under the Congressional Budget Office (CBO) baseline. Health care spending for Medicare and Medicaid is projected to be a larger proportion of federal outlays—increasing by 8 percentage points. The projected increase in Medicare and Medicaid costs, however, simply reflects the projected increase in cost of the U.S. health care system. Reducing health care cost growth will reduce the increases in Medicare and Medicaid costs.²

Spending for Social Security is projected to increase moderately from 23 percent of total outlays to 26 percent; this increase is primarily due to the retirement of the baby-boom generation. Spending for net interest payments is projected to increase from 7 percent to 14

FIGURE C

Nondefense discretionary outlays, 1962–2024



Source: Office of Management and Budget data (OMB 2015, tables 8.7 and 10.1) and (for projections) CBO 2014a

ECONOMIC POLICY INSTITUTE

percent due to higher interest rates and more debt. Under the CBO’s assumptions, discretionary spending is projected to be a considerably smaller share of total outlays (23 percent versus the current 35 percent).

Nondefense discretionary spending

Nondefense discretionary investment spending fosters economic growth; that is, it leads to more goods and services being available and higher income in the future. Direct investments include education spending, public physical capital (i.e., infrastructure spending), and research and development. There are also indirect investments that improve the health of Americans (a form of human capital investment), such as food inspections and spending for the Centers for Disease Control and Prevention and the Environmental Protection Agency, among other investments. Other NDD expenditures include federal salaries for government workers who

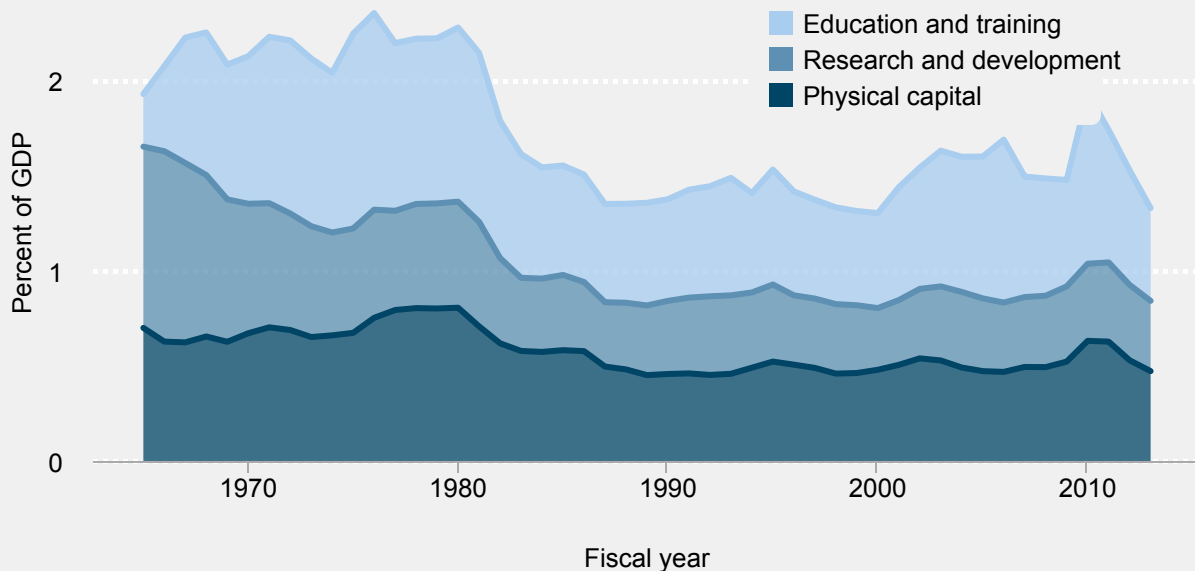
make sure that Social Security and other benefits are paid on time, safety services (e.g., hurricane and tornado warnings, Federal Aviation Administration air traffic controllers), the court system, and law enforcement.

The 60-year declining trend in NDD spending (actual and projected) as a percent of GDP is displayed in **Figure C**. Between 1962 and 2013, NDD spending averaged 3.8 percent of GDP. The average was almost a full percentage point higher for a brief span between 1975 and 1982.³ By 2013, NDD spending was equivalent to 3.5 percent of GDP. The CBO projects that NDD spending as a percent of GDP will hit a 55-year low by 2016 and will continue to fall to 2.5 percent of GDP by 2024, in large part because of the BCA budget caps.

The dramatic fall in NDD spending relative to the size of the economy has had serious implications for public investments (discussed in detail below), as well as for

FIGURE D

Nondefense federal investment spending, 1965–2013



Source: Office of Management and Budget data (OMB 2015, tables 9.6, 9.8, 9.9, and 10.1)

ECONOMIC POLICY INSTITUTE

other vital federal government functions. For example, budget cuts and flat budgets have compromised the “weather infrastructure”—the computer systems, the satellite network, and staff of the National Oceanic and Atmospheric Administration (of which the National Weather Service is a part)—that provides severe weather alerts to protect the public from imminent weather threats (Miles 2014).

In addition, the budget cuts for the Internal Revenue Service (IRS) have resulted in an erosion of taxpayer services and tax enforcement—it is now easier for tax cheats to evade paying taxes. These budget cuts have contributed to undermining public trust in the fairness of the tax system (National Taxpayer Advocate 2014).

The sorry state of our public investments

The 50-year history of public investments as a percent of GDP is shown in **Figure D**. Federal public investment spending averaged 2.2 percent of GDP between 1965 and 1981. After 1981, public investment spending fell relative to GDP, and after 1986, it averaged 1.5 percent of GDP. The increased spending from the American Recovery and Reinvestment Act of 2009 (ARRA), which temporarily lifted public investment spending to 1.9 percent of GDP in 2010, was still lower than the pre-1981 average. This fall—and continuing low levels of public investment spending—have had and will continue to have an adverse impact on economic growth and America’s place in the world economy.

Public investments in physical capital (primarily infrastructure—roads, bridges, drinking water systems,

sewage systems, waterways, etc.) have fallen from 0.8 percent of GDP in 1980 to 0.5 percent in 2013. The American Society of Civil Engineers (ASCE) gave America's infrastructure a grade of just D+ in 2001. By 2009, the ASCE awarded America's infrastructure a grade of D (even closer to failing). The grade rose slightly to D+ by 2013, most likely due to the increased spending under ARRA in 2010 and 2011. ASCE, however, notes that over the next eight years, the United States needs to spend at least \$1.6 trillion (about \$200 billion per year) above projected infrastructure spending levels to achieve a grade of B. Research reviewed by Bivens (2012) has shown that infrastructure investments have significant positive effects on private-sector productivity and economic growth.

Federal nondefense spending on research and development (R&D) has fallen from 1 percent of GDP in 1965 to 0.4 percent of GDP in 2013 (defense R&D spending, which is not shown in the figure, has similarly fallen). In a recent book, Mazzucato (2013) argues that the government is in the best position to take on the risk and cost of "breakthrough" basic research. The private sector tends to under-invest in basic research because of the uncertainty of finding a new product or process that yields a positive return. Also, while private and public R&D produces new knowledge, public R&D readily diffuses that knowledge throughout the economy. Research shows that public R&D spending often complements private R&D spending and has a positive effect on private-sector productivity (CBO 2014b).

Federal spending for education and training has fallen from 1 percent of GDP in 1975 to 0.5 percent of GDP in 2013. Funding education is primarily a state and local function, but federal spending can help reduce the disparities in per pupil funding levels across states and localities. In 2012, per pupil expenditures in public schools were \$19,500 in New York State, but only \$6,200 in Utah. Within each state there is also dramatic variation in per pupil spending levels. Federal funding to states for

education does help to reduce variation across and within states, but the reduction is relatively small because federal funds account for less than 10 percent of total school revenues.⁴

Recent research clearly shows a positive association between per-pupil spending and student outcomes (Baker 2012). The research further shows that school resources that cost money are positively correlated with student outcomes. Jackson, Johnson, and Persico (2014) find compelling evidence that reducing inequality of spending among school districts by increasing resources for low-income districts improves various student outcomes, including higher school completion rates, higher earnings, and reduced poverty. Equalizing per-pupil spending and improving student outcomes requires an increase in overall education spending at the national level. This would lead to an increase in spending in low-income school districts, rather than a neutral change that would redistribute funds from high-income to low-income districts.

The bottom line on our spending problem

Speaker Boehner is correct in that we have a spending problem, but he is absolutely wrong as to what the nature of that problem is. Federal investments in America's future—nondefense discretionary spending—has fallen relative to GDP and is projected to continue falling because of congressional actions. Public investment spending for infrastructure, education, and R&D has fallen relative to GDP, thus undercutting future economic growth. To return public investment spending as a percent of GDP to its 1980 level would have required an additional \$150 billion in 2013—an amount roughly equivalent to the capital gains, dividends, and tax benefits received by the richest 5 percent of Americans that year (CBO 2013). This amount, however, is below what is needed just to improve our infrastructure to an acceptable condition.

Many deficit hawks claim to be firmly in favor of sustaining nondefense discretionary spending, arguing that the need to preserve this spending is precisely why future outlays for the large social insurance programs (particularly Social Security, Medicare, and Medicaid) must be cut.

Social Security spending will increase slightly as the baby boomers retire, but then stabilize, and the overall increase in revenue needed to bring the system into long-run actuarial balance without cutting benefits is very modest—well under 1 percent of GDP. Health care spending in the federal budget is indeed projected to grow consistently in the coming decades, but the projected pace of this increase has been significantly reduced in recent years—an important fact about budgeting that has yet to fully inform the budget debate. Most important for weighing fiscal policy choices, the projected growth in Medicare and Medicaid spending is due to America’s dysfunctional health care system and not to serious problems of design with either of these programs. In fact, costs per enrollee for these public insurance programs have risen more slowly than for private insurance over recent decades. The United States spends roughly twice as much per capita on health care as most economically developed OECD countries (which also tend to have much higher shares of health care costs borne by the public sector), but our health outcomes tend to be worse than in these countries. The passage of the ACA (aka Obamacare) was a necessary but small first step toward getting health care costs under control. But congressional actions have also exacerbated the health cost containment problem, for example, by enacting a Medicare drug benefit in 2003 (Medicare Part D) that explicitly forbade Medicare from negotiating with pharmaceutical companies over drug prices.

Finally, it should be noted that budgetary savings gained from simply cutting the generosity of public insurance programs will just shift these costs onto households. And given that the public sector does a better job in contain-

ing overall health cost-growth, this cost-shift will likely increase the growth rate of national health care spending, thus increasing the overall burden of financing health care for Americans. It is very strange indeed that some argue that greater public investment should be “financed” by shifting health care costs onto American households and thereby increasing these costs.

We are not broke!

The narrative that “we’re broke” suggests that America is bankrupt—a statement that must be investigated. It conjures up images of Americans with pants pockets turned out seeking to borrow a dime. This narrative, however, is at odds with reality.

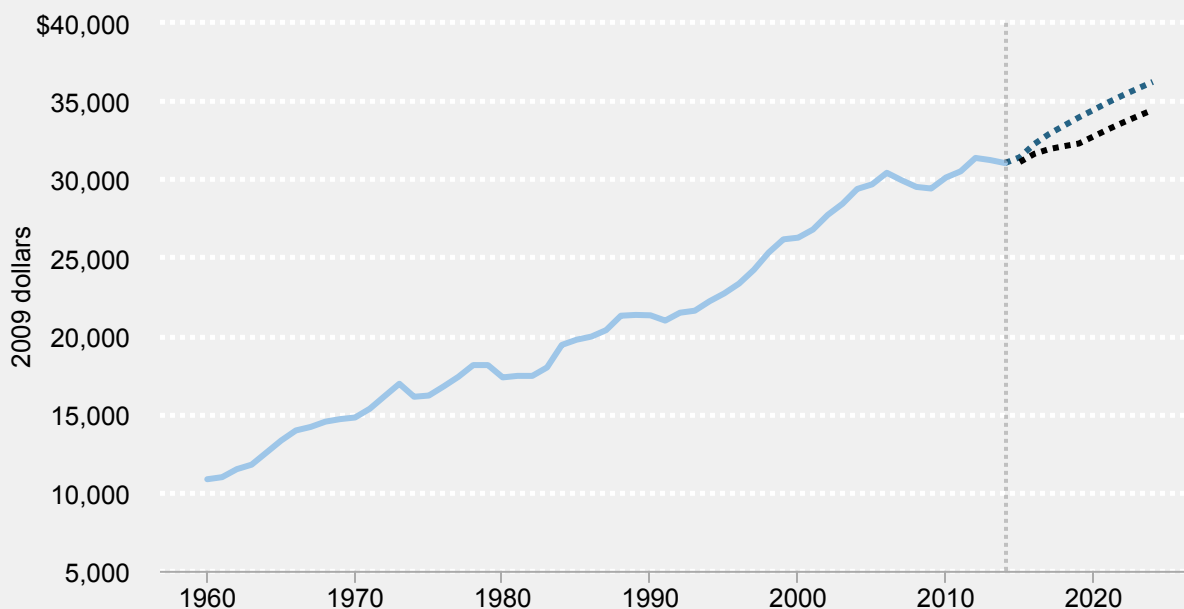
One way to measure the economic health of the American people is per capita real or inflation-adjusted income after taxes and before transfers.⁵ The trend in per capita real income since 1960 is displayed in **Figure E**. Between 1960 and 2013, per capita real income has followed a general upward trend, almost tripling from \$10,850 in 1960 to over \$31,000 by 2013. Per capita real income has not increased in every year, however, as it tends to fall slightly during economic downturns.

In Figure E, per capita real income is projected to 2024 using the CBO’s baseline economic and budget projections. The top dotted line in the figure is the baseline projection under the assumption that the tax code does not change after 2014 and temporary tax provisions expire as scheduled. By 2024, per capita real income, at over \$36,000, is projected to be 16 percent higher than it was in 2013. The lower dashed line in the figure is the projection under the assumption that a 3 percent of GDP tax hike is phased in over three years beginning in 2015. Even with this tax increase, per capita real income continues on a projected upward trajectory, increasing by 10 percent between 2013 and 2024 to \$34,500.⁶

While average real income has been steadily increasing, the gains, however, have not been evenly distributed.

FIGURE E

Per capita inflation-adjusted income, after taxes and before transfers, 1960–2024



Note: The top dotted line is CBO's baseline projection under the assumption that the tax code does not change after 2014 and temporary tax provisions expire as scheduled. The bottom dotted line is CBO's projection under the author's assumption that a 3-percentage-of-GDP tax hike is phased in over three years beginning in 2015.

Source: EPI calculations of data from Bureau of Economic Analysis (BEA) NIPA table 2.1 data and CBO 2014a

ECONOMIC POLICY INSTITUTE

Between 1989 and 2013, the income share of the bottom 80 percent of Americans fell from 44 percent to just 40 percent.⁷ Over the same period, the share of income going to the richest 1 percent of Americans increased from 16.6 percent to 19.6 percent.

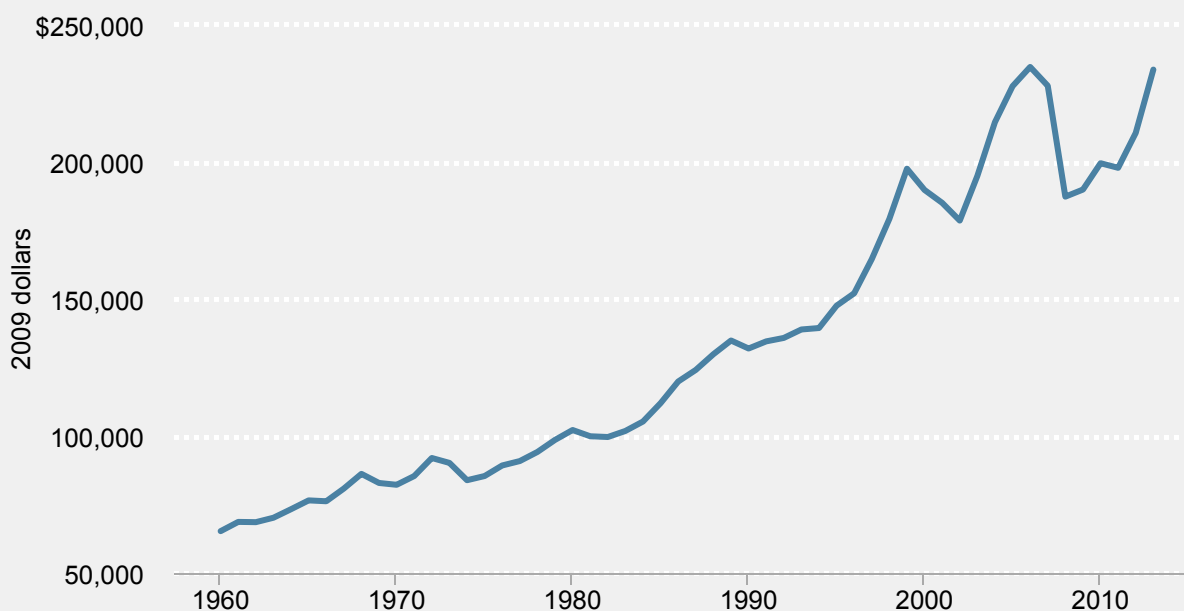
Wealth levels in the United States have also dramatically increased since 1960. **Figure F** displays the 50-year trend in per capita real net wealth (assets minus debt). Real wealth increased by over 200 percent between 1960 and 1999 (when the dot-com bubble burst). Even with all the financial troubles after 2000 (i.e., the bursting of the dot-com and housing bubbles, the financial crisis, and the 2007–2009 Great Recession), per capita real wealth was 18 percent higher in 2013 than in 1999.

As with income, much of the real wealth increase accrued to those at the top of the income distribution. The wealth share of the bottom 80 percent fell from almost 35 percent in 1989 to less than 27 percent in 2013.⁸ At the other end of the income distribution, the wealth share of the top 1 percent increased from 21 percent to almost 25 percent over this 24-year period.

By all objective measures, America is not broke. Average inflation-adjusted income and wealth levels have been steadily increasing over the past 50 years, and there is no reason to expect that these trends will not continue for the foreseeable future. The only problem is that the gains in income and wealth have not been evenly distributed: Most of the gains have accrued to those at the top

FIGURE F

Per capita inflation-adjusted net wealth, 1960–2013



Source: EPI calculation of data from Board of Governors of the Federal Reserve System 2015

ECONOMIC POLICY INSTITUTE

of the income distribution. Consequently, Americans can afford to pay higher taxes, but tax policy changes need to address the problem of rising income and wealth inequality.

Where could additional revenue come from?

The United States is not broke—inflation-adjusted income and wealth levels have steadily increased over the past half century and can reasonably be expected to continue increasing for the foreseeable future. We can afford to pay for needed public investments and strengthening our social insurance system. The main question is where the tax revenue should come from.

Most Americans file an annual income tax return and, consequently, are familiar with income as a tax base.

Income can be defined as the sum of consumption (spending on goods and services) plus additions to wealth (saving and appreciation of assets).⁹ Income can also be viewed as the sum of labor income (i.e., wages and salaries) and capital income (e.g., investment returns).

Some policy analysts and economists have advocated replacing the income tax base with a consumption tax base (saving would be exempt from taxation) or a labor income tax base (capital income would be exempt from taxation).¹⁰ The idea of consumption taxes has been around for at least 350 years since Thomas Hobbes (in 1651) advocated their use.¹¹ Such a change, however, would require a much higher tax rate to maintain current revenue levels since both the consumption and labor income tax bases are narrower than an income tax base. Furthermore, given the rather low U.S. saving rate, the

consumption tax base would likely be larger than the labor income tax base.

Most nations, including the United States, do not tax just one tax base, but use a variety of taxes. The U.S. federal government taxes income (labor and capital) under the individual and corporate income tax systems and the payroll tax, and taxes consumption through various excise taxes and customs duties. In fiscal year 2014, the federal government raised 46.2 percent of total revenues from the individual income tax, 10.6 percent from the corporate income tax, 33.9 percent from social insurance and retirement contributions (primarily payroll taxes), 3.1 percent from excise taxes, and 6.2 percent from other sources (OMB 2015).

Capital income

Whether or not capital income should be taxed has long been debated by academic economists (see, for example, Treasury 1977 and Meade 1978). Some economists have argued that the optimal tax rate on capital income is zero (see, for example, the discussion in Salanié 2003). The theoretical studies showing a zero optimal tax rate on capital income are based on restrictive models with strong assumptions. Several recent studies (e.g., Conesa, Kitao, and Krueger 2009, Jacobs and Schindler 2012, and Apps and Rees 2012), using more flexible models, show that the optimal capital income tax rate is significantly positive.

There are several other reasons to tax capital income. First, the share of income from capital has been rising over the past four decades and stands at about 40 percent of total income (see **Figure G**). Before 1975, capital's share of income was approximately 33 percent (with some year to year variation around that). Karabarbounis and Neiman (2014) show the rise in capital's share of income is not confined solely to the United States; many other developed countries have experienced a similar rise since the late 1970s or early 1980s. Piketty (2014) suggests capital's share of income could continue to increase

in the future. Switching to a wage or labor income tax base would likely lead to steadily rising tax rates as the tax base continually shrinks to prevent tax revenues from falling.

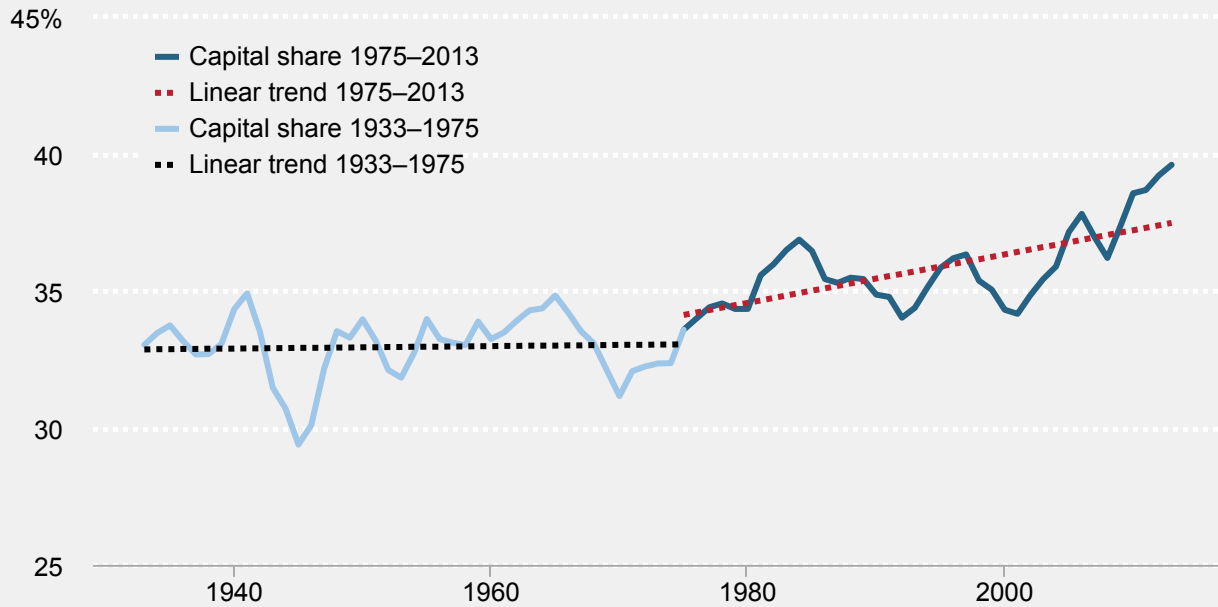
Second, shifting from an income tax would have distributional consequences. The great majority of capital is owned by high-income individuals, and most capital income is received by high-income individuals. Increasing capital's share of income has contributed to the rise in income inequality because labor income is more evenly distributed than capital income. Shifting to a wage or consumption tax base would increase the tax burden on lower-income taxpayers and make the tax system much less progressive.

Third, there is some truth to the old adage "an old tax is a good tax." Meade (1978) notes that individuals and families have already adjusted their behavior to the expectation that the income tax will continue; any change could have unintended (and adverse) behavioral consequences. Additionally, Gravelle (1994) argues that any shift in the tax base could bring windfall gains or losses to different groups of taxpayers.

Capital income is taxed in a variety of ways under the federal income tax. Some is not taxed at all, some is taxed under the personal income tax system, some under the corporate income tax system, and some is taxed under both the personal and corporate income tax systems (see the box on taxing businesses). As capital's share of income continues to increase, a larger share of tax revenue will have to come from capital income, with the double benefit of increasing tax revenue and reducing the growth in income inequality. For example, the tax rate on capital gains and dividends could be increased and the treatment of capital gains at death could be changed, as proposed by President Obama in his 2015 State of the Union address.

FIGURE G

Capital's share of national income, actual and linear trend, 1933–2013



Source: EPI calculations of Bureau of Economic Analysis (BEA) NIPA tables 1.7.5 and 1.12

ECONOMIC POLICY INSTITUTE

How businesses are taxed

Business entities organized as C corporations are subject to the corporate income tax. In calculating taxable income, businesses deduct from total receipts the costs of producing the goods sold (including the wages and salaries of employees), interest paid on debt (corporate bonds and loans), and various other expenses and tax preferences. Taxable income is essentially multiplied by 35 percent to get income tax before credits. The corporate income tax actually has a progressive rate structure (with a couple of bubble rates of 39 percent and 38 percent) on income up to \$10 million; income

above \$10 million is taxed at a constant 35 percent tax rate. Various credits are then subtracted, such as the foreign tax credit and the general business credit. In the 2011 tax year, profitable corporations had \$1,067.9 billion in net income, of which \$931.9 billion was subject to tax. After credits, these corporations paid \$200.2 billion in taxes for an average tax rate of 18.8 percent (IRS 2014).

Most C corporations pay dividends to shareholders out of after-tax income (they also often retain some earnings for new investments or share repurchases). Some of the dividends may be subject to tax under the indi-

vidual income tax. Dividends paid to taxable shareholders are considered income and reported on the shareholder's tax return. Qualified dividends, however, are taxable at preferential rates (with a maximum rate of 20 percent), and dividends received in retirement accounts are not taxed until withdrawn at retirement (Roth accounts are an exception—the dividends received are not taxed at all). Retained earnings can increase the value of corporate stock, which can lead to capital gains if the taxable shareholder sells the stock. Realized long-term capital gains are taxed at a preferential rate with a maximum of 20 percent.

Profitable C corporations deducted \$452.4 billion in interest in the 2011 tax year and all C corporations (profitable and not profitable) deducted \$751.1 billion in interest in the 2011 tax year. Interest paid on debt is not taxable at the corporate level, but the creditor may be taxed on the interest income received (IRS 2014). Interest received on corporate bonds held in retirement accounts are not taxed at the individual level until retirement (or not at all in the case of Roth accounts). The difference in the tax treatment of a business's debt versus equity leads to bias toward debt financing of new investment and away from equity financing.

Most businesses, however, are not taxed at the corporate level; they are solely taxed under the individual income tax system. These businesses are known as pass-through entities—sole proprietorships (e.g., the corner Mom and Pop grocery), partnerships (e.g., law firms and accounting firms), and S corporations (corporations with 100 or fewer share-

holders). In the 2011 tax year, about 95 percent of all business entities were pass-throughs, and these businesses accounted for about 44 percent of all business receipts (IRS 2015). Taxable income for pass-throughs is calculated in much the same way as for C corporations: Businesses deduct the costs of producing their output (as well as other deductions) from receipts. Unlike in C corporations, however, the income flows through to the individual shareholders or owners, who report the income on their form 1040 tax return and pay all taxes.

The current Washington tax reform mantra is “broaden the income tax base and reduce the tax rates.” As anyone who has filled out a form 1040 tax return knows, not all income is taxable. Some income is explicitly excluded from taxation (such as municipal bond interest), and taxpayers are allowed a variety of deductions, all of which reduce taxable income. In the 2012 tax year, total taxable income for all individual income taxpayers was about 70 percent of adjusted gross income (AGI).¹² Businesses are also allowed a variety of deductions that reduce the corporate income tax base.

This narrowing of the tax base is due to the special deductions, exclusions, and exemptions (sometimes characterized as “loopholes”) that have been in the tax code since the passage of the progressive income tax in 1913. These provisions are known as tax expenditures, a term first used when the Department of the Treasury became interested in tracking and accounting for these tax subsidies in the mid-1960s. Tax expenditures are officially defined in the Congressional Budget and Impoundment Act of 1974 as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”¹³

Both the Department of the Treasury and the Joint Committee on Taxation (JCT) prepare annual lists and estimates of tax expenditures. In its latest list of tax expenditures (2014), the JCT identifies over 250 tax expenditures in the individual income and corporate income tax systems. The aggregate revenue loss is estimated to be \$1,190.6 billion or about 7 percent of GDP in fiscal year 2014.¹⁴ The aggregate revenue loss is, however, highly concentrated among a handful of tax expenditures—the 25 largest individual income and corporate income tax expenditures account for 90 percent of the revenue loss of all 250-plus tax expenditures.

Yogi Berra once said, “In theory, there is no difference between theory and practice; in practice there is.” In theory, broadening the tax base is easy by eliminating useless tax expenditures; in practice, Gravelle and Hungerford (2013) argue that many of the large tax expenditures will be difficult to eliminate or even modify.

First, many are widely used and popular with the public or policymakers; examples include the deductions for mortgage interest, state and local taxes, and charitable contributions. Past proposals to eliminate or curb certain tax expenditures by President Obama and by former House Ways and Means Chairman Dave Camp were quickly dismissed by various interest groups as well as by members of both parties.

Second, some provisions are difficult to measure and allocate to specific taxpayers (at least in a widely accepted manner), such as the exclusion for employer-provided health insurance and certain pension benefits.

Third, some are effective in accomplishing the social and economic goals for which they were designed; the EITC is a prime example.

Although the aggregate revenue loss of tax expenditures is over \$1 trillion, Gravelle and Hungerford (2013) argue that it would be difficult (but not impossible) to gain much more than about \$150 billion in additional tax rev-

enue by eliminating the “low-hanging fruit.” This revenue gain could increase public investment spending by about 0.8 percent of GDP, but would not be enough to significantly reduce tax rates.

In addition to raising revenue, eliminating or curbing many tax expenditures could help make the tax system more progressive and reduce income inequality. Many of the large tax expenditures disproportionately benefit higher-income taxpayers (see, for example, Hungerford 2006b and CBO 2013) and have been described as having an “upside down” subsidy feature (Surrey 1970). Most of the benefits of itemized deductions (e.g., mortgage interest, charitable contributions, and state and local taxes) accrue to the top 20 percent in the income distribution, and 30 percent of the benefits accrue to the richest 1 percent. The benefits of preferential rates on capital gains and dividends are even more skewed to the top, with 68 percent of the benefits accruing to the richest 1 percent.

The tax base: Should the United States adopt a VAT?

Most other advanced economies have adopted a value added tax (VAT). On average, the countries collect revenue from the VAT that is equivalent to 6.7 percent of GDP¹⁵—ranging from a low of 3.4 percent of GDP in Australia to a high of 9.9 percent of GDP in Denmark and New Zealand. Our nearest neighbor, Canada, has a VAT with revenues equal to slightly over 4 percent of GDP. If the United States were to adopt a VAT with revenues equal to 6.7 percent of GDP (holding all else constant), which is the average for 14 of the most advanced economies, the federal budget would be in surplus for the next 30 years. Furthermore, even with such a VAT, the United States would still have one of the lowest tax burdens among the advanced economies. The most common and persuasive argument against adopting a VAT is that consumption taxes are regressive and excessively burden lower-income people (Gravelle 2011).¹⁶

Concluding remarks

The United States is the richest nation in the world. Per capita income and wealth have been steadily rising over the past half century. Public investments in roads, education, and basic research have been a major contributor to this growth. Federal spending for public investments relative to GDP, however, fell dramatically in the 1980s and has remained at a low level since then. Recent austerity measures enacted by Congress will undoubtedly further reduce spending on public investments. This is Washington's real spending problem, and the solution to this problem is to increase tax revenue.

Another problem has developed alongside our spending problem: the increasing concentration of income and wealth at the top of the income distribution. Part of the solution to this problem is a progressive tax and transfer system. For example, increasing taxes on capital income will reduce the after-tax income of the richest 1 percent. Furthermore, the increased public investment spending will help reduce income inequality by creating more higher-paying jobs and boosting productivity growth.

About the author

Thomas L. Hungerford joined the Economic Policy Institute in 2013 as a senior economist and is also director of tax and budget policy. Prior to joining EPI, Hungerford worked at the General Accounting Office, the Office of Management and Budget, the Social Security Administration, and the Congressional Research Service. He has published research articles in journals such as the *Review of Economics and Statistics*, *Journal of International Economics*, *Journal of Human Resources*, *Journal of Urban Economics*, *Review of Income and Wealth*, *Journal of Policy Analysis and Management*, *Challenge*, and *Tax Notes*. He has taught economics at Wayne State University, American University, and Johns Hopkins University. He has a Ph.D. in economics from the University of Michigan.

Endnotes

1. An exception to this is spending increases and/or tax cuts proposed for macroeconomic stabilization purposes (for example, the American Recovery and Reinvestment Act of 2009 or the Economic Stimulus Act of 2008—signed into law by President George W. Bush). This exception is perfectly reasonable, as textbook economics suggest that fiscal stabilizations are most effective when financed with debt.
2. Reinhart (2011) summarizes evidence showing Medicare reimbursements grew at a slower rate than that of private insurers. Some argue that rising health care costs are due to cost shifting by providers, who charge private insurers more because of shortfalls from Medicare and Medicaid. In other words, the federal health programs are driving the rising costs of health care. Recent research, however, gives little support for the cost shifting argument (Frakt 2011 and Reinhart 2011); rising Medicare and Medicaid costs reflect what is happening in the private sector, not the other way around.
3. The majority of this increased spending was for education and training, ground transportation, natural resources and the environment, and community and regional development.
4. Federal revenue reduces the standard deviation of the logarithm of revenues per pupil by less than 5 percent. Author's estimate using the Census Bureau's 2012 Public Elementary-Secondary Education Finance Data.
5. This income measure shows how much everyone in the economy on average earns from labor and capital.
6. It is implicitly assumed that the additional tax revenue is wasted, and that no additional goods and services are purchased.
7. Author's estimates from analysis of the 1989 and 2013 Survey of Consumer Finances (Board of Governors of the Federal Reserve System various years).
8. Author's estimates from analysis of the 1989 and 2013 Survey of Consumer Finances (Board of Governors of the Federal Reserve System various years).

9. This is known as the Haig-Simons definition of income. Robert Haig (1921) and Henry Simons (1938) examined the issue of what is income. Haig (1921, 7) notes that income is “the money value of the net accretion to one’s economic power between two points of time.” Simons (1938, 50) defines income as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” The Haig-Simons income concept is much broader than what most taxpayers understand as income and than what the Internal Revenue Code defines as gross income: “all income from whatever source derived” (26 U.S.C. 61). The Haig-Simons definition would include as income the market value of home production, the rental value of owner-occupied housing, and accrued capital gains, all of which are difficult to measure.
10. The U.S. income tax base is not strictly an income tax base because some saving, such as contributions to and earnings from retirement accounts, is not taxed.
11. Alexander Hamilton argued for a national consumption tax in Federalist No. 21. Hungerford (2006a) notes that federal consumption taxes (customs duties and excise taxes) provided almost 90 percent of federal revenue until 1913.
12. The 2012 tax year is the last year for which individual income tax information is publicly available.
13. 2 U.S.C. 622.
14. This figure is calculated by simply adding together the estimated revenue loss of each individual tax expenditure. This may overstate or understate the true revenue gain from eliminating all tax expenditures. See Hungerford 2006b for a brief discussion.
15. International tax information is available from the OECD website (www.oecd.org).
16. The additional revenues from a VAT, however, can be used to expand and strengthen the social welfare system, which has a very progressive benefit structure, and to pay for needed public investments, which can foster economic growth and a more equal distribution of the fruits of that growth. Many countries with a VAT, while having progressive tax systems, achieve much more redistribution

through spending programs than through the tax system. CBO (2014) estimates that in 2011, the progressive U.S. federal tax system reduced income inequality by 8 percent, but that government transfers reduced inequality by 19 percent. Avi-Yonah (2014) argues that this research suggests the best route to reducing income inequality is to strengthen the public insurance system financed by a VAT.

References

- Apps, Patricia, and Ray Rees. 2012. *Capital Income Taxation and the Mirrlees Review*. Institute for the Study of Labor Discussion Paper No. 6615.
- Avi-Yonah, Reaven S. 2014. “Taxation and Inequality: A Case for the VAT.” *Challenge*, vol. 57, no. 3, 97–104.
- Bivens, Josh. 2012. *Public Investment: The Next ‘New Thing’ for Powering Economic Growth*. Economic Policy Institute Briefing Paper No. 338.
- Baker, Bruce D. 2012. *Revisiting the Age-Old Question: Does Money Matter in Education?* The Albert Shanker Institute.
- Board of Governors of the Federal Reserve System. 2015. *Financial Accounts of the United States – Z.1, Historical Annual Tables, table B.101*.
- Board of Governors of the Federal Reserve System. Various years. *Survey of Consumer Finances*. <http://www.federalreserve.gov/econresdata/scf/scfindex.htm>
- Boehner, John. 2012. “Where Are the President’s Spending Cuts?” Speech to the U.S. House of Representatives, 112th United States Congress, December 11.
- Bureau of Economic Analysis (BEA) (U.S. Department of Commerce). N.d. *National Income and Product Account (NIPA) tables [online data tables]*. Various years.
- Conesa, Juan Carlos, Sagiri Kitao, and Dirk Krueger. 2009. “Taxing Capital? Not a Bad Idea After All,” *American Economic Review*, vol. 99, no. 1, 25–48.
- Congressional Budget Office (CBO). 2001. *The Budget and Economic Outlook: Fiscal Years 2002–2011*.
- Congressional Budget Office (CBO). 2012. *Changes in CBO’s Baseline Projections since January 2001*.

- Congressional Budget Office (CBO). 2013. *The Distribution of Major Tax Expenditures in the Individual Income Tax System*.
- Congressional Budget Office (CBO). 2014a. *An Update to the Budget and Economic Outlook: 2014 to 2024*.
- Congressional Budget Office (CBO). 2014b. *The Distribution of Household Income and Federal Taxes, 2011*.
- Department of Treasury. 1977. *Blueprints for Basic Tax Reform*.
- Frakt, Austin B. 2011. "How Much Do Hospitals Cost Shift? A Review of the Evidence." *The Milbank Quarterly*, vol. 89, no. 1, 90–130.
- Gravelle, Jane G. 1994. *The Economic Effects of Taxing Capital Income*. Cambridge, Mass: MIT Press.
- Gravelle, Jane G. 2011. "The Distributional Case against a VAT." *The VAT Reader*. Falls Church, Va.: Tax Analysts.
- Gravelle, Jane G., and Thomas L. Hungerford. 2013. *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*. CRS Report R42435.
- Haig, Robert Murray. 1921. "The Concept of Income—Economic and Legal Aspects," in *The Federal Income Tax*, Robert Murray Haig (ed.). New York: Columbia University Press, 1–28.
- Hobbes, Thomas (1651/1968). *Leviathan*. Harmondsworth, England: Penguin.
- Hungerford, Thomas L. 2006a. *U.S. Federal Government Revenues: 1790 to the Present*. CRS report RL33665.
- Hungerford, Thomas L. 2006b. "Tax Expenditures: Good, Bad, or Ugly?" *Tax Notes*, vol. 113, no. 4, 325–334.
- Hungerford, Thomas L., and Rebecca Thiess. 2013. *The Earned Income Tax Credit and the Child Tax Credit: History, Purpose, Goals, and Effectiveness*. Economic Policy Institute Issue Brief #370.
- Ippolito, Dennis S. 2012. *Deficits, Debt, and the New Politics of Tax Policy*. Cambridge, Mass.: Cambridge University Press.
- Internal Revenue Service (IRS). 2014. "SOI Tax Stats—Table 17—Corporation Returns with Net Income, Form 1120" (online data table for year 2011)
- Internal Revenue Service (IRS). 2015. "SOI Tax Stats—Integrated Business Data—Table 1: Selected Financial Data on Businesses" (online data table for year 2011).
- Jackson, C. Kirabo, Rucker Johnson, and Claudia Persico. 2014. *The Effect of School Finance Reforms on the Distribution of Spending, Academic Achievement, and Adult Outcomes*. National Bureau of Economic Research Working Paper No. 20118. <http://www.nber.org/papers/w20118>.
- Jacobs, Bas, and Dirk Schindler. 2012. "On the Desirability of Taxing Capital Income in Optimal Social Insurance," *Journal of Public Economics*, vol. 96, 853–868.
- Karabarbounis, Loukas, and Brent Neiman. 2014. "The Global Decline of the Labor Share," *Quarterly Journal of Economics*, vol. 129, no. 1, 61–103.
- Kimmel, Lewis H. 1959. *Federal Budget and Fiscal Policy 1789-1958*. Washington, D.C.: Brookings Institution.
- Klein, Ezra. 2011. "The U.S. Government: An Insurance Conglomerate Protected by a Large, Standing Army." *The Washington Post*, Feb.14.
- Kleinbard, Edward D. 2014. *We Are Better Than This*. Oxford: Oxford University Press.
- Mazzucato, Mariana. 2013. *The Entrepreneurial State*. London: Anthem Press.
- Meade, James Edward. 1978. *The Structure and Reform of Direct Taxation*. London: George Allen and Unwin.
- Miles, Kathryn. 2014. "Our Failing Weather Infrastructure." *New York Times*, Oct. 31.
- National Taxpayer Advocate. 2014. *Annual Report to Congress*, Internal Revenue Service.
- Office of Management and Budget (OMB). 2015. *The President's Budget of the U.S. Government, Fiscal Year 2016*. Historical Tables.
- Piketty, Thomas. 2014. *Capital in the Twenty-First Century*. Cambridge, Mass: Harvard University Press.

Rank, Mark Robert. 2004. *One Nation, Underprivileged*. Oxford: Oxford University Press.

Reinhardt, Uwe. E. 2011. "The Many Different Prices Paid to Providers and the Flawed Theory of Cost Shifting: Is It Time for a More Rational All-Payer System?" *Health Affairs*, vol. 30, no. 11, 2125–2133.

Salanié, Bernard. 2003. *The Economics of Taxation*. Cambridge, Mass.: The MIT Press.

Simons, Henry C. 1938. *Personal Income Taxation*. Chicago: University of Chicago Press.

Surrey, Stanley S. 1970. "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures." *Harvard Law Review*, vol. 83, no. 4, 705–738.

U.S. Congress. Joint Committee on Taxation. 2014. *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018*. JCX-97-14.