

# Fiscal Fact

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## The Economics of the Blank Slate: Estimating the Effects of Eliminating Major Tax Expenditures and Cutting Tax Rates

By

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Senators Max Baucus and Orrin Hatch, the Chairman and Ranking Member of the Senate Finance Committee, have proposed in a letter to colleagues a “blank slate” approach to tax reform. They envision an income tax system “without all of the special provisions in the form of exclusions, deductions and credits and other preferences that some refer to as ‘tax expenditures.’” For income tax provisions that the Joint Committee on Taxation (JCT) regards as tax expenditures, the “blank slate” would retain only those that could be successfully defended in terms of simplicity, efficiency, and fairness. The senators emphasize the opportunity to channel the new revenue into income tax rate cuts while noting that some could go toward deficit reduction.

The senators recognize that an item should not necessarily be dropped from the income tax code just because it is called a tax expenditure by the JCT. (The U.S. Treasury also compiles a tax expenditure list with somewhat different items and estimates than the JCT's.) The benchmark against which the JCT and Treasury measure tax expenditures is based on what is known as the Haig-Simons concept of income. That tax base is inherently complicated, has a strong bias against saving and investment, and ignores many important policy and administrative concerns. A different benchmark, such as income used for consumption (a “personal expenditure tax”), would differ sharply in what it calls a tax expenditure.<sup>1</sup> Moreover, the JCT and the Treasury make many subjective, sometimes arbitrary, sometimes differing choices when envisioning the baseline and drawing up their tax expenditure lists.

A key consideration when deciding if a so-called tax expenditure should be kept or ended, and one which Senators Baucus and Hatch explicitly mention, is how the income tax provision affects economic growth. Would abolishing the provision severely damage investment, employment, production, international

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<sup>1</sup> For an illuminating discussion of the difference between the pure income and consumed income tax bases, see Office of Management and Budget, *Budget of the United States Government, Analytical Perspectives, Fiscal Year 2009*, ch. 19, 318-325. One can be most confident a tax provision should truly be classified as a tax expenditure if it qualifies as a tax expenditure under both the pure income and consumed income baselines.

competitiveness, and future opportunities? Would the damage to the economy eliminate some or all of the expected revenue gain? Would ending the provision raise enough net tax revenue to warrant the economic damage?

We have used our dynamic simulation model to examine eleven large tax expenditure provisions in the individual income tax that together comprise over half the dollar amount of all tax expenditures. In each case, the model estimated the impact of abolishing the tax provision on gross domestic product (GDP), investment, and employment, as well as the static and dynamic revenue effects. The model also estimated the outcome if the static revenue gain were used to finance an across-the-board rate cut.

The following case studies will detail the results from the individual macroeconomic simulations, but three general findings are worth highlighting:

1) When an income tax provision primarily affects returns to saving and investment and moderates the income tax bias against those activities, eliminating it from the tax code would often badly hurt growth while bringing in little or no revenue. In some instances, revenue would decline.

Examples include eliminating the lower rates on capital gains and qualified dividends, eliminating the home mortgage interest deduction, and lengthening depreciation lives for capital investments (i.e. moving from MACRS to ADS). Indeed, our model suggests that even the economic benefits of cutting tax rates across the board do not make up for the economic harm caused by eliminating these types of tax provisions.

2) With some tax credits that aggressively phase out as taxpayer income rises, the marginal tax rate spikes generated by the claw-backs are so damaging that GDP and pre-tax incomes would actually be higher if the credits were not in the tax code.

Examples of provisions with economically harmful phase outs include the Earned Income Tax Credit, the Child Tax Credit, and the various education tax credits. Indeed, our model shows that eliminating these tax expenditures would not only generate more tax revenues but also raise economic output.

3) Ending some deductions and exemptions would slow growth but not by much compared to the revenue gain, and using the revenue to cut tax rates would lead to a larger, stronger economy.

Examples of these types of tax expenditures include the charitable deduction, the exclusion of employer-provided health insurance, and the state and local tax deduction. Our model shows that using the revenues generated by eliminating these provisions to cut individual tax rates

across-the-board would significantly boost GDP which, in turn, could generate more tax revenues.

### **The Tax Foundation's Dynamic Simulation Model**

There are two main components to the Tax Foundation's Taxes and Growth Dynamic Simulation Model. The first is an individual income tax calculator. Using a large, anonymous sample of individual income tax records (the IRS's 2008 Public Use File), the tax calculator estimates the impact on individual income tax rates and collections of changes in tax provisions and economic activity. The Tax Foundation model also includes equations to estimate government receipts from a variety of other taxes and fees based on tax parameters and the size and composition of the economy.

The simulation model's other major component is a Cobb-Douglas production function based on neoclassical economics and on empirical relationships observed since World War II.<sup>2</sup> This part of the model relates inputs to output. It estimates how changed marginal tax rates, which alter work and investment incentives, lead to adjustments in capital and labor supplies and, in turn, new levels of output and incomes.

The model takes account of interactions among its components, and reaches a solution through several rounds of iteration. The model does not predict the year-by-year path of tax revenues and output, but estimates the revenue and output changes that will occur after people have fully adjusted to the new tax rules. The adjustment process is not instantaneous but neither does it take an inordinately long time. With capital, experience indicates that most of the adjustment will have been completed after five years for equipment and after ten years for structures.

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<sup>2</sup> One of its originators of this type of production function, Paul Douglas, was a distinguished economist who later became a distinguished U.S. senator.