Backgrounder

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# Why the Budget Deficit Should Not Stop Tax Reform: The Ensuing Struggle over "Neutrality"

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President George W. Bush recently announced that he will appoint a bipartisan advisory panel to recommend "revenue-neutral" tax reform options to the Department of the Treasury. The President's commitment to tax reform has many reform activists excited, but the inclusion of the term "revenue-neutral" in the agenda should give them pause. Revenue neutrality creates a significant political obstacle to fundamental tax reform and virtually guarantees future tax increases unless federal spending is brought under control.

The rationale behind fundamental tax reform is that the U.S. tax code overtaxes and unduly burdens citizens with high compliance costs and is filled with incentives that distort decisions and hurt economic growth. The revenue-neutral requirement precludes solving many of these problems because it is designed to collect the same amount of revenue that is currently collected. Since such neutrality is achieved by "offsetting" tax decreases for some by increasing taxes on others, it adds still more complexity to the tax code.

Furthermore, because revenue neutrality is inextricably tied to the federal deficit, the greater danger is that adhering to this principle will completely undermine fundamental tax reform in the long run. The impending shortfalls in Social Security and Medicare, which guarantee future federal deficits, are so large that these programs must be reformed apart from tax policy changes. The real cost of the federal deficit is too large to adhere to a "neutrality" require-

## Talking Points

- The difference between a *revenue*-neutral reform plan and a *deficit*-neutral plan is one of semantics. Either way, fundamental tax reform will be meaningless if constrained by "neutrality" because the focus will always remain on shrinking the deficit with tax increases.
- The long-term funding shortfalls in Social Security and Medicare are close to $72 trillion, and no amount of tax increases can close this budget gap. Only a simplified, pro-growth tax code, coupled with Social Security and Medicare systems that allow citizens to fund their own retirement and health care, can solve the true budget crisis that the U.S. government faces.
- The decision to implement fundamental tax reform has to be grounded in the idea that the highly complex U.S. tax code unduly burdens and overtaxes its citizens. The notion that citizens exist simply to fund the federal government is incompatible with fundamental tax reform.

This paper, in its entirety, can be found at: *www.heritage.org/research/taxes/bg1808.cfm*

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ment, and attempting to do so will merely nullify the long-run benefits of fundamental tax reform.

## Why Reform the Tax Code?

Americans now spend nearly $200 billion annually to comply with the 10,000-page federal income tax code. Some project that this cost could rise to $350 billion by 2007.[1] The complexity stems from the myriad of deductions and credits that "phase out" for taxpayers at various income levels, the special-interest and corporate welfare breaks, and the parallel tax system known as the alternative minimum tax, which is designed to tax those that benefit from "too many" deductions and credits. Aside from the outright complexity of the code—which inefficiently diverts money from private citizens to the government—the U.S. tax code punishes success and discourages saving and investment through multiple layers of taxation.

Federal marginal income tax rates are applied on a "progressive" scale: As individuals earn more money, they keep less of every dollar that they earn. Also, higher-income taxpayers cannot take advantage of many of the deductions and credits that lower-income taxpayers receive.

Because these deductions and credits have increased over the years, decreasing numbers of citizens pay any income taxes at all. The number of zero-tax filers has increased to almost 40 million, and those who are among the top 50 percent of all earners now pay 96 percent of total federal individual income taxes.[2] This credit-filled progressive rate structure, therefore, provides an incentive to earn less income and drastically reduces the number of citizens that pay income taxes.

One example of the multiple tax layers built into the code is the non-deductibility of payroll taxes. Workers pay a 7.65 percent payroll tax for Social Security and Medicare that is deducted from every paycheck they receive.[3] Nonetheless, the pre-payroll tax amount (gross wages) is used to calculate taxable income. Another multi-layer tax occurs when citizens save their after-tax income in regular savings accounts; all earnings on those funds are also taxed.

Similarly, when businesses distribute their after-tax profits through dividends and capital gains, shareholders pay individual income taxes on these funds. These punitive, multi-layered taxes divert private resources and provide disincentives to saving and investment. Consequently, the U.S. tax code retards economic growth and lessens opportunities for all citizens to improve their lives.

To correct these problems, the federal tax code needs a major overhaul. Requiring a reform plan to be revenue-neutral, however, is likely to create more of the problems that already exist in the tax code.

## Revenue Neutrality Amounts to Deficit Neutrality

The recently announced tax reform agenda does not explain the precise meaning of the term "revenue neutrality." In fact, the seemingly benign term is included only in the last sentence of the White House's September 2 press release:

> The Panel will be asked to present revenue-neutral reform options to the Secretary of the Treasury, at least one of which should be a reform of the current individual income tax system.[4]

1. See J. Scott Moody, "The Cost of Tax Compliance," Tax Foundation, February 2002, at *taxfoundation.org/compliance2002.html* (October 14, 2004).
2. As of 2001, the top 4 percent of earners pay 50 percent of total federal individual income taxes. See U.S. Department of the Treasury, "Individual Income Tax Returns: Table 3—Number of Returns, Adjusted Gross Income (AGI), and Total Income Tax, by Selected Percentiles: Tax Year 2001," September 26, 2003, at *www.irs.gov/pub/irs-soi/01in03ts.xls* (October 14, 2004), and Scott A. Hodge, "40 Million Filers Pay No Income Taxes, Many Get Generous Refunds," Tax Foundation, June 5, 2003, at *www.taxfoundation.org/ff/childcredit.html* (October 14, 2004).
3. This figure represents the percentage explicitly paid by non–self-employed workers. Of this 7.65 percent, 5.3 percent is for Social Security's retirement and survivors program, 0.9 percent is for Social Security's disability program, and 1.45 percent is for Medicare. Social Security taxes are collected on the first $84,900 that workers earn each year, and Medicare taxes are collected on all earned income.

In principle, a revenue-neutral reform plan is one that collects the same amount of revenue as the current tax code. This idea sounds simple enough, but there are practical problems with defining the term that jeopardize fundamental tax reform. Because the political pressure for revenue neutrality stems from concerns about increasing the federal deficit, these difficulties center around the federal budgeting process. In practice, a revenue-neutral plan *could* collect the same amount of revenue as the current-law baseline budget.

Using this approach to maintain neutrality ensures that recently passed tax cuts will be allowed to expire. As a result, income tax rates will climb back to Clinton-era levels; double taxation on dividends and capital gains will increase to pre-2003 levels; marriage penalty reductions will be reversed; and the death tax will not be abolished. Because rolling back these tax cuts runs counter to fundamental tax reform, an alternative approach would be desirable.

An obvious alternative is to use a baseline budget that includes the renewal of these expiring tax cuts. The drawback to this approach is that the plan would be projected to bring in less revenue than under current law, thereby leading to a larger federal budget deficit. This is a telling difference in the two approaches, though, because it is concern about the federal budget deficit—not simply federal revenue—that landed the term "revenue-neutrality" in the reform agenda.

In fact, Congress's preoccupation with the deficit is the main reason that recent tax cuts are set to expire. The projected federal deficits were used by both Democrats and Republicans to justify attaching "sunset" provisions to tax cuts passed in both 2001 and 2003, with various cuts set to expire between 2005 and 2012.

Based on this record, it is more accurate to say that *deficit* neutrality rather than *revenue* neutrality poses a threat to tax reform. Interestingly, the deficit projections that Congress used to justify these sunset provisions grossly understated the true size of the federal deficit.

## Faulty Accounting and the $422 Billion Deficit Chimera

The annual congressional budgeting process ignores the long-term funding shortfalls in Social Security and Medicare and focuses only on near-term cash-flow projections. The problem is that these long-term obligations swamp those that are reported in the budget. During the recent corporate scandals, Congress reacted harshly when private-sector companies omitted relevant information from their financial statements. The irony here is that if the private sector adhered to the same accounting standards used in congressional budgeting, there might have been no corporate scandals.

According to recent projections by the Congressional Budget Office (CBO), the federal budget deficit for 2004 will be $422 billion and the cumulative 10-year deficit will be $2.4 trillion.[5] These estimates are calculated by looking only at the federal government's projected cash flows (i.e., the revenue going into the Treasury versus the revenue going out).

As large as these figures may be, however, the cash-flow accounting method used by Congress ignores the majority of the U.S. government's unfunded obligations. When the future payouts "dedicated" to Social Security and Medicare recipients are considered, the federal deficit is almost $75 trillion.

The recent Trustees Reports for Social Security and Medicare show that these programs have a long-term revenue shortfall of $10.4 trillion and $61.6 trillion, respectively, for a combined deficit of $72 trillion.[6] These figures are in present-value terms (i.e., the amount of money it would require today to fully fund these future obliga-

4. The White House, "President Bush Provides Leadership on Tax Reform," press release, September 2, 2004, at *www.whitehouse.gov/news/releases/2004/09/20040902-7.html* (September 7, 2004).

5. See Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2004, Summary Table 1, at *www.cbo.gov/showdoc.cfm?index=5773&sequence=0* (October 14, 2004).

tions).[7] The real unfunded obligation of the U.S. government is a staggering sum that hardly compares to the $2.4 trillion cash flow deficit reported by the CBO.

To put the cumulative $72 trillion figure in perspective, in 2003, U.S. gross domestic product (GDP) was $10.8 trillion, and total outstanding U.S. public and private debt (not including the unfunded Social Security and Medicare obligations) was $22 trillion. That same year, the U.S. government collected a total of $1.8 trillion in revenue.

In other words, the true cost of the federal deficit is *40 times* the amount the government collected in revenue. The truth is that no amount of tax increases can close this budget gap: The government has simply promised more than it can deliver.

Using these same debt-to-income ratios, a family earning $60,000 per year could buy a home worth almost $2.5 million. Not many banks would jump at the chance to make that loan.

One problem for U.S. taxpayers is that the cash-flow deficits in Social Security and Medicare do not really explode until a few years after the baby boomers have retired (around 2018); therefore, the problem seems to be one that will not have to be confronted until far in the future.[8] However, it is not going away, and focusing on the annual cash-flow deficit does not change the fact that the true cost of the deficit is $72 trillion. Still, it is more likely that the short-term cash-flow deficits will be used to undermine fundamental tax reform.

## The Bleak Outlook for Fundamental Tax Reform

If history is any guide, "moderate" Members of Congress will use the cash-flow deficits to weaken fundamental tax reform. For instance, a group of Senators successfully used deficit fears to scale back the 2001 and 2003 tax cuts when they were originally introduced in Congress. This record, and the stance that several Senators are now taking on extending certain provisions of these tax cuts, foreshadow the danger to fundamental tax reform.

Early this year, for example, Senator Olympia Snowe (R–ME) directed her staff to "revisit so-called 'trigger' proposals that would offset tax cuts if the current large deficits in the federal budget fail to recede."[9] These aptly named trigger proposals would offset tax cuts for some taxpayers with tax increases on others. Senator George Voinovich (R–OH) refused to back President Bush's 2003 tax cuts if they exceeded a cash-flow "cost" of $350 billion, and he is on record as saying that the time to extend the tax cuts is "not ripe yet."[10]

As the annual cash-flow deficits from Social Security and Medicare grow, there is little doubt that the easy political solution will be to raise taxes. Yet before too long, these cash-flow deficits will be so large as to render that solution—and fundamental tax reform—pointless.

The only way to have meaningful tax reform is to recognize that the true costs of our federal budget deficit cannot be "offset" with tax increases because Social Security and Medicare are structurally unsustainable. Unless Congress fixes these programs apart from overhauling the tax code, a

6. See Andrew J. Rettenmaier and Thomas R. Saving, Ph.D., "The 2004 Medicare and Social Security Trustees Reports," National Center for Policy Analysis, *NCPA Study* No. 266, June 4, 2004, at *www.ncpa.org/pub/st/st266/* (October 14, 2004).

7. These present-value figures cover the complete life of Social Security and Medicare and represent the most inclusive measure of liabilities for these programs. However, even looking at only the next 75 years, the unfunded liabilities would amount to $33.2 trillion—a staggering sum in its own right.

8. The surplus Social Security and Medicare revenues are not actually kept in a trust fund for later use. All surplus funds are transferred to the Treasury and used for general expenditures. Despite the fact that Social Security will require transfers from the general budget beginning in 2018, the Trust Fund exhaustion date is projected to be 2042.

9. See Geoff Earle, "Tax Fight Simmers: A Centrist Attack on President's Cuts Is ' Not Ripe Yet,'" *The Hill*, February 18, 2004, at *www.hillnews.com/news/021804/taxfight.aspx* (September 13, 2004).

10. *Ibid.*

"revenue-neutral" tax reform plan will not produce the long-run economic benefits of a simplified, pro-growth tax code.

## Seven Ways to Define "Neutrality"

Taken literally, a "revenue-neutral" reform plan is one that collects at least as much revenue as the current tax code. In practice, however, there is no difference between *revenue* neutrality and *deficit* neutrality because political concerns about the budget deficit are the underlying reason for requiring reform options to be revenue-neutral. In any event, the concept defies a simple, enforceable guideline that is compatible with fundamental tax reform.

The following is a list of seven "neutral" options, all of which focus *only* on the federal government's cash-flow deficit.[11]

- **Increase some personal tax cuts with "offsets" on other taxpayers.** Congress frequently tries to maintain some sort of neutrality by offsetting tax cuts for one group of citizens with tax increases for some other group. A favorite of some politicians is to increase taxes on "the rich" to give tax cuts to the "middle class." The very notion of offsetting tax cuts for some with tax increases on others is counter to fundamental tax reform, which is based on the principle of taxing a broad base of the population at one low rate.
- **Increase personal tax cuts with corporate tax "offsets."** One goal of tax reform is to rid the tax code of special-interest–driven subsidies and deductions, especially on the corporate side. This goal should not be subverted, however, to maintain "neutrality" by raising corporate taxes and lowering personal taxes. Corporations are merely legal entities, and individuals ultimately bear the burden of all corporate taxes, either through higher prices or through lower incomes.
- **Maintain neutrality each fiscal year.** If a reform plan has the stated goal of maintaining a budget balance every fiscal year, tax rates will have to be adjusted each year (in every budget cycle). Given Congress's propensity to spend more every year, the budgeting process would have a built-in tax increase to close the annual budget gap.
- **Maintain neutrality for a 10-year budget window.** This plan would be no different from one that maintains a balance every fiscal year. Because Congress re-appropriates budgets every year, the 10-year budget window would simply be shifted forward each year. The same logic applies to any other budget-window term. At best, Congress might increase taxes every two or three years using an option that balances the budget over some extended time period. Regardless of the time frame, this plan would build tax increases into the budgeting process.
- **Remain budget-neutral under current law.** Many of the provisions of the 2001 and 2003 tax cuts expire during the next few years—some as early as 2005. If current law is used to project a baseline budget, previous reforms in dividend and capital gains taxes, as well as the elimination of the estate tax, will be reversed. Of course, these tax reforms reduced double taxation and improved incentives to save and invest, which are both key goals of fundamental tax reform.
- **Remain budget-neutral with the 2001 and 2003 tax cut extensions.** If the 2001 and 2003 tax cuts are extended and made "permanent," the baseline cash-flow deficit will be larger than the one that is currently projected. Congressional concerns about the projected cash-flow deficit are the very reason that these tax cuts were made temporary in the first place. This scenario only makes any reform plan that much more difficult to pass without offsetting tax increases in other areas, thus undermining the goals of fundamental tax reform.
- **Stabilize the deficit around an "optimal" percentage of tax revenue.** Congress could

11. Because congressional budgeting focuses on cash-flow deficits, revenue-neutral options that account for off-budget unfunded liabilities are not considered here. Including these liabilities would provide a more complex set of revenue-neutral options, all of which would further hinder successful tax reform.

try to maintain neutrality by keeping deficits within a certain range, perhaps as a percentage of total revenue (or even GDP). At first blush, this option might seem attractive. However, this approach is no different from any of the others because it keeps tax revenues tied to the deficit without providing any sort of check on federal spending. Because spending is guaranteed to rise faster than revenues at some point, deficits are sure to fall outside of the acceptable range. As a result, this approach would build automatic tax increases into the system, thereby weakening fundamental tax reform.

The problem with each of these approaches is that they tie tax reform to a hard-to-implement concept—budget neutrality—without addressing the spending side of the government ledger. The result is that any revenue-neutral reform plan will be meaningless in a few years because taxes will have to be increased to shrink budget deficits.

The decision to implement fundamental tax reform has to be grounded in the idea that the overly complex U.S. tax code unduly burdens and overtaxes its citizens. The notion that citizens exist simply to fund the federal government is incompatible with fundamental tax reform.

## Six Principles for Fundamental Tax Reform

Filling in the details of any tax reform plan will be difficult, in part because of the complexity of the tax code. However, if policymakers adhere to the following six principles, it will be easier for them to reach compromises on the details.

- **Neutrality will undo tax reform.** The difference between a *revenue*-neutral reform plan and a *deficit*-neutral plan is one of semantics. Either way, fundamental tax reform will be undermined if constrained by "neutrality" because the focus will remain on the budget deficit. Because Social Security and Medicare are unsustainable, the real cost of the federal deficit is so large that it is simply unmanageable. Unless these entitlement programs are reformed apart from fixing the tax code, the long-run benefits of fundamental tax reform will not be realized.
- **Progressive tax rates are punitive.** When all people are taxed at the same rate, people who earn more money pay more taxes. A progressive tax rate structure penalizes success by taking more of every dollar earned from those who move up the income scale, thereby creating a disincentive for individuals to improve their lives.
- **Corporations do not pay taxes.** Corporations are merely legal entities. They are run by people, and they sell goods and services to people. Whether through higher consumer prices or lower wages, people bear the burden of corporate taxes.
- **Not taxing capital is the same as taxing consumption.** People can only do two things with their money—spend it or save it. Taxing income only when it is earned, not when it is saved, effectively transforms the income tax into a consumption tax. Instituting a national sales tax without repealing the Sixteenth Amendment to the U.S. Constitution would ensure that we had both an income tax *and* a national sales tax, adding yet more complexity and double taxation to the tax code.
- **The tax code is too complicated.** The U.S. tax code contains more than 10,000 pages and is filled with special deductions, credits, subsidies, and phase-outs. Americans now spend nearly $200 billion annually simply to comply with the federal income tax code. Both directly and indirectly, the complexity of the code costs taxpayers too much money.
- **Social engineering is incompatible with tax reform.** It is counterproductive to tax members of society differently based on how they earn their income, how they spend their income, or the social choices that they make. These types of provisions in the tax code add complexity and result in unintended consequences. Ever since President Bush's tax cuts, the number of zero-tax filers has increased to almost 40 million, and those who are among the top 50 percent of all earners now pay 96 percent of all federal individual income taxes. If these trends continue, the tax base will be so

small that any reform plan will result in a substantial tax increase for most people.

## Conclusion

The U.S. tax code takes too much money away from Americans, punishes success, discourages saving and investment, distorts other economic behavior, and saddles Americans with overly burdensome compliance costs. For these reasons, the federal tax code needs a major overhaul.

Unfortunately, however, the current political environment calls for any reform option to be "revenue neutral"—a requirement that will undermine fundamental tax reform. The term *revenue*-neutral is simply a euphemism for *deficit*-neutral, and tying tax reform to shrinking the federal deficit ensures that there will be no meaningful reform unless spending is controlled.

The only reason that this "neutral" approach appears sensible is that the congressional budgeting process ignores the enormous unfunded future liabilities of Social Security and Medicare—estimated at $72 trillion. These programs are structurally unsustainable and need to be reformed apart from fixing the tax code.

Only a simplified, pro-growth tax code, coupled with Social Security and Medicare systems that allow citizens to fund their own retirement and health care, can solve the true budget crisis that the U.S. government faces. Attaching fundamental tax reform to impending budget deficits and failing to fix these entitlement programs would nullify the long-run benefits of tax reform.

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