THE FALSE CHARGE OF A $5 TRILLION "TAX CUT" IN THE HOUSE REPUBLICAN BUDGET

"You can go on their website, look at Congressman Ryan's budget. The centerpiece of Governor Romney's entire economic plan is a new $5 trillion tax cut, a lot of it going to folks like me, a lot of it going to the wealthiest Americans." – President Barack Obama, August 18, 2012, Rochester, NH.

Key Points

- The House Republican budget proposed revenue neutral tax reform. It did not propose a net tax cut and characterizing the House Republican budget as including a large tax cut is a clear distortion.

- There is broad bipartisan support for enacting tax reform that removes distortions and lowers rates.

- Only by isolating the rate reductions assumed in the House Republican budget can one characterize the House Republican budget as cutting taxes, but if this approach is taken then any significant effort to reform the tax code will include large "tax cuts."

- The Bowles-Simpson, Rivlin-Domenici, and Senate Gang of Six plans all proposed tax reform that would lower rates and assumed that they would reduce tax credits by an amount necessary to cover the revenue loss of the rate reductions plus increase revenues by as much as $2.3 trillion over a decade. If the same methodology to calculate the tax cuts in the House Republican budget is applied to these bipartisan plans, then they include tax cuts of between $3.4 and $4.4 trillion.

- Despite President Obama's call for tax reform, his own budget includes nearly 100 proposed changes to the tax code, layering in more complexity and distortions to an already byzantine tax system.

Since House Republicans put forth a comprehensive tax reform plan in their budget resolution this past spring, the President and others have attacked the budget as cutting taxes by up to $5 trillion. An analysis by the Tax Policy Center (TPC) in March, for instance, claimed that the tax plan would cause a $4.64 trillion revenue loss over the next decade.[1] This figure, which has been repeated in various political forums and in the press as if it were a formal "score" of a detailed tax package, is misleading and the methodology upon which it rests is fundamentally flawed. The key to understanding this flaw is to recognize that nearly all tax reform plans involve a two-step process: broaden the tax base by curbing or eliminating the labyrinth of special deductions and loopholes that litter the code in order to lower tax rates across the board. The latter, in isolation, reduces revenue, while the former raises revenue.

The goal of any significant tax reform package is to do these two steps *in tandem* so that, at the very least, the net incoming revenue amount to the government is not altered in a significant way (i.e. the tax package is intended to be revenue neutral). The problem with the TPC analysis is that it only looks at the revenue loss associated with lowering tax rates and does not consider the base-broadening measures that would necessarily offset that revenue shortfall. In other words, it only looks at one side of the tax reform ledger and therefore presents a skewed view of the overall revenue impact of a fully-formed tax reform package. If other tax reform plans, like the one proposed by the Bowles-Simpson Commission, were viewed through the same narrow lens, they too would result in a revenue shortfall of a similar order of magnitude.

Before examining those magnitudes, it is useful to clarify the intended revenue effect of the House Republican tax reform plan within the context of the budget resolution and the revenue levels it sets.

Baselines, Revenue and Tax Policy

The House budget resolution established a binding revenue line that is consistent with a so-called "current policy" baseline. That current policy revenue baseline assumes that the tax policies in place today – *all* the 2001/03 tax relief provisions, the AMT patch, current estate tax parameters, etc. – are extended over the 10-year budget window. A "current law" revenue baseline, in contrast, assumes that all 2001/03 tax provisions expire and the AMT is allowed to ensnare millions of more middle class Americans, which would result in a tax hike of roughly $4.5 trillion over 10 years.[2]

The current policy revenue baseline in the House budget resolution is therefore one plausible scenario for how policymakers might choose to avoid the large tax increase implicit in current law and keep the overall tax burden on the economy in line with the U.S. historical average. It is similar in spirit to OMB's "adjusted policy" baseline and CBO's "alternative fiscal scenario" baseline, both of which assume that all 2001/03 tax provisions are extended and the AMT is fully patched. It is important to point out that the current policy baseline does not result in a

[1] TPC Analysis

[2] Both the Obama Administration and the House Budget Committee make similar assumptions with respect to developing an "adjusted" or "current policy" baseline. Table S-9 in the President's budget adjusts the baseline to assume the extension of 2001 and 2003 tax relief, relief from the AMT, and extension of current estate tax provisions. By using this adjusted baseline, the President can show his proposals to sunset tax relief for higher income individuals as a revenue increase that reduces the deficit. The House Budget Committee makes similar adjustments to revenues to develop a current policy baseline and shows comparisons of the President's budget and the House Republican budget to a current policy and current law baseline (See table 1 for the adjustments).

loss of revenue over the next decade. According to this baseline, revenues continue to rise each year and end the 10-year budget window *above* their long term average of 18 percent of GDP.

Within the confines of this baseline, the Ways and Means Committee is charged with writing the actual tax reform legislation. In other words, the budget resolution simply sets the overall revenue hurdle (the budget resolution is not a tax bill) and the Ways and Means Committee establishes the tax policy to clear that hurdle. If that hurdle were not met, the legislation would be in violation of the budget rules. This means that tax reform legislation must broaden the tax base and lower tax rates in a manner than will be revenue neutral with respect to a current policy baseline. The tax reform plan in the budget resolution is not intended to lead to a tax increase, or a revenue loss, relative to that baseline. By way of contrast, the President's budget represents a $2 trillion tax increase over the next decade relative to the current policy or the OMB adjusted baseline.

There is no shortage of tax credits, deductions, exclusions, and other preferences in the code. According to OMB, these distortions amount to $1.1 trillion annually. The largest beneficiaries from these tax preferences are high income taxpayers. For instance, the top 1 percent of taxpayers reap about 3 times as much benefit from special tax credits and deductions (excluding refundable credits) than the middle class and 13 times as much benefit than the lowest income quintile. In recent years, the sum of tax expenditures in the code has actually exceeded the amount of revenue collected through the individual income tax.

These special tax preferences make the tax code notoriously complex. In fact, individuals, families and employers spend over six billion hours a year trying to negotiate a labyrinth of special rules, deductions and tax schedules. The National Taxpayer Advocate at the IRS calls the complexity of the tax code the most serious problem facing taxpayers and says that the only meaningful solution is a drastic simplification. The IRS estimates that it takes the average person about 23 hours to prepare a tax return. The code is so complex that 60 percent of Americans have to use paid tax preparers to complete their forms correctly. Another 20 percent rely on tax preparation software, such as Turbo Tax, to complete their forms. The total cost of complying with the individual and corporate income tax (gathering the requisite information, preparing the forms, etc.) amounts to nearly $200 billion per year. If tax compliance were an actual industry engaged in productive economic activity, instead of a metric of wasted time, energy and money, it would be one of the largest in the U.S.

Tax Reform and Revenue

According to the TPC, the tax plan highlighted in the budget resolution would lead to a revenue shortfall of $4.6 trillion relative to a current policy baseline. This represents a one-sided revenue loss because the analysis counts the revenue shortfall from tax rate reductions and AMT repeal, but does not consider *any* revenue offset from base broadening because these base broadening elements were not detailed in the budget resolution. As mentioned earlier, the budget resolution is not a tax bill. It is up to the Ways and Means Committee to decide the manner and magnitude of base broadening as it writes detailed, scorable tax reform legislation. But implicit in the budget resolution is the fact that this tax reform legislation is intended to be revenue neutral relative to a current policy baseline. The TPC analysis is misleading because it mistakes the lack of detail on base broadening in the budget resolution for a conscious policy choice to lower rates *without* broadening the tax base.

One-Sided Revenue Loss* in Various Tax Reform Proposals in Trillions	10-year Total
House Republican Budget **	-$4.641
Bowles-Simpson Commission	-$3.358 to -$4.355
Rivlin-Domenici	-$3.590
Gang of Six	-$3.942

* Assumes no revenue gain from tax base broadening to offset loss from rate reductions and AMT repeal.
** Tax Policy Center estimate.

If such a one-sided revenue score were applied to other recent tax reform plans that are similar in spirit, if not in substance, to the tax reform plan offered in the House budget, they too would show trillions in revenue losses over the next decade. For instance, the Bowles-Simpson Commission put forth four templates for tax reform that broadened the tax base and lowered tax rates to varying degrees. If these templates were charged for lowering the individual and corporate tax rates and eliminating the AMT but not given credit for any base broadening (as the TPC does for the House tax plan), the Bowles-Simpson Commission's tax plan would show a revenue loss of between $3.4 and $4.4 trillion over the next decade.[3] Likewise, the tax plans offered by Alice Rivlin and Senator Pete Domenici and the so-called "Gang of Six"[4] in the Senate would lead to a 10-year revenue loss of $3.6 and $3.9 trillion, respectively.

These one-sided revenue losses do not tell the entire revenue story of each tax plan, however, as each claims it would *raise* substantial amounts of revenue. The Bowles-Simpson Commission says its plan would raise nearly $1 trillion in revenue over the next decade relative to one "plausible" variation of current policy. Rivlin-Domenici say they would raise $2.3 trillion while the Gang of Six claim their plan would raise $1.2 trillion over 10 years.

Advertised Revenue Gain* in Various Tax Reform Proposals in Billions	
Bowles-Simpson Commission	+$961
Rivlin-Domenici	+$2,300
Gang of Six	+$1,200

* According to each plan's source documents.

These claims rightly take into account the revenue gains from base-broadening that offset the revenue losses from rate reductions (along with other revenue-raising provisions included in the plans). According to the Rivlin-Domenici plan numbers, for instance, their

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[3] These figures were estimated in the following manner: TPC's estimate of the House budget tax plan was taken as the "base case." Each of the other plans were estimated as percentage deviations from this base case relative to the specifics of their tax rate structures. For instance, the Bowles-Simpson three-rate tax structure of 8/14/23% was estimated to raise roughly the same individual tax revenue than the House budget's two-rate structure of 10/25% but slightly more revenue on the corporate side given its slightly higher tax rate (26% vs. 25% in the House tax plan). In this manner, this one tax template in Bowles-Simpson was estimated to lose roughly $4.4 trillion over 10 years if it were analyzed by TPC.

[4] The Gang of Six proposed a three-rate structure with a range of tax rates (i.e. top rate between 23-29%). This estimate is of the midpoint of each range (i.e. a top rate of 26%).

base-broadening (restructuring of itemized deductions and elimination of most tax expenditutures) would raise over $3.5 trillion cumulatively by 2020, which more than makes up for the revenue reduction from lower rates and a repeal of the AMT. And, while Rivlin-Domenici described some of the tax expenditures they would target they did not identify exactly how they would reduce or eliminate tax expenditures.

The important point, however, is that the code is littered with distortions. Individual tax preferences alone now sum to $1.1 trillion annually, or $11 trillion over 10 years. Curbing or eliminating such tax preferences would provide substantial revenue amounts to fund the lowering of tax rates across the board. Any analysis of a tax reform package that does not take into account such revenue offsets is being purposefully misleading about the likely revenue impact of tax reform.

Bipartisan Support for Tax Reform

Tax reform enjoys broad and strong bipartisan support. In addition to the House Republican budget, Bowles-Simpson Commission, the Rivlin-Domenici, and the Senate Gang of Six, the President says he supports tax reform. Just this month, the President stated, "I want to reform the tax code so it's simple and fair." According to the White House, the President has called on Congress to enact comprehensive tax reform that would "lower tax rates," "cut inefficient and unfair tax breaks," and "cut the deficit by $1.5 trillion." And, Secretary Geithner has testified in favor of tax reform, stating, "The code should be simpler, combining lower tax rates for individuals and corporations with fewer loopholes and carve-outs—which will increase efficiency so that businesses compete based on the products and services they provide, not the tax breaks they are able to collect."[5]

If the President's proposal is to raise revenue by $1.5 trillion from tax reform and lower rates, then he must reduce tax deductions, credits, and other benefits by at least $1.5 trillion plus make additional reductions in order to offset the revenue loss from lowering tax rates. House Republicans have advanced fundamental tax reform in their last two budgets. Unfortunately, while the President and his Administration have provided no details on a tax reform plan, their budget includes proposals that add complexity to the tax code. For instance, the President's FY 2013 Budget includes nearly 100 proposals to change the tax code. Of these changes, roughly 5 provisions would *increase* marginal tax rates. Over 25 provisions add complexity to the tax code by giving tax breaks to favored industries or individuals and nearly 40 provisions seek to discourage certain activities or punish certain industries. In total, nearly 70 provisions aim to pick "winners or losers" through the tax code, while only a handful of provisions would eliminate the bundle of tax preferences that litter the code.[6]

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[5] In his remarks on September 27, 2012 the President spoke in favor of tax reform. The White House website lists the President's five principles for tax reform. Secretary Geithner testified to the House Budget Committee this year in favor of tax reform.

[6] These proposals are described in more detail in the Department of Treasury's Greenbook, an explanation of the President's FY 2013 revenue proposals: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

Examining the President's new tax proposals illustrate the complexity he would add to the code. For example, his budget proposes to "provide 30-percent basis 'boost' to properties that receive an allocation of tax-exempt bond volume cap and that consume that allocation." This proposal offers a more favorable formula for affordable-housing developers to calculate their tax credits for spending on their properties. Another proposal attempts to "encourage mixed income occupancy by allowing low-income housing tax credit (LIHTC)-supported projects to elect a criterion employing a restriction on average income." Irrespective of the policy intentions of such changes, the sheer volume, and complexity of the President's new tax proposals are symptomatic of a wildly complex tax code that has been used to micro-manage incentives and behavior and whose guidebook on regulations now comprises six full volumes and sums to nearly 12,000 pages. Instead of reforming the tax code to lower rates and eliminate distortions in the code, the President's budget would raise tax rates and add new elements of complexity.

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