$100,000 are probably not in the subset of the population that is likely to be motivated to pursue higher education as a result of tax incentives.

Tax Reform

Finance Committee Chair Max Baucus, D-Mont., recently said, “Many tax benefits, including for education, currently give the most help to those who already have the most opportunities... We should ensure more students get more education.” He added that “promoting education and opportunity will pay dividends. We can accomplish all of this with tax reform.” (For the statement, see Doc 2012-12500 or 2012 TNT 113-24.) But before the government “invests” more in education, it should figure out exactly what it is buying with taxpayer funds, because it is not at all clear that the benefits are reaching the people who need them the most.

It seems likely that education tax incentives do more than just influence behavior, heightening the need for them to be scrutinized as a part of reform. In 2001 the JCT noted that “it is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, it is not possible to say whether such subsidies would increase or decrease economic efficiency without some empirical analysis of the social benefits that would arise from creating new subsidies.”

Obama’s National Commission on Fiscal Responsibility and Reform recommended eliminating most tax expenditures, which would appear to include almost all of the education tax incentives. It also proposed turning the tax deduction for charitable giving into a tax credit, with the goal of giving all donors the same level of tax benefit. The proposal limited the credit to donations worth more than 2 percent of a taxpayer’s adjusted gross income. Obama effectively rejected the proposal.

Using the tax code for education initiatives, instead of the loan and grant programs already administered by the Department of Education, adds unnecessary complexity for students and their families, as well as the IRS. Moreover, federal initiatives might be contributing to the cost of tuition for students and the families that are funding their educational pursuits. It would be worthwhile for Congress to consider which provisions should be discarded or at least reformed.

ECONOMIC ANALYSIS

How Much Deficit Reduction For a Grand Bargain?

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Deficit reduction will be a numbers game. After the election, bridging the so-called fiscal cliff and treading dangerously close to the debt ceiling, Congress and whoever is president will come to the main event: a grand bargain on medium-term deficit reduction. Here are some quantitative facts to help you see your way through the political smoke screen.

(1) Putting federal government finances on a fast track to sustainability will require about $3.4 trillion of deficit reduction over 10 years (relative to the Congressional Budget Office’s current-policy baseline). For all the priority given to deficit reduction, economics provides surprisingly little guidance for policymakers on the size of the debt and deficit. Generally, small is better except, like now, when unemployment is high. Beyond that, the only additional guidepost we receive comes from arithmetic: The deficit should be sustainable. That means the debt-to-GDP ratio should be stabilized or, in other words, the federal debt should grow no faster than nominal GDP. Why? If not, the economy will eventually blow up.

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That’s not much of a standard, but it’s the best we have. Translated into guidance for writing budgets, it says that deficits should not be allowed to exceed about 3 percent of GDP. Figure 1 shows that, allowing for a reasonable period of adjustment, achieving this goal would require about $3.4 trillion of deficit reduction relative to the CBO’s current-policy baseline (called the alternative fiscal scenario).

Why an adjustment period? As we said, too much deficit reduction when unemployment is high is counterproductive, as the United Kingdom is now discovering. (Also, a new IMF study suggests that fiscal stimulus is more beneficial than previously thought. See IMF, “World Economic Outlook: Coping With High Debt and Sluggish Growth,” Oct. 2012.) There is an implicit consensus that precipitous deficit reduction is undesirable given the near universal agreement that the fiscal cliff must be avoided.

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As tedious as it may seem, it is extremely important to pay attention to baseline deficit forecasts. Whenever you hear the expression “my plan reduces the deficit by X trillion dollars,” it is always relative to some baseline (and usually over a 10-year period). The most commonly used baseline is the CBO’s current-policy baseline (not to be confused with the largely irrelevant current-law baseline). That incorporates extension of all the Bush tax cuts, alternative minimum tax relief, and extension of all expiring provisions, except the temporary 2 percent payroll tax cut. On the spending side, it includes the $1 trillion of savings from the caps on expenditures in the Budget Control Act of 2011 but not the additional sequestration scheduled to take effect on January 1, 2013.

By no means is the CBO’s current-policy baseline the only one out there. For example, President Obama’s budget and the Bowles-Simpson plan use different baselines. Unless savings from proposals are computed relative to the same baseline — and often they are not — the amounts of claimed deficit reduction are not comparable.

(2) Contrary to popular belief, the Bowles-Simpson plan would have reduced the deficit by $6.3 trillion over 10 years (relative to the CBO’s current-policy baseline), and more than 40 percent of that deficit reduction would have come from tax increases. The much-touted Bowles-Simpson deficit reduction plan is widely characterized as reducing the deficit by $4 trillion and having a 2-1 ratio of spending cuts to tax increases. An eye-opening study by Richard Kogan of the Center on Budget and Policy Priorities blows this myth out of the water (“What Was Actually in Bowles-Simpson — and How Can We Compare It With Other Plans?” Oct. 2, 2012, Doc 2012-20493, 2012 TNT 192-17).

The misunderstanding is because of inconsistent use of baselines. Back in 2010, the Bowles-Simpson plan computed savings over an eight-year period and used a baseline that assumed the Bush tax cuts would not be extended for the wealthy. Translating the plan to a CBO current-policy baseline, the total savings over a 10-year period are $6.3 trillion. Of that amount, $2.6 trillion is the result of tax increases, including a 15-cent-per-gallon gas tax increase, revenue-raising tax reform, and denial of the Bush tax cuts for individuals with incomes greater than $200,000 and families with incomes greater than $250,000.

(3) Denying extension of the Bush tax cuts to high-income families, as proposed in the Bowles-Simpson plan, would reduce the deficit by $950 billion over 10 years. Although tax rate increases for the wealthy will be off the table if Mitt Romney is elected, there is a decent chance that the momentum from an Obama victory might persuade some House Republicans to go along, especially if in return they can get major concessions on spending and the...
promise of a sincere effort on tax reform. After all, even JP Morgan CEO Jamie Dimon said he would be amenable to a top rate of 39.6 percent. (See Peter Schroeder, “Jamie Dimon: I Don’t Mind Paying Higher Taxes to Help Solve Economic Crisis,” The Hill, Oct. 10, 2012.) The $950 billion figure includes $127 billion of interest savings (CBO, Table 1.5).

(4) A reduction of forces in Afghanistan, not included in the CBO current-policy baseline but assumed by most budget experts to be realistic, would reduce the CBO baseline deficits by $987 billion over 10 years. Usually it is the Democrats who are trying to downplay the size of our fiscal problems, but this view of the CBO approach is shared by budget analysts in both parties. As Gordon Gray, former economic adviser to Republican Sens. Rob Portman of Ohio and John McCain of Arizona, explained: “It seems implausible that war spending would actually grow… This formulation suggests that the alternative fiscal scenario overstates spending by nearly $1 trillion.” (See “CBO January 2012 Baseline: Behind the Numbers,” American Action Forum, Feb. 7, 2012, emphasis in the original.) The $987 billion figure includes $135 billion of interest savings. Given all this, the $3.4 trillion of deficit reduction suggested in Figure 1 requires only about $2.4 trillion of real cutting.

(5) The amount of deficit reduction (relative to the size of the economy) necessary for sustainability will be significantly larger in the decade following the 10-year budget window. There is no rest for the weary. If we somehow achieve the $3.4 trillion of deficit reduction shown in Figure 1, it will only be a good start. The projected relentless growth of entitlement spending will kick into high gear after 2022. Figure 2 shows that outlays for Social Security, Medicare, and Medicaid spending will increase from an average of 11.8 percent of GDP during 2013-2022 to an average of 14.3 percent of GDP from 2023 to 2032. That means that approximately double the deficit reduction will be needed after 2022 of what is needed to achieve sustainability over the next 10 years.