Should the Focus Be on Tax Policy Or Entitlement Spending?

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The federal government is on a collision course with financial ruin thanks to the recession, years of postponing entitlement reform, and a tax system that is cracking and might already be broken. The recent budget resolutions passed by Congress, while slightly more responsible than President Obama's initial proposal, do little to put the United States back on the path of sustainability.

Experts at a recent Tax Analysts conference on Obama's tax policy largely agreed that the president's tax and budget plans would at best forestall long-term fiscal ruin, and might even hasten its arrival. Leonard Burman, director of the Urban-Brookings Tax Policy Center, argued that the middle-income tax cuts are tying the administration's hands and that he doesn't see the necessity of bigger deficits. Chris Edwards of the Cato Institute was even harsher and said that the administration is doing little to confront the nation's fiscal problems, while still raising taxes in a way that will harm economic growth and the nation's ability to compete abroad. But the Peterson Foundation's Eugene Steuerle made the more salient point: It is government spending, not tax policy, that is out of control. (For coverage of the Tax Analysts conference, see p. 139.)

In part two of his analysis of the various budget proposals, Martin Sullivan provides even more evidence that no amount of income and corporate tax reform will solve the country's fiscal crisis (p. 143). According to Sullivan, the main forces driving the trend toward high debt-to-GDP ratios and deficits are entitlement spending and interest payments. Sullivan projects that from 2009 to 2030 under the Senate's budget resolution, Social Security spending will grow from 4.8 percent to 6.0 percent of GDP; Medicare will grow from 3.0 percent to 5.7 percent; and Medicaid will rise from 1.8 percent to 2.4 percent. The numbers are even worse under the House and Obama plans. As a result, the debt-to-GDP ratio will stand at an astonishing 120 percent by 2030. Reversing this trend, assuming no changes to current law, will require $380 billion a year in spending cuts or tax increases. These are sobering numbers indeed.

David Cay Johnston takes issue with the continuing emphasis on financial bailouts in the government's recovery efforts. Johnston thinks that the solution to the deficit problem is to focus government efforts on job creation. He writes that jobs are the best source for new tax revenue and harkens back to Keynes's belief that increasing national income and increasing employment are the same thing. Although Johnston is correct that the government seems to be neglecting job creation in order to save the financier class, it is unlikely that even full employment would create enough revenue to fully offset future deficits. (For Johnston's Take, see p. 239.)

Johnston argues that the solution is jobs. Many might argue that the solution to this crisis is higher taxes, possibly including the imposition of a regressive VAT. But, based on Sullivan's numbers, isn't this fighting the symptoms of the problem rather than the underlying cause? Should middle- and lower-income Americans really be expected to pay more taxes in order to continue to fund runaway government entitlement programs? At some point, it would be nice to hear experts and policymakers move away from rhetoric emphasizing the need for VATs, base broadening, and revenue to whether current entitlement programs are working, desirable, and sustainable. But don't hold your breath waiting.

News Analysis

Lee Sheppard asks this week what the recession might mean for the corporate tax. Covering the 9th annual European/American Tax Planning Strategies Conference, Sheppard writes that citizens suddenly care quite a bit about tax administration (p. 149). Speakers at the conference warned about possible protectionist tax changes and noted the need for greater information sharing. Overseas, governments seem to be focusing on capping interest deductions and forcing greater information disclosure. Joann Weiner writes that U.S. businesses and politicians are more interested in proposals to end or limit deferral (p. 151). Weiner points out that the business community is hostile to any changes to deferral unless there is a sharp reduction in the corporate tax rate. At some point, the private sector will have to take House Ways and Means Committee Chair Charles Rangel's advice and either work with the government on restructuring deferral in exchange for a small rate cut or be shut out of the process. It seems highly likely that deferral of active-source foreign income will be reformed in a way that raises revenue.

Joseph Thorndike believes that people might become more motivated to support broad tax reform if tax return information was public. Publication of all tax returns would allow private citizens to get a clearer picture of who is benefiting from the tax system and Congress's repeated use of targeted tax provisions. Thorndike's proposal is not unprecedented. Tax return information was published both under the Civil War-era income tax and in 1924. His article appears on p. 148.

Commentary

The AIG bonus controversy became a bit more muted when New York Attorney General Andrew Cuomo announced that 15 of the top 20 recipients of the retention bonuses agreed to give the money back. Although the Senate might still take up a punitive tax bill targeting companies using bailout funds to pay lavish amounts to some of the same employees who caused the current meltdown, momentum for the measure slowed considerably thanks to the pressure from Cuomo. With this wave of repayment, Robert Wood looks at the tax consequences for giving back bonus payments (p. 185). After wondering why the tax aspects of givebacks have gotten so little attention, Wood focuses his analysis on possible tax disadvantages to the give-back and the chances of claiming a deduction if the return of bonus amounts were voluntary. Although Wood closes his article by stating that his concerns might be an overreaction to a rapidly developing issue, it seems more likely that the tax problems surrounding the return of the bonuses will probably surface throughout the year.

The American Recovery and Reinvestment Act of 2009 enacted in February provided $20 billion in energy tax incentives and $60 billion in new energy spending. Scott McCandless, Diana Steele, Kerry Gordon, and John Harman provide a summary of both sets of provisions on p. 190, including newly created options designed to encourage companies to go green. Sonja Pippin looks at the tax questions confronting U.S. citizens working for international organizations, addressing a topic that received considerable attention during the nomination hearing of Treasury Secretary Timothy Geithner (p. 194).

Cancellation of indebtedness might become the big issue of the 2009 and 2010 tax seasons. Certainly, the IRS and National Taxpayer Advocate Nina Olson are spending an inordinate amount of time anticipating taxpayer problems with this complex area of the tax code. Monte Jackel, Jeffrey Maddrey, and Robert Crnkovich analyze the new cancellation of indebtedness deferral provision that was enacted in recent stimulus legislation. The authors' special report points out multiple issues and ambiguities in the new law that will need to be promptly addressed by the IRS if the statute is to function properly and provide the relief Congress intended (p. 197). Charles Rettig provides a special report on p. 207 that addresses the problems and pitfalls confronting tax practitioners, especially in the wake of changes to section 6694. Rettig looks at the penalties and disclosure requirements that apply to tax practitioners and defends the profession as a whole.

The housing crisis is at the heart of the recession, and in 2008 Congress enacted a provision designed to offer a $7,500 interest-free loan to first-time home buyers over a period of 15 years. Sheldon Smith provides an analysis of the 2008 credit on p. 231, concluding that the government's attempt to encourage more home purchases as housing prices continue to fall might create additional problems in the future. Sheldon Kay and Bradley Kay look at the Tax Court decision in *Wichita Terminal* and conclude that the court's use of an inference that a failure to call a witness or produce a document means that such evidence would have been adverse to the party has outlived its usefulness (p. 234). This week's Shelf Project proposes raising $100 billion through the use of a carbon tax proposed by Ian Parry. The article, which starts on p. 243, argues for the imposition of a $20-per-ton tax on carbon emissions. Although Congress and the president seem to favor a cap-and-trade system, Parry is among many experts and economists who prefer the use of a direct carbon tax to reshape the country's energy consumption. Robert Willens provides his own take on the Seventh Circuit's decision to overrule the Tax Court in *Menard Inc. v. Commissioner*, in Of Corporate Interest on p. 249. ■