The Heritage Foundation

BACKGROUNDER

No. 3219 | MAY 25, 2017

Pathways for Pro-Growth, Fiscally Responsible Tax Reform

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Abstract

The U.S. tax code must be updated. The current tax system is economically destructive, overly complex, and unfairly treats similar taxpayers differently. Responsible tax reform can increase economic prosperity and produce welfare gains for all Americans through increases in job creation, investment, output, and real wages. Congress should pursue tax reform in a fiscally responsible way. As spending is driving growing deficits and debt, Congress should reduce and control spending while alleviating the overall tax burden faced by individuals and businesses. Congress can pursue deficit-neutral tax reform and comply with reconciliation and other relevant budget rules, making tax reform a reality without making the nation's fiscal situation any worse.

Key Points

- Congress should reform the U.S. tax code such that the code applies the most efficient and least economically destructive forms of taxation, has low rates on a broad base, and is as transparent, predictable, and simple as possible.
- Congress should pursue tax reform in a deficit-neutral manner. Reforming the largest drivers of debt is crucial for long-term tax certainty and to reap the benefits of economic growth resulting from proper tax reform.
- Congress can pursue deficit-neutral tax reform and comply with reconciliation and other relevant budget rules by cutting direct spending through deliberate reforms, using automatic sequestration, or a combination of the two.
- The time for tax reform is now. Anemic economic growth and worsening long-term fiscal projections signal the importance of reforming the tax system and controlling spending—further delay will only exacerbate these problems.

The tax code is in dire need of an update. In its current form the U.S. tax system is economically destructive, overly complex and—unfairly—treats similar taxpayers differently. Responsible tax reform can increase economic prosperity and produce welfare gains for all Americans through increases in job creation, investment, output, and real wages.

Congress should pursue tax reform in a fiscally responsible way. As spending is driving growing deficits and debt, Congress should reduce and control spending while alleviating the overall tax burden faced by individuals and businesses. Congress can pursue deficit-neutral tax reform and comply with reconciliation and other relevant budget rules, making tax reform a reality without making the nation's fiscal situation any worse.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3219**

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Window of Opportunity for Tax Reform

The time for tax reform is now. Anemic economic growth and worsening long-term fiscal projections signal the importance of tax and spending reform—further delay will only exacerbate these problems.[1] The basic principles of a good tax system are straightforward. The tax system should: Apply the most efficient and least economically destructive forms of taxation, have low rates on a broad base that eliminates the double taxation of investment, and be as transparent, predictable, and simple as possible while respecting the core institutions of civil society and protecting the rights to life, liberty, and property.[2]

U.S. tax rates are too high. Reform should lower and consolidate tax brackets for families, individuals, businesses, and investors. Combined marginal tax rates for some individuals and capital investments can exceed 50 percent. Such high marginal tax rates impede economic growth by discouraging additional work, entrepreneurship, savings, and investment. High marginal tax rates are an especially inefficient means of raising revenue because a rate increase can cause disproportionate economic losses.[3]

The U.S. business tax system is the most significant tax impediment to economic growth. The U.S. government attempts to tax the worldwide income of American corporations at the highest tax rate in the developed world. The U.S. also has one of the worst systems for business deductions of investment expenses.[4] By not allowing the deduction of all expenses in the year they are incurred, the tax code makes investment more costly, which lowers returns to investors, impedes wage growth, and slows job creation. Tax reforms should modernize what is currently one of the worst international tax systems in the world.

Over time, the tax code has accumulated numerous politically motivated credits, deductions, exclusions, and exemptions. These tax privileges distort otherwise efficient economic decisions and increase the cost of the tax code by narrowing the base, necessitating higher overall rates and increasing the complexity of compliance. Simplifying and updating the tax system should entail removing politically motivated privileges, reforming the system of business taxation, and lowering tax rates across the board.

> The primary pathway for tax reform in this Congress is through reconciliation.

Pro-growth tax reform that provides tax relief for American families and businesses faces political barriers to success. According to some, a standalone bill subject to the 60-vote threshold in the Senate may struggle to gain sufficient support for passage and could potentially lead to the inclusion of unrelated matters for logrolling purposes. One example is the proposed $1 trillion of infrastructure spending possibly being linked to reform.[5] Such an infrastructure spending plan could be detrimental to tax reform if it includes new tax subsidies or siphons off savings to pay for spending rather than using the savings to lower tax rates.

Using reconciliation to pursue tax reform can strengthen the permanency of the reforms and increase the effort's probability of success. Tax cuts without offsetting spending reforms are historically short-lived.[6]

1. Congressional Budget Office, "The 2017 Long-Term Budget Outlook," March 30, 2017, https://www.cbo.gov/publication/52480 (accessed May 12, 2017).
2. David R. Burton, "A Guide to Tax Reform in the 115th Congress," Heritage Foundation *Backgrounder* No. 3192, February 10, 2017, http://www.heritage.org/taxes/report/guide-tax-reform-the-115th-congress.
3. Daniel Mitchell, "Lowering Marginal Tax Rates: The Key to Pro-Growth Tax Relief," Heritage Foundation *Backgrounder* No. 1443, May 22, 2001, http://www.heritage.org/taxes/report/lowering-marginal-tax-rates-the-key-pro-growth-tax-relief.
4. Kyle Pomerleau, "International Tax Competitiveness Index 2016," Tax Foundation, October 2016.
5. Administration officials have signaled willingness to include infrastructure and childcare subsidies to get votes from Democrats. However, others in the Administration have said that reconciliation is the preferred path for a clean tax package. Gary Cohn, director of the National Economic Council, said, "We're going to absolutely do taxes under reconciliation." See Nancy Cook and Ben White, "Trump Expected to Include Democrat-Friendly Spending in Tax Plan," *Politico*, April 25, 2017, http://www.politico.com/story/2017/04/25/donald-trump-tax-plan-democrats-237575 (accessed May 4, 2017), and Chuck Stanley, "Reconciliation Offers Path To Tax Reform, Trump Adviser Says," Law360.com, March 10, 2017, https://www.law360.com/articles/900617/reconciliation-offers-path-to-tax-reform-trump-adviser-says (accessed May 4, 2017).
6. Christina D. Romer and David H. Romer, "Do Tax Cuts Starve the Beast? The Effects of Tax Changes on Government Spending," Brookings Institution *Papers on Economic Activity* (Spring 2009), http://eml.berkeley.edu//~dromer/papers/Romer_BPEA_Reprint.pdf (accessed May 12, 2017).

If navigated responsibly, the lower vote threshold under reconciliation in the Senate provides a path toward more permanent tax reform.

Reconciliation

Pursuing tax reform in this Congress, using reconciliation, begins with the fiscal year 2018 congressional budget resolution, in which lawmakers would provide the framework for tax reform by spelling out the desired revenue and outlay implications of their effort. Tax reform should reduce the tax burden on Americans and make corresponding adjustments to spending outlays. Without reducing spending, significant tax relief could be short-lived as growing deficit and interest pressures threaten higher future taxes, and a possible future fiscal crisis. Fiscally responsible tax reform will adjust both sides of the budget ledger.

The primary pathway for tax reform in this Congress is through reconciliation. This process enables Congress to fast-track tax reform in the Senate, limiting debate[7] and lowering the necessary vote threshold to a simple majority, instead of requiring 60 votes as is typical in the Senate to overcome a filibuster.

In order to trigger reconciliation, Congress must include reconciliation instructions in the concurrent budget resolution and establish revenue and outlay baselines for a minimum of five years. Typically, the budget resolution covers a period of 10 years (11 including the current fiscal year). However, Congress is free to establish any budget window it chooses, as long as it covers at least five years.[8]

The purpose of reconciliation is to expedite consideration of budget legislation that changes revenues or spending, such that those changes bring government finances in line with the levels proscribed in the congressional budget resolution. While reconciliation is typically seen as a deficit-reduction tool, especially at times of high and rising deficits, the process itself establishes no such requirement. Reconciliation also facilitates increases in the debt limit.

However, related budget rules encourage lawmakers to pursue deficit reduction or deficit neutrality in order to avoid a point of order against the reconciliation bill that would require a supermajority to overcome. Two rules in particular could derail tax reform in the Senate if the proposed package increased deficits: the pay-as-you-go rule and the Byrd rule.

Pay as You Go (PAYGO)

The Senate PAYGO[9] rule and the statutory Pay-As-You-Go Act[10] both impact revenue legislation, whether it is pursued via reconciliation or another legislative vehicle.

The Senate rule prohibits the consideration of any direct (mandatory) spending and revenue legislation that would increase the deficit over a 10-year budget window. Legislation that would increase direct spending or reduce revenues must also include equivalent amounts of direct spending cuts, revenue increases, or a combination of the two, in order to be deficit neutral.

The Senate PAYGO rule is enforced via a point of order. Any Senator may raise the point of order to prevent the consideration of legislation that would increase deficits via changes to mandatory spending or revenues. Increases in discretionary spending are exempt from PAYGO. However, discretionary levels are controlled by the Budget Control Act of 2011 and the 302(a) allocations provided in the congressional budget resolution.

Legislation that violates PAYGO could proceed if no Senator chose to raise such a point of order, meaning the Senate PAYGO must be actively triggered. Overcoming such a point of order would require a supermajority in the Senate to grant a waiver to the motion.

The statutory Pay-As-You-Go Act implements an automatic sequestration, after the fact, whenever Congress enacts legislation that increases the deficit via direct spending increases or revenue reductions. The statutory rule considers the net effect of all legislation enacted during a session of Congress. The Office of Management and Budget (OMB) keeps two cumulative scorecards, counting the cumu-

7. Debate in the Senate on any reconciliation measure is limited to 20 hours (10 hours on a conference report), and amendments must be germane.

8. Congressional Budget and Impoundment Control Act of 1974, Public Law 93–344, July 12, 1974, 88 Stat. 297.

9. Bill Heniff, "Budget Enforcement Procedures: The Senate Pay-As-You-Go (PAYGO) Rule," Congressional Research Service, August 4, 2015, https://fas.org/sgp/crs/misc/RL31943.pdf (accessed April 21, 2017).

10. Robert Keith, "The Statutory Pay-As-You-Go Act of 2010: Summary and Legislative History," Congressional Research Service, April 2, 2010, https://democrats-budget.house.gov/sites/democrats.budget.house.gov/files/documents/CRS-stat-paygo.pdf (accessed April 21, 2017).

lative budgetary effects of all PAYGO legislation, averaged over rolling five-year and 10-year periods starting with the budget year. The OMB uses these scorecards to determine whether a sequestration is necessary. If Congress ends its session with a net PAYGO deficit on the five-year or 10-year scorecard for that year, the statutory PAYGO Act requires the President to issue a sequestration order, meaning the cancellation of budgetary resources for certain, non-exempt direct spending programs, as defined in law.

Good tax systems should be stable and predictable.

For example, if Congress enacted a tax cut in 2018, without equivalent offsetting direct spending cuts, the OMB is required to record any increase in the deficit projected from this tax cut as an average increase on the rolling five-year and 10-year PAYGO scorecards. Mandatory spending programs that are not exempt (as many are) would face automatic cuts based on the scorecard balances at the end of the session.

A major shortcoming of the statutory PAYGO rule is that it applies sequestration to a very limited subset of mandatory spending programs. Many of the largest and fastest-growing programs are completely or partially exempt. Sections 255 and 256 of the Balanced Budget and Emergency Deficit Control Act exempt Social Security, Medicaid, and food stamps, among a host of other programs. Special rules apply to Medicare, limiting sequestration to no more than 4 percent of budgetary resources in any given year.[11] As federal health care spending and Social Security are projected to drive more than half of the expected growth in spending over the next decade, current sequestration exemptions are woefully misguided. Although these programs require sensible, targeted reforms that secure benefits for vulnerable beneficiaries and reduce economic distortions driven by current program design, the threat of sequestration carries the promise of spurring debate over more deliberate reforms and cuts, in the face of looming indiscriminate reductions.

Byrd Rule

Another provision, specific to the reconciliation process, requires that reconciliation must not increase the deficit outside the budget window. If Congress established a 10-year budget window in its budget resolution, and the reconciliation bill increased deficits in year 11, a Senator could raise a point of order to prevent the bill from becoming law. A motion to waive such a point of order would require a supermajority vote in the Senate.

What are now known as the "Bush tax cuts" were the product of two pieces of legislation, which were both passed using reconciliation and were subject to the Byrd rule.[12] The Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 both avoided triggering a Byrd rule point of order by sunsetting provisions that led to tax reductions, which prevented deficit increases beyond the 10-year budget window. In a letter to Speaker Paul Ryan (R–WI), the Joint Committee on Taxation recently estimated that a temporary reduction in the corporate tax rate to 20 percent for the first three years of the 10-year budget window would still have revenue losses outside that window. This is largely due to the assumption that firms will take advantage of the lower rate to repatriate offshore profits that would have been taxed at a higher rate outside the window, and credits becoming eligible to be used in the outside years.[13] This score makes even a temporary tax cut without offsetting spending reforms unlikely to conform to the Byrd rule.

Conducting tax policy on a temporary basis by allowing necessary tax reforms to expire undermines much of the expected benefits promised by reform. Good tax systems should be stable and predictable. The expiration of pro-growth reforms diminishes the effectiveness of the change by discouraging longer-term projects that otherwise would have occurred if the new system was in

11. Balanced Budget and Emergency Deficit Control Act of 1985, Public Law 99–177.
12. Robert Keith, "The Budget Reconciliation Process: The Senate's 'Byrd Rule,'" Congressional Research Service, July 2, 2010, https://digital.library.unt.edu/ark:/67531/metadc491526/m1/1/high_res_d/RL30862_2010Jul02.pdf (accessed May 15, 2017).
13. Letter to Paul D. Ryan from the Joint Committee on Taxation, April 25, 2017, http://www.politico.com/f/?id=0000015b-a645-d0b0-afdb-b7c7e71d0001 (accessed May 15, 2017).

place longer. Temporary tax legislation also introduces policy uncertainty, which can reduce investment, output, and employment.[14] Uncertainty can also divert business resources towards lobbying for reauthorization rather than focusing on productive growth promoting traditional business activities.[15]

Traditionally, budget resolutions and their reconciliation instructions have been for 10 years, not the minimum five years. If all Congress wanted was to implement a permanent tax cut, a budget resolution could contain instructions for 20 years or more. A Byrd rule point of order would still pertain to the outside years, and the provisions that led to revenue reductions would need to sunset. However, a sufficiently long budget window would effectively allow a permanent tax change. Congress would still need to address growing spending separately, since, without reform, rising deficits and debt, driven primarily by health care and old age entitlements, would threaten a fiscal crisis and higher future taxes. In order for tax relief to be sustainable, Congress must reduce spending.

Deficit Neutrality

Systemic deficits and growing debt constrain tax reform efforts and unnecessarily turn any conversation on tax reform into a debate about how to achieve revenue neutrality. The ever-present limit of revenue-neutral tax reform is dangerous. It forces Congress to make a false choice between otherwise pro-growth tax reform tied to additional revenue raisers, and no reform at all. Holistic tax reform should take both sides of the federal ledger into account.

Spending reforms can make sustainable tax reform deficit neutral without being revenue neutral. Reforming the tax code should not require finding new revenue sources. Persistent deficits are the result of uncontrolled spending, not insufficient taxation. Without spending-based reforms, deficits will continue to grow, requiring still higher taxes in the future. Evidence from economists Christina and David Romer suggests that tax cuts are largely reversed within five years of passage.[16] Portions of both the Reagan tax cuts in 1981 and the Bush tax cuts in the early 2000s were not sustainable. In the face of rising deficits and unwillingness to address increasing spending, legislators seek new sources of revenue or allow tax cuts to expire. Spending reforms are a critical component of sustainable tax reform in light of high government deficits and debt, and have been shown to be the most certain way to reduce debt-to-GDP ratios.[17] Tax changes without offsetting spending reforms are historically ineffective, but pairing spending reforms with tax cuts can strengthen the permanency of tax reform and help place the federal budget on a sustainable path.

Reforming the tax code should not require finding new revenue sources. Persistent deficits are the result of uncontrolled spending, not insufficient taxation.

Washington's spending problem also presents a more subtle challenge to predictable and transparent pro-growth tax reform. Burgeoning debt presents a future tax liability that will eventually come due, either in the form of higher direct taxes or other less direct economic costs. Reforming the largest drivers of the debt is crucial for long-term tax certainty and to achieve the economic growth resulting from prudent tax reform.

Many business and capital tax reforms, such as lower corporate tax rates and expensing, will create revenue losses in the short run, but over a number of years the reforms will stimulate investment and increase output. As the economy grows, revenue

14. Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty," NBER *Working Paper* No. 21633, October 2015, http://www.policyuncertainty.com/media/BakerBloomDavis.pdf (accessed May 15, 2017).
15. Seth H. Giertz and Jacob Feldman, "The Costs of Tax Policy Uncertainty and the Need for Tax Reform," Tax Notes *Special Report*, February 25, 2013, http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1088&context=econfacpub (accessed May 15, 2017).
16. Christina D. Romer and David H. Romer, "Do Tax Cuts Starve the Beast? The Effects of Tax Changes on Government Spending," *Brookings Papers on Economic Activity* (Spring 2009), http://eml.berkeley.edu//~dromer/papers/Romer_BPEA_Reprint.pdf (accessed May 15, 2017).
17. Alberto Alesina and Veronique de Rugy, "Austerity: The Relative Effects of Tax Increases Versus Spending Cuts," Mercatus Center at George Mason University, March 7, 2013, https://www.mercatus.org/publication/austerity-relative-effects-tax-increases-versus-spending-cuts (accessed May 15, 2017).

increases, offsetting much or even all of the short-run losses.[18] Not all pro-growth tax reforms result in economic growth strong enough to compensate for all the lost revenue, however. Lowering and consolidating individual income tax brackets can encourage additional economic participation and entrepreneurship. Changes to individual income taxes can also benefit "pass-through" businesses, those businesses that are taxed under the individual income tax rather than as traditional corporations. Lower individual taxes have real economic benefits, but not necessarily in excess of the lost revenue. This should not leave lawmakers to search for other sources of revenue. Instead, Congress must rethink how much of the American people's money it is spending, and pursue reform systematically.

Needed: Spending Controls

Congress should pursue holistic tax reform through reconciliation in a deficit-neutral manner. By combining reforms to direct or mandatory spending with tax reforms, Congress can proof its reconciliation bill against PAYGO and Byrd-rule barriers to enactment, without chasing higher revenues from possibly counterproductive tax proposals. Congress can make the tax code more efficient and pro-growth, while at the same time providing spending and tax relief to the American people.

There are two main pathways toward such pro-growth, fiscally responsible tax reform:

1. Specific Spending Reductions. Congress can pursue specific spending reductions through reforms of mandatory and direct spending programs (except Social Security, changes to which are not allowed under reconciliation). Tax and mandatory spending reforms can have significant effects outside the standard 10-year budget window. A longer budget window of 20 years could allow Congress' revenue and spending baselines to reap additional dynamic and timing gains from tax reform and longer-term spending reforms.

Tax reform's full benefits will not be completely realized in the short run. Because capital stocks, wages, and output will grow slowly over many years, the full tax-revenue benefit to the government will be partially realized in years beyond the current 10-year budget window. There are also significant onetime transition costs that reduce revenues more in the near term. According to one estimate of the current House Republican Blueprint, static revenue losses (not counting economic growth effects) in the second decade of the reform fall by more than half of the cost in the first 10 years.[19]

In order to make spending cuts more politically palatable, certain mandatory spending reforms could also be phased in during a longer, 20-year budget window. Certain reforms to Medicare should be phased in gradually. The Heritage Foundation, for example has proposed that Medicare premium support be phased in after five years of enactment.

2. Automatic Cuts. Congress can adopt provisions that automatically cut direct spending, and that improve statutory PAYGO legislation. Such a revised PAYGO provision should have no sequestration exemptions (excluding only Social Security to comply with reconciliation restrictions), subjecting nearly all direct spending programs to automatic cuts. The total spending cut over the period of the budget window should meet or exceed projected tax reductions and associated interest costs, estimated at bill passage. Over the budget window, spending cuts should fully offset tax cuts plus incurred interest.

Congress could also pursue a combination of spending cuts and automatic reductions from revised PAYGO provisions. The Heritage Foundation "Blueprint for Balance" identifies several reforms to health care, welfare, and other direct spending programs that Congress could pursue through reconciliation.[20]

Extraneous Matters

Using reconciliation to adjust current law is not always a straightforward matter. The process can be convoluted and based on subjective criteria, especially in the Senate. The Byrd rule sets up a six-part test to ensure that no "extraneous matters" are pursued through a reconciliation measure. The Senate parliamentarian would advise the Presiding Officer,

18. Michael Schuyler, "Growth Dividend from a Lower Corporate Tax Rate," Tax Foundation *Special Report* No. 208, March 12, 2013.

19. Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation, July 2016, https://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan/ (accessed May 15, 2017).

20. Romina Boccia et al., "Blueprint for Balance: A Federal Budget for Fiscal Year 2018," The Heritage Foundation, March 28, 2017, http://www.heritage.org/budget-and-spending/report/blueprint-balance-federal-budget-fiscal-year-2018.

though it is ultimately up to the Presiding Officer to rule on the matter.[21] Arguably, provisions to automatically cut spending to reflect revenue reductions brought about by tax reform should meet Byrd-rule requirements by having an impact on outlays that is directly related to the provision.

The Time to Pursue Deficit-Neutral Tax Reform Is Now

The tax code is overdue for reform. The current U.S. tax system is economically destructive, overly complex, and unfairly treats similar taxpayers differently. Responsible tax reform can increase economic prosperity and produce welfare gains for all Americans through increases in job creation, investment, output, and real wages.

Congress should pursue tax reform in a fiscally responsible way. As spending is driving growing deficits and debt, Congress should reduce and control spending while alleviating the overall tax burden faced by individuals and businesses. Congress can pursue deficit-neutral tax reform and comply with reconciliation and other relevant budget rules by cutting direct spending through deliberate reforms or automatic sequestration, or a combination of the two. The best way to make lasting tax reform a reality is by addressing the key drivers of spending and debt at the same time. Tax relief and spending relief should go hand in hand.

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21. James Wallner, "A Parliamentary Guide to Enforcing the Byrd Rule in the Reconciliation Process," Heritage Foundation *Backgrounder* No. 3206, March 23, 2017, http://www.heritage.org/political-process/report/parliamentary-guide-enforcing-the-byrd-rule-the-reconciliation-process.