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A Simple Route to Major Deficit Reduction

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A 2% cap on tax deductions and exclusions would reduce the national debt by $2 trillion over a decade.

Putting a cap on tax expenditures - those features of the tax code that are a substitute for direct government spending - can break the current fiscal impasse and prevent the dangerous explosion of the national debt. If a cap is combined with entitlement reforms, the government will also be able to reduce tax rates and increase some spending to accelerate the economic recovery.

Republicans and Democrats agree that deficits must be cut and the ratio of federal-government debt to GDP reduced. But Republicans want to reduce the deficit by cutting government spending while Democrats insist that raising revenue must be part of the solution.

Yet the distinction between spending cuts and revenue increases breaks down if one considers tax expenditures. Here are some examples. If I buy a solar panel for my house, a hybrid car, or an energy-efficient refrigerator, the government pays me. But instead of sending me a check, it gives me a tax credit or a tax deduction. There are dozens of such examples that increase the annual budget deficit by billions of dollars. Congress should review these tax expenditures and eliminate those that the country cannot afford.

To be sure, the largest tax expenditures are the deductions that individuals can take on their tax returns for mortgage interest, state-income and local-property taxes paid, and also the exclusions from taxable income from municipal bond interest, and for employer-provided health insurance. Any attempt to limit such deductions and exclusions would generate fierce opposition. That's why an overall cap would be more feasible.

Limiting the tax savings from all deductions and the two major tax exclusions to 2% of an individual's adjusted gross income would reduce the deficit in 2013 by $220 billion. This 2% cap does not refer to the amounts of the deductions and exclusions but to the tax saving. This means that for someone taxed at a 25% marginal tax rate, the 2% cap would limit deductions and exclusions to 8% of that individual's adjusted gross income.

The 2% cap could also be modified to retain the existing deduction for all charitable contributions and to allow employees to exclude the first $8,000 of employer-paid health-insurance premiums from the cap. This would still reduce the current year's deficit by $141 billion. That translates to about a $2.1 trillion reduction in the national debt over the next decade.

Higher tax rates, in short, are not necessary in order to raise substantial revenue. Indeed, some of the $2.1 trillion could be used to reduce current tax rates and promote growth.

The existing charitable deduction in particular deserves to be maintained. Unlike other deductions and exclusions, it does not benefit the taxpayer but provides important private support for universities, religious and cultural institutions, and hospitals.

The 2% overall cap on tax expenditures should be politically more acceptable than changes in the treatment of mortgage interest or other specific deductions because it treats all tax expenditures equally. It would also reduce after-tax income proportionately more for higher-income individuals. The cap would also encourage most individuals who now itemize to instead take the standard deduction. This would vastly simplify these taxpayers' returns.

To avoid pushing an already weak economy into recession, the 2% cap could be introduced gradually. A 5% cap would reduce the first-year government deficit by only about $50 billion and could be tightened over several years.

Limiting tax expenditures would raise substantial revenue, though the deficit in 2023 would be nearly 5% of GDP and the debt-to-GDP ratio would be 80%. That's still too high. Thus President Obama was wrong to say in the State of the Union address that another $1.5 trillion of deficit reduction over the next decade would stabilize federal finances. It won't. Even with the $2.1 trillion from capping tax expenditures, it would require an additional $300 billion of spending cuts in 2023 and later years to reverse the rising debt-to-GDP ratio and get it heading back to 50% or less.

The truth is that federal finances cannot be stabilized by reducing discretionary outlays alone. Even if the defense sequester is repealed, defense spending in 2023 will be down to 3% of GDP because of previous budget decisions. Nondefense discretionary outlays are also projected to be less than 3% of GDP. The reduction of deficits and debt requires slowing the growth of Social Security and federal health-care programs. Together these programs will cost nearly 13% of GDP in 2023. Reducing the annual growth rate of these programs by just 1% would reduce the 2023 deficit by some $300 billion.

There are many ways to reduce the growth of entitlement spending. One is to change the age at which individuals are eligible to receive benefits. Another is to modify the inflation indexing rules. Another is to increase the copayments in Medicare. The options are well known. What is needed is the political courage to enact these structural changes.

The combination of a cap on tax expenditures and a reform of entitlement programs would stabilize federal finances over the next decade. Once this is achieved, Republicans and Democrats should also be able to agree on some short-term increases in government spending to improve the nation's infrastructure and stimulate a more rapid economic recovery. But structural reductions in future deficits are the crucial context for any increase in near-term government spending.

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