SPENDING ON AN EMPTY WALLET: A CRITIQUE OF TAX EXPENDITURES AND THE CURRENT FISCAL POLICY

I. INTRODUCTION

On August 29, 2005, one of the most destructive hurricanes to hit the United States struck New Orleans, Louisiana.[1] The damage from the powerful category three Hurricane Katrina stranded hundreds of thousands as it obliterated the Big Easy.[2] The region was awarded $62 billion in federal aid, but "[a]nalysts

1. NAT'L OCEANIC & ATMOSPHERIC ADMIN., KATRINA AMONG STRONGEST HURRICANES EVER TO STRIKE U.S.; WETTER, MUCH WARMER THAN AVERAGE JUNE-AUGUST FOR NATION (2005), http://www.noaanews.noaa.gov/stories2005/s2506.htm; *Bush: No New Taxes Needed to Pay for Recovery: Unnecessary Spending Must Be Cut, President Says*, CNN.com, Sept. 16, 2005, http://www.cnn.com/2005/POLITICS/09/16/bush.main/index.html [hereinafter *No New Taxes*].

2. *See* NAT'L OCEANIC & ATMOSPHERIC ADMIN., CLIMATE OF 2005: SUMMARY OF HURRICANE KATRINA (last updated Dec. 29, 2005), http://www.ncdc.noaa.gov/oa/climate/research/2005/katrina.html; *When Can I Go Home? Relief Efforts Underway for Those Stranded by Storm*, CNN.com, Aug. 30, 2005, http://www.cnn.com/2005/WEATHER/08/29/katrina.relief/index.html.

estimate[d] reconstruction costs [would] be at least $200 billion."[3] In the days after Hurricane Katrina, and in spite of pledging the full support and purse of the federal government to Gulf Coast reconstruction efforts, President George W. Bush maintained that taxes would not be raised to cover the unexpected cost.[4] With the largest deficit in American history and war still raging in Iraq, the question must be asked, how can America afford to help the victims of Hurricane Katrina and fund the Iraq war without raising taxes under President Bush's plan?[5]

The answer may not be as hard as it sounds. There are currently 146 tax breaks enacted in federal law; cutting just a few of those could allow for the funding of two national emergencies without continually borrowing money from foreign nations.[6] However, with a 2006 budget that includes a deficit in excess of $400 billion and a 2007 projected budget of over $300 billion,[7] will repealing tax cuts allow the affected region to recover or will other measures have to be taken?[8]

The first two parts of this paper focus on the damage done to the hurricane-affected region, the proposals of aid set forth by the President in his speech delivered from Jackson Square in New Orleans, and the Katrina Emergency Tax Relief Act of 2005. Part III of this paper is a brief history of the American response to another comparable natural disaster and how that reconstruction project was funded, highlighting what we can learn from our past. Part IV focuses on the fiscal problem America faces in the aftermath of Katrina and due to the continued war in Iraq. The final part of this paper is a discussion

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3. *No New Taxes*, *supra* note 1.

4. *Id.* (stating the President's position that "[w]e should not raise taxes" in order to rebuild the Gulf Coast).

5. The goal of this paper is not to suggest the U.S. discontinue funding for hurricane recovery and its enduring mission of freedom and democracy abroad. This paper merely suggests how to, when necessary, reduce outflows on obscure expenses and increase inflow to lessen the record deficit.

6. *See* Tom Curry, *Tax Breaks Compound Hurricane Recovery Woes: Fiscal Watchdog Urges Congress to Scrutinize Special Tax Preferences*, MSNBC.com, Sept. 27, 2005, http://www.msnbc.msn.com/id/9466231; *America the Bankrupt: GAO Head Takes Fiscal Show on the Road to Warn Of Trouble Ahead*, CBSnews.com, Oct. 28, 2006, http://www.cbsnews.com/stories/2006/10/28/business/main2135398.shtml (noting that "the United States has spent the last few years racking up debt [owed to foreign lenders] instead of saving for the future.").

7. OFFICE OF MGMT & BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 2007, 313 tbl. S-1, http://www.whitehouse.gov/omb/budget/fy2007/pdf/budget/tables.pdf [hereinafter FISCAL YEAR 2007 BUDGET] (last visited Jan. 18, 2007).

8. Some politicians propose that spending cuts alone will cover rebuilding costs for Katrina. *See, e.g.*, *'Trim the Fat' to Pay for Katrina: Republic Senators Say Party Failing to Control Spending*, CNN.com, Sept. 19, 2005, http://www.cnn.com/2005/BUSINESS/09/19/katrina.impact/index.html [hereinafter *Trim the Fat*].

of possible solutions to America's current fiscal crisis.

II. HURRICANE KATRINA AND THE LEGISLATIVE RESPONSE

At 6:10 a.m. local time on Monday, August 29, 2005, Hurricane Katrina struck just south of Buras, Louisiana.[9] The storm made landfall with sustained winds of approximately 125 miles per hour and hurricane force winds stretching up to 125 miles from its center.[10] After hammering the southeastern Louisiana coastline, Katrina traveled along the eastern Louisiana-Mississippi border before cutting diagonally across Mississippi.[11] While the strength of the wind gusts and tornados that followed in the wake of Katrina caused considerable damage, the most significant destruction occurred when several levees in New Orleans broke, covering nearly eighty percent of the city with water from Lake Pontchartrain, the Mississippi River, and storm surge from the Gulf of Mexico.[12] The worst storm surge from Hurricane Katrina was estimated to be 24-28 feet along the Mississippi coast, with an estimated surge of 10-19 feet in eastern Louisiana.[13]

By mid-morning on August 29, President Bush declared parts of Louisiana, Mississippi and Alabama disaster areas[14] under the Stafford Act.[15] When the storm dissipated into a tropical depression 150 miles inland, near Clarksville,

9. ADEL GRAUMANN ET AL., NOAA'S NATIONAL CLIMATIC DATA CTR., HURRICANE KATRINA: A CLIMATOLOGICAL PERSPECTIVE 2 (2005), http://www.ncdc.noaa.gov/oa/reports/tech-report-200501z.pdf [hereinafter KATRINA: CLIMATOLOGICAL PERSPECTIVE].

10. *Id.*

11. RICHARD X. KNABB ET AL., TROPICAL CYCLONE REPORT: HURRICANE KATRINA 37 fig.1 (2005), http://www.nhc.noaa.gov/pdf/TCR-AL122005_Katrina.pdf.

12. CDC & EPA, HURRICANE KATRINA RESPONSE: INITIAL ASSESSMENT 3 (2005) http://www.epa.gov/katrina/reports/envneeds_hab_assessment.pdf [hereinafter HURRICANE KATRINA RESPONSE] (noting that the water was as deep as 25 feet in some places); Peggy Mihelich, *Storm Surge the Fatal Blow for New Orleans: Levees Fail to Hold Back Water*, Sept. 1, 2005, http://www.cnn.com/2005/WEATHER/09/01/orleans.levees/index.html.

13. KATRINA: CLIMATOLOGICAL PERSPECTIVE, *supra* note 9, at 4.

14. *See* Press Release, The White House, Statement on Federal Disaster Assistance for Alabama (Aug. 29, 2005), *available at* http://www.whitehouse.gov/news/releases/2005/08/20050829-12.html; Press Release, The White House, Statement on Federal Disaster Assistance for Louisiana (Aug. 29, 2005), *available at* http://www.whitehouse.gov/news/releases/2005/08/20050829-2.html; Press Release, The White House, Statement on Federal Disaster Assistance for Mississippi (Aug. 29, 2005), *available at* http://www.whitehouse.gov/news/releases/2005/08/20050829-4.html; TPM Hurricane Katrina Timeline, (last updated Sept. 20, 2005) http://www.talkingpointsmemo.com/katrina-timeline.php [hereinafter Katrina Timeline].

15. Robert T. Stafford Disaster Relief and Emergency Assistance Act, P. L. 93-288, 88 Stat. 143 (1974) (codified as amended in scattered sections of the U.S.C.) (allowing the Federal Government to assist local governments with recovery efforts in affected areas).

Tennessee, the result was "the costliest hurricane in U.S. History and the deadliest hurricane in 77 years."[16] One year after the hurricane, 1,836 deaths have been confirmed, including 1,577 from Louisiana alone,[17] with reconstruction costs estimated as high as $200 billion in 2005.[18] In the aftermath, over one million people were displaced from their homes[19]—"a humanitarian crisis on a scale not seen in the U.S. since the Great Depression."[20]

On September 15, 2005, President Bush delivered a speech from Jackson Square, in the French Quarter of New Orleans, which laid out his plan "to assist recovery efforts and to prevent bureaucratic errors of the sort that slowed the response to Hurricane Katrina."[21] Some of the details of President Bush's aid package for Hurricane Katrina victims and regions included:

- One hundred percent reimbursement to states to cover their costs of health care for treating some evacuees from August 29 through January 1, 2006;
- $1.9 billion to reimburse states for the cost of educating displaced students . . . .;
- Six-month forgiveness on student loan interest for affected areas, at an estimated cost of $100 million;
- Individual worker recovery accounts of up to $5,000 for job training;
- Increased subsidy rate on Small Business Administration loans and loan guarantees, at a cost of $130 million . . . .; [and]

16. DAVID JOHNSON, NATIONAL OCEANIC AND ATMOSPHERIC ADMINISTRATION, SERVICE ASSESSMENT: HURRICANE KATRINA 7, 37 (2006), http://www.weather.gov/om/assessments/pdfs/Katrina.pdf; *see also* KNABB, *supra* note 11, at 1 (proclaiming Katrina as "the costliest and one of the five deadliest hurricanes to ever strike the United States.").

17. *Katrina: One Year Later*, Accuweater.com, Part 4, http://wwwa.accuweather.com/promo-ad.asp?dir=aw&page=katrina1yr_4 (last visited Jan. 18, 2007) ("One year after Katrina, there is still uncertainty about the total number of deaths caused by Hurricane Katrina."); *see* Michelle Hunter, *Deaths of Evacuees Push Toll to 1,577*, Nola.com, May 19, 2006, http://www.nola.com/news/t-p/frontpage/index.ssf?/base/news-5/1148020620117480.xml&coll=1 (noting that Louisiana's official death toll includes out-of-state deaths).

18. *No New Taxes*, *supra* note 1.

19. Blaine Harden & Shankar Vedantam, *Many Displaced by Katrina Turn to Relatives for Shelter*, WASH. POST, Sept. 8, 2005, at A01.

20. CTR. FOR AMERICAN PROGRESS, HURRICANE KATRINA: RESOURCE GUIDE, http://www.americanprogress.org/site/pp.asp?c=biJRJ8OVF&b=1034063 (on file with Houston Business & Tax Law Journal).

21. *No New Taxes*, *supra* note 1.

- Homesteading for low-income refugees to move back into the area.[22]

Further federal aid was approved for the region by unanimous vote in both the House and Senate on September 21, 2005, codified as H.R. 3768[23] and commonly referred to as the Katrina Emergency Tax Relief Act of 2005 ("KETRA").[24] The primary tax provisions of this act include:

1. Tax favored withdrawals from retirement plans . . . .;
2. Recontributions of withdrawals for home purchases cancelled due to Hurricane Katrina;
3. Loans from qualified plans for relief relating to Hurricane Katrina;
4. Work opportunity tax credit for "Hurricane Katrina employees";
5. Employee retention credit for employers affected by Hurricane Katrina;
6. Temporary suspension of limitations on charitable contributions;
7. Additional exemption for housing Hurricane Katrina displaced individuals; . . .
8. Charitable deduction for contributions of food inventory;
9. Charitable deduction for contributions of book inventories to public schools;
10. Exclusions of certain cancellations of indebtedness by reason of Hurricane Katrina;
11. Suspension of certain limitation on personal casualty losses;
12. Required exercise of [IRS administrative] authority; . . . .
13. Extension of replacement period for nonrecognition of gain . . . .;
14. Special [look-back] rule for determining earned income [credit and refundable child credit]; and
15. Secretarial authority to make adjustments regarding taxpayer and dependency status [for taxpayers affected

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22. *Id.* (citing Associated Press, Highlights of Katrina Aid) (punctuation altered).

23. STAFF OF JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF H.R. 3768, THE "KATRINA EMERGENCY TAX RELIEF ACT OF 2005," AS PASSED BY THE HOUSE AND THE SENATE ON SEPTEMBER 21, 2005 1 (Comm. Print 2005), http://www.house.gov/jct/x-69-05.pdf [hereinafter Technical Explanation of H.R. 3768].

24. Pub. L. No. 109-73, 119 Stat. 2016 (codified in scattered sections of 26 U.S.C.).

> by Hurricane Katrina].[25]

It is important to note the specifics of some of the provisions contained in KETRA, as well as some of their effects. The first of these provisions, tax-favored withdrawal from retirement plans,[26] provides:

> [A]n exception to the 10-percent early withdrawal tax in the case of a qualified Hurricane Katrina distribution from a qualified retirement plan, a 403(b) annuity, or an IRA. In addition, . . . income attributable to a qualified Hurricane Katrina distribution may be included in income ratably over three years, and the amount of a qualified Hurricane Katrina distribution may be recontributed to an eligible retirement plan within three years.[27]

This provision enables Katrina victims to make withdrawals from retirement plans to pay for personal disaster relief. It therefore begs the question of whether those affected by a hurricane will be able to support themselves in retirement, having withdrawn possibly all of their retirement money to pay their disaster costs.[28]

The second provision is the recontribution of withdrawals for home purchases cancelled due to Hurricane Katrina.[29] This provision provides, in pertinent part:

> [A] distribution received from 401(k) plan, 403(b) annuity, or IRA in order to purchase a home in the Hurricane Katrina disaster area may be recontributed to such a plan, annuity, or IRA in certain circumstances.
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> . . . .
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> Any amount re-contributed is treated as a rollover. Thus, that portion of the qualified distribution is not includible in income (and also is not subject to

25. *See id.*

26. *Id.* § 101.

27. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 3.

28. Furthermore, the retiree might not be able to expect much from Social Security, especially if it is privatized. *See generally* Strengthening Social Security for the 21st Century (Feb. 2, 2005), http://www.whitehouse.gov/infocus/social-security/200501/socialsecurity.pdf (discussing President Bush's plans for social security, including private accounts).

29. Katrina Emergency Tax Relief Act of 2005 § 102.

> the 10-percent early withdrawal tax).[30]

This is a generous concession by the Internal Revenue Service ("IRS"), as it provides for a repayment of the tax-free withdrawal mentioned above on a contribution that was tax-free in the first place. Additionally, it helps answer the question above of what funds will be available at retirement to less fortunate people if social security is privatized—under this section they can simply recontribute the money as if it was never withdrawn and be in the same position they were in before the hurricane. Moreover, it encourages refugees to move back to the hurricane-affected area to receive tax breaks; although the traditional economic neutrality norm of tax policy would discourage people from making decisions based on taxes, this is an instance where that policy is best reversed.

The third provision of KETRA is the availability of loans from qualified plans for Hurricane Katrina relief.[31] It provides:

> [S]pecial rules in the case of a loan from a qualified employer plan to a qualified individual made after the date of enactment and before January 1, 2007 . . . .
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> Under the provision, the exception to the general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or (2) the greater of $10,000 or the participant's accrued benefit under the plan.
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> Under the provision, in the case of a qualified individual [a person whose principal place of abode is located within the hurricane disaster area] with an outstanding loan on or after August 25, 2005, from a qualified employer plan, if the due date for any repayment . . . occurs [between August 25, 2005 and December 31, 2006], such due date is

30. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 5.
31. Katrina Emergency Tax Relief Act of 2005 § 103.

delayed for one year.[32]

This provision of KETRA has substantial benefits to Katrina victims because it displaces some of the immediate hardships that would have affected many of those most affected by Katrina. It essentially affects those who have taken loans from qualified retirement plans.[33] Such loans are usually secured by the benefit already accrued in such plans. Without the provision above, many people would potentially lose their accrued benefit in their retirement plans because otherwise it would have been used to satisfy any outstanding loan they were unable to pay back as a result of the hurricane.

The fourth provision pertinent to this discussion is the work opportunity tax credit for Hurricane Katrina employees.[34] The provision provides that an employer who hires an employee affected by Katrina will receive a deduction for that employee's wages equal to the amount of the credit given to that employer for hiring the employee.[35] The credit equals "40 percent of the first $6,000 of qualified first-year wages," resulting in a maximum credit per employee of $2,400.[36] Generally "the work opportunity tax credit is available [only to] employers hiring individuals from one or more of eight targeted groups."[37] The groups include: "(1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income . . . benefits."[38] This measure of the relief act encourages employers to hire displaced Katrina individuals by allowing them the same tax credit for hiring other such disadvantaged individuals.

Another provision important to this discussion is the employee retention credit for employers affected by Hurricane Katrina. "[This] provision provides a credit of 40 percent of the qualified wages (up to a maximum of $6,000 in qualified wages per employee) paid by an eligible employer to an eligible employee."[39] This is almost the inverse of the previous provision;

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32. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 7-8.
33. *See* Katrina Emergency Tax Relief Act of 2005 § 103.
34. *Id.* § 201.
35. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 10-11.
36. *Id.* at 10.
37. *Id.*
38. *Id.*
39. *Id.* at 13.

it provides for a tax credit to an employer in the disaster area who retains employees who were also affected by the hurricane. This is unprecedented, as there is no current tax credit for wages being paid by employers located within a disaster area.[40]

In the third title of KETRA, Congress provided certain incentives for specific charitable giving related to the hurricane.[41] The first provision in Title III is the temporary suspension of limitations on charitable contributions.[42] For an individual, "the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years as contributions described in [Internal Revenue Code §] 170(b)(1)(A)."[43] For a corporation, "the deduction for qualified contributions is allowed up to the amount by which the corporation's taxable income . . . exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years, subject to the limitations of [§] 170(d)(2)."[44]

Currently under the tax code, charitable contributions are deductible up to a certain limit "depend[ing] on the type of taxpayer, the property contributed, and the donee organization."[45] In general, an individual taxpayer can deduct charitable contributions up to "50 percent of the taxpayer's contribution base for the taxable year."[46] A corporation's deduction for a charitable contribution is generally limited to ten percent of its taxable income.[47] That is why § 301 is probably one of the most beneficial provisions of KETRA—it provides an incentive for all individuals and corporations alike to contribute large sums of money to help those affected by Hurricane Katrina, especially wealthier persons (because such a deduction is more valuable to them). More money from private donations means less money has to come out of the pockets of those who are less able to afford it if the taxes end up being raised as a result of the damage.

The next provision of Title III is the additional exemption for

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40. *Id.*

41. *See* Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, §§ 301-306, 119 Stat. 2016, 2022-26 (codified in scattered sections of 26 U.S.C.).

42. *See id.* § 301.

43. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 15.

44. *Id.*

45. *Id.* at 14; *see generally* I.R.C. § 170 (2000 & West 2006).

46. I.R.C. § 170(b)(1)(A).

47. *Id.* § 170(b)(2).

housing Hurricane Katrina displaced individuals.[48] This provision "provides an additional exemption of $500 for each Hurricane Katrina displaced individual of the taxpayer. The taxpayer may claim the additional exemption for no more than four individuals. Thus, the maximum exemption amount is $2,000."[49] As a resident of the city that housed the majority of the displaced individuals as a result of Katrina (Houston), the author is perhaps in a more unique position to favor this provision. Through this provision, it appears the government is rewarding the good Samaritans who housed any Katrina evacuee. While it is a somewhat modest exemption, it is at least a modicum of gratitude that many of those housed may not be able to express monetarily.

The fourth and final title of KETRA deals with additional tax relief in the form of discharge of indebtedness. The first provision, and most important for this discussion, is the exclusion of certain cancellations of indebtedness.[50] Under this provision:

> [G]ross income of a qualified individual does not include any amount which would otherwise be includible in gross income by reason of a discharge (in whole or in part) of nonbusiness debt if the indebtedness is discharged by an applicable entity. For these purposes, nonbusiness debt is any indebtedness other than indebtedness incurred in connection with a trade or business. The discharge of indebtedness relief allowed under this provision does not apply to any indebtedness to the extent that real property constituting security for such indebtedness is located outside the Hurricane Katrina disaster area. As under the present-law rules, the amount excluded from gross income under this provision reduces the tax attributes of the taxpayer.[51]

This provision is another way the IRS is helping to relieve the monetary burden placed on hurricane-affected individuals. Ordinarily, discharge of non-business debt is includible in gross income as earnings.[52] However, as a result of this provision, the

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48. *See* Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, § 302, 119 Stat. 2016, 2023-24 (codified in scattered sections of 26 U.S.C.).

49. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 19.

50. *See* Katrina Emergency Tax Relief Act of 2005 § 401.

51. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 28-29.

52. I.R.C. § 108. Discharge of debt is taxed just as if the taxpayer had earned that amount of money as income. *See id.*

discharge is not included in gross income and is not taxable. This is a rather generous provision, as it allows many of those affected by the hurricane to have their debts discharged free of being burdened by paying the tax on such indebtedness. This is not to be construed as allowing one to not repay his debt and avoid any consequences—the discharge must be voluntarily given by the creditor.

The second provision of Title IV is the suspension of certain limitations on personal casualty losses.[53] This provision "removes two limitations on personal casualty or theft losses to the extent those losses arise in the Hurricane Katrina disaster area . . . and are attributable to Hurricane Katrina."[54] The two limitations are:

> First, personal casualty or theft losses meeting the . . . requirements need not exceed $100 per casualty or theft. Second, such losses are deductible without regard to whether aggregate net losses exceed 10 percent of a taxpayer's adjusted gross income. For purposes of applying the 10 percent threshold to other personal casualty or theft losses, losses deductible under this provision are disregarded. Thus, the provision has the effect of treating personal casualty or theft losses from Hurricane Katrina as a deduction separate from all other casualty losses.[55]

This provision is one of the more helpful provisions because traditional limitations usually bar most people from being able to utilize personal casualty losses (i.e., for someone making $100,000, the casualty loss must be greater than ten percent of his gross income plus $100, meaning his aggregate losses for the year must exceed $10,100).[56] While many people's personal damages as a result of Hurricane Katrina would have surpassed traditional limitations, § 402 helps those with either very high incomes or losses of less than ten percent of their adjusted gross income. Thus, many of the losses sustained can be deducted by those who need it most.

The final provision in the fourth title pertinent here is the extension of replacement period for non-recognition of gain.[57]

53. *See* Katrina Emergency Tax Relief Act of 2005 § 402.

54. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 30.

55. *Id.*

56. *See* I.R.C. § 165(h) (2000 & West 2006).

57. *See* Katrina Emergency Tax Relief Act of 2005 § 405.

This provision:

> [E]xtends from two to five years the replacement period in which a taxpayer may replace converted property, in the case of property that is in the Hurricane Katrina disaster area and that is compulsorily or involuntarily converted . . . by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be in this area.[58]

Current applicable law states that if a taxpayer realizes a gain from an involuntary conversion (such as a house that is destroyed by a flood or hurricane), that gain is deferred for tax purposes to the extent the taxpayer purchases property similar or related in service or use to the converted property.[59] To receive the deferment, the taxpayer must replace his involuntarily-converted property within two years from the date it was converted.[60] However, § 405 extends that time period by another three years for property in the hurricane disaster area,[61] allowing many of those who lost their homes to settle their other affairs before they have to jump into another property or be taxed on the gain from their converted property.

All in all, the provisions of the Katrina Emergency Tax Relief Act are aimed at helping those affected by Hurricane Katrina by lightening their tax burden and providing for many ways to either delay reported income or deny it all together for tax purposes. KETRA also provides incentives for economic development to continue both for those still in the area and for those who were forced to leave.

In sum, because these provisions defer income (and thus, taxes), they also provide less money to cover the current expenditures by the government and the mounting deficit. However, the current fiscal atrocity facing the United States is in no way the sole result of any natural disaster, unless fiscal irresponsibility is caused by Mother Nature.

III. COMPARISON TO A SIMILAR TIME IN U.S. HISTORY

Hurricane Katrina has become the most expensive and destructive hurricane to ever strike the United States[62] and

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58. TECHNICAL EXPLANATION OF H.R. 3768, *supra* note 23, at 36.
59. I.R.C. § 1033.
60. *Id.* § 1033(a)(2)(B)(i) (West 2006).
61. *See* Katrina Emergency Tax Relief Act of 2005 § 405.
62. FRANCES FRAGOS TOWNSEND, DEPT. OF HOMELAND SECURITY, THE FEDERAL

joined the list of the ten most deadly natural disasters in this country.[63] It is important to compare Katrina to another recent major natural disaster in American history, Hurricane Andrew, to establish a baseline of what an appropriate response should be in the wake of Katrina and to provide further guidance regarding how to handle future emergencies.

Hurricane Andrew, the most comparable natural disaster to Katrina, hit the United States in 1992.[64] Hurricane Andrew struck the Bahamas, damaged much of south Florida, and headed up over southeastern Louisiana before disintegrating.[65] The storm was directly responsible for twenty-six deaths[66] and $43.672 billion in damages,[67] making it the second most expensive hurricane in history (behind Katrina).[68] Furthermore, the government's response to Andrew was perceived as slow (a criticism aimed in 1992 at George Bush, Sr., and also at his son in 2005 after Hurricane Katrina).[69]

The federal government's response to Andrew was less unified than its response to Katrina. For example, there was no legislative response like KETRA. Furthermore, as opposed to the estimated $200 billion needed to repair the damage done by Katrina, the government merely contributed $823 million in grants to help rebuild south Florida roads, utilities, businesses, and homes after Andrew.[70] The IRS's response to Hurricane

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63. *Katrina Joins List of 10 Deadliest U.S. Disasters*, LiveScience.com, Sept. 14, 2005, http://www.livescience.com/forcesofnature/ap_050914_worst_disasters.htm.

64. *See* NAT'L HURRICANE CTR., PRELIMINARY REPORT: HURRICANE ANDREW (1992) http://www.nhc.noaa.gov/1992andrew.html.

65. *See generally id.* (discussing Hurricane Andrew's path and severity).

66. NOAA COSTAL SERVICES CTR., HURRICANE ANDREW (1992) http://www.csc.noaa.gov/crs/cohab/hurricane/andrew/andrew.html.

67. *See* ERIC S. BLAKE ET AL., NOAA/NWS/TROPICAL PREDICTION CTR./NAT'L HURRICANE CTR., THE DEADLIEST, COSTLIEST, AND MOST INTENSE UNITED STATES HURRICANES FROM 1851 TO 2004 (AND OTHER FREQUENTLY REQUESTED HURRICANE FACTS) tbl.3a (last modified July 28, 2005), http://www.nhc.noaa.gov/pastcost2.shtml (listing Hurricane Andrew as the costliest U.S. hurricane from 1900-2004).

68. NAT'L OCEANIC & ATMOSPHERIC ADMIN., CLIMATE OF 2005: SUMMARY OF HURRICANE RITA, (last updated Sept. 22, 2005), http://www.ncdc.noaa.gov/oa/climate/research/2005/rita.html (describing Hurricane Andrew as "the second costliest U.S.-landfalling hurricane"); *Cf.* BLAKE, *supra* note 67, at tbl.3a (listing Hurricane Andrew as the costliest U.S. hurricane based on data through 2004).

69. Bill Adair, *10 Years Ago, Her Angry Plea Got Hurricane Aid Moving: Three Days After Andrew, An Official's Bluntness Stirred Washington into Action*, ST. PETERSBURG TIMES, Aug. 20, 2002, at 1A. Exasperated by the slow federal response to Hurricane Andrew, Kate Hale, then Director of Dade County Federal Emergency Management Director, famously exclaimed, "Where in the hell is the cavalry on this one? . . . They keep saying we're going to get supplies. For God's sake, where are they?" *Id.*

70. Adrian Sainz, *Ten Years After Hurricane Andrew, Effects Are Still Felt*, SUN-

Andrew was similar to its response to Katrina, but certainly less comprehensive. It allowed taxpayers affected by Andrew to delay filing their tax returns, but only on federal income tax due between August and December of 1992.[71] The IRS also gave charitable deductions for contributions to tax-exempt charitable organizations using those contributions to help the victims of Hurricane Andrew.[72] It is clear that many of the provisions used in KETRA to aid victims of Hurricane Katrina were based on aid previously given to victims of other natural disasters, although the aid granted in KETRA was far more expansive than the previous aid had been.

The damage created by Hurricane Katrina far surpassed that of Andrew and, as such, requires more funding to rebuild the affected areas.[73] By the first anniversary of Hurricane Katrina, "103 million cubic yards of debris out of 122 million total have been removed in Alabama, Mississippi, Texas, and Louisiana."[74] As one analyst noted, "[b]y comparison, Hurricane Andrew generated seventeen million cubic yards."[75] However, the economic environment between then and now is a good comparison because of the extensive damage caused by Andrew and its close temporal proximity to the first Gulf War.

In 2006, the White House announced the year's deficit would be $423 billion, up from $318 billion in 2005.[76] In contrast, the 1992 fiscal year deficit was about $255 billion (in 2005 dollars).[77] There is no doubt this was a large deficit to overcome, but the fact is that it *was* overcome.[78] Michael Barone of *U.S. News & World Report* indicated that the reduction of the 1992 deficit can

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SENTINEL, http://www.sun-sentinel.com/news/weather/hurricane/sfl-1992-ap-mainstory,0, 913282.story (last visited Oct. 21, 2006).

71. News Release, Internal Revenue Serv., IRS Gives Tax Relief to Hurricane Victims (Aug. 28, 1992), IR-News Rel. 1992-88, Stand. Fed. Tax Rep. (CCH) ¶ 46,488.

72. News Release, Internal Revenue Serv., Tax Exemption for Hurricane Andrew Relief Organizations (Sept. 11, 1992), IR-News Rel. 1992-90, Stand. Fed. Tax Rep. (CCH) ¶ 179,1.

73. Holbrook Mohr, *Katrina Leaves 80 Dead, Damage in the Billions*, Aug. 25, 2005, http://www.livescience.com/forcesofnature/ap_050825_katrina.html.

74. The White House, The One Year Anniversary of Katrina, http://www.whitehouse.gov/infocus/katrina (last visited Jan. 12, 2007) (capitalization altered).

75. Taxpayers for Common Sense, *The Costs of Katrina: Rebuilding the Gulf*, http://www.taxpayer.net/budget/katrinaspending (last visited Jan. 18, 2007).

76. FISCAL YEAR 2007 BUDGET, *supra* note 7, at 313 tbl.S-1.

77. Michael Barone, *Bush Well on Way to Meeting Deficit Promise*, USNews.com, July 15, 2005, http://www.usnews.com/usnews/opinion/baroneweb/mb_050715.htm.

78. *See, e.g.*, CONG. BUDGET OFFICE, HISTORICAL BUDGET DATA tbl.1 (2006), http://www.cbo.gov/budget/historical.pdf#search=%22Congressional Budget Office %2B Deficits%22 (showing America to be at a deficit of about $255 billion in 1993 and reaching a surplus of over $69 billion in 1998).

be attributed to three things: the end of the savings and loan problem, increased tax receipts, and decreased outlays and expenditures.[79] While two of the three things used to reduce the 1992 deficit should be red herrings to the current administration, the first factor on Barone's list is naturally precluded today. The main thrust of Barone's article reveals that receipts increased by about $100 billion in each fiscal year from 1994-1999, while outlays were limited to between $41 and $51 billion during that same time period.[80]

The fiscal similarities of the years 1992 and 2006 are readily apparent. What is not so apparent is a current strategy to get our nation out of its current hole—one that will be as effective as the strategy used in 1992.

IV. THE *FISCAL* DISASTER FACING AMERICA

America's national deficit has risen to be one of the highest deficits in our nation's history.[81] Before the Katrina disaster, the "Congressional Budget Office estimated the 2006 budget deficit [to be] $314 billion," down $17 billion for the 2005 fiscal year.[82] However, that was before Congress approved $62 billion for relief in the hurricane-affected area and before estimates for the rebuilding of affected areas rose to $200 billion.[83] The Senate's grant of money for the hurricane-affected area also comes during the reign of an administration that has yet to veto a spending bill received by its own party.[84] With a prescription drug plan that will cost $700 billion over ten years, a highway bill that will cost $286 billion,[85] and a 10.5% discretionary spending increase, the United States is operating at a pace that it cannot sustain.[86]

Many in Washington called for a simple solution of

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79. *See* Barone, *supra* note 77 (discussing three factors contributing to elimination of the 1992 deficit); *Katrina Cited as Deficit Likely to Top $400 Billion*, CNN.com, http://www.cnn.com/2006/POLITICS/01/120bush.budget.reut/index.html [hereinafter *Katrina Cited*] (last visited Sept. 4, 2006).

80. *See Katrina Cited*, *supra* note 79.

81. *Analysts: Growing Deficit Hobbles Economy*, FoxNews.com, January 15, 2006, http://www.foxnews.com/story/0,2933,181726,00.html [hereinafter *Growing Deficit Hobbles Economy*] (noting that the 2004 deficit was a record $413 billion and the 2005 deficit was the third highest at $319 billion). The White House projection that the 2006 deficit will exceed $400 billion makes our current deficit one of the largest recorded. *Id.*

82. *Id.*

83. *See* Howard Fineman, *Money, Money, Everywhere*, NEWSWEEK, Sept. 26, 2005, at 25.

84. *Id.* at 28.

85. *Id.*

86. *See Growth of Federal Spending in Bush's Term*, Boston.com, Jan. 5, 2004 (on file with Houston Business & Tax Law Journal).

"trimming the fat" from the 2006 budget to fund the recovery costs for Katrina.[87] Republican Senator Jon Kyl of Arizona suggested that if Congress were to:

> [S]imply take about a fourth of [the $286 billion highway bill] and all of the various pork projects that were in the highway bill, and redirect some of that to the Gulf region, we would have billions of dollars to help rebuild that area and . . . not waste money that would otherwise be spent on a lot of things that don't have much to do with rebuilding highways and bridges . . . .[88]

Some of the pork projects in the highway bill included: "$2.6 million for walkway and bikeway improvements in Coney Island; $1.3 million for sidewalk lighting and landscaping at Cedars-Sinai Medical Center in Los Angeles; and $1.3 million for a day-care center and park-and-ride facility in Champaign, Illinois."[89] The highway bill also included "$223 million to build the now-infamous bridge in Alaska to connect Ketchikan to Gravina Island, with a population of only 50 people."[90] While these expenditures are certainly significant for the citizens living in those regions, utilitarianism directs us to try to achieve the greatest good for the greatest number of people.[91] Surely, decreasing the national deficit achieves a greater good than building a bridge for fifty people or landscaping a medical center. It is these "pork barrel" spending projects which Senators like Kyl and Biden, D-Delaware, seek to eliminate so America does not have to go into more debt to fund the recovery efforts for Hurricanes Katrina and Rita.[92]

Obviously, solely trimming the fat from current projects won't completely fund the recovery efforts of a natural disaster such as Hurricane Katrina but the rest of the spending can be made up, without raising taxes, in a variety of different manners discussed more in depth in Part V of this paper.

One of the many concerns regarding Bush administration

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87. *See Senators: Cut Fat to Fund Katrina Recovery*, CNN.com, Sept. 18, 2005, http://www.cnn.com/2005/POLITICS/09/18/katrina.cost/index.html [hereinafter *Cut Fat*]; *Trim the Fat*, *supra* note 8.

88. *Trim the Fat*, *supra* note 8.

89. *Cut Fat*, *supra* note 87.

90. Curry, *supra* note 6.

91. Utilitarianism, 25 ENCYCLOPÆDIA BRITANNICA 644 (15th ed. 2003).

92. *See Cut Fat*, *supra* note 87 (quoting Democrat Senator Joe Biden of Delaware: "We have two national emergencies . . . . One relates to our interest in Iraq and the other in the Gulf, and I don't think you can take from one to deal with the other.").

spending is that the money is not being spent strategically and wisely.[93] Much attention has been drawn to the rebuilding contracts handed out with unusual haste after Hurricane Katrina.[94] "In the weeks after the storm, more than 80 percent of at least $1.5 billion in FEMA contracts were awarded with little or no competition, or had open-ended or vague terms that previous audits have cited as being highly prone to abuse."[95] Senator Joe Lieberman, D-Connecticut, questioned FEMA's contract strategy and worried that "taxpayers may end up paying more money . . . than they should have."[96] Senator Susan Collins, R-Maine, also voiced concerns over the money being spent on hurricane recovery.[97] She noted that "hundreds of thousands of hurricane victims remain[ed] in hotel rooms and emergency shelters—despite more than $2 billion already spent by FEMA for 120,000 temporary trailers and mobile homes. Only 109 Louisiana families [had] been put in those homes, while tens of thousands of state residents remain[ed] in shelters."[98]

The concerns of the money allocated for hurricane recovery are valid. Of the $62 billion granted by Congress for Hurricane Katrina relief thus far, FEMA received $60 billion, distributed as follows: $23.2 billion for individual assistance, such as home repairs and personal expenses up to $26,200 per family; $7.7 billion for public assistance, such as debris removal and road repair; $1.6 billion for temporary housing; $6.5 billion is for logistics, inspections, etc.; $8 billion for mission assignments; and $3 billion for mission assignments overseen and funded by FEMA but managed by the Army Corps of Engineers.[99] The Army Corps of Engineers received $400 million of the $62 billion, broken down as $170 million for operations and maintenance and $126 million for flood control and coastal emergencies.[100] The remaining $1.9 billion of the allocated funds thus far went to the Department of Defense for contracting out repairs on damaged bases and providing 50 helicopters, 20 ships, 24.2 million liters of water, 67 million pounds of ice and 13.6 million meals.[101]

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93. *See generally FEMA Pledges to Reassess No-Bid Contracts*, Chron.com (Hous.), Oct. 6, 2005, http://www.chron.com/disp/story.mpl/special/05/katrina/3385000.html [hereinafter *No-Bid Contracts*].

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *See generally* Fineman, *supra* note 83, at 25.

100. *Id.*

101. *Id.*

However, once given to FEMA, the money was then filtered through multiple organizations, many of which have close political ties to the current administration.[102] Companies like Bechtel Corp., Fluor Corp., Shaw Group, Inc. and CH2M Hill were awarded $100 million or more for their services to help with Katrina recovery efforts.[103] Interestingly, Bechtel and Fluor are also two of the largest companies involved in the Iraq War,[104] while Shaw Group is a client of former FEMA director Joe Allbaugh.[105] With concerns about how much money was given to contractors on a no-bid basis and how much money has already been mismanaged, one has to wonder how giving money to contractors with extremely close political ties will affect the amount of money needed for hurricane recovery.[106] To date, there are reports that fraud and the no-bid contracts awarded for Katrina recovery could result in up to $2 billion in waste.[107]

There are valid concerns not only about the money being spent on Katrina, but also about expenditures elsewhere in the government as well. Part V discusses a few of the problems with our current fiscal policy and some ways in which it can be improved so the U.S. can begin to reduce the record-setting deficit it now faces.

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102. *Id.*

103. Tom McGhee, *Firm's Katrina Contract Audited*, DENVER POST, August 10, 2006, at C-01.

104. Mark Gongloff, *Betchel Wins Iraq Contract: Private Contractor Wins State Dept. Work Worth Up to $680M to Rebuild Iraq's Infrastructure*, CNNMoney.com, April 18, 2003, http://money.cnn.com/2003/04/17/news/companies/war_bechtel/index.htm?cnn=yes; *see also* Sheryl Fred, *Postwar Profits: How a Handful of Construction Firms got an Early Invitation to Rebuild Iraq*, Mar. 12, 2003, http://www.capitaleye.org/inside.asp?ID=69.

105. Philip Shenon, *Official Vows Investigation of No-Bid Relief Contracts*, N.Y. TIMES, Sept. 14, 2005, at A23.

106. *Audit: U.S. Lost Track of $9 Billion in Iraq Funds*, CNN.com, Jan. 31, 2005, http://edition.cnn.com/2005/WORLD/meast/01/30/iraq.audit ([a]ccording to the inspector general's report, "[s]evere inefficiencies and poor management by the Coalition Provisional Authority ha[d] left auditors with no guarantee the [Iraqi reconstruction] money was properly used . . . .") (punctuation altered); Tim Reid, *How U.S. Lost Billions in Wild West Gamble to Rebuild Iraq*, Timesonline.co.uk, Jan. 26, 2006, http://www.timesonline.co.uk/article/0,,7374-2010424,00.html (detailing certain losses of Iraq funds including payments for work never completed and money gambled away).

107. Hope Yen, *Fraud, Katrina Contracts Could Waste $2 Billion*, ABCnews.com, Dec. 25, 2006, http://abcnews.go.com/Business/wireStory?id=2750575 ("Federal investigators have already determined the Bush administration squandered $1 billion on fraudulent disaster aid to individuals after the 2005 storm. Now they are shifting their attention to the multimillion dollar contracts to politically connected firms that critics have long said are a prime area for abuse."). Audits of the Hurricane Katrina reconstruction money are due to be released in January 2007. *Id.*

V. PROPOSED RELIEF FROM *FISCAL* DISASTER

According to the Congressional Budget Office, "[t]he federal budget deficit totaled about $317 billion [for] fiscal year 2005."[108] In early 2006, the White House projected the deficit to surpass $400 billion.[109] Much of that increase was attributed to the costs of Hurricane Katrina, but White House officials still believed they could cut the deficit in half by 2009 by adhering to Bush economics and decreasing spending.[110] However, as this paper will explain, cutting the deficit could be done more quickly and easily by adjusting tax cuts and reducing outlays.

There are currently 146 tax breaks "enshrined in federal law includ[ing] everything from the deductibility of home mortgage interest . . . to the tax-free status of reimbursed employee parking expenses . . . ."[111] These tax breaks caused losses in revenue of nearly $730 billion in 2004, according to the Government Accountability Office (GAO).[112] The home mortgage interest deduction accounted for $76 billion in lost revenue in 2005 alone, while the tax-free status of reimbursed employee parking expenses accounted for another $2.7 billion in lost revenue.[113] Despite the fact that taking away someone's deduction will win no support in the political arena, something has to give in the face of the largest budget deficit in our nation's history. As one columnist noted:

> Consider this as a thought experiment: if hurricane recovery ends up costing the Treasury $235 billion, *all* of it could be paid for by Americans giving up *just for one year* three tax breaks: the tax-free status of employers' contributions for their workers' medical insurance premiums, the deductibility of home mortgage interest, and the $1,000-per-child tax credit for each child under age 17.[114]

According to a recent GAO report, tax expenditures doubled

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108. MARK BOOTH ET AL., CONG. BUDGET OFFICE, MONTHLY BUDGET REVIEW: FISCAL YEAR 2005 (2005) http://www.cbo.gov/showdoc.cfm?index=6693&sequence=0.

109. *Katrina Cited*, *supra* note 79.

110. *Id.*

111. Curry, *supra* note 6.

112. DAVID M. WALKER, U.S. GENERAL ACCOUNTING OFFICE, GOVERNMENT PERFORMANCE AND ACCOUNTABILITY: TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 4 (2005), http://www.gao.gov/new.items/d05690.pdf.

113. Curry, *supra* note 6.

114. *Id.*

from 67 to 146 between the years 1974 and 2004.[115] Over this period, the revenue forgone to the United States due to these expenditures tripled to nearly $730 billion.[116] In addition, "[a]s a share of the U.S. economy, the sum of tax expenditure outlay-equivalent estimates [has been] about 7.5 percent of GDP [gross domestic product] since . . . 1986."[117] On an outlay-equivalent basis, the "sum [of tax expenditure estimates] exceeded discretionary spending for most years during the last decade."[118]

Due to the situation the U.S. now faces with a seemingly insurmountable debt, continuing such growth in tax expenditures puts the country in an even deeper financial hole. One possible solution to lessen the debt is to have an equal share of citizens contributing more into the system.[119] These contributions would not be new taxes or greater taxes, but simply repealing a few of the tax breaks for a short amount of time could lessen our national deficit substantially and allow for greater and more responsible government spending.[120] "The fourteen largest tax expenditures . . . accounted for 75 percent of the aggregate revenue loss in fiscal year 2004."[121] Cutting only a few of these would lessen the national debt and allow for greater revenue into the federal government without having to create any "new" taxes in the system.

There is also broad national support for reducing tax cuts in order to deflate the deficit; by repealing some of the current tax breaks, the administration would also be conforming to the desires of the people it was elected to serve.[122] Although no one would be pleased by having to contribute more in taxes, the proportion in which the tax would be distributed should be somewhat comforting. Because deductions reduce only the amount of income on which you are taxed, and do not reduce dollar for dollar the amount of tax you pay, repealing a tax break is applied proportionally across the board to all income levels.

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115. WALKER, *supra* note 112, at 4.

116. *Id.*

117. *Id.* at 5; *see also* Adam Carasso & C. Eugene Steuerle, *Tax Expenditures: Revenue Loss versus Outlay Equivalents*, 101 TAX NOTES 287 (2003), *available at* http://www.taxpolicycenter.org/UploadedPDF/1000568_TaxFacts_101303.pdf (defining the term "outlay equivalent" as "the value of [a tax benefit] program were it administered as a taxable federal outlay to recipients").

118. WALKER, *supra* note 112, at 4-5.

119. *See supra* text accompanying note 114.

120. *See supra* text accompanying note 114.

121. WALKER, *supra* note 112, at 4.

122. David Sirota, Editorial, *The Deafening - and Dangerous - Silence on Taxes*, S.F. CHRON., Sept. 16, 2005, at B-11 ("Since 2001, polls have consistently shown Americans support reducing tax cuts in order to reduce the deficit and pay for critical priorities.").

While repealing these tax cuts would help offset the money being spent on hurricane recovery efforts, it will not solve our nation's current deficit problem. Other measures will need to be taken to ensure that our fiscal policy is watched tightly and that we increase receipts to the federal government.

A. *Two Detrimental Tax Cuts: Repealing PEP and Pease*

Despite the current dire situation facing our nation's finances, two tax cuts enacted in 2001 began taking effect January 1, 2006.[123] The first such tax cut repealed the personal exemption phase-out ("PEP").[124] Personal exemptions are phased out as income rises,[125] under the theory that those with less money need the exemption to help them survive and those with higher incomes do not need the exemption. As a result, repealing the high-income phase-out exemptions not only reduces the amount of taxes paid to the government, but also places additional tax burden on the lower classes to make up the difference. The second tax cut repealed the "Pease" provision of the tax code, named after the representative who created it, Donald Pease, D-Ohio.[126] The Pease provision limited the total amount of itemized deductions which could be claimed by higher-income taxpayers.[127] Cutting this provision means higher-income taxpayers can claim more deductions, thereby reducing the total amount of tax they pay.

Both tax provisions mentioned above were enacted in 1990 as part of Bush Sr.'s plan to help reduce the deficit.[128] It is odd that his son would repeal such tax cuts when facing a larger deficit than his father.[129] Several policy centers have cited that nearly fifty-four percent of the tax benefits of these new tax cuts

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123. CTR. ON BUDGET & POLICY PRIORITIES, SLIDE SHOW: KATRINA AND THE FEDERAL BUDGET 2, http://www.cbpp.org/pubs/katrina.htm (follow "Slide Show: Katrina and the Federal Budget" hyperlink) (last visited Jan. 21, 2007) [hereinafter KATRINA SLIDE SHOW].

124. ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, GETTING SERIOUS ABOUT DEFICITS? CALLS TO OFFSET HURRICANE SPENDING MISS THE POINT; BALANCED SET OF FIRST STEPS TOWARD FISCAL DISCIPLINE NEEDED 6 (2005), http://www.cbpp.org/10-6-05bud2.pdf [hereinafter GETTING SERIOUS ABOUT DEFICITS].

125. *See id.*

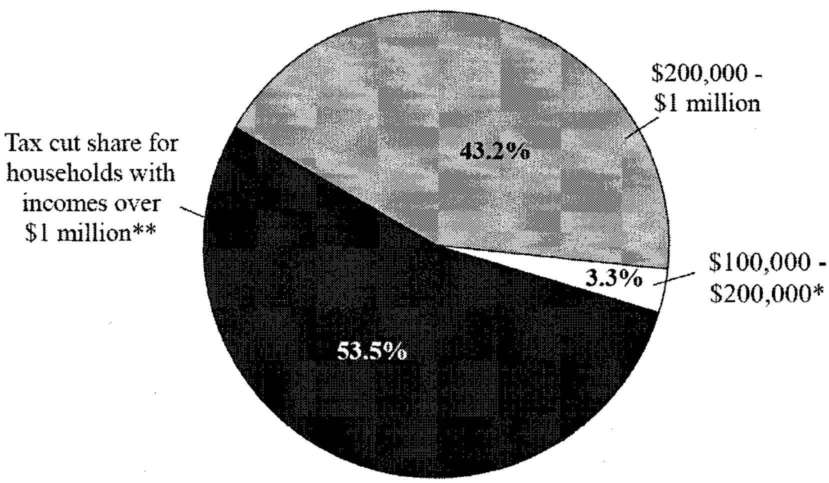
126. *See id.*

127. *Id.*

128. William Neikirk, *2 Taxes on Wealthy Expiring; 5-Year Phaseout Starts Jan. 1; Move to Cost Treasury $27 Billion*, CHI. TRIB., Dec. 31, 2005, at 8.

129. *See* ROBERT GREENSTEIN ET AL., CTR. ON BUDGET & POLICY PRIORITIES, TWO TAX CUTS PRIMARILY BENEFITING MILLIONAIRES WILL START TAKING EFFECT JANUARY 1: CONGRESS DECLINES TO RETHINK THESE TAX CUTS AS IT PROPOSES TO CUT AID TO LOW-INCOME FAMILIES 2 (2005), http://www.cbpp.org/12-28-05tax.pdf [hereinafter TWO TAX CUTS].

only benefit households of $1 million or more per year.[130] The Urban Institute-Brookings Tax Policy Center also found that only about three percent of the tax cut benefited households with income between $100,000 and $200,000, while approximately ninety-seven percent of the benefits were realized by households with income in excess of $200,000[131] [see Figure 1]. The cost of these tax cuts is estimated to be $146 billion over the first ten years they are in full effect.[132]



Percentage of tax break in 2010, by cash income class
* Households with incomes under $100,000 receive 0.1% of the tax cut.
**Just 0.2% of households have incomes over $1,000,000; 3.5% have incomes from $200,000 to $1,000,000; 11% have incomes between $100,000 and $200,000.

Figure 1[133]

Repealing measures like these, which were enacted to reduce the deficit in the first place, is a key reason why our current deficit is so deep. In fact, repealing the PEP and Pease provisions could make up for Katrina spending alone, without

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130. *See, e.g.*, Neikirk, *supra* note 128, at 8 ("According to the Center on Budget and Policy Priorities, a liberal think tank [in Washington D.C.], about 53.5 percent of [the savings] will go to households earning more than $1 million. Another 43.2 percent will go to those with incomes of $200,000 to $1 million. The rest will go to those earning $100,000 to $200,000."); GETTING SERIOUS ABOUT DEFICITS, *supra* note 124, at 6 ("The Urban Institute-Brookings Tax Policy Center reports that when these two tax cuts are fully in effect, 54 percent of their tax-cut benefits will go to households with income of over $1 million a year, with those households getting an average annual tax cut of $19,200 from these two measures.").

131. GETTING SERIOUS ABOUT DEFICITS, *supra* note 124, at 6.

132. *Id.* at 6-7.

133. TWO TAX CUTS, *supra* note 129, at 1 fig.1.

increasing the tax burden of the middle and lower classes[134] [see Figure 2]. Indeed, the cost of the tax cuts in 2005 was $75 billion more than the estimated cost of Katrina recovery[135] [see Figure 3].

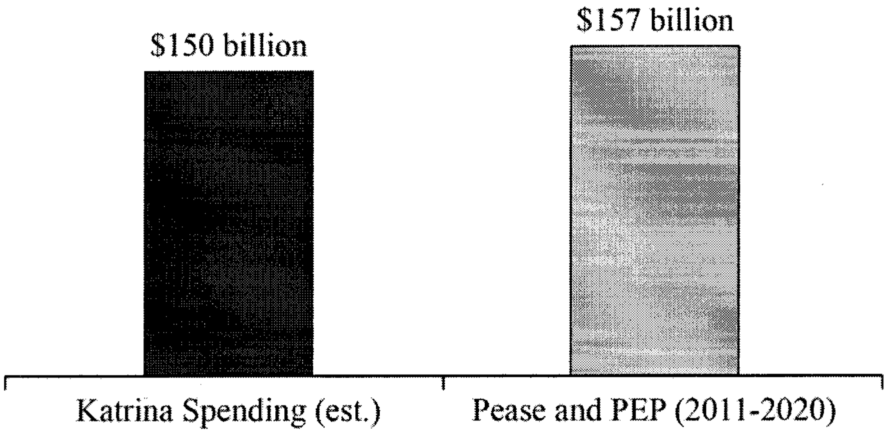

Figure 2[136]

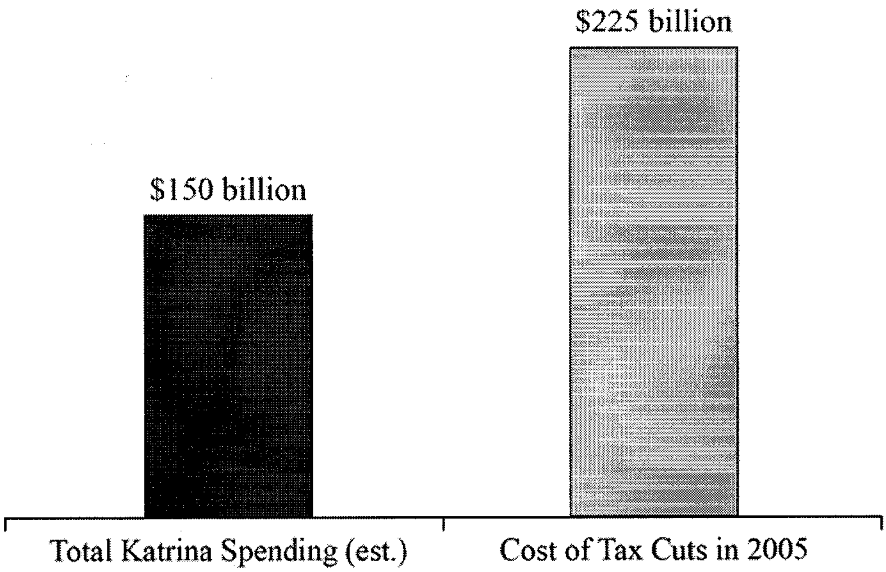

Figure 3[137]

Generally, the people most affected by the repeal of these

134. *See* KATRINA SLIDE SHOW, *supra* note 123, at 2.
135. *Id.* at 3.
136. *Id.* at 2.
137. *Id.* at 3.

provisions are the ones who should be shouldering the higher tax burden, if the true intent of the progressive tax system is to be upheld.[138] To allow the extremely wealthy in this country to collect tax cuts they do not need is simply backwards economics and damages the current status of our financial welfare. Robert Greenstein, executive director of the Center on Budget and Policy Priorities (CBPP), stated that keeping these two taxes "should be a basic component of efforts to stop digging the deficit hole deeper."[139]

It seems antithetical to allow substantial tax cuts for the wealthy in this country when the primary victims of Hurricane Katrina were the poor and needy, who can least afford the additional cost or tax burdens. Perhaps the priorities of the Bush administration should be adjusted to stop courting wealthy Americans with tax cuts and turn its attention to the real problem of its fiscal liberalism.

B. *Cutting Domestic Spending: Taking from Those Who Need It Most*

Instead of allowing for increased monetary inflow into the system to make up for the increased spending caused by Hurricane Katrina and the war in Iraq, the Bush administration has instead proposed decreased outflow in the form of cuts to domestic spending.[140] While cutting outlays is one component to reducing the deficit, surely it is not the only measure that will fix the problem. If it is, then the administration risks taking too much money away from programs that desperately need it.[141]

A report from the CBPP estimated that tax cuts already in existence in 2005 would cost more than $110 billion over the years 2006 to 2011.[142] However, in order to keep itself on its self-imposed budgetary track set in April 2005, Congress cut domestic

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138. *See* BLACK'S LAW DICTIONARY 1498 (8th ed. 2004) (defining a progressive tax as "a tax structured so that the effective tax rate increases more than proportionately as the tax base increases .... With this type of tax, the percentage of income paid in taxes increases as the taxpayer's income increases.").

139. GETTING SERIOUS ABOUT DEFICITS, *supra* note 124, at 7.

140. *See* ARLOC SHERMAN & RICHARD KOGAN, CTR. ON BUDGET & POLICY PRIORITIES, WHAT DO THE ACROSS-THE-BOARD CUTS MEAN FOR DOMESTIC APPROPRIATIONS? 1 (last revised Jan. 6, 2006), http://www.cbpp.org/12-8-05bud2.pdf ("Pressure to offset Katrina's costs ... led Congress to cut entitlement programs more deeply than the 2006 congressional budget resolution called for.").

141. *Id.* at 1 (discussing several programs affected by the across the board cuts, including "Community Development Block Grants, Head Start, child care, EPA clean water grants, Title 1 education for the disadvantaged, special education for people with disabilities, and Section 8 tenant-based housing vouchers").

142. *Id.* at 2.

programs by $9 billion for fiscal year 2006.[143] In addition, Congress suggested further cuts to all non-emergency funding equally by one percent, with the exception of veterans' funding which was not affected.[144] This means that the cuts in domestic spending will not even save enough money to counteract the cost of the tax cuts previously mentioned, nor will they help offset the money spent on hurricane recovery.[145] Furthermore, discussing the one percent cuts, the CBPP report authors contended that the "appropriated programs of benefit to families with low incomes, middle-class Americans, and state and local governments would essentially be cut more deeply *not* to reduce the deficit, but to finance a portion of the cost of tax cuts, which primarily benefit the well-off. . . . "[146]—once again confirming that the current administration should shift its focus from courting the well-off to achieving fiscal responsibility.

Included in the across-the-board cuts are a 15.7% reduction in Community Development block grants and a 3.8% cut of Children and Family Services Programs funding, including a 2.8% cut in funding to the Head Start program.[147] The 2.8% cut to Head Start prevented 25,000 low-income children from participating in 2006,[148] with approximately 1,900 of them in Texas alone.[149] Specifically, in Texas, the one percent across-the-board cut reduced elementary and secondary education funding by $48.4 million.[150] Once again, it is important to reiterate that these cuts in spending did not even cover the lack of revenue from the PEP and Pease tax cuts previously mentioned, nor did they cover the added cost of recovery from Hurricane Katrina,[151] and neither will spending cuts cover outlays for other needs such

143. *Id.* at 1.

144. *Id.*

145. *Id.* at 2.

146. *Id.*

147. *Id.* According to the Administration for Children and Families website:

> Head Start and Early Head Start are comprehensive child development programs that serve children from birth to age 5, pregnant women, and their families. They are child-focused programs and have the overall goal of increasing the school readiness of young children in low-income families. . . . Head Start began] with a task force recommendation in 1964 for the development of a federally sponsored preschool program to meet the needs of disadvantaged children . . . .

U.S. Dep't of Health & Human Servs., Admin. for Children & Families, Office of Head Start, About Head Start, http://www.acf.dhhs.gov/programs/hsb/about (last visited Sept. 11, 2006).

148. SHERMAN & KOGAN, *supra* note 140, at 2.

149. *Id.*,at tbl.3, http://www.cbpp.org/12-8-05bud2-tables.pdf.

150. *Id.* at tbl.1.

151. *See id.* at 2, http://www.cbpp.org/12-8-05bud2.pdf.

as Iraq.

C. *Eliminate Earmarks: Shut Down "Earmark Favour Factories"*[152]

The only reasonable measure left to control the deficit caused by large outlays for projects as a result of Katrina, the Iraq War, and the large tax cuts given to wealthy Americans is to increase revenue over expenditures. This is best done either by eliminating the current tax cuts which just took effect (and which fly in the face of the progressive system) or eliminate for a year or more several tax cuts which have been in the system for years. Yet one more way to help curb America's fiscal problem—watch how much money is given to "earmarks" and open them up to competitive bidding.

While there is no one definition for the term "earmark,"[153] it is commonly used to mean spending projects requested by individual members of Congress which are not open to competitive bidding.[154] Specifically, an earmark is a device used in an appropriations act to direct available funds for a specific activity.[155] These special requests are attached to appropriations bills and are legally binding if enacted.[156] To put it lightly, earmarks are a way for Congressmen and women to secure money for pet projects. This creates a fiscal problem in that these earmarks are not open to proper oversight.[157] Earmarks

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152. *Match Point for Doctor No*, ECONOMIST, Jan. 19, 2006, at 48 [hereinafter *Match Point*].

153. *See* Rebecca Hagelin, The Heritage Foundation, *The Unending Battle Against Pork Barrel Spending*, June 20, 2006, http://www.heritage.org/Press/Commentary/ed062006a.cfm ("An earmark is Washington lingo for what most people outside the Capital Beltway refer to as pork barrel spending—when a politician inserts into a bill a set amount of money for a specific project in his or her home district."); SANDY STREETER, CONGRESSIONAL RESEARCH SERVICE, EARMARKS AND LIMITATIONS IN APPROPRIATIONS BILLS 1 (2004) http://www.rules.house.gov/archives/98-518.pdf.

154. *See* STREETER, *supra* note 153, at 2; Earmark Reform: Dr. Coburn Launches an Earmark Toolkit (Apr. 15, 2006), http://coburn.senate.gov/ffm/index.cfm?FuseAction=Files.View&FileStore_id=690a9374-7c0f-4a46-ba8c-b46e11f09eb1 [hereinafter Coburn Earmark Toolkit] (noting that "[e]armarks are taken out of accounts that are supposed to fund broader programs that operate in a more competitive manner.").

155. STREETER, *supra* note 153, at 1

156. *Id.*

157. Coburn Earmark Toolkit, *supra* note 154 (explaining that earmark "provisions get slipped into reports by the bill authors late at night, behind closed doors meaning no one gets a chance to vote on them individually. To make matters worse, these spending bills are often rammed through Congress before anybody has time to actually read them."). Senator Coburn, R-Oklahoma, is chairman of the subcommittee on Federal Financial Management, Government Information and International Security. *See* About Us, Coburn.senate.gov., http://coburn.senate.gov/ffm/index.cfm?FuseAction=

are also loved by lobbyists.[158]

In the wake of the recent Jack Abramoff scandal,[159] it is hard to imagine a better time to reform the fiscal inadequacies included in earmarked funds, especially since some of the latest lobbying scandals involve earmarks. For example, former California congressman Randy Cunningham acknowledged trading earmarks for $2.4 million in bribes.[160] Jack Abramoff even once "bragged that appropriations committees were 'earmark favour factories.'"[161] Not surprisingly then, "between 1997 and 2004, appropriations earmarks have increased from under 2,000 to over 10,000,"[162] and by a staggering 970% in the last ten years.[163] Simply stated, earmarks reduce the federal budget for projects that should be paid for using state funds. While the point of this paper is not to abolish earmarks completely, in order to increase the federal revenue and help deflate the budget, earmarks should be checked regularly and be restricted from use by lobbyists.

Very few congressmen have made themselves open to such a change.[164] Tom Coburn, R-Oklahoma, a "freshman senator," has recommended numerous changes to fiscal policy and has led pointed attacks on federal spending—including asking how Congress could "justify spending $24 billion on 'earmarks' at a time of national emergency" (Katrina)[165] and "how [it could] justify spending $223 [million] on a 'bridge to nowhere' in Alaska when New Orleans was underwater."[166] Another congressman in support of fiscal restraint is John McCain, who has sought fiscal reform numerous times, including reducing the practice of earmarking.[167] In fact, the two joined together in early 2006 to

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AboutUs.Home (last visited Dec. 22, 2006). *See generally id.* (providing a comprehensive guide to earmarks and their effect on U.S. financial management).

158. *Match Point*, *supra* note 152, at 48 (stating that earmarks "are a way [for lobbyists] to smuggle pet projects into vast spending bills without even the pretence of proper oversight.").

159. *See generally* Massimo Calabresi, *The Gimme-Five Game*, CNN.com, June 28, 2005, http://www.cnn.com/2005/POLITICS/06/28/abramoff.tm/index.html (detailing how lobbyist Jack Abramoff exerted his power and influence in Washington using funds from Native American casinos).

160. *Match Point*, *supra* note 152, at 48.

161. *Id.*

162. Web Memorandum by Ronald D. Utt, The Heritage Foundation, Is Pork Barrel Spending Ready to Explode? The Anatomy of an Earmark (Nov. 10, 2004), http://www.heritage.org/Research/Budget/wm608.cfm.

163. *Match Point*, *supra* note 152, at 48.

164. *See* Coburn Earmark Toolkit, *supra* note 154.

165. *Match Point*, *supra* note 152, at 48.

166. *Id.*; *see also* Coburn Earmark Toolkit, *supra* note 154.

167. *See* Utt, *supra* note 162.

attack every earmark on the Senate floor.[168] In a letter addressed to Senate Majority Leader Bill Frist, they stated that the practice of inserting earmarks into conference reports "at the last minute stifles debate and empowers well-heeled lobbyists at the expense of those who cannot afford access to power. Decisions about how taxpayer dollars are spent should not be made in the dark, behind closed doors."[169]

D. *The Free Cash Flow Problem: What Works for Business Managers Does Not Work for the Government*

The solution to the deficit seems simple: spend less and accrue more. The problem is in discovering how to accrue more and in what ways to spend less. As discussed above, earmarks and pork barrel projects are two examples of things on which our government should be spending less money, and there is a plethora of other examples to choose from.[170] Yet another possible solution, finding a middle ground of certain programs to cut, is a harder argument to sell because it could only be based on the needs of the country at that certain time. All that really can be said is that more oversight is needed when setting out the budget, as well as a tighter kept watch on fiscal outlays.[171] The heart of the solution to the deficit lies in increasing the amount of revenue. This is best accomplished by spreading the revenue burden across the whole population equally, while still maintaining a progressive tax system. The best way to ensure that the burden of the deficit applies equally to all citizens is to attach it to something that all citizens are required to do: pay taxes.[172] As mentioned earlier, there are currently 146 tax cuts

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168. *See* Letter from Tom Coburn & John McCain, U.S. Senators, to Bill Frist, U.S. Senate Majority Leader, (Jan. 25, 2006), http://coburn.senate.gov/ffm/index.cfm?FuseAction=LatestNews.PressReleases&ContentRecord_id=466953f2-7e9c-9af9-75cf-07e525408f87 [hereinafter Coburn McCain Letter] (acknowledging a problem with earmarked funds and committing to challenge such earmarking); *see also* Stephen Dinan, *McCain, Coburn to Force Votes on Pork Spending*, WASH. TIMES, Jan. 27, 2006, at A1; Robert D. Novak, *Two Defeats for Earmarks*, Townhall.com, May 1, 2006, http://www.townhall.com/columnists/RobertDNovak/2006/05/01/two_defeats_for_earmarks (noting that Coburn and McCain defeated two earmarks in the first four months of 2006 with no plans to end their efforts).

169. *See* Coburn McCain Letter, *supra* note 168.

170. *See* discussion *supra* Part V.C.

171. In October 2006, the subcommittee on Federal Financial Management identified $1.1 trillion in waste or questionable spending. For a detailed breakdown of the committee's findings, see *Subcommittee Oversight Efforts Identify $1.1 TRILLION in Waste or Questionable Spending*, Dec. 20, 2006, http://coburn.senate.gov/ffm/index.cfm?FuseAction=LatestNews.NewsStories&ContentRecord_id=a11b987c-802a-23ad-4685-32f94535a0f3.

172. *See* Curry, *supra* note 6 (explaining that hurricane recovery could be paid for in

enshrined in federal law,[173] which accounted for roughly $728 billion in forgone revenue in 2004 *alone*.[174] And while they are a valued part of many people's tax filings every year, living without a few of those tax cuts for just one year could solve our deficit problem, at least in the short term.[175]

There are, of course, some who advocate that debt is a restricting factor on free spending, basing their argument on certain theories that advance the proposition of debts.[176] One such theory is the free cash flow problem, widely attributed to retired Harvard Business School professor Michael Jensen.[177] The theory advanced by Jensen is based on the assumption that having small cash reserves restricts your ability to spend freely.[178] The free cash flow problem posits that excess cash is detrimental to shareholders because managers tend to waste it through overinvestment and diversifying acquisitions; essentially, by putting it at risk instead of distributing the excess to shareholders.[179] It is this theory that leads to the conclusion that debt is a good thing, because it keeps managers in check.[180] If managers do not have funds to spend, they cannot risk damaging the company by losing those funds.[181] In essence, every dollar earned must go toward paying off the debt rather than toward acquiring new positions or extraneous purchases.[182] Free spending goes out the window.

Unfortunately, Jensen's theory is based on a business model[183] and does not hold water when applied to the government. While the free cash flow problem certainly would seem to limit the free spending of managers, it cannot be used to explain the fiscal policy of the Bush administration. If this theory held true, the government would spend less on starting new ventures and would be less willing to accept less inflow.

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one year by Americans giving up three tax breaks).

173. *Id.*

174. *See* WALKER, *supra* note 112, at 25.

175. *See Curry*, *supra* note 6.

176. *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986) (discussing the agency costs of debt and stating that "debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.").

177. *See generally id.* at 323-29.

178. *Id.* at 323.

179. *Id.* at 324.

180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.* at 323 (discussing the "agency costs of debt" as between managers and shareholders).

However, this has not been the country's experience under this administration. The PEP and Pease tax cuts took effect as scheduled with little hope of being recalled,[184] and the deficit is still growing—up $60 billion from an estimate in July 2006.[185] In early 2006, the White House warned Congress to expect requests for additional funding for Katrina recovery and the war in Iraq.[186] As predicted, the White House requested an additional $120 billion for the wars in Afghanistan and Iraq.[187] Certainly, then, the Bush administration has no problem spending while in a deficit, thus defeating application of the free cash flow problem.

E. *Tax Expenditures Equal Revenue Losses*

A large loss of revenue could also come by way of tax expenditures.[188] The "six types of tax expenditures [include]: exclusions, exemptions, deductions, credits, preferential tax rates, and deferral of tax liability,"[189] and in their simplest form, they are revenue losses. Despite the economic neutrality norm,[190] the goal of tax expenditures is to promote particular types of activities and provide financial relief to particular taxpayers.[191] Deciding which behaviors or expenses are to be considered tax expenditures is an arbitrary matter of judgment, but the general objectives usually promote social or economic values.[192] These expenditures are essentially spending programs.[193] They enable the government to subsidize certain expenses and aid those who are less able to pay taxes.[194] However, some contend that the majority of government

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184. *See* TWO TAX CUTS, *supra* note 129.

185. *See Katrina Cited*, *supra* note 79.

186. *See White House to Request Billions for Iraq War, Hurricane Relief*, CNN.com, Feb. 2, 2006, http://www.cnn.com/2006/POLITICS/02/02/budget.emergencyspend.ap/index.html [hereinafter *White House to Request Billions*].

187. *Bush to Seek $120 Billion More for Wars*, MSNBC.com, Feb. 2, 2006, http://www.msnbc.msn.com/id/11145948 [hereinafter *Bush to Seek $120 Billion More for Wars*] (noting that $70 billion will be reflected in the 2006 budget and $50 billion will be reflected in the 2007 budget); *see also* FISCAL YEAR 2007 BUDGET, *supra* note 7, at 315 tbl.S-2.

188. WALKER, *supra* note 112, at 4-5.

189. *Id.* at 9.

190. *See* Mary L. Heen, *Welfare Reform, Work-Related Child Care, and Tax Policy: The "Family Values" Double Standard*, Rich. J.L. & Pub. Int. (1997), http://law.richmond.edu/rjolpi/Issues_Archived/1997_Spring_Welfare_Reform/heen_fin.htm (noting that "taxes should influence allocation of resources in the economy as little as possible; otherwise, economic inefficiencies may result.").

191. WALKER, *supra* note 112, at 9.

192. *Id.*

193. *Id.* at 7.

194. *Id.* at 15.

spending through the tax code is not aimed at low income people; instead, they assert that tax breaks generally favor people with the best and most powerful lobbyists in Washington because such expenditures or entitlement programs often help the people who pay higher taxes.[195] For example, a deduction of $1,000 for home mortgage interest means that a taxpayer in the 39.6% tax bracket saves $396, while a taxpayer in the 15% bracket saves only $150.[196] Furthermore, this deduction cannot even be taken by taxpayers who do not itemize deductions on their tax returns.[197]

Itemization of deductions is beneficial only to people whose deductible expenses are higher than their standard deduction.[198] The standard deduction for 2004 was $4,850 (for those filing individually) and the personal exemption was $3,100.[199] This means that individuals who did not have itemized deductions in excess of $4,850 would have reasonably elected to take the standard deduction.[200] Itemized deductions are all allowable deductions other than the standard deduction and personal exemption.[201] Generally speaking, anyone with deductions amounting to less than $4,850 will not get the benefit of the many deductions in the tax code because they will simply elect the standard deduction. This is one of the reasons why a deduction is a greater benefit to a taxpayer in a higher tax bracket (i.e. higher income) than to a lower income taxpayer. The other reason, of course, is that a deduction only reduces taxable income,[202] so a $1 deduction is worth 35 cents to a taxpayer in the 35% bracket and only 15 cents to a taxpayer in the 15% bracket.[203]

Under the tax code, many deductions support the wealthy at the expense of the rest of the country.[204] A reduction in revenue

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195. *See, e.g.*, ROBERT MCINTYRE, CITIZENS FOR TAX JUSTICE, THE HIDDEN ENTITLEMENTS 2 (1996), http://www.ctj.org/pdf/hident.pdf.

196. *Id.*

197. *See id.*

198. Internal Revenue Serv., U.S. Dep't of the Treasury, Should I Itemize?, http://www.irs.gov/individuals/parents/article/0,,id=130480,00.html (last visited Oct. 21, 2006) [hereinafter Should I Itemize?]; *see* JAMES R. WHITE, U.S. GEN. ACCOUNTING OFFICE, TAX DEDUCTIONS: ESTIMATES OF TAXPAYERS WHO MAY HAVE OVERPAID TAXES BY NOT ITEMIZING 1 (2001), http://www.gao.gov/new.items/d01529.pdf, *noted in* WALKER, *supra* note 112, at 11 n.14.

199. WALKER, *supra* note 112, at 13 (reproducing a 1040 Form from 2004).

200. Should I Itemize?, *supra* note 198.

201. WHITE, *supra* note 198, at 2-3.

202. WALKER, *supra* note 112, at 10.

203. *Id.* at 14.

204. *See* MCINTYRE, *supra* note 195, at 2.

means less money can be spent on valuable community programs and other programs designed to benefit those who are less fortunate. Congress has, however, tried to correct this unfortunate result of tax expenditures by attempting to control the amount of revenue lost by enacting certain restrictions on the expenditure provisions.[205] "For example, the mortgage interest deduction is limited to interest on debt up to $1 million to buy, build, or improve first or second homes and up to $100,000 in home equity debt."[206] Another measure, which is currently a hot topic with the legislature, is the Alternative Minimum Tax (AMT).[207] The AMT ensures that high income taxpayers pay a certain amount of taxes, regardless of how much money they claim in deductions.[208] According to the Government Accountability Office:

> Under the AMT, taxpayers may have to add back some tax expenditures that they could otherwise claim under the regular tax system, such as deductions for state and local taxes and home equity loan interest, and they may have to include as income certain tax-exempt bond interest that is excluded under the regular tax system.[209]

Regardless of these restrictions, tax expenditures reduce revenue and should be cut back to help reduce the current deficit.

The congressional Joint Committee on Taxation (JTC) and the Treasury Department are legally required to report the cost of tax expenditures each year.[210] Such losses must be carefully examined because "the JTC and Treasury estimate the revenue loss from each tax expenditure separately, assuming that the rest of the tax code remains unchanged."[211] The loss might be greater or lesser than the amount predicted in its purest form because it is impossible to gauge human reaction to tax code changes with any degree of certainty. If a tax expenditure is removed, a person may take the standard deduction instead of itemizing, thus possibly lessening the actual loss projected from the tax

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205. WALKER, *supra* note 112, at 14.

206. *Id.*; *see* I.R.C. § 163(h)(3) (2000 & West 2006).

207. *See* Vanessa Richardson, *New Congress Likely to Favor Consumers: Democrats Eye Legislation to Help Americans With Taxes, Credit, Wages*, MSNBC.com, Jan. 4, 2007, http://www.msnbc.msn.com/id/16440753.

208. WALKER, *supra* note 112, at 15.

209. *Id.*

210. MCINTYRE, *supra* note 195, at 2.

211. WALKER, *supra* note 112, at 19.

expenditure.[212]

The Treasury's Office of Tax Analysis demonstrated this concept by examining the hypothetical repeal of five itemized deductions (charitable contributions, home mortgage interest expenses, state and local income taxes, state and local property taxes, and medical expenses).[213] According to 2002 data, these five expenditures totaled over $175 billion.[214] The Treasury determined that repealing all five expenditures at once would lessen the loss to $131 billion, a twenty-five percent decrease in lost revenue from the sum of the individual losses ascribed to the expenditures.[215] This figure would change depending on which provisions were repealed, but a twenty-five percent decrease is a good baseline from which to work.

Revenue loss attributed to individual tax expenditures, as opposed to corporate tax expenditures, accounts for an average of eighty-three percent of the sum of the total revenue loss every year.[216] The sum of loss from individual tax expenditures reached a high of $688 billion in 2002 and had only gradually decreased by 2004.[217] In contrast, revenue losses from corporate tax expenditures were $57 billion in 1992 and remained steady through 2004 with only minor fluctuations.[218] The majority of the loss was found in only a few expenditures: fourteen of the individual tax expenditures accounted for about seventy-five percent of the total loss in 2004.[219] The largest expenditure by far in 2004 was the "[i]ncome tax exclusion of employer contributions to medical insurance premiums and medical care."[220] While many of these expenditures are in the Internal Revenue Code for good reason and help encourage certain behaviors, some are there for lesser reasons and, if they were given up for just one year, the deficit could be decreased.

For example, the deductibility of home mortgage interest accounted for roughly $61.5 billon of loss in 2004.[221] This provision enables homeowners to deduct the interest that accrues on their home mortgages from their taxable income.[222] The

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212. *Id.* at 19-20.
213. *Id.* at 20.
214. *Id.*
215. *Id.*
216. *Id.* at 31. The treasury examined the time period between 1974 and 2004. *Id.*
217. *Id.* at 31-32.
218. *Id.*
219. *Id.* at 32-33.
220. *Id.* at 34 tbl.2.
221. *Id.*
222. *See* I.R.C. § 163(h)(3) (2000 & West 2006) (Qualified residence interest).

provision is subject to certain restrictions, but only for those people who happen to be one of the lucky few who own a home worth more than $1 million.[223] This deduction is also an exception from the general rule that personal interest is not deductible.[224] It is essentially a federal subsidy for home purchases.[225] As an example:

> If a family making $45,000 borrows $75,000 to buy a home, the federal government will offset about 13% of its total mortgage payments, a subsidy worth about $81 per month. But if a family making $500,000 takes out a $360,000 mortgage to buy a house, the government will subsidize about 35% of its mortgage payments, worth $1,020 a month.[226]

Additionally, this deduction is not applied to everyone. As previously stated, not only is the benefit limited to those who itemize their deductions, but it is also does not apply to those who do not own their homes.[227] Although home ownership is on the rise, according to the United States Census Bureau, 33.7 million homes were occupied by renters at the close of 2005.[228] This means that, at the very least, 33.7 million people do not get the benefit of the home mortgage interest deduction. Because there is nary a rationale for such a deduction, the provision could easily be cut with little effect on anyone with a slight inability to pay, thus potentially increasing revenue by over $61 billion.[229] The deduction may seek to promote home ownership, but in the words of one prominent study, "the home mortgage interest deduction does not appear to be an effective means of subsidizing

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223. *Id.* § 163(h)(3)(B)(ii) (stating that interest incurred on a qualified residence through acquisition indebtedness cannot exceed indebtedness of $1,000,000).

224. *See id.* § 163(h) ("[N]o deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.").

225. MCINTYRE, *supra* note 195, at 28 n.11.

226. *Id.* at 43.

227. *See* I.R.C. §163(h)(3) (requiring home ownership and only allowing a deduction for interest paid or accrued, thereby extending no tax benefit to taxpayers neither paying nor accruing such interest); *see also* Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L. J. 1347, 1352 n.20 (2000) ("The home mortgage interest deduction is a 'below the line' deduction. Thus, it only benefits those taxpayers who itemize their deductions. Less than 30% of taxpayers itemized deductions in 1996." (citations omitted)).

228. Press Release, U.S. Dep't of Commerce, Census Bureau Reports on Residential Vacancies and Homeownership (Jan. 31, 2006), http://www.census.gov/hhes/www/housing/hvs/qtr405/q405prss.pdf.

229. *See supra* text accompanying note 221.

home ownership."[230]

Another example of a wasteful tax expenditure is accelerated depreciation for corporate-owned machinery and equipment, which reduced potential revenue by approximately $37 billion in 2004.[231] Widely regarded as one of the largest corporate tax loopholes, this provision allows corporations to write off losses due to wear and tear on their machinery and buildings over fewer years than the machines actually take to wear out.[232] An example of this loophole: "in 1995, Eastman Kodak paid an effective federal tax rate of only 17.3%—less than half the 35% statutory corporate tax rate—mainly because of $124 million in tax subsidies from accelerated depreciation."[233] While it would be useful to curb such activity in the long run, cutting this program for even a short period of time could increase federal revenue and decrease the deficit.

A third costly tax expenditure is the child tax credit, which cost the United States Treasury $22.4 billion dollars in 2004.[234] While certainly this is a measure to help reduce taxes for those with children, there are other tax expenditures which have much the same function. The child tax credit is simply a $1,000 credit on an individual's taxes just for having a qualifying child under the age of seventeen.[235] Tax expenditures without purpose are not worthwhile. Before one thinks this change may harm those who need the credit to care for children, do not forget that there is a separate child and dependent care tax credit.[236] The child and dependent care credit has encouraging features and a worthwhile purpose. It is available to people who, in order to work or to look for work, have to pay for child care services for dependents under age thirteen.[237] The credit is also available to those who paid for the care of "a spouse or a dependent of any age

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230. Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, *in* 17 TAX POLICY AND THE ECONOMY 37, 38-39 (James M. Poterba ed., 2003).

231. WALKER, *supra* note 112, at 103.

232. ROBERT MCINTYRE & T.D. COO NGUYEN, CITIZENS FOR TAX JUSTICE & INSTITUTE ON TAXATION AND ECONOMIC POLICY, CORPORATE INCOME TAXES IN THE BUSH YEARS 8 (2004), http://www.ctj.org/corpfed04an.pdf.

233. MCINTYRE, *supra* note 195, at 13.

234. WALKER, *supra* note 112, at 34 tbl.2.

235. I.R.C. § 24 (Supp. 2003 & West 2006); Mark H. Levin, *The Working Families Tax Relief Act of 2004*, The CPA Journal Online, Jan. 2005, http://www.nysscpa.org/cpajournal/2005/105/essentials/p42.htm.

236. I.R.C. § 21 (2000 & West 2006); Internal Revenue Serv., U.S. Dep't of the Treasury, Claiming the Child and Dependent Care Credit: IRS Tax Tip 2006-46, http://www.irs.gov/newsroom/article/0,,id=106189,00.html (last visited Oct. 21, 2006) [hereinafter IRS Tax Tip 2006-46].

237. IRS Tax Tip 2006-46, *supra* note 236.

who is physically or mentally incapable of self-care."[238] The credit was allowed for $3,000 of expenses in 2005 for one dependent's care and $6,000 for the care of more than one dependent.[239] Additionally, this credit is phased out for those with higher incomes.[240] Workers earning $15,000 or less can get up to thirty-five percent of their child care expenses as a credit and the percentage lessens the more they earn.[241] Additionally, the total credit is phased out by $50 for every $1,000 of income exceeding the threshold.[242] The child and dependent care tax credit encourages those with children to find work and encourages them to maintain proper care for those receiving it, because the credit is not available if the paid caregiver is among the taxpayer's dependents.[243] Thus, the child and dependent care tax credit is the more proper tax credit because it encourages gainful employment, rendering the child tax credit wasteful in the amount of $22.4 billion or more that could otherwise help our economy.

A fourth revenue-losing tax expenditure is to allow taxpayers to take stepped-up basis of capital gains in property acquired on the death of another, which deprived the United States of $24.2 billion in 2004.[244] Basis is "the tax term [used to represent] a previously taxed amount which should not be taxed again (or is an amount deliberately not taxed and which should remain untaxed)."[245] An illustration of this stepped-up basis at death is when a donor has a $10,000 basis in property but the property appreciates in value to $15,000. If that donor gave away the property while alive, the donee would owe taxes on the $5,000 appreciation, but if that donor leaves that property for the donee upon the donor's death, the donee takes a "stepped-up" basis in the property of $15,000 without having to pay taxes on the same $5,000. This is an extra "gift" from the IRS that could

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238. *Id.*

239. *Id.*

240. *See* Deborah Fowles, Good News for Parents About the Child Tax Credit in 2005 (Mar. 3, 2006), http://financialplan.about.com/cs/taxes/a/ChildTaxCredit.htm (indicating that the threshold for married filing jointly is $110,000; for married filing separately is $55,000, and for any other filing status is $75,000).

241. I.R.C. § 21.

242. Fowles, *supra* note 240.

243. David Blau, *Rethinking U.S. Child Care Policy*, ISSUES IN SCIENCE & TECH., Winter 2001, http://www.issues.org/18.2/blau.html ("The subsidies encourage employment of both parents in two-parent families and of the single parent in one-parent families . . . .").

244. WALKER, *supra* note 112, at 34 tbl.2.

245. JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 50 (3d ed. 2004).

be put aside, at least temporarily, to help the U.S. recover from the enormous deficit that has mounted.

Fifth, capital gain on the sale of one's home is an interesting tax exemption because it is one of the few that does not become phased out when applied to higher incomes. Section 121 of the tax code allows an individual homeowner to exclude up to $250,000 of profit on the sale of her home if the home was used as her principal residence for at least two of the last five years.[246] The amount of the deduction doubles for married couples filing jointly.[247] While this is certainly a nice provision (because it encourages home ownership and eliminates the burden of excess tax liability on the sale of people's homes), there is currently no limitation as to which homeowners may claim this exemption; it applies equally to a homeowner who sells his home for $100,000 and a homeowner who sells his home for $4 million.[248] Without a phase-out limitation for taxpayers with higher incomes, this exemption of proceeds from the sale of a home cost the Treasury $29.7 billion in 2004.[249] While the author does not advocate a complete repeal of this tax exemption, it certainly should be phased out at a reasonable limit. To allow the wealthiest people in America to claim these exemptions wholesale is counterintuitive. This is a major tax expenditure that should be peeled back to allow greater revenue to flow to the treasury.

Other costly tax expenditures with terrible incentives are found in corporate taxation policies. One of these is the deferral of income of controlled foreign corporations, which exempted $7.24 billion from revenue in 2004.[250] "Multi-national corporations, whether American- or foreign-owned, are supposed to pay taxes on the profits they earn in the United States."[251] The complexities of corporate taxation and tax expenditures encourage companies to try to shift their income to countries that are more tax friendly.[252] This specific foreign income deferral provision encourages American companies to move their physical operations overseas and discourages them from setting up operations in America, which means fewer jobs created for

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246. I.R.C. § 121(a), (b)(1) (2000 & West 2006).

247. *Id.* § 121(a), (b)(2)(A)

248. *See generally id.* § 121.

249. WALKER, *supra* note 112, at 34 tbl.2.

250. *Id.* at 100 tbl.4.

251. MCINTYRE, *supra* note 195, at 22; *see also* Byron L. Dorgan, *Global Shell Games: Tax Evasion by Multinational Corporations*, WASH. MONTHLY, July 1, 2000, at 33 (noting that "In the U.S., corporations are contributing a paltry 10 percent of the federal income tax burden" and discussing the ramifications of this tax policy).

252. *See* WALKER, *supra* note 112, at 11.

Americans.[253] According to a study done as a joint project of Citizens for Tax Justice and the Institute on Taxation and Economic Policy:

> Over the past decade, corporations and their accounting firms have become increasingly aggressive in seeking ways to shift their profits, on paper, into offshore tax havens, in order to avoid their tax obligations. Some companies have gone so far as to renounce their U.S. "citizenship" and reincorporate in Bermuda or other tax-haven countries to facilitate tax-sheltering activity.[254]

The estimated loss of revenue from all the corporate tax measures combined equals between $30 and $70 billion per year.[255] Tax provisions that encourage multi-million dollar corporations to move operations off shore to avoid American taxes without consequence are counterproductive to the U.S. economy. These companies are able to profit from the U.S. without giving back, partly as a result of the tax friendliness of the corporate tax structure. The Treasury could gain at least $30 billion of revenue if the tax laws in this area were reformed.[256] This money could be used to reduce the deficit.

In total, the six tax expenditures mentioned above account for revenue loss of $204.8 billion at their lowest estimates.[257] Assuming the estimated twenty-five percent loss is due to human behavioral aspects beyond the reach of the tax code, there is still a revenue increase of $153.6 billion by repealing these tax breaks, at least for a limited period of time. These tax breaks represent some of the least useful of all the tax expenditures that cost the most to the Treasury. Repealing all of these provisions, or at least a majority of them, would probably better conform to the overall goals and policies of the tax code than if they were left active. Other tax expenditures which could be repealed without much deterioration to overall tax policies include: reimbursed employee parking expenses, which cost the Treasury $2.47 billion

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253. *See* MCINTYRE & NGUYEN, *supra* note 232, at 15.

254. *Id.* at 11.

255. *Id.*

256. *See id.* (noting that corporate offshore tax sheltering costs the U.S. Treasury at least $30 billion annually).

257. *See generally* discussion *supra* Part V (discussing the following six wasteful tax expenditures and the amount of revenue lost: deduction of home mortgage interest ($61.5 billion), accelerated depreciation of corporate machinery and equipment ($37 billion), child tax credit ($22.4 billion), step-up basis of capital gains at death ($24.2 billion), capital gains exclusion on home sales ($29.7 billion), offshore tax shelters ($30 billion), for a total of $204.8 billion.).

in 2004; "exclusion of net imputed rental income on owner-occupied homes," which represented $24.59 billion of foregone revenue in 2004; accelerated depreciation of machinery and buildings for individuals, which cost the Treasury $7.6 billion in 2004; "deductibility of corporate charitable contributions other than education and health," which resulted in $26.2 billion of lost revenue in 2004; and the largest tax expenditure on record, the exclusion of "employer contributions for medical insurance premiums and medical care," which resulted in $102.3 billion of lost revenue in 2004.[258]

Of these last provisions, however, two of the largest represent policies that we may be unwilling to sacrifice. Hardly anyone would want to retract the provision for exclusion of charitable contributions out of fear that it would discourage charitable donations. The same policy underlies the exclusion of employer contributions for medical care. Working Americans do not want to discourage employers from providing health care to their employees. On the other hand, why should this form of income not be taxed while most other forms are? This question should also be applied to reimbursed employee parking expenses. In-kind contributions should be taxed like regular income. Furthermore, the tax expenditure allowing for accelerated depreciation of machinery and buildings for individuals should be repealed for the same reasons that tax expenditure should be repealed for corporations.

Taking just the deduction for employee reimbursed parking expenses ($2.47 billion), exclusion of net imputed rental income on owner occupied homes ($24.59 billion), and accelerated depreciation of machinery and equipment for individuals ($7.6 billion), the Government is losing $34.66 billion in revenue. Again, accounting for a twenty-five percent loss due to unpredictable behavioral aspects, repealing these tax expenditures for just one year would increase revenue by about $25.995 billion.[259] In total, giving up just these nine tax expenditures (excluding the deductibility for charitable contributions other than education and health ($26.2 billion) and the exclusion of employer contributions for medical insurance premiums and medical care ($102 billion)) for just *one year* increases revenue by $179.6 billion,[260] effectively reducing the

258. *See* WALKER, *supra* note 112, at 105 tbl.4.

259. $34.66 billion reduced by twenty-five percent is $25.995 billion.

260. Figure derived from adding the total of the six previously mentioned tax expenditures ($204.8 billion) plus employee reimbursed parking expenses ($2.47 billion), exclusion of net imputed rental income on owner occupied homes ($24.59 billion), and accelerated depreciation of machinery and equipment for individuals ($7.6 billion). This

national deficit by more than forty-five percent (assuming a deficit of $400 billion).

VI. CONCLUSION

Since the war in Iraq began in 2003,[261] the United States has had to deal with many large projects that weigh heavily on the national deficit. In early 2006, the Congressional Budget Office estimated that $320 billion had already been spent on operations in Iraq and Afghanistan since the September 11 terrorist attacks in 2001.[262] This figure does not include the $120 billion requested by the White House for these wars in 2006.[263] On top of the money spent on these wars, unfortunate acts of nature have also taken their toll on the American public and economy. Estimates for the recovery amount of Hurricane Katrina are still coming in and building by the day. Congress had already spent over $62 billion on the recovery with total recovery estimates as high as $200 billion in 2005.[264] These two events alone have significantly contributed to making our current deficit one of the largest in United States history.[265] In 2004 the deficit was at an all-time numerical high of $413 billion.[266] However, these two events are not the main reasons for our nation's largest deficit.

There are many ways to decrease a deficit, the most effective being increasing revenue and decreasing spending. The Bush administration has cut funding to valuable programs rather than

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figure totals $239.46 billion. Reducing the figure to account for a twenty-five percent loss due to human behavioral aspects beyond the reach of the tax code equals $179.6 billion.

261. Ryan Chilcote, John King, & Barbara Starr, *U.S. Launches Cruise Missiles at Saddam*, CNN.com, Mar. 20, 2003, http://www.cnn.com/2003/WORLD/meast/03/19/sprj.irq.main (noting the "start of the military campaign against Iraq" on March 20, 2003).

262. Andrew Taylor, *$120 Billion Sought for Wars*, HELENA INDEP. REC., Feb. 3, 2006, http://www.helenair.com/articles/2006/02/03/national_top/a01020306_01.txt.

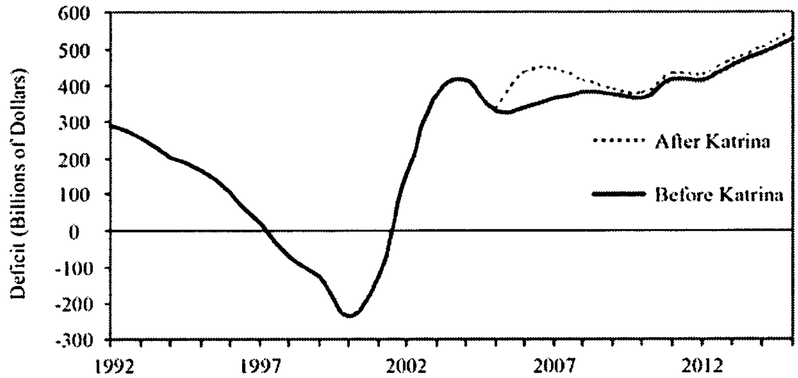
263. *Bush to Seek $120 Billion More for Wars*, *supra* note 187; *see also* FISCAL YEAR 2007 BUDGET, *supra* note 7, at 315 tbl.S-2.

264. Fineman, *supra* note 83, at 25; Jonathan Weisman & Jim VandeHei, *Bush to Request More Aid Funding*, WASH. POST, Sep. 15, 2005, at A1.

265. *Growing Deficit Hobbles Economy*, *supra* note 81 (noting that the 2004 deficit was a record $413 billion and the 2005 deficit was the third highest at $319 billion).

266. *Federal Borrowing Raised to Record Level*, CNN.com, Jan. 30, 2006, http://www.cnn.com/2006/POLITICS/01/30/treasuryborrowing.ap/index.html; *see* Roger Runningen & Ryan J. Donmoyer, *White House Cuts FY 2006 Deficit Forecast to $296 Billion*, Bloomberg.com, July 11, 2006, http://www.bloomberg.com/apps/news?pid=20601087&sid=aCMuQC3VsNWE&refer=worldwide_news ("The deficit hit $413 billion in 2004. While the biggest in total dollar terms, it represented 3.6 percent of gross domestic product, a smaller proportion compared with the 6 percent of GDP represented by the $208 billion shortfall in 1983.").

cut the tax expenditures that are most valuable to the wealthy.[267] As outlined above, there are several tax expenditures which are essentially counterintuitive to accepted tax policy norms, ones that deprived the United States of $204 billion in 2004 alone. In addition, the Pease and PEP tax cuts will cost the United States $157 billion and only benefit the richest in America.[268] Repealing these tax cuts could single-handedly pay for the recovery of Hurricane Katrina.[269] Although research has shown that Katrina will have little effect on long term deficit [see Figure 4], the fact that repealing just those two tax cuts could pay for the most expensive natural disaster in U.S. history with some left over adds perspective to the deficit debate.



Projected deficits come from the CBO August Baseline, adjusted for extension of the Bush tax cuts and a phase-down of spending in Iraq

Figure 4[270]

Indeed, the Bush administration seems to be more concerned with cutting funding to valuable programs such as medical care and education than it does with ensuring that the tax system stays progressive and those that earn the most, pay the most.[271] Perhaps the Bush administration should be pointed in the direction of the government after the deficit in 1992, and concern itself less with pleasing its party base to ensure contributions,

267. *See* discussion *supra* Part V.B.

268. KATRINA SLIDE SHOW, *supra* note 123, at 2 (Figure 2).

269. GETTING SERIOUS ABOUT DEFICIT, *supra* note 124, at 7.

270. *Id.* at 1 fig.1.

271. *See generally House Passes Cuts to Medicaid, Student Loans*, CNN.com, Feb. 2, 2006, http://www.cnn.com/2006/POLITICS/02/02/budgetcuts.ap/index.html ("The House . . . sent Bush a major bill cutting benefit programs like Medicaid and student loan subsidies.").

and more with making sure this record deficit does not affect those who need the programs they are cutting.

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