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Stabilizing the Economy Through the Income Tax Code

By Yair Listokin

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A. Introduction

Tax policy attempts to balance many goals. Those goals include revenue generation, economic efficiency, redistribution, equity between similarly situated taxpayers, and stabilization of economic cycles. The prominence of the economic stabilization goal has fluctuated over time. At one time, stabilization was considered one of the primary goals of tax policy. Pechman’s treatise on federal tax policy, for example, discusses “stabilization policy” as the first topic in its chapter titled “Taxes and Economic Policy.” But stabilization’s prominence has faded. In the latest edition of the Graetz and Schenk Federal Income Taxation casebook, for example, stabilization goes unmentioned in a list of criteria for evaluating whether tax policies are desirable.

The diminishing role of stabilization in tax policy most likely reflects economic trends. The years between 1983 and 2007 were marked by extremely low economic volatility, often called the “Great Moderation.” If the economy is relatively stable, why complicate tax and spending policy by focusing on stabilization in addition to other goals? It is no surprise that during the Great Moderation, a consensus developed in the tax policy community that tax policy should not be used to stabilize the economy.

The economic crisis of 2007-2009 upended that policy consensus. Keynesian fiscal stimulus to prop up the deteriorating economy became the first priority of the incoming Obama administration, leading to the rapid passage of an $800 billion stimulus that included significant changes in tax policy. That stimulus followed a tax cut stimulus enacted during the Bush administration. The passage of those bills demonstrates that stabilization has emerged from the recesses of tax policy analysis.

With the stabilization goal resurgent, how should tax policy be changed? Because stabilization has faded as a policy goal, there is little recent analysis of that question. This article offers several recommendations for making the income tax code a better stabilizer of the economy. Some of the recommendations are new, while others represent the resurrection of proposals that were introduced when stabilization was considered a higher priority of tax policy.

A tax policy that is more focused on stabilization should include the following features:

- Reduced reliance on tax expenditures relative to government spending; tax expenditures imply that government subsidization moves in tandem with the business cycle, thereby destabilizing the


8Other areas of policy analysis are also pursuing stabilization as a policy goal. Many new proposals for the regulation of financial institutions, for example, call for regulations to be deliberately countercyclical, with stricter capital requirements in boom times than in busts.

9An important exception providing a macroeconomic perspective on the effect of changing the tax system to a consumption base or eliminating the realization requirement is found in Jeffrey Strnad, “Some Macroeconomic Interactions With Tax Base Choice,” 56 S.M.U. L. Rev. 171 (2005).
economy. Example: Charitable contributions swing wildly in response to economic fluctuations. Because those contributions are tax deductible, the implicit government subsidy to charitable organizations also moves with the business cycle — the subsidy is higher in boom times than in busts. Replacing the charitable deduction with stable government subsidies of nonprofit organizations eliminates that procyclicality.

- Increased automatic sensitivity of income tax revenues to business cycle conditions: Our income tax system naturally collects lower revenue in busts, thereby stabilizing the economy. The degree to which a declining economy lowers government revenues, however, can be increased, enhancing the stabilization effect of the income tax. Example: Marginal income tax rates can be indexed to the economy’s rate of growth. In periods of negative growth, marginal rates should be lower than in times of strong growth.
- Increased sensitivity of tax expenditures to the business cycle; while some tax expenditures should be eliminated to enhance stabilization, others will remain. Automatic indexing of the size of tax expenditures to the business cycle will reduce the degree to which tax expenditures exacerbate the business cycle. Example: Private charitable foundations are required to spend a percentage of their endowment to maintain their tax subsidy. Instead of requiring a fixed percentage over the entire business cycle, the required percentage could be higher in busts and lower in booms.

The remaining sections of the article examine the effects of some aspects of the income tax code on the stability of the economy from a Keynesian macroeconomic perspective. They also explain why each of the suggestions above will lead to a more stable economy.

B. Income Taxes and Economic Stabilization

The macroeconomic effects of income taxes are often debated. This article provides a Keynesian perspective on short-run economic fluctuations. Keynesians believe sudden changes in aggregate demand for economic output can lead to short-run changes in actual output. Although Keynesian macroeconomics is not universally accepted, it is the standard textbook approach to short-run fluctuations and has gained more prominence with the economic crisis of 2007-2009. As a former chair of George W. Bush’s Council of Economic Advisers wrote in November 2008:

If you were going to turn to only one economist to understand the problems facing the economy, there is little doubt that the economist would be John Maynard Keynes. Although Keynes died more than a half-century ago, his diagnosis of recessions and depressions remains the foundation of modern macroeconomics. His insights go a long way toward explaining the challenges we now confront.

Keynes believed that components of spending, particularly investment, are prone to sudden shocks due to “animal spirits.” Keynes realized, however, that those shocks to components of demand cannot be isolated to the sector of the economy where they begin. Instead, demand in other sectors, such as consumption, is a function of total output. When total output goes down because of a negative shock to investment, consumers feel poorer because fewer of them are at work producing investment goods. Consumers therefore reduce consumption, exacerbating the impact of the initial negative shock to investment on total output. The secondary multiplier effect means that total output changes by more than the size of the initial shock.

Keynesians believe that because of that sensitivity to shocks, government policy should play a role in stabilizing aggregate demand, and hence output. There are two primary policy levers for stabilizing an economy: fiscal policy and monetary policy. Fiscal policy, which defines the government’s choices regarding spending and taxation, is the focus of this article.

In the Keynesian model, taxes suppress output. Money paid in taxes is money that cannot be spent on consumption or investment. Government spending, by contrast, stimulates output directly. Government spending also causes an increase in consumption via the multiplier effect. Increasing government deficits, which are either caused by lower taxes (and thus higher consumption) or higher government spending, thereby increase output in the short term. That increase in output as a result of higher deficits can be used to offset negative shocks to other sectors of the economy.

Fiscal policy stabilization can take two forms: automatic and discretionary. An example of discretionary fiscal stabilization is the Obama stimulus package, which altered tax rates and increased spending through statute to increase government deficits in response to a negative shock to the economy caused by the financial crisis.

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10See section 4942.
11A school of macroeconomics known as real business cycle theory understands short-run fluctuations as the result of shocks to technology and changes in individuals’ preference for leisure relative to employment. See N. Gregory Mankiw, Macroeconomics, Chapter 19 (5th ed. 2003).
12See, e.g., Mankiw, Macroeconomics (5th ed. 2003). Part IV is titled “The Economy in the Short Run” and emphasizes Keynesian macroeconomic models.

14See generally John Maynard Keynes, The General Theory of Employment Interest and Money (1936). For simplicity, I do not discuss the role of the desire to hold liquid assets, an important part of Keynes’ model.
15In the Keynesian model, there is no balanced budget requirement. An increase in taxes decreases consumption by individuals because they have less disposable income. Government spending remains unchanged by the increase in taxes. Thus, total spending goes down with the increase in taxes.
16Recall that the Keynesian model provides a short-term description of the economy. In the long run, prices will adjust so that government spending cannot permanently increase output.

Income taxes, by contrast, constitute a prime example of an automatic fiscal stabilizer. In an economy with an income tax, a negative shock to output is met by falling revenues. For a given level of government spending, the government budget deficit increases — exactly what Keynesian macroeconomics prescribes to stabilize the effects of a negative shock to output. The decrease in tax revenue is automatic. No statutes need to be passed or rules changed. Income taxes mean that government revenues are a function of output, so a change in output is partially offset by a corresponding change in income tax revenue. A fixed head tax, by contrast, collects the same revenue regardless of the state of the economy. As a result, a head tax is not stabilizing.

A progressive income tax provides more stabilization than a flat income tax. With a progressive tax, the average tax rate increases as income rises. Thus, a sudden drop in income leads to a drop in income tax receipts for two reasons. First, there is less income to be taxed. Second, the income that remains is taxed at a lower rate because the average tax rate is a positive function of income. As a result, a progressive income tax is more sensitive to income than a flat income tax.

The remainder of the article builds on the Keynesian policy prescriptions just described to examine the stabilization properties of different features of the tax code.

C. Tax Expenditures Are Destabilizing

1. Tax expenditures and business cycle fluctuations. Tax expenditures are defined as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” Tax expenditures represent reductions from the revenue that would otherwise be collected under a comprehensive income tax. Prominent examples of tax expenditures include the tax deductibility of mortgage interest, charitable contributions, and the exclusion of employer-provided health benefits from income. The costs of tax expenditures have generally been rising. Tax expenditures in 2008 were estimated to equal approximately 7 percent of GDP. After the tax reform of 1986, by contrast, tax expenditures totaled approximately 5 percent of GDP.

Tax expenditures are perceived as substitutes for government expenditures. The Joint Committee on Taxation states that “special income tax provisions are referred to as tax expenditures because they may be considered to be analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives.” Instead of directly providing health insurance, the government subsidizes healthcare through the tax code by excluding employer-provided health coverage from income. Similarly, the government supports the provision of public goods by making charitable contributions tax deductible. Alternatively, the government could use government spending to produce public goods directly.

As I demonstrate in a related article, most tax expenditures make an economy less stable than an identical economy with government spending in lieu of tax expenditures. To see why, consider first a negative shock to investment that hits an economy with direct government spending on public goods. In that economy, government spending is likely to be unaffected by the decrease in output. As a result, the negative shock to investment induces no secondary effect on the provision of public goods.

Contrast that outcome with a tax expenditure for charitable giving. Donations to charity are a positive function of income. As a result, a negative shock to investment and total output leads to lower charitable donations. Because each dollar of charitable donations is subsidized by the government, lower donations mean that the government subsidy of public goods via the charitable deduction decreases. Thus, subsidies for public goods go down in response to a negative shock to investment — exacerbating the initial effect of a negative shock to the economy.

With progressive rates, tax expenditures also make charitable giving more expensive during recessions. If everyone’s income is reduced, then a progressive tax system implies that at least some individuals’ marginal tax rates decrease as the individuals shift from a higher tax bracket to a lower one. For those individuals, the after-tax cost of giving a dollar to charity is higher in recessions than at other times. An individual in a 23 percent income tax bracket must give up 67 cents of disposable income to give a dollar to charity. If a recession causes that individual’s income to slump and moves him into a 25 percent income tax bracket, then he now must give up 75 cents of disposable income to give a dollar to charity. Thus, the price of charitable giving has gone up during recessions, further reducing the amount of charitable giving and increasing the procyclicality of the charitable-giving tax expenditure.

My earlier article identifies situations in which the destabilizing effect of tax expenditures will be more or less significant. The more sensitive a tax-subsidized element of consumption is to total output and income (that

20Section 163(h).
21Section 170(a).
22Section 106.
26See, e.g., Daniel Gross, “The Coming Charity Crisis: How the Struggling Economy Is Hurting Donations,” Newsweek, June 12, 2008 (noting that “charitable giving fell in real terms in years in which the economy was in recession, or in years in which there was a significant stock market dislocation”).
is, the higher the income elasticity of demand for a good),
the greater the destabilizing effect of the expenditure. For
example, if charitable giving does not fluctuate in re-
sponse to changes in output, then the spending base
eligible for the tax subsidy for charitable giving does not
vary with the business cycle, mitigating the procyclical
effect of the expenditure.27 By contrast, if charitable
giving is extremely sensitive to economic conditions — as
it appears to be empirically28 — then a tax subsidy for
charitable giving is particularly destabilizing because the
tax subsidy will swing in tandem with swings in the rest
of the economy.
Income-based phaseouts of tax expenditures stabilize
the economy. The effect of phaseouts is very similar to the
effect of progressive income taxes. A phaseout implies
that a reduction in income reduces the degree of phase-
out, raising the average tax expenditure (or equivalently,
reducing the average income tax rate). That stabilizing
effect of phaseouts helps offset the destabilizing effect of
tax expenditures.

2. Policy implications. The preceding analysis yields
several policy recommendations. All else equal, a gov-
ernment spending program is preferable to a tax expendi-
ture program from a stabilization perspective. As
stabilization grows in importance as a goal of tax policy,
there should be a shift toward direct spending programs
rather than tax expenditures, particularly when the tax
expenditure benefits an item that swings in tandem with
the economy.

The relatively destabilizing effect of most tax expendi-
ture grows as the form of spending that benefits from
the tax subsidy becomes more sensitive to changes in
output. Many prominent tax expenditures are directly
tied to employment. For example, an individual must be
employed to enjoy the benefits of the exclusion of
employer-provided health insurance from income, tax
incentives for savings such as 401(k) plans, and the
earned income tax credit. Because unemployment rises in
recessions and falls in booms,30 some work-related tax

27If marginal rates are lower because of a progressive tax
system, the effective subsidy will be lower because the same
base is subsidized at a lower rate. Some goods, such as low-cost,
low-quality foods or public transportation, termed “inferior
goods,” are consumed in greater amounts as income goes down.
Disregarding the “price effect” associated with lower marginal
rates, tax expenditures for inferior goods stabilize economic
activity — the subsidy for those goods rises as incomes go
down.

28See Gross, supra note 25.
29Those conclusions apply to tax expenditures that are fixed
over the business cycle. Most tax expenditures fit into that
category — mortgage interest, charitable contributions, and
employer-provided healthcare can be deducted or excluded
from income throughout the business cycle. Other tax expendi-
tures, such as accelerated depreciation, are frequently altered
over the course of the business cycle. Those tax expenditures
have very different business cycle effects, a subject that is
discussed in section E.
30For example, unemployment rates in March 2009 were
approximately double the rates of January 2007. See http://
data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=
latest_numbers&series_id=LNS14000000.

expenditures are likely to be extremely procyclical. More
money is implicitly spent through tax expenditures when
individuals are employed than when they are unem-
ployed.31 As a result, the destabilizing effect of many
prominent tax expenditures is likely to be extremely
significant — making it more imperative that govern-
ment move away from tax expenditures and toward other
forms of expenditure.

D. Average Income Tax Rates and the Business Cycle
While reducing reliance on tax expenditures relative to
government spending stabilizes the economy, there are
many other reforms to the income tax code that can
further reduce the amplitude of the business cycle.

A flat income tax acts as an automatic stabilizer.
Shocks to income are partially stabilized by correspond-
ing and offsetting changes in tax receipts. A progressive
income tax adds a further element of stabilization. Pro-
gressivity implies that negative shocks are met with a
reduction in average tax rates as well as a reduction in the
income tax base, leading to an even larger decrease in tax
receipts.

Income tax policy can do even more to stabilize the

economy. By lowering all marginal income tax rates in
recessions and raising them in expansions, policymakers
could enhance the stabilizing effect of the income tax. A
business-cycle-sensitive marginal rate structure can be
achieved by either a discretionary or automatic mecha-
nism.

1. Discretionary fiscal stabilization. Historically, discre-
tionary fiscal policy has been used to make average tax
rates more sensitive to the status of the business cycle. In
recessions, Congress often lowers income tax rates tem-
porarily or offers a one-time refund to stimulate the
economy.32 Those actions, if timed correctly, imply that
average tax rates will be lower in business-cycle troughs
than peaks, providing added stabilization to the
economy (to the extent that the additional disposable
income from the lower tax rates is consumed rather than
saved).

The stabilization provided by changing statutory av-

erage tax rates over the course of the business cycle is not
automatic. Its efficacy depends on the ability of the
legislative process to time the business cycle appropri-
ately. Considerable evidence demonstrates that discre-
tionary changes in tax rates designed to stabilize the

31Some of that procyclicality will be offset by unemployment
insurance, leading to more government spending when unem-
ployment rates are high. But if exclusions for employer-
provided healthcare are a substitute for direct government
provision of healthcare, then that specific tax expenditure
remains procyclical, even if there are some other forms of
government spending that are countercyclical.
Stat. 613 (granting individual income tax refunds to combat the
2008 recession); Economic Growth and Tax Relief Reconciliation
the 2001 recession). The efficacy of such temporary changes in
tax rates is much debated. Many believe that consumers save
most of a temporary tax rebate, thereby reducing the degree to
which the economy is stimulated. See Taylor, supra note 6.
economic policy are often ill-timed.\textsuperscript{33} Because of lags in the legislative process, the reduction in rates takes effect after the economy has bottomed out and has begun to grow rapidly. Thus, discretionary altering of income tax rates often has a procyclical effect, despite having the opposite intent.

That flaw in discretionary tax policy explains many economists’ preference for discretionary monetary policy over fiscal policy as a stabilization mechanism. As one textbook argues, “Monetary policy has a much shorter lag than fiscal policy, because a central bank can decide on and implement a policy change in less than a day.”\textsuperscript{34} While true under current institutional settings, that argument for discretionarily monetary policy stabilization over discretionary fiscal policy stabilization does not stem from anything inherently superior about monetary policy. Instead, monetary policy responds quickly because of Congress’s delegation of monetary stabilization policy to an agency — the Federal Reserve. If Congress chose to similarly delegate authority for fiscal stabilization to an agency, then discretionary fiscal policy could respond as quickly as discretionary monetary policy.

To implement discretionary fiscal policy, Congress could delegate some of its taxing powers to an agency. Congress would continue to set a mandate for the average income tax rate over the course of the business cycle and therefore determine the average revenue collected through the income tax. The agency would be charged with adjusting tax rates to counteract the business cycle, consistent with an average overall income tax rate that maintains the statutory prescription.

For example, suppose that Congress specifies two income tax brackets, one with a marginal rate of 10 percent and the other with a marginal rate of 30 percent, and that the economy has an average growth rate of 3 percent.\textsuperscript{35} In some years, however, the economy stagnates (0 percent growth), while in others it grows at 6 percent.

The agency would be tasked with moving marginal rates down in years of stagnation and up in years of rapid growth. Thus, the first bracket may have a marginal rate of 8 percent when the economy stagnates and 12 percent when the economy booms, while the second bracket could have a marginal rate of 25 percent in times of zero growth and 35 percent in years of 6 percent growth. Those rates would allow the agency to reach Congress’s statutory average marginal rates while allowing average rates to provide greater stabilization for the economy.\textsuperscript{36}

The discretionary fiscal policy agency would be similar to the Federal Reserve. Congress has established broad goals for the Fed — to minimize inflation and help the country maintain high levels of employment. The Fed, however, has considerable discretion regarding the use of monetary policy to attain those statutory goals. A discretionary fiscal policy agency could be granted similarly high levels of autonomy to alter income tax rates to provide for stable economic growth.

Delegating power over tax rates to an agency may constitute an unconstitutional delegation of Congress’s power to legislate. Congress, for example, cannot grant the president a line-item veto enabling the president to undo a provision in a bill passed by Congress.\textsuperscript{37} It is unlikely, however, that allowing an agency to shift marginal rates as prescribed by Congress rises to the level of an unconstitutional delegation. For example, Field \textit{v. Clark}\textsuperscript{38} allows delegation when Congress prescribes an action contingent on the occurrence of certain events. Thus, if Congress specified that a fiscal policy agency must alter marginal tax rates when it determines that the economy is in recession, it is likely that delegation is constitutional.

\textbf{2. Automatic fiscal stabilization.} Even if delegation to an agency of business-cycle-related tax rate adjustments is constitutional, it does not mean it is likely to occur. Congress will undoubtedly be reluctant to part with some measure of its taxing authority — one of the legislative branch’s primary powers. As a result, effective discretionary fiscal stabilization, although theoretically attainable, may prove to be impossible.

Enhanced automatic fiscal stabilization remains possible. Income tax statutes can mandate that marginal rates be a positive function of the economy’s overall growth rate. Proposals along those lines were made in the 1960s,\textsuperscript{39} but have gone unmentioned in recent years.\textsuperscript{40}


\textsuperscript{34}Mankiw, supra note 11, at 382. But see Alan Auerbach, “The Effectiveness of Fiscal Policy as Stabilization Policy,” paper presented at Bank of Korea International Conference, “The Effectiveness of Stabilization Policies,” Seoul, May 2005, 8-12 (arguing that discretionary fiscal policy is more countercyclically responsive than commonly believed).

\textsuperscript{35}Just as the Federal Reserve does not know the economy’s true natural growth rates when formulating monetary policy, the fiscal agency described here need not know the economy’s true growth rate to make marginal income tax rates sensitive to the growth rate. Errors in estimating the natural rate of growth merely translate into changes in the structural deficit across the business cycle. If policymakers wish to eliminate a structural deficit, however, then they need to be sensitive to the economy’s natural growth rate and adjust average tax levels to offset errors in estimating the natural growth rate.

\textsuperscript{36}The degree of sensitivity of marginal income tax rates could be dictated by Congress, or it could be left to the agency’s discretion. For example, Congress could establish that the lower bracket could never have a marginal rate below 5 percent or above 15 percent. Alternatively, the agency could have unfettered discretion in altering rates to counteract the business cycle. In that case, the agency might have negative income tax rates for the lower bracket in severe recessions and high rates (e.g., over 20 percent) in boom periods.


\textsuperscript{38}143 U.S. 649 (1892).

\textsuperscript{39}In his treatise \textit{Federal Tax Policy} (5th ed. 1985) at 23-24, Pechman describes such a proposal as the “stabilizing budget policy of the Committee for Economic Development.”
With the end of the Great Moderation, the time has come to revisit and update those proposals.

Returning to our example with two income tax brackets, the income tax code could state that when the economy is growing at its natural rate of 3 percent, the two brackets should have marginal rates of 10 percent and 30 percent, respectively. The tax code would also specify a function whereby the marginal tax rate moved with the economy’s growth rate. For example, the marginal rate of each bracket could rise 2 percentage points for each percentage point of growth above the economy’s natural rate (for a slope of -2). With that specification, marginal rates would be 12 percent and 34 percent when the economy grows at a 5 percent clip, while rates would be 2 percent and 22 percent, respectively, when the economy shrinks by 1 percent in a year. In that way, the income tax code will increase the sensitivity of income tax collections to the state of the economy. Average tax rates will change not only because a progressive tax code makes average rates a function of income, but also because the marginal rates themselves are a function of total income. As a result, the income tax code will cushion the business cycle to a greater degree.

Altering rates as described may also have a price effect on economic activity that further stabilizes the economy. Individuals who can shift work and income between years will have incentives to have higher incomes in periods when marginal tax rates are lower — they get to keep more of their earnings in those years than in other years. Those incentives are countercyclical. They encourage people to expand economic activity during recessions.

The sensitivity of tax rates to the economic growth rate is a matter of statutory choice. The income tax code could prescribe a greater sensitivity (for example, marginal rates are 3 percent higher for each additional 1 percent of annual growth) or a lower sensitivity (marginal rates are 0.5 percent higher for each additional 1 percent of growth). The sensitivity of the tax rates to growth rates need not be linear. Instead, the income tax code might respond only to large business cycle swings. For example, the code might prescribe that the two income tax brackets have marginal rates of 10 percent and 30 percent unless annual economic growth is negative; then marginal rates should be 2 percent and 20 percent. A nonlinear function like that has the advantage of maintaining stable income tax rates in most environments. However, it also has the disadvantage of making rates extremely contingent on small differences in growth rates, so that marginal rates are dramatically lower when growth is negative 0.1 percent than when it is positive 0.1 percent.

3. Policy implications. Marginal income tax rates that are a negative function of the growth rate cushion the business cycle, adding to the preexisting stabilizing effects of a progressive income tax. If income suddenly goes down, a large reduction in tax collections makes disposable income, and therefore consumption (a function of disposable income), more stable than it otherwise would be.

There are many different possibilities for creating a positive relationship between marginal tax rates and growth rates. Those include an agency that adjusts rates or statutory provisions that adjust rates automatically in response to the business cycle. The degree of sensitivity of marginal rates to the business cycle is also a variable that can be controlled by policymakers. By formalizing the sensitivity of rates to the state of the business cycle through an agency or statute, policymakers will improve on the current method of ad hoc adjustments to the tax code in the face of recessions, because those adjustments are subject to the whims of the political process and are often ill-timed.

E. Adjusting Tax Expenditures

The previous two sections established that 1) tax expenditures rise and fall with the business cycle; 2) income taxes and a progressive tax system imply a positive correlation (and a countercyclical effect) between income tax receipts and economic growth; and 3) the countercyclical effects of the income tax can be strengthened by making marginal tax rates a positive function of the economy’s growth rate, thereby making the economy more stable. This section takes the premise of point 3 — that marginal rates can vary across the business cycle — and applies it to tax expenditures. By varying tax expenditure subsidies across the business cycle, the destabilizing effect of tax expenditures can be modified or even eliminated.

1. Countercyclical tax subsidies. The automatic adjustment of marginal income tax rates described in the previous section exacerbates the destabilizing effect of tax expenditures. If marginal tax rates are lower in recessions, then the implicit government spending associated with tax expenditures decreases for two reasons. As discussed in section A, implicit spending goes down because there is less economic activity to subsidize. The low marginal rates associated with recessions described in section B, however, imply that the economic activity that does go forward is effectively subsidized at a lower rate. Moreover, the instability of marginal tax rates creates incentives to push subsidized activities toward periods of higher tax rates. Charitable contributions cost the giver less when the top marginal rate is 35 percent (as in an expansion) than when it is 25 percent (as in a recession), even if the charitable giver’s tax bracket is

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40 Taylor describes a fiscal policy rule similar to the one mentioned here, but does not suggest that the sensitivity of average rates to the state of the economy can or should be manipulated through government policy. Indeed, he notes that the sensitivity of tax receipts to government spending declined throughout the 1990s. See John B. Taylor, “Reassessing Discretionary Fiscal Policy,” 14 J. Econ. Perspectives 21, 30-34 (2000).

41 The comments of note 34 supra apply to the case of automatic adjustment of marginal rates to business cycle conditions.
unchanged. That creates a further incentive to “consume” charity in expansions rather than recessions.

Making tax expenditures less procyclical requires the uncoupling of tax expenditures from income tax rates. The value of a tax expenditure is determined by an individual’s marginal rate, but an alternative system of tax preferences might give a tax subsidy to all qualified expenditures that is independent of the individual’s marginal rate. Decoupling can be achieved through the use of uniform tax credits in place of deductions.

Once tax subsidies are decoupled from marginal tax rates, the subsidy rate can be linked to the business cycle. In boom times, when the activity the government hopes to encourage might occur in any case, the tax subsidy will be lower; in recessions, the tax subsidy should be greater. For example, Congress might specify that charitable contributions get a tax subsidy of 25 percent when the economy is growing at its expected rate. When the economy is in recession, the subsidy might increase to 30 percent, while the subsidy may be only 20 percent when the economy is growing at an unsustainable rate.

The proposal for a negative relationship between the size of tax expenditures and the growth rate echoes the proposal for a positive relationship between marginal income tax rates and the growth rate described above. The proposal offers many benefits. As constituted, most tax expenditures rise in high growth periods and fall in recessions. Tax expenditures combined with progressive tax rates also create incentives to move activities that benefit from tax expenditures to boom periods; boom periods have higher income and therefore higher marginal rates, making the implicit subsidy of tax expenditures larger. Making tax expenditures a function of the business cycle and decoupling them from marginal income tax rates ameliorates or eliminates both effects.

Consider the amount of implicit government spending on tax expenditures. Total implicit spending through expenditures is a function of both the subsidy rate and the amount of expenditure on tax-favored goods and services. Because amounts (of most goods) go down in recessions, implicit government spending through expenditures is lower in recessions. If the tax subsidy rate is higher in recessions, however, the implicit government spending through tax expenditures may no longer go down in recessions. If the percentage increase in tax subsidy rate is greater than the percentage decrease in spending on the favored goods, then tax expenditures will no longer go down in recessions. Also, the increase in tax subsidy rates during recessions will also decrease the amount that the tax-favored spending goes down in recessions. Higher tax subsidy rates make it cheaper to purchase tax-favored goods in recessions than at other times. Indeed, if that effect is strong enough, the amount of spending on tax-favored goods may even rise in recessions if the incentive effects outweigh the generally depressing effects of the recession.

2. Countercyclical tax expenditure regulations. The previous sections focused on altering tax subsidy rates to counter economic fluctuations. But even if tax subsidy rates cannot be adjusted, tax expenditures might still have a role in stabilizing economic activity, despite their generally destabilizing features. Eligibility for tax expenditures can introduce countercyclical incentives, even if tax expenditure rates are constant.

Spending requirements for private foundations provide an example for how tax expenditure eligibility requirements can be made countercyclical. Sections 170, 501(c)(3), and 509(A) establish a regime whereby donations to certain private foundations are deductible from taxes. Also, the foundations are themselves tax exempt—any income they earn is not subject to tax. Section 4942, however, requires private foundations to distribute at least 5 percent of their income annually. That 5 percent rule is tied to the aggregate fair market value of the assets of the private foundation.

That spending requirement has a procyclical lean. In expansionary periods when assets appreciate, private foundations will be required to increase spending to comply with the 5 percent rule. In busts, assets depreciate, and foundations can cut spending and still abide by the 5 percent rule. Thus, the spending rule exacerbates the business cycle. That procyclical leaning operates independently of the generally procyclical quality of tax expenditures discussed in section C.

Even if deduction rates and penalty tax rates under section 4942 are unchanged, section 4942(e), which requires the 5 percent contribution, could be amended to account for the business cycle. The amended section 4942(e) should require a low distribution rate (for example, 3 percent) in booms and a high distribution rate (for example, 8 percent) in recession periods. That cyclically adjusted spending rule would counteract the current procyclical tendencies of section 4942. Indeed, if the difference in required distribution rates between booms and recession periods is sufficient, private foundation spending could become countercyclical.

Similarly, formal depreciation rates need not be changed directly to change effective depreciation rates. Instead, the classification of property into alternative classes with different depreciation rates might be adjusted for the business cycle, keeping rates constant. For example, section 168(e) segregates forms of tangible property into different classes, each of which gets a

43 President Obama’s recent proposals regarding the mortgage interest deduction and charitable deduction make progress toward that goal.

45 Recall that progressive tax rates and flat tax expenditure rules linked to marginal income tax rates actually make spending on tax-favored goods more expensive in recessions, so that is a substantial change from the status quo.
46 Section 4942(a) establishes the provision for additional taxes. Section 4942(e) describes the threshold for requirement of additional taxes as 5 percent.
47 Section 4942(e)(1)(A).
48 The exact numbers could be modified to provide some continuity in spending by the foundation.
different depreciation rate. The faster the rate of depreciation, the greater the value of the tax offsets from depreciation. If the same form of property was classified to have rapid depreciation during times of recession and slow depreciation during periods of rapid growth, then the effective depreciation rates vary in a countercyclical fashion. For example, the code declares that a fruit-bearing tree is “10-year property” for depreciation purposes. Instead, the tree might be 7-year property when the economy is shrinking and 15-year property when the economy is booming. That would allow greater depreciation allowances — thus lower tax payments — in periods of recession. In that way, tax expenditures can be made countercyclical without formally changing depreciation rates.

Definition-fiddling is a more complicated means of varying tax expenditure rates with the business cycle. It is undoubtedly less desirable than the proposal outlined above for formally altering tax subsidy rates to account for the economy’s growth rate. Definition-fiddling, however, has one important virtue relative to formal variation of tax subsidy rates — it does not require the decoupling of tax subsidies from marginal rates.

3. Policy implications. Government already attempts to configure tax subsidies along the lines described in the previous sections. For example, Congress frequently enacts accelerated depreciation rates during recessions to encourage investment spending. Congress has also altered the definition of investments eligible for credits during recessions. As described above, however, the timing of those alterations has been spotty. There may be a long lag between the beginning of a recession and the initiation of tax subsidies. Even if subsidies are increased during a recession, they are often maintained well into the next boom. That diminishes the price effect that encourages more investment during recessionary periods, because the accelerated depreciation rates are available at all times. It also amplifies the postrecessionary boom, as an ordinary uptick in investment is met by government subsidies that amplify the increase.

Tax expenditures should be attuned to the business cycle in either of the ways described in the section on marginal income tax rates. A fiscal policy agency might adjust subsidy rates with the business cycle according to directions provided by a statute. That would enable policymakers to maintain some discretion over the appropriate tax subsidy rates while eliminating the inertia associated with implementing changes in tax expenditure rates via statute. Alternatively, automatic tax expenditure policy stabilization might be written into the income tax code. The rates at which tax-favored goods are subsidized can be made into an explicit function of the economic growth rate. Whether through an agency or directly by statute, making tax expenditures a negative function of the growth rate can mitigate the destabilizing effects of tax expenditures described in section C.

F. Conclusions

In today’s era of economic uncertainty, the role of the income tax code in stabilizing or destabilizing the economy deserves renewed attention. While scholars of the early post-World War II period were well aware of the inherently stabilizing properties of an income tax, many features of today’s income tax code have never been examined from a stabilization perspective. This article examined the effect of several prominent features of the tax code on economic fluctuations. Several conclusions emerged. Most notably, many tax expenditures exacerbate business cycle fluctuations. From a stabilization perspective, tax expenditures should be replaced by government spending. Also, the automatically stabilizing effect of an income tax could be enhanced by making marginal rates vary with the business cycle. If marginal income tax rates are higher in expansions and lower in recessions, then the income tax can introduce a greater countercyclical force into the economy. Government deficits (which are expansionary), will shrink even more in booms and rise even higher in busts, partially offsetting the effect of shocks to the economy. Finally, that variable rate approach can be applied to tax expenditures as well as marginal rates — as long as tax subsidy rates can be uncoupled from marginal tax rates. Tax subsidies that rise in recessions and fall in expansions can mitigate and even reverse the current procyclical effects of most tax expenditures.

While those recommendations may well be helpful in mitigating business cycles, they are far from exhaustive. The role of government spending is of considerable importance in stabilization, yet it received little examination here. The article also ignored the role of income tax policy in fostering or discouraging the economic imbalances that set the stage for the 2007-2009 financial crisis. Those and other topics should be the subjects of future research and policy debate as the tax policy community responds to the end of the Great Moderation.