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Tax Reform: Reducing Tax Rates and the Deficit October 15, 2012

There is a growing bipartisan consensus on the merits of enacting comprehensive tax reform that lowers tax rates and broadens the tax base – as was done in the 1986 tax reforms – while also reducing the deficit. Combining rate reduction with substantial cuts to tax preferences has the potential to not only help address our growing debt, but also to reduce economic distortions and promote robust economic growth.

Some commentators have used a recent experiment conducted by the Joint Committee on Taxation (JCT) to suggest that such tax reform is not possible since the experiment reduced the current law top rate from 39.6 percent down to only 38 percent. **That conclusion is false and most comparisons between the JCT experiment and existing comprehensive tax reform plans are highly misleading.** In this paper, we explain why:

- The experiment **raises \$4.5 trillion for deficit reduction** over a decade relative to current policy by assuming as a starting point that all the tax cuts from the last decade will expire. That is far more revenues than other plans, substantially reducing the savings available for rate reduction.
- The study only repeals itemized deductions and the interest exclusion for new state and local bonds, **leaving trillions of dollars in other tax expenditures untouched** -- including the largest tax expenditure in the code, the employer health insurance exclusion.
- The study taxes capital gains at 38 percent, which JCT estimates **would lose revenue** since investors will realize fewer gains.

In its experiment, JCT dedicates only **\$700 billion** for rate reduction, whereas actual tax reform could rely on far more revenues for rate reduction by repealing or reforming other tax expenditures and by using some of the \$4.5 trillion of net revenues to reduce rates. In any plan, the main priority of tax reform should be to help address our growing debt.

Though the JCT experiment is not comparable to bipartisan tax reform plans on the table, it does highlight the important and difficult trade-offs involved between tax expenditure reduction, rate reduction, and deficit reduction. Identifying enough revenue to reduce both deficits and rates will require bold thinking and tough choices.

Understanding the JCT Experiment

The JCT experiment begins with the premise that policymakers let all the 2001/2003/2010 tax cuts and Alternative Minimum Tax (AMT) patches expire as scheduled at the end of the year. That alone would raise about **\$4.5 trillion** in new revenues over the next ten years.

From that starting point, the experiment eliminates all itemized deductions and the preference for newly-issued state and local bonds, raising nearly \$2.6 trillion through 2022. However, the experiment *spends* most of that money on repealing the AMT, repealing PEP and Pease, and extending the current child tax credit and Earned Income Tax Credit (EITC) expansion. It also taxes capital gains as ordinary income, which JCT believes would actually *lose revenue* because investors will opt not to realize gains.

Taken together, we estimate these changes *cost* **\$1.9 trillion**, eating up most of the revenue gained from cutting tax expenditures. Left over would be **\$700 billion** available for reducing tax rates from their current law levels, which JCT estimates would pay for a 4 percent reduction in rates (the top rate would fall from 39.6 percent to 38 percent, the second from 36 percent to 34.6 percent, and so on).

Fig. 1: Resources Available for Deficit Reduction and Rate Reduction in JCT Study

	10-Year Fiscal Impact
Revenue Increasing Provisions	
Repeal All Itemized Deductions	\$2,455 billion
Repeal Interest Exclusion for Newly-Issued State and Local Bonds	\$124 billion
Increased Deficits from Reform	\$37 billion
Sub-Total, Additional Revenue	\$2,616 billion
Revenue Losing Provisions	
Repeal the Alternative Minimum Tax	-\$986 billion
Repeal PEP and Pease Provisions	-\$379 billion
Maintain EITC and Child Tax Credit at Current Levels	-\$402 billion
Tax Capital Gains as Ordinary Income (38% top rate)*	-\$150 billion*
Sub-Total, Lost Revenue	-\$1,916 billion
Revenue Remaining to Reduce Rates	\$700 billion
Memo: Deficit Reduction Relative to Current Policy	\$4.5 trillion

Source: Joint Committee on Taxation. CRFB estimate for capital gains at 38 percent rate.

Note: All estimates are relative to current law. Numbers may not add exactly to totals due to rounding.

*Capital gains numbers not provided by JCT separately, though according to JCT methodology a 38 percent cap gains rate would lose money relative to current law. We assume 10-year cost of \$150 billion.

That \$700 billion pays for only a 1.6 point reduction in the top rate should not be a surprise. Importantly, trillions of dollars more could be used for further rate reduction by dedicating less money to deficit reduction and repealing or reforming more tax preferences in the code. Such a plan could still be enacted in a fiscally responsible way that contributes significant new revenues to stabilizing the national debt as a share of the economy.

The “Zero Plan”: How Low Can Tax Reform Reduce Rates?

Looking at the details behind the JCT experiment, it is quite clear that the top rate can be brought down far below the 38 percent shown in the study and subsequent commentary, while still contributing to deficit reduction. To begin with a rough rule of thumb, imagine if the \$4.5 trillion of deficit reduction were *swapped* with the \$700 billion of rate reduction. That scenario would result in more than *six times* as much revenue for rate reduction – likely enough to reduce the top marginal rate to 30 percent or lower.

Indeed, a number of bipartisan tax reform plans, including those from the Simpson-Bowles Fiscal Commission, the Domenici-Rivlin Debt Reduction Task Force, and the 2005 President's Advisory Panel on Federal Tax Reform, all put forward proposals to reduce the top rate to 30 percent or less while still dedicating \$1 to \$2 trillion to deficit reduction.

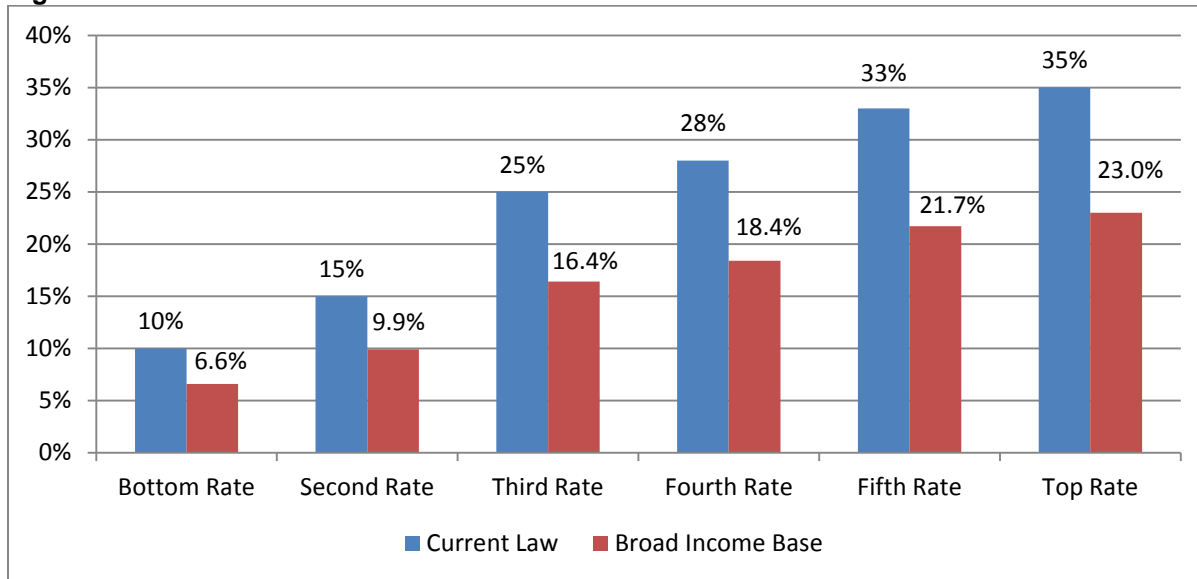
In thinking about tax reform, it is useful to begin with the premise that all tax expenditures are eliminated. In 2010, the Simpson-Bowles Fiscal Commission took this approach by putting forward what was coined the “zero plan.” The zero plan repealed nearly every tax preference in the code in order to show how low rates could be reduced. On a static basis, the Tax Policy Center estimated the individual rates could be brought down to three consolidated rates of **8 percent, 14 percent, and 23 percent**, while still raising the equivalent of roughly \$150 billion of net revenue in 2015 (\$80 billion relative to the Fiscal Commission’s baseline at the time, which assumed the upper income tax cuts would expire in 2010).

In 2005, the Department of Treasury conducted a similar exercise for the President's Advisory Panel on Federal Tax Reform. Like the Fiscal Commission, it put aside money for net revenue which we estimate at nearly \$1.2 trillion over ten years in today’s terms.¹ The Panel’s study found that a zero-plan approach would allow all tax rates to be reduced by roughly one third – with the top corporate and individual rates falling to 23 percent (in the context of a corporate integration system).

Although these two analyses differ in some respects, both show that the full elimination of all tax expenditures would allow the top tax rate to fall to 23 percent while still putting aside more than \$1 trillion for deficit reduction. An actual tax reform plan would be highly unlikely to achieve these same rate levels because there would be an interest in keeping, reforming, or at least slowly phasing out many tax expenditures repealed immediately in this exercise. However, this 23 percent top rate can serve as a helpful starting point for thinking about bold tax reforms.

¹ The exercise was designed to raise \$866 billion from 2006-2015 in order to pay for the cost of patching the AMT relative to current law; raising the same revenue as a percent of GDP from 2013-2022 would generate roughly \$1.05 trillion. On top of this, the current tax base is narrower than the base at the time due in large part to an expanded EITC and child tax credit. Taking these and other changes to the tax code into account leads to our \$1.2 trillion estimate.

Fig. 2: Tax Rate Schedule of Broad Income Base with Graduated Rates



Source: Treasury Department

A Bridge from 38 Percent to 23 Percent

It would be an understatement to say that the 23 percent top rate identified by the Treasury study is far lower than the 38 percent top rate identified by the JCT experiment. Although it is difficult to compare these experiments on an apples-to-apples basis, it is important to understand the differences in broad terms.

In the table below, CRFB has attempted to show – using rough numbers – what it would take to get from the JCT’s 38 percent rate to Treasury’s illustrative 23 percent. As a rough rule of thumb, we assume that each 1.6 point reduction in the top rate costs about \$800 billion (somewhat higher than the \$700 billion for the initial rate reduction to account for increasing costs as the base broadens).

CRFB starts by assuming capital gains are taxed at 28 percent instead of 38 percent, which based on JCT’s methodology would *increase* total revenue. JCT’s methodology estimates that a rate of 38 percent would cause a reduction in realization of capital gains that outweighed the higher tax rate, without accounting for any macrodynamic growth effects.

We also take the total \$4.5 trillion pot of money marked for deficit reduction and reduce it to \$1.2 trillion as done in the Treasury study. Using the remainder for rate reduction allows for a top rate of roughly 31 percent.

Beyond that, CRFB assumes the repeal of a number of the larger tax expenditures not addressed by the JCT experiment – using rough numbers meant to show orders of

magnitude rather than exact effects. After repealing the employer health exclusion, preferences for other employer-provided or -facilitated benefits (i.e. life insurance, fringe benefits, cafeteria plans, etc.), step-up basis of capital gains at death, and a number of other tax expenditures, CRFB was able to get the top rate down to just above **25 percent**.

Fig. 3. Bridging the Gap from a Top Rate of 38 Percent to 23 Percent

	\$\$ for Deficit Reduction (billions)	\$\$ for Rate Reduction (billions)⁺	Top Rate[^]
Current Law	\$4,500	\$0	39.6%
JCT Run from Current Law*	\$4,500	\$700	38.0%
Assume Capital Gains Rate of 28% (instead of 38%)	\$4,500	\$900	37.6%
Reduce Deficit Reduction to \$1.2 Trillion	\$1,200	\$4,200	31.1%
Also Repeal of Health Exclusion (~\$1.5t)	\$1,200	\$5,700	28.1%
Also Eliminate Various Insurance Preferences (~\$200b)	\$1,200	\$5,900	27.7%
Also Eliminate Special Preferences for Citizens and Federal Employees Working Abroad (~\$100b)	\$1,200	\$6,000	27.6%
Also Tax Cafeteria Plans and Fringe Benefits (~\$200b)	\$1,200	\$6,200	27.2%
Also Cut Step-up Basis for Cap Gains at Death (~\$400b)	\$1,200	\$6,600	26.4%
Also Cut Certain Pass-Through Business Breaks (~\$300b)	\$1,200	\$6,900	25.8%
Also Eliminate All Credits Except EITC and CTC (~\$250b)	\$1,200	\$7,150	25.3%
Repeal All Remaining Tax Expenditures (Treasury Study)	\$1,200	Unspecified	23.0%

Note: Very rough estimates meant to show orders of magnitude not precise scores.

*JCT run assumes all expiration of 01/03/10 tax cuts except those related to the child tax credit and EITC, repeal of all itemized deductions, repeal of interest exclusion on State and Local bonds, repeal of preferential rates on capital gains and dividends, repeal of the Alternative Minimum Tax, and repeal of PEP and Pease provisions.

⁺Tax expenditure repeal estimates are rough based on prior scores from CBO, JCT, and the Tax Policy Center.

[^]Assumes the top rate can be reduced 1.6 percentage points for each \$800 billion of revenue.

The remaining untouched tax expenditures – including all retirement preferences, the child tax credit, and the EITC – should be enough to reduce the rate down to 23 percent. It would be *theoretically* possible to go even lower by reducing the revenue target, identifying new revenue sources, and/or addressing certain components of the tax code not considered tax expenditures – such as the standard deduction and personal exemption.

Prominent Tax Reform Proposals Show Broad Base and Low Rates

While as a technical matter one might be able to reduce the top rate below 23 percent, as a practical matter the rate will almost certainly be higher in any enacted tax reform plan. The idea behind a “zero-plan” approach is to begin with a level playing field and force policymakers to prioritize which tax expenditures they truly care about. Based on these decisions, tax expenditures could be added back into the code either as is, in a smaller form, or on a temporary basis to create a reasonable transition. Any of those additions could be financed with higher rates.

Even beginning with the zero-plan approach, there is no question that tax reform will be difficult politically, economically, and technically. Yet, a number of bipartisan plans have shown it possible to reduce tax expenditures, rates, and deficits all at once.

Box 1: 4 Percent under Current Law Is Not the Same as 4 Percent under Current Policy

Many commenters have suggested that if the JCT experiment allows for only a 4 percent reduction in rates from current law, the same would be true from current policy. In other words, if the experiment were applied to a baseline which assumes the continuation of current tax cuts, the top rate would fall from 35 percent to only 33.6 percent. Although this finding may seem to make intuitive sense, it is absolutely false and based on a misunderstanding of the JCT report.

As we’ve shown, if the JCT experiment dedicated \$4.5 trillion toward rate reduction rather than deficit reduction the rate could be bought down from 38 percent to around or below 30 percent. A similar conclusion would be reached by beginning with a current policy baseline. **The primary reason further rate reduction would be possible is that the JCT exercise uses much of its gross revenue to pay for provisions which are already a part of the current policy baseline.**

Under JCT’s experiment, Figure 1 of this analysis shows that \$700 billion of revenues would be available for rate reductions after taking into account the costs of repealing the AMT, PEP and Pease, extending the child credit and EITC expansions, and taxing capital gains at 38 percent.

Conducting the same experiment from a current policy baseline would raise *less* from tax expenditure cuts – roughly \$2.3 trillion instead of \$2.6 trillion – since lower rates reduce the value of deductions. On the other hand, there would be *no cost* to repealing PEP and Pease or expanding the child credit and EITC since they are already part of the current policy baseline. In addition, the cost of repealing the AMT would be far lower since current policy already assumes this provision is “patched” to only affect 4 million people instead of 30 to 40 million under current law. Finally, taxing capital gains and dividends as ordinary income would *raise* revenue since the starting point for both taxes is lower (15 percent as opposed to 20 percent for capital gains and 39.6 percent for dividends) and the ending point for capital gains is not as far down the Laffer curve.

All told, we estimate the JCT experiment relative to current policy would raise about **\$2.15 trillion for rate reduction, more than 3 times as much as the \$700 billion from current law.** Based on the simplifying assumption that the top rate is the only one that matters for revenue purposes, this might allow for a roughly **5 point reduction in the top rate, the equivalent of 14 percent overall.**

Fig. 4: Simulating the JCT Experiment under Current Policy

	Current Law	Current Policy
Eliminate All Itemized Deductions	\$2.45 trillion	\$2.2 trillion
Repeal Interest Exclusion for New State and Local Bonds	\$125 billion	\$100 billion
Eliminate the Alternative Minimum Tax	-\$985 billion	-\$450 billion
Eliminate PEP and Pease	-\$380 billion	\$0
Maintain EITC and Child Tax Credit at Current Levels	-\$400 billion	\$0
Tax Capital Gains and Dividends as Ordinary Income	-\$150 billion	\$300 billion*
Resources Available for Tax Rate Reductions	\$700 billion	\$2.15 trillion
Reduction in Top Rate	1.6 points	4.9 points
Percent Reduction	4%	14%

Note: Rough numbers meant to show orders of magnitude and not exact figures.

*Raising capital gains rates from 15% to 30% would raise roughly \$100 billion; taxing dividends as ordinary income would raise roughly \$200 billion.

Both the Simpson-Bowles and Domenici-Rivlin commissions put forward tax reform plans that would identify enough base broadening to reduce the top rate to 28 percent while retaining some support for low-income workers and parents as well as for homeownership, charitable giving, health insurance, and retirement. Both plans also raised as much as \$2 trillion for deficit reduction according to analyses from the Tax Policy Center.²

Similarly, in 2005 the President's Advisory Panel on Federal Tax Reform put forward a "Growth and Investment Plan" that reduced the top rate to 30 percent while retaining support in the same areas of the tax code as Simpson-Bowles and Domenici-Rivlin (though all in different ways), holding capital gains and dividends rates at 15 percent, and expanding many preferences for savings. At the time, the Treasury Department estimated that plan would have raised about \$1.25 trillion over a decade to meet its mandate to offset a permanent fix for the AMT and leave \$400 billion for transition relief, which would be the equivalent of close to \$1.65 trillion if enacted today.

An appendix at the end of this analysis compares how each of these tax reform plans would reform elements of the tax code.

Conclusion

Undertaking fundamental tax reform is certainly a challenging task that requires making hard choices. The more lawmakers want to reduce rates, the tougher those choices will be in the context of fiscally responsible and deficit reducing tax reform. Tax reform will be more challenging still if lawmakers chose to meet certain distributional targets.

However, nothing in the recent JCT experiment shows tax reform that lowers rates, broadens the base, and reduces the deficit is impossible or untenable. In fact, a careful read of the report confirms that a bold approach to reforming tax expenditures could allow for a top tax rate well below 30 percent.

It would be a mistake for lawmakers to agree to rate reductions that they are unwilling to offset in the context of a comprehensive deficit reduction package. But it would also be a mistake not to use the opportunity of tax reform to create a simpler, fairer, and more pro-growth tax code.

² Tax Policy Center analysis of Fiscal Commission Illustrative Plan, http://www.taxpolicycenter.org/taxtopics/Fiscal_Commission_Final_Report.cfm. Tax Policy Center analysis of Domenici-Rivlin plan, http://www.taxpolicycenter.org/taxtopics/BPC_Plan.cfm.

Appendix: Comparison of Prominent Tax Reform Proposals

Tax Code Elements	JCT Study	Simpson-Bowles “Pure Zero Plan”	Simpson-Bowles “Illustrative Plan”	Domenici-Rivlin (Updated)	2005 Tax Panel “Growth and Investment Plan”
Tax Rates	14.4% 26.9% 29.8% 34.6% 38.0%	8% 14% 23%	12% 22% 28%	15% 28%	15% 25% 30%
Standard Deduction	Retained	Retained	Increased 10%	Replaced with work and family credits	Replaced with work and family credits
Personal Exemptions	Retained	Retained	Retained		
Child Credit & EITC	Retained	Repealed	Retained		
Alt. Minimum Tax	Repealed	Repealed	Repealed	Repealed	Repealed
Mortgage Interest Deduction	Repealed	Repealed	Converted to 12% credit; capped at \$500K mortgage	Converted to 15% credit; limited to \$25K of interest	Converted to 15% credit; capped at \$412K mortgage
Charitable Deduction	Repealed	Repealed	Converted to 12% credit; 2% of AGI floor	Converted to 15% credit	Retained with 1% floor
Employer Sponsored Health Insurance Exclusion	Retained	Repealed	Capped, phased out from 2018 to 2038	Capped, phased out from 2015 to 2025	Capped at average premium
State & Local Tax Deduction	Repealed	Repealed	Repealed	Repealed	Repealed
Interest Exclusion on State & Local Bonds	Repealed for new bonds	Repealed for all bonds	Phased out for new bonds	Repealed for private activity bonds	Unspecified
Retirement Savings	Retained	Repealed	Consolidated and capped at \$20K or 20% of AGI	Consolidated, replaced with 15% credit up to \$20K or 20% of AGI	Consolidated and reformed
Capital Gains and Dividends	Taxed as ordinary income (top rate 38%)	Taxed as ordinary income (top rate 23%)	Taxed as ordinary income (top rate 28%)	Taxed as ordinary income (top rate 28%)	Taxed at 15%
Step-up Basis for Capital Gains at Death	Retained	Repealed	Repealed	Repealed	Unspecified
Other Tax Expenditures	All other tax expenditures retained	Virtually all tax expenditures repealed	Most tax expenditures repealed	Most other tax expenditures repealed	Most tax expenditures modified or repealed
Revenue Raised	~\$4.5	~\$1.75 trillion [^]	~\$2 trillion ⁺	~\$2 trillion ⁺	~\$1.65 trillion [*]

[^]Original revenue estimate looked at single year (2015).

⁺Columns reflect individual tax reform proposals but do not include recommendations for excise taxes, the estate tax, chained CPI, or payroll tax revenue.

^{*}The Treasury Department’s original analysis estimated \$1.25 trillion in deficit reduction over the 2006-2015 period when assuming no transition rules, which CRFB roughly estimates at about \$1.65 trillion over the 2013-2022 period when accounting for the larger economy and the narrower tax base.