The Fiscal Commission Has Forgotten Its Role

By Calvin H. Johnson

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The National Commission on Fiscal Responsibility and Reform is tasked with reducing the deficit to avoid an impending budget catastrophe. Instead it is proposing lower corporate tax rates and a wasteful research and development program at a time when we need more revenue. We also need some new ideas to make the tax system fairer, more efficient, and more comprehensive. The commission's final report would also benefit from the discipline of a distributional table, because its proposals appear to shift the tax burden downward. In the coming crisis, it is the wealthy who will need to make sacrifices.

We face a budget catastrophe with unsustainable deficits. The National Commission on Fiscal Responsibility and Reform was assigned the role of proposing ways to prevent that catastrophe. It has released a draft proposal[1] in anticipation of the December 1 deadline for the full report.

The commission got distracted from its mission. It wants to hand out sweets by cutting revenues and providing tax incentives. This is not the time, however, to be reducing the tax revenue from corporations,[2] nor is it the time to make permanent a wasteful research and development program. Alexander Pope wrote: ''Act well your part, there all the honor lies.''[3] Somebody else should hand out the sweets. The job of the commission is to make us take cod liver oil and close the deficit: It has forgotten its role.

The draft proposal would collect $1.1 trillion more revenue by repealing everything on the tax expenditure budget list. The tax expenditure budget is not a terrible first-draft list to use for revenue collection. But the proposal uses only $80 billion (or 7¼ percent) of that revenue pickup for deficit reduction.[4] The best estimate of our deficit needs is $1.4 trillion a year,[5] so the proposal's deficit reduction from its principal source of revenue amounts to only 6 percent of the real deficit needs. There must be more deficit reduction on the tax side. The commission is squandering its limited ideas.

Aggressive New Proposals Needed

Nor is there anything new on the commission's list of ideas to identify the potholes in tax. We should be spending $4 million a year right now to pay for 20 top-flight professionals to go on search-and-destroy missions for tax shelters. Our tax system is too full of loopholes to accurately reflect the income of our richest taxpayers. In Leona Helmsley's world as she knew it, only the little people paid taxes. Our tax system too often creates loopholes that absorb revenue when it should be generating revenue.

The Shelf Project, which I am a part of, has proposed 50 different ways to raise $1 trillion a year.[6] Each project can be used independently when Congress is ready to raise revenue. All the proposals would make the tax system fairer and more efficient. However, it will take work — and probably some motivational viciousness — to make the tax system more comprehensive, fair, and efficient. The commission is not working hard enough to raise revenue by making the system capture all the possible revenue from the highest incomes or by making it fairer and more efficient.

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[1] National Commission on Fiscal Responsibility and Reform, ''Co-Chairs Proposal'' (Nov. 2010), *Doc 2010-24196*, *2010 TNT 218-35*.

[2] A cut in corporate rates is fine if the commission would increase revenue from the corporate tax. Calvin H. Johnson, ''Replace the Corporate Tax With a Market Capitalization Tax,'' *Tax Notes*, Dec. 10, 2007, p. 1082, *Doc 2007-26347*, or *2007 TNT 238-36*, proposes an 8/10th percent tax on corporations, but it is loophole-proof because it is imposed on market capitalization, and raises significant revenue.

[3] Alexander Pope, *Essay on Man*, Epistle IV.

[4] I use the proposal's annual figures for 2015 as a sample.

[5] Alan J. Auerbach and William G. Gale, ''Déjà Vu All Over Again: On the Dismal Prospects for the Federal Budget,'' Tax Policy Center (Apr. 2010), *Doc 2010-9538*, *2010 TNT 83-34*.

[6] Johnson, ''Fifty Ways to Raise a Trillion,'' statement on the Shelf Project for the Senate Finance Committee hearings on lessons from the Tax Reform Act of 1986 (Sept. 23, 2010). An earlier inventory is in Johnson, ''How to Raise $1 Trillion Without a VAT or a Rate Hike,'' *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*.

Discipline of Distribution Analysis

The commission needs to impose on the discipline of a distributional analysis of its proposals before the draft becomes final. The proposals appear to give tax cuts to the wealthy at a time when those individuals should be paying more tax. The proposals seem to shift the tax burden down onto people less able to pay. They would cut the earned income tax credit, which applies to the lowest quintile of incomes, so as to lower the corporate tax, which is paid by the top decile of incomes. In this revenue crisis, rates at the bottom can't be increased so those at the top can be decreased.

A distributional table acceptable the American public will undoubtedly have to shift the tax burden up to reach more wealth of the new super-rich and the overpaid. The wealthiest taxpayers will have to sacrifice in the impending crisis. But in any event, a consensus proposal should not shift the tax burden onto the rural and the newly poor. A stereotype of the partisan divide, moreover, is that Republicans want to cut spending and Democrats want to raise taxes. The proposal raises three-fourths of its $372 million for deficit reduction by reducing spending. The better estimate of real need is $1.4 trillion, not $372 million, so the commission must be more ambitious. In its ratio of spending to tax and in its distributional impact, this is a very conservative proposal, to the right of the consensus that the American people must reach.

Bracket Contraction

The proposal recommends fewer tax rate brackets to ''simplify'' the law. Fewer tax brackets compresses the differences between tax rates paid by billionaires, middle-income taxpayers, and the poor. There is little simplification and much deception in that idea. Because the brackets are largely dealt with by TurboTax nowadays, it doesn't matter how many there are. Even for those using tables on paper, the rate is not hard to find once taxable income is known. It is about as easy to find your row on a tax table with 25 different brackets as it is to find it in a three-bracket table. At that level of effort, the number of rows in the table should not affect the tax burden. Using fewer tax rates to simplify the tax law is sneaky, and the debate must be transparent. A commission that remembers its responsibilities should not do that.

The Wasteful Research Credit

Probably the worst idea in the proposal is the recommendation to make permanent the 20 percent research credit. The credit is a grand waste of money. The most heavily subsidized industry in America is the development of computer and video games like ''Grand Theft Auto'' and ''Doom III.''[7] The research credit and other silly tax subsidies turn a 10 percent pretax return from those games into a better than 20 percent after-tax return.[8] If a wise engineer were awarding prizes to encourage the development of objects that would benefit humanity, these violent games would not be on the list.

We want to subsidize research that will change the world for the better. But we need human intelligence to identify breakthroughs after enough time has passed to recognize the breakthrough. Most research never results in a breakthrough and wastes money. If the commission wants to offer proposals to subsidize R&D, moreover, it needs to provide real money. At least with real money, people understand that real costs are being wasted.

There is nothing in the requirements for the research credit that ensures that the costs provide any external value. Late in the Clinton administration, Treasury proposed regulations that would have denied the credit for routine artisan work using known tools of the trade. The research would have had to be patentable to qualify for the credit. Patentability is a weak test. It does not ensure that the costs generate external value for humanity that cannot be captured by the ordinary market price. Patented projects are not necessarily breakthroughs. Not everything patentable should be subsidized. The Bush administration removed even the patentability standard, leaving nothing in the definition of eligible R&D expenditures to ensure that there is some benefit, not captured by the market price, for society now or for future generations.

The credit identifies the new investments to be generated generated by the research credit just by the fact that they are money-losing in the absence of tax. Investments lose money in the absence of tax primarily because market demand for the product is insufficient. Doom III might well not have been developed if its creators had counted on real demand. The subsidy applies to investments that would not be made in the absence of tax because they are terrible investments. That is a silly way to identify things to subsidize. The research credit the commission endorses is a waste. Again, a commission that remembered its roles would not do that.

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[7]*See* http://en.wikipedia.org/wiki/Grand_Theft_Auto_(series); and http://en.wikipedia.org/wiki/Doom_3.

[8]Johnson, ''Capitalize Costs of Software Development,'' *Tax Notes*, Aug. 10, 2009, p. 603, *Doc 2009-15569, 2009 TNT 151-9*.