

# BACKGROUND

No. 3041 | AUGUST 03, 2015

## New Generation of Tax Reform Offers Greater Potential for Growth

*Curtis S. Dubay*

### Abstract

*Tax reform is vital to restoring the economy and improving prosperity and opportunity for American families. A new generation of tax reform plans that improve the tax system while simultaneously cutting taxes can better spur the economy than traditional tax reform that was revenue neutral. The plan released earlier this year by Senators Mike Lee (R-UT) and Marco Rubio (R-FL) was the first of this new wave of plans. However, tax-cutting reform brings with it new challenges that traditional tax reform did not need to address. Foremost among them are raising a sufficient amount of revenue and the relative size of tax cuts for the various income groups. Both issues are easier to address if Congress fully adopts dynamic scoring for tax reform plans.*

Earlier this year, Senators Mike Lee (R-UT) and Marco Rubio (R-FL) released a tax reform plan.<sup>1</sup> Their plan would reduce tax rates, lessen double taxation, and eliminate many tax preferences that do not promote economic growth. These policies have traditionally been part of tax reform.

However, Lee-Rubio deviates from traditional tax reform in one important way: It would cut taxes substantially. In the past, tax reform has been revenue neutral, which means that it raises the same amount of revenue as the current system. It has also been distributionally neutral, which means the various income groups continue paying the same portion of the tax burden as they pay under the current system. Lee-Rubio has broken this mold, perhaps for good as other new tax reform plans have also shed revenue neutrality.<sup>2</sup>

### KEY POINTS

- A new generation of tax-cutting tax reform plans have recently been released, led by the plan from Senators Mike Lee (R-UT) and Marco Rubio (R-FL).
- Tax-cutting reform plans cut taxes, as their name suggests, whereas traditional tax reform was both revenue and distributionally neutral.
- Tax-cutting reform plans have greater potential for economic growth and, therefore, can better improve opportunity and prosperity for American families than traditional tax reform because a lower revenue target allows them to establish more pro-growth policies.
- Tax-cutting plans face challenges not posed by traditional tax reform. They need to address how they will meet certain revenue requirements and determine how they will shift the tax burden among various income groups.
- Both challenges can be overcome more easily if Congress fully adopts dynamic scoring.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3041>

**The Heritage Foundation**  
214 Massachusetts Avenue, NE  
Washington, DC 20002  
(202) 546-4400 | [heritage.org](http://heritage.org)

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Tax-cutting tax reform would increase tax reform's potential for fostering economic growth, but also bring with it new challenges that traditional tax reform would not need to address.

### **The Tax System Should Raise Necessary Revenue Efficiently**

At the federal level, taxes are necessary to raise money for Congress to fund “a limited government at the lowest level possible for constitutionally appropriate activities.”<sup>3</sup> A tax system should raise that revenue in the most economically efficient way possible. All taxes create economic distortions. Policymakers should aspire to create a system that minimizes the amount of distortions. The more economically inefficient a system is, the more it infringes on economic liberty by slowing the economy, job creation, and income growth.

Congress should create an efficient tax code that raises the revenue that it needs to carry out its constitutionally enumerated duties and then leave that system in place permanently. However, Congress constantly meddles with the code.

Congress should change the tax code only in specific circumstance, such as when tax revenue grows above its historical average as a share of the economy. Because tax receipts usually grow faster than the economy, this will happen during periods of prolonged economic expansion. When this happens, Congress should cut taxes.

This was the case after the latter part of the 1990s. In 2000, tax revenues reached a post-World War II high of 20 percent of the economy because of strong growth at the end of the previous decade.<sup>4</sup> As a result,

Congress cut taxes in 2001 and 2003. A desire to boost the ailing economy was another reason for the tax cuts.<sup>5</sup>

Currently, tax receipts are near their historical average, which is around 17.5 percent of gross domestic product (GDP).<sup>6</sup> In the coming years, revenues will grow above that average, barring an economic slowdown.<sup>7</sup> Therefore, a tax cut will likely be in order in the near future.

### **All taxes create economic distortions. Policymakers should aspire to create a system that minimizes the amount of distortions.**

It is vital that policymakers remember that spending is much too high and will grow continually higher in future years. This explosion of spending, not a lack of tax revenue, will drive deficits and debt accumulation to unsustainable levels. Congress should work to lower spending now, rather than look to extract more revenue from American taxpayers.

The historical average of revenue is the measure often used as a target for tax revenue because revenues tend to return to that level regardless of the makeup of the tax system. Through a combination of economic factors and political ones, revenues fall back to that level no matter how hard Washington tries to wring more revenue out of the system.

Lowering revenues below that level is feasible and desirable if Congress brings spending down to a

1. Curtis S. Dubay and David R. Burton, “The Lee-Rubio Tax Plan’s Business Reforms Are Tremendously Pro-Growth,” Heritage Foundation *Backgrounder* No. 3000, March 9, 2015, <http://www.heritage.org/research/reports/2015/03/the-leerubio-tax-plans-business-reforms-are-tremendously-pro-growth>.
2. See Andrew Lundeen and Michael Schuyler, “The Economic Effects of Rand Paul’s Tax Reform Plan,” Tax Foundation, June 18, 2015, <http://taxfoundation.org/blog/economic-effects-rand-paul-s-tax-reform-plan> (accessed July 9, 2015).
3. Curtis S. Dubay and David R. Burton, “A Tax Reform Primer for the 2016 Presidential Candidates,” Heritage Foundation *Backgrounder* No. 3009, April 7, 2015, <http://www.heritage.org/research/reports/2015/04/a-tax-reform-primer-for-the-2016-presidential-candidates>.
4. U.S. Office of Management and Budget, *Budget of the United States, Fiscal Year 2016: Historical Tables* (Washington, DC: U.S. Government Printing Office, 2015), Table 1.2, <https://www.whitehouse.gov/omb/budget/Historicals> (accessed June 3, 2014).
5. Curtis S. Dubay, “Setting the Record Straight: Clinton Tax Hikes Slowed Growth, Bush Tax Cuts Promoted Recovery,” Heritage Foundation *Backgrounder* No. 2601, September 6, 2011, <http://www.heritage.org/research/reports/2011/09/setting-the-tax-record-straight-clinton-hikes-slowed-growth-bush-cuts-promoted-recovery>.
6. The Heritage Foundation, “Higher Spending Drives America’s Deficit Crisis,” *2015 Federal Budget in Pictures*, 2015, <http://www.heritage.org/federalbudget/americas-deficit-federal-spending>.
7. Congressional Budget Office, “Updated Budget Projections: 2015 to 2025,” March 2015, <http://www.cbo.gov/sites/default/files/cbofiles/attachments/49973-UpdatedBudgetProjections.pdf> (accessed July 9, 2015).

more reasonable level. If Congress did that, it could lower tax revenue below the historical average without causing deficits and debt to spike. Those who want to lower taxes can simultaneously be for lower deficits and less debt.

## Economic Growth

In addition to cutting taxes when revenues grow too high, Congress should change the code when it has become inefficient and a major impediment to economic growth. In such a state, tax reform is necessary to undo the ongoing damage. Such is the case with the current dilapidated system; hence the strong desire of many policymakers to fix it.

Tax reform is vital to restore economic growth because the current code is an immense weight on the economy, holding it back from reaching its potential. The tax code is a drag on the economy because it levies high tax rates on productive activities, such as working, saving, investing, and taking risk; taxes investment multiple times at high rates; and picks winners and losers instead of allowing solely market forces to dictate outcomes. All of these factors depress wages and opportunities for American families.

The central purpose of tax reform is to alleviate this harm by restoring economic growth, increasing wages, and expanding opportunity. It does this by lowering marginal tax rates on families, businesses, investors, and entrepreneurs to increase their incentives for engaging in productive activities. It also establishes a correct tax base that does not tax savings and investment multiple times (known as a consumption tax base) and does not pick winners and losers.<sup>8</sup>

## Traditional Tax Reform

Traditionally, tax reform has sought to accomplish these objectives while remaining both revenue and distributionally neutral. Recent prominent examples include the tax plan from the 2012

presidential campaign of Governor Mitt Romney (R-MA)<sup>9</sup> and the plan released by former Chairman of the House Ways and Means Committee Dave Camp (R-MI) in 2014.<sup>10</sup> These plans should not be called tax cuts because they do not lower revenue compared with the current system.

**Revenue Neutrality.** Revenue neutrality means that the new tax system raises the same amount of revenue as the current system over the traditional 10-year budget window. Tax reform can be revenue neutral while lowering tax rates because setting a proper consumption tax base would expand the base compared with the current hybrid income-consumption base, which is full of unjustified credits, deductions, and exemptions.

Congress formerly used a static revenue estimate when evaluating changes to tax policy, but a static revenue estimate does not account for the macroeconomic changes that would result from an improved tax system. It therefore underestimates the amount of revenue that a pro-growth tax reform would raise.

A dynamic score, which accounts for macroeconomic effects, would estimate higher revenues than the static score would. Congress could make tax reform more pro-growth if it uses a dynamic score because it could make more pro-growth improvements to the code and still achieve revenue neutrality.

Congress, working with the revenue estimators at the Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO), has recently taken important strides toward dynamic scoring. For instance, the budget resolution passed by the House and Senate this year called for the JCT and the CBO to dynamically score legislation that would substantially affect the economy.<sup>11</sup> The House will use the dynamic score as its official estimate of such legislation. It is unclear whether the Senate will do the same or use the dynamic score as an addendum to the static score.

**Distributional Neutrality.** Tax reform that keeps the current tax distribution in place is referred

8. Dubai and Burton, "A Tax Reform Primer for the 2016 Presidential Candidates."

9. Curtis S. Dubai, "Tax Policy Center's Skewed Analysis of Governor Romney's Tax Plan," Heritage Foundation *Backgrounder* No. 2735, September 25, 2012, <http://www.heritage.org/research/reports/2012/09/tax-policy-centers-skewed-analysis-of-governor-romneys-tax-plan>.

10. Curtis S. Dubai and David R. Burton, "Chairman Camp's Tax Reform Plan Keeps Debate Alive Despite Flaws," Heritage Foundation *Backgrounder* No. 2890, March 14, 2014, <http://www.heritage.org/research/reports/2014/03/chairman-camps-tax-reform-plan-keeps-debate-alive-despite-flaws>.

11. Concurrent Resolution on the Budget for Fiscal Year 2016, S.Con.Res. 11, 114th Cong., 1st Sess., § 3112, <http://www.gpo.gov/fdsys/pkg/BILLS-114sconres11enr/pdf/BILLS-114sconres11enr.pdf> (accessed June 2, 2015).

to as distributionally neutral. This means that the various income categories generally pay the same amount of tax as they do under the current system. For instance, the middle 40 percent of taxpayers pay 27 percent of the total federal tax burden under the current system.<sup>12</sup> In a distributionally neutral tax reform plan, they would continue paying approximately the same amount.

Distributional neutrality should be judged by the *entire federal tax burden*, not just the federal income tax. The income tax is the most prominent federal tax, accounting for more than 46 percent of the federal tax burden using 2014 data. The other 54 percent of revenue comes mostly from the payroll tax (34 percent) and the corporate income tax (11 percent).<sup>13</sup> Their distribution is equally as important as that of the income tax when assessing distributional neutrality since the American people bear those burdens the same as they bear the income tax, and tax reform would likely change them as well.

A tax reform plan, including a flat tax, can retain all the features of a pro-growth plan (lower rates and consumption base) and still remain distributionally neutral. For instance, The Heritage Foundation's New Flat Tax is distributionally neutral.<sup>14</sup>

### Lee–Rubio More Pro-Growth by Combining Reforms and Tax Cuts

Tax reform and tax cuts have usually been distinct policies, but they can be combined, as in the Lee–Rubio plan. On the individual side, the Lee–Rubio plan reduces the top marginal tax rate to 35 percent, reduces the number of rates to two, eliminates the double taxation of business income, and increases the Child Tax Credit from \$1,000 to \$3,500 per child. For businesses, the plan lowers the rate to 25

percent, allows full expensing, and institutes a territorial system. The business reforms would be tremendously pro-growth.<sup>15</sup> The plan also expands the tax base to make it closer to a consumption base by eliminating many deductions, credits, and exemptions for families and businesses.

These are the traditional tax reform policies in the Lee–Rubio plan. Unlike traditional tax reform, it is not revenue neutral because it cuts taxes. According to the Tax Foundation, the plan reduces revenue over its first 10 years (the standard budget window used by Congress) by approximately \$1.7 trillion on a dynamic basis. On a static basis, it cuts taxes by \$5 trillion.<sup>16</sup>

The combination of the pro-growth policies—such as lower marginal tax rates for families, the elimination of double taxation of business income, and the business tax reforms—with a large tax cut amplify the plan's growth effects. A tax-cutting tax reform plan can achieve more growth because it can institute more pro-growth policies, such as lower rates, than a revenue-neutral plan because it has to raise less revenue. For instance, The Lee–Rubio plan is significantly more pro-growth than the Camp tax reform proposal.<sup>17</sup>

If it were more like traditional reform, Lee–Rubio would have reduced tax rates less or reduced the size of other growth-promoting policies that reduce revenue, so the plan raised as much revenue as the current system, thus reducing its growth effects.

Tax-cutting tax reform would also have greater potential to make more Americans better off. Traditional tax reform, because it is revenue neutral, creates winners and losers. It mixes policies that reduce taxes with policies that raise taxes in other areas. A well-designed revenue-neutral plan should make

12. Curtis Dubay, "How Much Do the Top 1 Percent Pay of All Taxes," The Daily Signal, April 15, 2015, <http://dailysignal.com/2015/04/15/how-much-do-the-top-1-percent-pay-of-all-taxes/>.

13. U.S. Office of Management and Budget, *Budget of the United States: Historical Tables*, Table 2.1.

14. J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, <http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three>.

15. Dubay and Burton, "The Lee–Rubio Tax Plan's Business Reforms Are Tremendously Pro-Growth."

16. See Michael Schulyer and William McBride, "The Economic Effects of the Rubio–Lee Tax Reform Plan," Tax Foundation *Fiscal Fact* No. 457, March 9, 2015, <http://taxfoundation.org/article/economic-effects-rubio-lee-tax-reform-plan> (accessed June 4, 2015). The Tax Foundation estimate shows a yearly static revenue decrease of \$414 billion in 2015 dollars. Budget figures are usually in current year. Presenting them that way would show a larger revenue decrease.

17. For the growth effects of the Lee–Rubio plan, see Michael Schulyer and William McBride, "The Economic Effects of the Rubio–Lee Tax Reform Plan." For the growth effects of the Camp plan, see Rea Hederman, John Ligon, and Rachel Greszler, "Heritage's Macroeconomic Estimate of Camp's Tax Reform Proposal," The Daily Signal, February 26, 2014, <http://dailysignal.com/2014/02/26/heritages-macroeconomic-estimate-camps-tax-reform-proposal/>.

most taxpayers better off, especially under dynamic scoring. However, some taxpayers would likely pay lower taxes under the current system.

In contrast, a tax-cutting reform plan is more likely to avoid creating losers because it is not concerned with the revenue-neutrality constraint. Therefore, it does not need to institute policies that raise taxes to balance out the tax-reducing ones.

### The New Challenges of Tax-Cutting Tax Reform

Because traditional tax reform was revenue neutral, it did not need to deal with revenue reductions. Tax-cutting tax reform plans like Lee–Rubio do in some cases. Furthermore, tax-cutting reforms would likely shift the existing tax burden among income groups. Plans like Lee–Rubio will need to address concerns such as shifting raises.

**Revenue Challenge.** With increased scrutiny on deficits and debt in Washington, a tax reform plan that cuts taxes could be more difficult to pass than a revenue-neutral plan. Whether Congress uses static or dynamic scoring matters a great deal when determining the difficulty of enacting a tax-cutting tax reform plan.

If Congress fully agreed to use dynamic scoring and the JCT found similar growth and revenue effects as the Tax Foundation, the Lee–Rubio tax cut should be acceptable to Congress. The CBO estimates that revenues will be \$41.8 trillion over the next 10 years.<sup>18</sup> A \$1.7 trillion cut would reduce that to \$40.1 trillion, which would put revenues at roughly 17.5 percent of GDP.<sup>19</sup>

This would be a sizeable tax cut, but since revenues are on pace to exceed their historical average in the coming years under the current system, the Lee–Rubio tax cut would return them closer to their historical average. As explained earlier, when revenues rise above their historical norm, it is appropriate for Congress to cut them.

This would be the case if Congress continued to delay making necessary spending reductions. If it made the necessary changes to lower spending, it

could negate the necessity of maintaining revenues at their historical average. Then, the Lee–Rubio plan could be made even more pro-growth, for instance, by lowering rates even further.

### With increased scrutiny on deficits and debt in Washington, a tax reform plan that cuts taxes could be more difficult to pass than a revenue-neutral plan.

If Congress does not fully move to dynamic scoring, the \$5 trillion static tax cut would reduce revenues to just over 16 percent of GDP. A dynamic score would more accurately reflect the impact that tax reform has on the economy and revenues. However, if Congress insisted on using a less accurate static score and therefore felt the need to reduce the deficit impact of the plan, it could either reduce spending or increase the revenue raised by Lee–Rubio.

For instance, on the tax side it could increase the plan’s revenue by a combination of adding rates, eliminating the mortgage interest deduction entirely since the plan does not tax interest income to lenders,<sup>20</sup> or reducing the size of the generous child tax credit.<sup>21</sup> Congress has ample ways to cut spending.

**Distributional Challenge.** How much taxes on various income groups would be reduced is central to the debate when Congress cuts taxes. A tax cut that lowers taxes more for higher-income taxpayers than for middle-income and low-income earners would garner more scrutiny than one that does the reverse.

To measure how much taxes are cut for each income category, Congress and analysts will use the following metrics:

1. **Share of the total tax cut.** This measure looks at the total size of the tax cut and evaluates it based on the percentage of that cut each income group would receive.

18. Congressional Budget Office, “Updated Budget Projections: 2015 to 2025.”

19. Calculated using the GDP estimate from *ibid.*

20. Curtis S. Dubay, “The Proper Tax Treatment of Interest,” Heritage Foundation *Backgrounder* No. 2868, February 19, 2014, <http://www.heritage.org/research/reports/2014/02/the-proper-tax-treatment-of-interest>.

21. Curtis S. Dubay, “Congress Should Be Cautious About Expanding the Child Tax Credit,” Heritage Foundation *Issue Brief* No. 4241, June 26, 2014, <http://www.heritage.org/research/reports/2014/06/congress-should-be-cautious-about-expanding-the-child-tax-credit>.



- 2. Reduction of tax bill.** This evaluation looks at how much the average tax bill of the various income classifications would fall, either as a percentage of their tax bill or by dollar amount.
- 3. Tax cut as a percentage of income.** A third way to measure tax cuts is their size relative to an income group's earnings.
- 4. Share of total tax burden.** This metric looks at how much of each income group's tax burden would change as a percentage of the total federal tax bill.

Members of Congress and analysts will use these measures to make cases for and against the tax cut, using the metrics that best fit their positions. Each measure is valid, although they can give varying answers about which income group receives the most tax relief. Some may show that lower-income and middle-income taxpayers receive larger tax cuts, while others may show that higher-income taxpayers receive more relief.

The fourth measure of a tax cut—each income group's share of the total tax burden—will likely receive the most attention because it will determine how close a plan comes to being distributionally neutral. A tax plan that reduces the share paid by top earners, which would mathematically necessitate an increase for lower-income groups, would be called regressive (and likely unfair).

A tax reform plan that keeps the current distribution in place would likely receive less criticism. However, given the large number of Americans who pay no federal income tax, that distribution can be hard to maintain, depending on how a tax reform plan changes the income tax. Since those who have no federal income tax liability pay payroll and other federal taxes, it is imperative that a distributional analysis account for those taxes to determine accurately how much each income category pays in federal taxes.

### **Dynamic Scoring Impacts Distributions**

The important distinction between static and dynamic scores is as applicable to distributional issues as to revenue. For the share of the tax cut and

reduction of tax bill measures, dynamic scoring is unnecessary because the baseline is the current tax system.

A dynamic score is necessary for measuring how much taxes are reduced as a share of income because tax reform would increase incomes. Measuring the changes in taxes paid on static income would be inaccurate because it would overstate taxes paid by all taxpayers. This metric is particularly important because how much a tax-cutting tax reform plan raises each income group's after-tax income will be a major point of debate.

Dynamic scoring is also important for assessing changes in the share of the total tax burden because tax reform would fundamentally alter the tax code and prompt families and businesses to make different economic decisions, which would change how much the respective income groups pay in taxes.

Because of the policy changes and tax cuts in Lee-Rubio, it would likely shift the share of the tax burden paid by the various income classifications. As of now, how much it shifts the tax burden for each group is unclear. However, if Congress seeks to enact the plan or any tax-cutting tax reform plan, these measures will become an important part of the debate.

### **Conclusion**

Tax reform is vital to restoring economic prosperity and opportunity for American families. Traditionally, tax reform has been revenue neutral, but a new wave of plans, led by the Lee-Rubio plan, has recently dropped that constraint. Cutting taxes in tax reform can substantially boost tax reform's growth potential, but brings with it challenges that are easier to manage if Congress adopts dynamic scoring.

Policymakers who want to enact tax-cutting tax reform should work to make sure that the Senate fully adopts dynamic scoring as the House has already done. If Congress completely embraces dynamic scoring, the chances of achieving tax-cutting tax reform would improve substantially.

—*Curtis S. Dubay is Research Fellow in Tax and Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*