The Domenici-Rivlin Tax Reform Proposal

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ABSTRACT

The future health of the United States economy depends on adopting policies to prevent federal debt from rising faster than the economy can grow. Stabilizing the debt, in turn, depends on slowing the growth of federal spending, especially for health care, but will also require additional revenues. This imperative creates an opportunity to reform the tax system to make it more efficient and less of a drag on economic growth. The bipartisan Debt Reduction Task Force (Domenici-Rivlin) proposed a balanced set of policies for capping discretionary spending, controlling the growth of entitlement spending, and raising additional revenue from a reformed tax system. This paper describes the tax reform options considered by the Task Force and the economic and political reasoning that led to their proposals.[2]

If the looming debt crisis facing the United States has a silver lining, it is that the need to raise more revenues to stabilize the debt may finally provide the political impetus to reform the nation's complex and inefficient tax code. Tax reformers have argued for years that current tax laws distort economic activity, favor some groups over others, and impose huge compliance costs in time, money, and aggravation. The tax code could be simpler, fairer and more efficient. But politics almost always frustrates that goal. With rare exceptions (the Tax Reform of Act 1986), tax changes, often driven by narrowly focused interest groups, keep adding more loopholes and complexities, while the advocates of simplification, fairness and efficiency find little support. Now, however, the urgent need to raise more revenue while minimizing the drag on economic growth may provide the catalyst for drastically improving the tax system.

This paper discusses the tax reform proposals advocated by the Bipartisan Policy Center's Debt Reduction Task Force, which were part of a long-term plan to stabilize the growing debt and put the federal budget on a sustainable path. I had the privilege of co-chairing the Task Force with former Senator Pete Domenici (R-NM). Our colleagues on the Task Force were a diverse group of citizens with different ideologies, experience, and

[1] The author is indebted to John Soroushian for research assistance as well as to the wonderful staff of the Bipartisan Policy Center who made the Debt Reduction Task Force's work possible.
[2] Bipartisan Policy Center. 2010. *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*

points of view, supported by an able staff. We had lively debates about all aspects of our plan, especially the tax proposals, before we reached consensus. My hope is that this paper will give the reader a sense of how we thought about the tax problem, what options we considered, and why we made the choices we did.

The Challenge of Debt Stabilization

Deficits and public debt have been the center of controversy among macroeconomists for decades and the current debate is especially intense. Economists with sterling credentials disagree over whether or not the stimulus "worked" and whether additional deficit spending right now would accelerate or retard recovery. This dispute overlaps the ideological divide between those who think a large, intrusive government is stifling private sector initiative and those who think the government is not doing nearly enough to help individuals get ahead and invest in future growth.

But those ideological controversies are irrelevant to the clear thinking about the situation that the United States faces over the next decade and beyond. For the foreseeable future, if policies are not changed, federal spending will grow faster than the economy and faster than revenues at any set of tax rates. This trajectory cannot be sustained indefinitely. Any country whose public debt keeps rising faster than its GDP can grow will eventually be in trouble. The only question is, "When?" The United States enjoys a unique ability to live beyond its means. Because of the size of our economy, the dollar's position as a world currency, our past record of fiscal responsibility, and the lack of attractive alternative safe-havens, markets are likely to be slow in sending us warning signals. Moreover, we got used to not worrying about increasing indebtedness because our debt/GDP ratio was rather low by world standards or even our past history. We thought that, even if current policies were driving debt up faster than economic activity, we had plenty of time to fix those policies before the size of the debt became a problem. However, because of the deep recession and our policy responses to it, the U.S. debt/GDP ratio rose from 40 to 70 percent between 2008 and 2011 and is projected keep rising even as the economy recovers. Under the quite plausible assumptions of the Congressional Budget Office (CBO) alternative fiscal scenario—essentially the continuation of past political decisions to kick hard choices down the road—the federal debt will rise to about 100 percent of GDP by 2021 and 190 percent by 2035.[3]

One does not have to be a "deficit hawk" to see that the federal budget is on a risky and ultimately unsustainable path. Unlike more extreme and controversial goals—balancing the budget or paying off the debt—stabilizing the debt so that it is no longer growing faster than the economy is a common sense goal that ought to have broad appeal. The Debt Reduction Task Force took on the job of reaching consensus on a set of budgetary policies that would stabilize the debt at about 60 percent of GDP in ten years and then begin to bring it down. The exact percentage is less important than the concept of returning to a fiscal path on which debt grows more slowly than the economy over time.

[3] Congressional Budget Office. 2011. *CBO's 2011 Long-Term Budget Outlook (June)*

The rapid growth of projected spending is not driven by policies that grew out of the recession and attempts to mitigate it, but by the combination of demographics and rising health care costs. The retirement of the huge baby boom generation, which has already begun, plus increasing longevity will swell the ranks of Medicare, Medicaid, and Social Security beneficiaries. Rising per capita health costs multiplied by the tsunami of senior retirement will drive up spending for the health entitlements rapidly.

Congressional Budget Office estimates that total spending for the health entitlements and Social Security will grow from 10 percent of GDP in 2010 to 16 percent by 2035 on quite moderate assumptions about health care cost increases.[4]. The demographic assumptions behind these projections are not controversial, but there is a lot of uncertainty about the rate at which per capita health care spending will rise. Efforts to increase the efficiency of health care delivery are underway and should be aggressively pursued, but they will take time and are not certain to succeed. Given the speed at which medical knowledge is accumulating and effective medical interventions are becoming available, it is hard to believe that even dramatic increases in efficiency and reductions in waste will be able to keep health spending from rising faster than other spending, and the portion financed by the government from rising at least modestly faster than GDP for the foreseeable future.

Is there a plausible scenario for stabilizing the debt under which the combined impact of the demographic onslaught and rising health care spending on the federal budget can be absorbed without significantly increased revenues? The Debt Reduction Task Force came reluctantly to the conclusion that the answer was “no.” We developed proposals to slow the growth of health entitlements (including a controversial Medicare restructuring) and put Social Security on a sustainable fiscal path for the foreseeable future. We imposed severe restraints on both defense and domestic discretionary spending. We took credit for the debt service savings that would go with proposed cuts in spending and smaller deficits. But when we looked at the debt increase still projected even after serious (some thought risky) spending restraint, we realized more revenue would be needed to stabilize the debt.

The conclusion that revenues would have to rise as a percent of GDP was hard for the Republican members of the group to swallow, just as the entitlement and domestic spending cuts were hard for the Democratic members. But resistance to revenue increases was mitigated by the prospect of using the need for more revenues to forge a bipartisan consensus on tax reform. Similarly, the Simpson-Bowles Commission, on which I also served, coupled its spending reduction proposals with dramatic (albeit somewhat less detailed) proposals for overhauling the tax code.

One way to raise more revenues and move toward debt stabilization would be to take no legislative action at all—stick with the laws on the books as the year 2012 ends. In this case, the Bush-era tax cuts would lapse and the alternative minimum tax would throw increasing proportions of households into higher tax brackets. Federal revenues would rise to about 23 percent of GDP. Combined with current law extensions on the spending side (especially, no “doc fix”--not countermanding the legislated cuts in doctors’ fees),

[4] Ibid

this inaction would slow but not stop the rise in the ratio of debt to GDP.[5] But their prospect effectively illustrates the need for tax reform. Raising revenues by means of across the board tax rate hikes and increasing the reach of the poorly designed alternative minimum tax, while keeping all the tax expenditures of the current code, is surely undesirable. We can do better than that!

Tax Reform Options Considered

The Task Force had a wide-ranging discussion of tax reform options. Attention focused most heavily on the individual income tax because it is the largest source of federal revenue and notorious for its complexity and distorting effects. The individual income tax code is riddled with exclusions, deductions, and special provisions that favor certain kinds of income over others. Economists have argued for decades that treating different kind of income differently leads to over-investment in tax favored activities and under-investment in others. Excluding some kinds of compensation (such as health and retirement benefits) from taxable income encourages employees to choose more benefits over higher wages as a form of compensation. In particular, the exclusion of employer-paid health benefits from taxable income encourages employees to take their compensation in the form of generous health insurance, which may lead to the overuse of health care and help drive up health care spending. Tax-favored spending often furthers a worthy cause (such as making home-ownership more affordable), but does so less efficiently than a spending program with the same objective. It also frequently does so in ways that favor upper-income households. The mortgage interest deduction, for example, is of no benefit to low and moderate income homeowners who do not itemize, but gives proportionately larger benefits to homeowners in higher tax brackets, including owners of vacation homes. The Alternative Minimum Tax was designed to ensure that high income people paid at least a minimum amount of taxes despite special provisions from which they might benefit, but has now become an additional complexity that will throw increasing numbers of taxpayers into higher tax brackets if Congress does not continue to interdict its effects. Dealing with all these complexities is costly and aggravating for tax-payers and requires most of them to seek professional help to prepare their taxes.

The net effect of the special provisions, moreover, is to narrow the base of the income tax so that raising a given amount of revenue requires higher rates than would be necessary with a broader-based tax. Since higher marginal rates are thought to discourage work and investment, a tax system with a broader base and lower rates is likely to enhance economic growth. For all these reasons the Task Force proposed a drastic simplification of the individual income tax (described below) which eliminated most special provisions, converted a few of them to more progressive forms, and lowered rates.

The Task Force devoted less attention to the corporate income tax, which is a much smaller source of federal revenue, but adopted a similar approach—broaden the base and lower the rates. Special provisions, many of them favoring particular industries with political clout, have narrowed the base of the corporate income tax and greatly increased

[5] Ibid

its complexity. As a result, rates must be higher to raise the same amount of revenue as would have been raised without these provisions. Indeed, U.S. corporate income tax rates are among the highest in industrial countries. This arguably undermines the incentive of multi-national corporations to invest in the U.S. and encourages them to maximize opportunities to earn and report their income in lower tax countries. Hence, the Task Force recommended broadening the base of the corporate tax and lowering its rates. The top corporate rate was made equal to the top rate of the reformed individual income tax (27 percent) to reduce incentives of small businesses to make decisions about incorporation based on tax rate considerations.

In addition to reforming the income taxes, the Task Force opted for shifting part of the burden of federal taxation to a broad based consumption tax. It proposed a Debt Reduction Sales Tax (DRST) at a rate of 6.5 percent. The rationale was that household saving in the United States has declined over several decades while consumption rose, leaving U.S. investment heavily dependent on the inflow of foreign savings. The strong investment needed for future growth should be financed to a greater extent by domestic savings. Shifting the balance of federal taxation toward consumption would tend to encourage households to save rather than spend. The United States is in fact the only advanced nation that does not have a broad-based consumption tax at the national level, although most states and some localities tax sales at varying rates. The downside of consumption taxation has always been its regressivity, since lower income households consume more of their income than upper income ones do. However, comprehensive tax reform presents the opportunity of increasing the progressivity of the income tax enough to offset the regressivity of a consumption tax. In fact, the combined income and consumption tax reforms proposed by the Task Force resulted in a federal tax system that maintained approximately the same progressivity as the current federal tax system.

The Task Force was conscious of the political opposition to a value added tax (VAT). In fact the Senate had recently passed a resolution rejecting consideration of a VAT by an overwhelming, but purely symbolic, vote. Hence, we did not call the consumption tax a VAT, although we expected it to be collected in the manner of a VAT and rebated to exporters as is the practice in other countries. Instead, we called it a Debt Reduction Sales Tax.

The Task Force also had a vigorous discussion about various energy taxes. The objective of encouraging Americans to shift from fossil fuels to less polluting energy sources made a carbon tax attractive. The Task Force also discussed an increase in the federal gas tax, which has not been increased since 1993 and is far lower than gas taxes in other countries, but found the more comprehensive carbon tax a superior option. A carbon tax was favored by many, perhaps most, of the members, but the group felt that its recommendations would lose credibility if they included two major new taxes. Hence, we decided to choose between the carbon tax and the broad-based consumption tax (the DRST). The consumption tax won, largely because it would raise more revenue than could be raised from a carbon tax at what were thought to be feasible rates, and because the carbon tax revenues would be less predictable as a major source of revenue.

The only other tax included in the recommendation was a “soda tax” on sweetened drinks. This decision was not based on revenue needs, but was a nod to the possibility of discouraging obesity.

The Task Force was aware of many other options for tax reform, many with strong policy rationales to support them. We briefly discussed cap and trade as an alternative to carbon taxation; other “sin” taxes, such as raises the taxes on alcohol and tobacco; and a transaction tax to capture some of the high profits of financial trading and discourage trading excesses. We did not get into more technical proposals dear to the hearts of many economists, such as integrating the individual and corporate income taxes. The Task Force was creating a proposal that it hoped could secure political support and move toward enactment relatively promptly as part of a comprehensive debt stabilization plan, so it seemed best to stick with familiar tax concepts but offer two proposals that, taken together, would dramatically improve the efficiency and simplicity of the tax code and might command bipartisan support. Hence it emphasized two major proposals: Reform of the income taxes by broadening the base while lowering the rates and introducing a comprehensive consumption tax at the federal level.

<u>The Sizzle: The Burman-Minarik Proposal</u>

The centerpiece of the Task Force’s tax reform package was the proposal to reform the individual income tax drafted by two members of the Task Force, Joseph Minarik and Leonard Burman.[6] The proposal was an aggressive application of the basic tax reform rubric: simplify, broaden the base, and lower the rates. Its boldness appealed to members of the Task Force, one of whom remarked, “This proposal will give our report real sizzle,” so it became known as the sizzle proposal.

The proposed tax code would have only two tax brackets, 15 and 27 percent. It would eliminate most itemized deductions (including state and local taxes) and the standard deduction and radically restructure two others. The mortgage interest deduction would be eliminated in favor of a 15 percent refundable credit on home mortgage interest (principal residence only) up to $25,000. The tax payer would not have to apply for this credit; the lender would apply and pass the credit on to the taxpayer as a reduction in his mortgage interest bill. Similarly, all taxpayers would be eligible for a refundable 15 percent credit for charitable contributions. The taxpayer would not have to apply for this one either. The charity would get a 15 percent matching grant from the government which would enhance the taxpayer’s contribution. Handling these credits in this way would reduce the number of household required to file taxes and simplify the process of doing so.

The proposal also replaced the earned income tax credit and various provisions that benefit families with children with a simpler structure. There would be a universal child credit of $1,600 per child (indexed to the CPI) and a flat earnings credit on the first $20,300 of earnings. Both would be handled through withholdings and not require a special application or waiting until the end of the year to receive the benefit.

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[6] Task Force member Donald Marron also contributed his tax expertise, as did several consultants to the Task Force.

Under this new code a whole collection of tax expenditures would disappear, including a complex set of overlapping tax benefits for students. Some of these might be resurrected as student aid programs, since they are essentially spending programs now, but they do not belong in the tax code.

Other important changes include phasing out the exclusion of employer paid fringe benefits from taxable income. The big item here is health care benefits. The Task Force considered this change to be both a tax reform and a health care financing reform. The reform package also involved taxing capital gains and dividends as ordinary income, albeit at the new lower rates.

The proposal appealed to both conservatives and liberals on the Task Force. Conservatives liked the reduction of distortions and the lower marginal rates. Liberals liked the increased progressivity accomplished by eliminating and restructuring deductions and exclusions. The refundable home mortgage credit, for example, is far more progressive than the current deduction. And, course everyone liked the simplification.

Subsequent Modification—Political Reality Sets in

Late in 2010 when the Task Force released its report (the same week when the Simpson Bowles Commission released theirs), optimists hoped the President would devote his State of the Union address to major proposals for long-run deficit reduction along with shorter-term proposals for accelerating the recovery and creating jobs. He had created the Simpson Bowles Commission for the express purpose of having a bipartisan set of recommendations on the debt that could command support after the election. The Commission delivered, and the Domenici-Rivlin Task Force added another major example of a balanced bipartisan plan that included both entitlement and tax reform. The economy was still lagging and needed immediate efforts to increase demand and accelerate job creation, but such a package would have had far more credibility if combined with a strong long-run debt stabilization plan along the lines proposed by both bipartisan groups. But the President chose to stick to the jobs message and missed the opportunity to tie the goals of job creation and debt stabilization together.

After the bitter fight over the debt ceiling, however, another opportunity arose for serious debt action in the form of the Joint Select Committee (JSC). The JSC had extraordinary powers. It had the opportunity to go beyond its minimum mandate and produce bold proposals for reducing the growth of health entitlements and raising more revenue from a reformed tax code. It could even have mitigated its severe time constraints by doing its work in two stages. In other words, it had the power to stabilize the debt if it had the political will to use its powers. Many members of the House and Senate of both parties were urging them to seize this extraordinary opportunity. Simpson, Bowles, Domenici

and I testified together to urge the JSC to put together a deal in the range the $4-5 trillion in deficit reduction over ten years, which would be sufficient to stabilize the debt.[7].

The JSC worked extremely hard, examined multiple options and at times seemed within reach of a big deal. Success depended on Republicans being will to accept substantial revenue increases from a reformed tax code and Democrats being willing to accept structural reforms in entitlements, especially Medicare, that would slow the growth of health spending. In the end, however, the JSC totally failed and broke up in disarray. Prospects for tax and reform in the near term faded.

During this period of hope the Debt Reduction Task Force worked closely with many members and staff of the JSC. We decided to modify our tax reform proposals to eliminate the Debt Reduction Sales Tax, on the grounds that it had no visible political support, had not been proposed by Simpson Bowles, and would take several years to implement even it could be enacted. Taking out the DRST left our total package short of future revenue. Part of that shortfall was made up by restructuring the income tax proposal slightly and raising the top rates on both the individual and corporate taxes from 27 percent to 28 percent.

<u>Lessons Learned</u>

For one who believes that bipartisan compromise is necessary to solve big problems like stabilizing the debt, the experience of working with both the Domenic Rivlin Task Force on Debt Reduction and the Simpson Bowles Commission was exhilarating and heartening. It is possible to bring conservatives and liberals, Republicans and Democrats, together in a civil constructive discourse about how to stabilize the debt. It is possible to reach a consensus—even one that includes many currently serving legislators. But the contours of the consensus package have to include both additional revenues and slower growth of health entitlement spending. The arithmetic dictates this result.

The disappointing part is that, so far, we have not witnessed the political will and leadership courage to turn a bipartisan compromise into legislation. May 2012 bring better news!

[7] Rivlin, Alice, Pete V Domenici, 2011. "Testimony by Sen. Pete V. Domenici and Dr. Alice Rivlin; Co-Chair, Bipartisan Policy Center Debt Reduction Task Force to the Joint Select Committee on Deficit Reduction, U.S. Congress" *Join Select Committee on Deficit Reduction* (November 1)