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Tax Reform Must Not Lose Revenues — and Should Increase Them

By Paul N. Van de Water

The federal government needs a tax system that provides adequate revenues to finance critical national needs and avoid spiraling debt and interest burdens. As the aging of the population and rising health care costs push up spending for Social Security and Medicare, and with continuing national security challenges, simply paying for existing federal commitments will require more revenues. Recent deficit-reduction efforts have squeezed discretionary appropriations and shortchanged important areas where the federal government has major responsibilities.

Although the nation's long-term fiscal outlook has improved substantially in recent years and does not constitute a crisis, policymakers will have to take further steps to reduce projected deficits and debt. Without a change in policies, the ratio of debt to gross domestic product (GDP) — 77 percent at the end of 2016 — will gradually grow to 102 percent by 2036 and 113 percent by 2046, according to our most recent projections.[1]

To deal with these budgetary pressures, any plan to reform the federal tax system should aim to increase revenues — as virtually all bipartisan deficit-reduction commissions of recent years, and the Senate's Gang of Six in 2011, have called for. Otherwise, the entire burden of reducing the deficit to prevent unsustainable debt levels will fall on federal programs, including Social Security and Medicare. Programs for low- and middle-income households shouldn't be cut to pay for tax cuts favoring those at the top of the income scale.

At a bare minimum, tax reform should not lose revenues. Key Republican congressional leaders have promised that tax reform will be revenue-neutral. They should be held to that promise — measured using standard revenue estimates and without resorting to accounting gimmicks.

Several Factors Are Placing Pressure on Spending

Three factors will place upward pressure on federal spending in coming years. First, existing commitments for Social Security, Medicare, and Medicaid will cost more as the population grows

[1] Richard Kogan, Paul N. Van de Water, and Chloe Cho, *Long-Term Budget Outlook Has Improved Significantly Since 2010 but Remains Challenging*, Center on Budget and Policy Priorities (CBPP), August 18, 2016, http://www.cbpp.org/research/federal-budget/long-term-budget-outlook-has-improved-significantly-since-2010-but-remains

older and as health costs continue to rise across the U.S. health care system, in both the private and public sectors. Second, relief from the overly austere statutory caps on non-defense discretionary (NDD) spending is needed to avoid shortchanging critical activities. Third, we will need increased resources to address critical unmet needs, such as infrastructure.

The aging of the population will inevitably drive up costs for Social Security, Medicare, and Medicaid, which provide income and health security and long-term services and supports for older Americans. The share of the population that is 65 or older will grow from 15 percent to 21 percent over the next 20 years and inch up thereafter, and the share that is 85 or older — when health care costs per person are much higher — will grow even more rapidly. This demographic shift stems from the retirement of the baby-boom generation, born from 1946 to 1964, and the drop in birth rates that followed the baby boom. In addition, health care spending — in both the public and private sectors — has long grown faster than the economy and will likely continue to do so, in substantial part due to medical advances that improve health and save lives but add to cost. As a result, spending for Social Security and the major federal health programs is projected to grow from 10.4 percent of GDP in 2016 to 13.9 percent by 2036 and 14.6 percent by 2046.[2]

Recent deficit-reduction efforts have focused disproportionately on the parts of the budget controlled by the annual appropriations process: NDD spending and defense. This has squeezed spending for NDD activities to levels that are or will soon become too low to sustain without risking damage to areas important to long-term economic growth, such as research and education, as well as transportation. Customer service at federal agencies such as the Social Security Administration and the Internal Revenue Service has deteriorated along many dimensions. For example, over half of people who call Social Security for assistance now get a busy signal or give up after being placed on hold for a long time. Providing health care for a growing and aging population of veterans, carrying out the 2020 decennial census, and maintaining current levels of housing assistance as rents continue rising will put further pressure on NDD spending. For all these reasons, lawmakers should provide relief from the sequestration cuts to defense and non-defense discretionary spending by enacting alternative deficit-reduction measures, including additional revenues.[3]

Resources will also be needed to offset the cost of most new initiatives that the federal government might undertake. These might include such proposals as making college more accessible and affordable, expanding employment and training programs, establishing a program of paid family leave, increasing the earned income and child tax credits, and insuring against the cost of long-term services and supports. Without additional revenues, these or other major initiatives likely won't be feasible.

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[2] Kogan, Van de Water, and Cho.

[3] David Reich and Chloe Cho, *Will Congress Ease the Continuing Pressure on Non-Defense Discretionary Programs or Worsen It?*, CBPP, March 14, 2017, http://www.cbpp.org/research/federal-budget/will-congress-ease-the-continuing-pressure-on-non-defense-discretionary.

Tax Reform Should Raise Revenues

Proposals to reform the federal tax system generally aim to reduce marginal personal and corporate income tax rates and offset the cost of the rate reductions, in whole or in part, by expanding the tax base. For example, the House Republican "Better Way" tax plan would reduce the top individual income tax rate on capital gains and dividends from 23.8 percent to 16.5 percent and the top corporate rate from 35 percent to 20 percent.[4]

Broadening the tax base entails limiting tax deductions, exclusions, and other tax breaks known collectively as "tax expenditures." Although many tax expenditures have merit, others are inequitable or inefficient, and tax expenditures disproportionately benefit the well-off. Martin Feldstein, a former chair of President Reagan's Council of Economic Advisers, argues that tax expenditures are "a major form of government spending" and that cutting them "is really the best way to cut government spending."[5]

The revenue gains from curbing tax expenditures, however, should not all be devoted to reducing tax rates. Applying all such savings exclusively to tax-rate reduction would exhaust what may be the most promising and politically feasible options for increasing revenues and thus would effectively take revenue-raising off the table for deficit reduction for years to come. That, in turn, would place the burden of deficit reduction entirely on federal programs.

Without additional revenue, rising deficits will fuel efforts to cut Social Security, Medicare, and other programs. Social Security and Medicare will be vulnerable because they account for most of the projected growth in federal spending, even though that growth stems primarily from the aging of the population and rising health care costs, not from more generous benefits. Critics of Social Security and Medicare argue disingenuously that benefits must be cut in order to "protect" or "preserve" these programs; these arguments will only intensify if insufficient revenues allow the debt to climb faster than GDP. That's how House Republican leaders have rationalized their plan to radically restructure Medicare by converting it to a premium support, or voucher, system and raising its eligibility age.[6]

Programs for low- and moderate-income households will also remain a prime target of budget cuts, as they have been in recent congressional Republican budget plans, if revenues are inadequate. For example, the budget plan that the House Budget Committee approved in March 2016 would have secured 62 percent of its cuts from low-income programs such as SNAP (food stamps) and

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[4] Chuck Marr and Chye-Ching Huang, *House GOP "A Better Way" Tax Cuts Would Overwhelmingly Benefit Top 1 Percent While Sharply Expanding Deficits*, CBPP, September 16, 2016, http://www.cbpp.org/research/federal-tax/house-gop-a-better-way-tax-cuts-would-overwhelmingly-benefit-top-1-percent.

[5] Robert Greenstein and Joel Friedman, *Balancing the Budget in Ten Years and No New Revenue Are Flawed Budget Goals*, CBPP, March 9, 2016, http://www.cbpp.org/research/federal-budget/balancing-the-budget-in-ten-years-and-no-new-revenue-are-flawed-budget-goals.

[6] Paul N. Van de Water, *House Republican Health Plan Would Radically Restructure Medicare*, CBPP, July 26, 2016, http://www.cbpp.org/blog/house-republican-health-plan-would-radically-restructure-medicare.

Pell Grants, slashing them by two-fifths overall, while achieving no deficit reduction whatsoever from curbing tax expenditures.[7]

To minimize threats to Social Security, Medicare, and low-income programs, restore some of the recent cuts in defense and non-defense discretionary spending, and leave room for needed initiatives, any tax reform effort should *raise* revenue.

At the Very Least, Tax Reform Should Be Revenue-Neutral

Because increasing taxes is always a challenge and is anathema to some policymakers, enacting tax reform legislation that raises revenue is likely to be difficult in the current political environment. But at the very least, tax reform should be revenue-neutral — that is, it shouldn't lose revenues.

Several congressional leaders — notably House Speaker Paul Ryan, House Ways and Means Chairman Kevin Brady, and Senate Majority Leader Mitch McConnell — have said that tax reform should be revenue-neutral.[8] That means that any tax reductions should be offset by tax increases, not by budget cuts. (Tax reductions that are offset by budget cuts would be deficit-neutral but not revenue-neutral.) To be sure, savings can be secured from some federal programs. But those savings should be used to finance needed initiatives and contribute to long-term deficit reduction, not to make tax cuts larger. The public should hold Republican leaders to their promise.

In achieving the goal of revenue-neutrality, legislators should use honest estimates of the impact of tax reform. First, Congress should resist the temptation to use budget gimmicks, such as timing shifts that increase revenues in the short run but reduce them in the long run. Second, Congress should use traditional budget estimates, from its Joint Committee on Taxation, that do not attempt to quantify the possible effects of tax changes on the overall size of the economy.

Although some tax reform proposals would indeed increase economic efficiency and output, estimates of the macroeconomic effects of policy changes are highly uncertain. Economists differ substantially on the size of macroeconomic feedbacks from reducing marginal income tax rates or other tax changes. And when tax cuts are deficit financed, estimates of their economic effects vary greatly depending on assumptions about how they will ultimately be paid for — assumptions that are inherently speculative and outside the scope of the legislation being evaluated.[9] Using traditional budget estimates that don't attempt to incorporate uncertain estimates of macroeconomic feedbacks represents the more prudent, conservative approach. That is especially true given that policymakers will always find it easier to cut taxes in response to an unanticipated revenue windfall than to raise taxes in response to unanticipated losses, such as those that will occur if Congress counts on substantial economic gains that do not materialize.

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[7] Richard Kogan and Isaac Shapiro, *House GOP Budget Gets 62 Percent of Budget Cuts from Low- and Moderate-Income Programs*, CBPP, March 28, 2016, http://www.cbpp.org/research/federal-budget/house-gop-budget-gets-62-percent-of-budget-cuts-from-low-and-moderate-income.

[8] Naomi Jagoda, "Brady makes the case for revenue-neutral tax reform," *The Hill*, January 25, 2017, http://thehill.com/policy/finance/316045-brady-makes-the-case-for-revenue-neutral-tax-reform.

[9] Paul N. Van de Water and Chye-Ching Huang, *Budget and Tax Plans Should Not Rely on "Dynamic Scoring,"* CBPP, November 17, 2014, http://www.cbpp.org/research/budget-and-tax-plans-should-not-rely-on-dynamic-scoring.

As Congress considers tax reform legislation, assuring adequate revenues should be a primary consideration. In light of the budgetary pressures created principally by the aging of the population and rising health care costs, tax reform ought to raise additional revenues and contribute to reducing projected federal deficits and debt. At an absolute minimum, policymakers should draw a bright line and insist that tax reform at least be revenue-neutral, both in its first decade and beyond.