Analysis: Hidden Dynamite In Proposed New Tax-Law Overhaul

By: Denny Gulino – July 1, 2013

Among the words that can turn off inquiring minds, words that act as sort of a language narcotic, "tax expenditures" ranks very high, masking the vast societal shifts that they bring about.

"Tax expenditures" or government giveaways - taxes that certain groups and industries get to avoid or reduce - are the hidden movers that have influenced generations of Americans in ways that are mostly unrealized.

The all-time favorite, the exemption of mortgage interest, has gone mostly to some sectors of American society, hardly at all to others. Trillions of dollars of foregone tax gifts that could have helped lift generations of minority Americans into higher median incomes, into university educations, never happened, prolonging income disparities by many decades if not large parts of centuries.

There's no borrowing against a house to finance children's education without home ownership, and ownership is a lot harder without that mortgage exemption, and for minorities it has been harder to get the mortgage in the first place - because of lower incomes.

But that deprivation goes far beyond American minority populations. No more than a third of all taxpayers ever itemize deductions, the IRS confirms, and so claim the generous deductions.

Congress has responded to that unfairness to some extent, with more tax giveaways aimed exclusively at education. Those benefits are also spread very unevenly and many analysts say don't come close to counterbalancing the many decades of uncollected mortgage interest deductions. This year is the 100th anniversary of the mortgage tax break.

Erskine Bowles, promoting a zero-based revolution in tax giveaways along with Senate Finance Committee Chairman Max Baucus and ranking Republican Orrin Hatch, tells whoever will listen - including CNBC Monday morning - that 73% of Americans currently do not itemize deductions. That's a lot of people who get no benefit from the mortgage exemption or any other breaks among a very long list of tax giveaways embedded in the tax code.

That disparity, 37 million beneficiaries versus 143 million who see no benefit, Bowles said, is the key to tax reform.

Bowles says that if those giveaways were ended then incomes up to $70,000 would pay an only 8% income tax rate. How much total tax revenue is given away? Almost the same as the amount of individual and corporate tax that is collected, $1.2 trillion.

Soon after the tax giveaways are inserted into the tax code they are treated as birthrights by those who benefit. Only members of the House Ways and Means Committee and Baucus's Finance Committee can do the inserting and once there, the giveaways never have to be reviewed without being the target of specific legislation - which virtually never happens.

When sequestration was applied to government spending, there was no sequestration of the tax giveaways and, as "off-budget," they do not show up on the annual budget documents and do not become part of the deficit reduction conversation.

Decade by decade the tax giveaways have expanded regardless of which political party controlled government purse strings, with only rare efforts to rein a few of them in. That did happen when first-mortgage deductions were limited to the first million in debt or the first $100,000 of home equity debt and when credit card and other personal loan interest was excluded.

The invention of the term "tax expenditures" is credited to Treasury Assistant Secretary of Tax Policy Stanley Surrey, acknowledged as one of the foremost tax theorists of his generation. He was being critical of Congress for using them as a "vast subsidy apparatus to reward favored constituencies." He died in 1984 but tax expenditures are still very much here.

Since Surrey the point of view that the tax giveaways actually are a birthright, not tax forgiveness, has spread. For those like libertarian Cato Institute, the money belongs to those who earned it, not the government, so there's no gifting involved.

In that context the full dimension of what is slowly beginning to happen is more clear. It is a campaign by Baucus, Hatch, Rep. Dave Camp, Bowles and a host of other tax reform advocates to do no less than kill every tax expenditure and start with "a clean slate."

That's everything, the mortgage deduction, the charitable contributions deduction, the employer health insurance contribution deduction, all of the more than trillion dollars worth of tax breaks generated in nearly 200 different categories.

The definition of "quixotic" is a quest for something that is exceedingly unrealistic and in the view of many nothing better applies to this piece of overall tax reform.

At second glance, the size of the projected deficits, the competitive taxing disadvantage worldwide and an increased realization of the unfair distribution of tax breaks could mean there is finally no alternative. Of course having no alternative is sometimes only the start of the debate. Theoretically there's no alternative to raising the statutory debt limit late this year and yet oddsmakers are betting against any longer-term fix.

Legislators will be able to say they're trying to lower rates. The other crucial part of reform, the bigger net to capture more income to tax, doesn't count as a tax hike in campaign sound bites.

For his part, Bowles will showcase his pitch with a visit to President Obama next week. "I'm going to recommend to the president that we take this $1.3 trillion - which over 10 years counting inflation is $15 trillion - and use about 96% of that money to reduce income tax rates."

The rest of the money would be used to reduce the deficit.

As if cutting out popular tax breaks is not enough of a hurdle, the tax reform campaigners also want to cut corporate taxes, not generally a top priority in any survey which find a perception corporations aren't paying enough.

"If we can bring down the corporate tax rate the corporations will have more money to invest in this country to create jobs over here," Bowles said. That is a key to making the U.S. "more globally attractive place to invest your capital."

How will Congress or the American people go along with cutting tax breaks so many of them love? "It will be tough," Bowles concedes.

Nevertheless he said his arguments will work "when you show that you can take income tax rates to 8% up to %70,000 (income) ... and 14% up to $210,000 and have a maximum marginal income tax rate of 23% if you wipe out all of these tax expenditures."

Bowles continued, "You could take the corporate rate to 26% and you could pay for a territorial (international taxation regime) so that $1.5 trillion that's captured overseas could come back to America and create jobs here."

Bowles repeated, "Eighty percent of the tax expenditures that are in the Code today go to the top 20%" of Americans. "Almost three-quarters of the American people never even use these tax expenditures."

After wiping out all tax expenditures and creating the "clean slate" the pressure the dynamics of the tax reform debate will change in the calculations of the tax reformers. Because every billion in tax expenditure added back in will raise the taxes of everyone else. Those who don't benefit will finally have something on which to hang their objections.

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How will Congress as a whole, or the American people go along with eliminating tax breaks so many of them love? "It will be tough," Bowles concedes.

He said his argument will work "when you show that you can take income tax rates to 8% up to %70,000 (income) ... and 14% up to $210,000 and have a maximum marginal income tax rate of 23% if you wipe out all of these tax expenditures." And, Bowles said, "you could take the corporate rate to 26% and you could pay for a territorial (international taxation regime) so that $1.5 trillion that's captured overseas could come back to America and create jobs here."

So after wiping out all tax expenditures, each one's cost to add it back in will be, according to the hopes of the tax reformers, powerful arguments for change. Because, Bowles said, every tax break added back in will cause everyone else's tax rates to go back up. The spotlight will then shift to the element always missing in the issue of tax expenditures, the unfairness issue.

For Baucus and Hatch in the Senate to cooperate across party lines is not unprecedented. In fact, they both cosponsored legislation in March -- to establish permanent tax breaks for farmers and ranches who donate land for conservation.