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Beyond Tax Reform Jujitsu: Getting to 'Yes'

BY JOHN BREAUX AND TRENT LOTT

Congress and the administration can still achieve the first major overhaul of our nation's tax laws in nearly 30 years; such reform could occur with or without an agreement to enact fundamental entitlement spending reform.

While challenges remain, none are intractable—most are matters of degree. Let us look at the fundamentals and draw some conclusions as to how Congress and the administration might be able to get to "yes."

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A former Senate majority leader, Senate Republican whip, and House Republican whip, Sen. Lott is one of a handful of officials to have held elected leadership positions in both the House and Senate. During his 16 years in the House and 19 years in the Senate, he worked closely with seven presidential administrations and was regarded as a savvy coalition builder and dealmaker.

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Sen. Breaux led a long and distinguished career in the U.S. Congress. He was elected to the House in 1972 at the age of 28—at the time of his election he was the youngest member of Congress. Sen. Breaux was a widely recognized bipartisan leader in the Senate, and in 1993 was appointed by his Democratic colleagues to the post of chief deputy whip, a position he held until his retirement. Following his retirement from the Senate, Sen. Breaux co-chaired President George W. Bush's Advisory Panel on Tax Reform.

Consensus on the Need for Reform Exists; Differences Persist but Are Smaller Than Many Think

Tax reform is inherently difficult to achieve as tax writers must grapple with the substance and politics of once-in-a-generation reform. For example: How much base broadening should there be? What should the tax distribution tables after reform look like? How to ensure U.S.-based multinationals can compete on a level playing field with their competitors, while at the same time ensuring the corporate tax base is not eroded?

Rather than succumbing to "analysis paralysis" principals must now begin to make difficult political decisions.

These are all weighty issues about which much has been written. As a starting point, however, it is critical to note that there is broad bipartisan consensus among senior tax writers and the president that the Internal Revenue Code should be overhauled. Members and staff have already done much of the important work hearing from stakeholders and sorting through issues. The analytical work is well under way, and rather than succumbing to "analysis paralysis" principals must now begin to make difficult political decisions.

Of course, the single biggest stumbling block to tax reform is the absence of agreement between the parties on whether reform should be revenue neutral with all of the increased revenues that result from base broadening utilized to offset the cost of lower rates (as many congressional Republicans advocate), or used for deficit reduction purposes (the approach sought by President Obama and many congressional Democrats). Even here, a closer look at the differences leads us to believe that the perceived gap between the parties is not as great as many think, and could be easily bridged were

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both parties to measure revenue from a reasonable starting point.

Revenue Differences: The Root of the Problem

A look at differing fiscal year 2014 budget proposals lays bare the different political perspectives, which appear daunting.

The party-line House Republican budget proposal calls for a simpler tax code with just two individual tax rates (10 percent and 25 percent), plus elimination of the alternative minimum tax. The legislative blueprint also calls for a 25 percent corporate rate while transitioning to a more competitive system of taxing the foreign earnings of U.S.-based multinationals. All of this would be done on a revenue-neutral basis, through enacting significant base-broadening measures.

The Senate Democrats' FY 2014 budget proposal, also passed on a party-line vote, offers a very different vision: it pursues tax reform for the chief purpose of raising roughly $1 trillion in new revenue (over 10 years) from upper-income individuals and large corporations, rather than lowering rates in a revenue-neutral manner.

In the middle we have the president's FY 2014 budget proposal, which asks for revenue-neutral business tax reform while simultaneously seeking to increase revenue to the tune of roughly $1 trillion (over 10 years) for the purposes of deficit reduction. However, the president's public statements have been clear: While $1 trillion may be his preferred approach, he is open to a deficit reduction agreement that includes about $600 billion in tax increases on upper-income individuals. He includes in his budget $582 billion of such revenue raisers—a limitation on the use of itemized deductions and implementation of the so-called Buffett rule, a minimum tax on individuals with income exceeding $1 million.

While there has been much discussion and political controversy over how to achieve tax reform, somewhat lost in the discourse is the degree to which overlap between the political parties exists.

Over and above this, the president includes about $400 billion in additional taxes, $100 billion of which comes from applying a chain-weighted consumer price index to the indexing of tax provisions for inflation. Of note, the president also includes several entitlement spending reductions in his budget as well (including a chained CPI for calculating Social Security cost of living adjustments).

There Is More Common Ground Than Meets the Eye

Observers of the political jujitsu in Washington may believe that Republicans and Democrats are incapable of agreeing on anything. However, while there has been much discussion and political controversy over how to achieve tax reform, somewhat lost in the discourse is the degree to which overlap between the political parties exists.

Business tax reform is an excellent case in point: President Obama and congressional Republicans and Democrats alike believe revenues raised should be utilized to pay for substantially lowering the 35 percent corporate rate. While details differ a bit (the president proposes a 28 percent corporate rate, with lower rates for manufacturers, while Ways and Means Committee Chairman Dave Camp (R-Mich.) proposes 25 percent for all U.S. businesses), these differences can be bridged.

So too can differences with respect to taxation of U.S. companies doing business overseas—moving toward a territorial-type system with protections for the U.S. tax base gives both sides a good measure of what they want, while transitioning the United States away from our antiquated and anti-competitive international tax rules. And, Republicans and Democrats alike will insist that "passthrough" entities do not get left behind, both for sound policy and parochial reasons.

Reforming the tax code for non-business individual income is a bit trickier, as congressional Republicans want to apply the same principles of business tax reform to the taxation of individuals, meaning they want revenue-neutral reform with sharply lower rates and a greatly expanded tax base. To do this, they are willing to take on sacred cows, including the mortgage interest deduction.

The differences with the president here are twofold. First, as noted, the president has insisted upon increasing net revenue by $600 billion (over 10 years), all of which is harnessed on upper-income taxpayers by virtue of further limiting their tax preferences. Second, revenue differences aside, the president appears reluctant to endorse base-broadening for lower rates even if a fixed sum of revenue is applied to deficit reduction. Thus, his version of individual reform is largely to keep rates where they are while raising the effective rate of tax for some individuals (and providing some incentives for small businesses like increased expensing of investments).

Still, we believe most of these differences can be bridged. One way is obvious: Fast-track tax and entitlement reform through a process agreed to that would round out a "grand bargain" on deficit reduction. This would require Republicans and Democrats to agree to specified new tax revenue and entitlement spending reductions, each totaling in the hundreds of billions of dollars. If past is prologue, this is unlikely to occur.

While more than $3 trillion in deficit reduction has occurred since the beginning of 2011, all of this has occurred as a result of reluctant dealmaking at the precipice of looming fiscal crisis, with one party holding all of the cards. Each side has won a round or two, but attempts to do deficit reduction on a bipartisan basis have failed each time. Such talks could always be resurrected in the context of raising the debt ceiling later in 2013, but there is a lot of pessimism about the potential for success currently.

However, the point is this: If a "grand bargain" does not materialize, there are at least two other solutions that could be considered.

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(1) Enact Business Tax Reform Only

One plausible path forward is for Congress and the president to focus on revenue-neutral tax reform for businesses only, which is where most agreement exists, while ''agreeing to disagree'' about non-business individual reform.

Such reform would need to lower rates substantially for both businesses chartered as C corporations and passthrough entities, but would not lower rates or decrease tax preferences for non-business income. It would also provide tax writers with the important opportunity to transition from our antiquated system of taxing business income on a worldwide basis. This has the effect of trapping profits overseas, which is a result no one should like.

In this scenario, congressional Republicans would agree to defer their desire to lower rates for non-business individual income, and the president would agree to punt the battle to raise taxes again on ''upper-income individuals.'' And, while focused on business tax reform, important but noncontroversial individual items (such as taxpayer simplification and taxpayer protection provisions) could be included as well.

Many Republicans would prefer to go further of course, and many Democrats may oppose this on the grounds that it cedes their best chance for ''new revenue'' for the duration of this Congress, and, perhaps, the remainder of the Obama administration. But the rationale for this sort of compromise is clear: The parties put aside their differences and focus on what is achievable.

The politics should work too: While Republicans would generally prefer to ''broaden the base,'' on the individual side, one can infer that significant reductions to tax preferences for a broad swath of taxpayers (such as the exclusions for employer-provided health care and municipal bond interest, and the deductions for state and local taxes and mortgage interest) would be necessary to achieve their goals. These are the thorniest issues to tackle politically, and also happen to be the provisions that President Obama suggests should be pared back for upper-income taxpayers (the resulting revenue to be used for deficit reduction). And taxpayers who benefit most from these preferences tend to reside in the higher tax (and higher cost) ''blue'' states like New York, California, and Illinois.

(2) Adopt a Realistic Baseline From Which to Measure Revenue Changes

As mentioned, the key to tax reform is an agreement on revenue. President Obama wants $600 billion in statically scored revenue, and congressional Republicans are determined to give him none. But are they really that far apart? Part of the answer may depend upon what revenue baseline they are using to measure proposed changes.

If they adopt a ''current policy'' baseline, as both parties have done in the recent past, policymakers will find they are closer to an agreement on revenue than at first meets the eye.

Using a current policy baseline is not new. Over the past several years, while the political parties have differed in their policy goals (in particular the appropriate level of taxation of upper-income individuals) they have more or less agreed to use a realistic baseline as a common starting point for measuring revenue changes. They should do so again here.

Current Law or Current Policy?

First, some background: Until the fiscal cliff deal produced the American Taxpayer Relief Act (ATRA; Pub. L. No. 112-240) on Jan. 1, there was a $4 trillion-plus disparity between how official scorekeepers (the Joint Committee on Taxation and the Congressional Budget Office) and how the administration and most elected officials measured the ''score'' (or cost) of tax policy proposals. This enormous gap in assumptions resulted from the fact that the major individual tax cut provisions enacted and extended over the last 12 years were subject to automatic sunset, and thus not deemed to be ''permanent'' for official scorekeeping purposes.

Official scorekeepers measure the cost (or score) of any proposed tax changes relative to revenue expected to be collected under a ''current law'' baseline. Unlike official scorekeepers, who are bound to measure against a current law baseline, the administration and most lawmakers (on both sides of the aisle) assumed ''current tax policy'' would be extended permanently and used that baseline to measure the cost or savings of particular tax proposals.

By way of example, all Obama administration budget requests and deficit reduction plans have utilized an adjusted (current policy) baseline to measure the cost of tax policy proposals. For example, in the FY 2013 budget proposal a baseline shift of $4.5 trillion allowed the administration to measure the cost of making the Bush tax cuts permanent for income below $250,000 (while allowing the Bush rates to expire for income above that) at $850 billion in new revenue. Compare this to JCT, which, utilizing a current law baseline, scored the president's tax proposals as a net tax cut of $3 trillion.

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As the administration put it, ''An important step in addressing the Nation's fiscal problems is to be upfront about them and to establish a baseline that provides a realistic measure of the deficit outlook before new policies are enacted. This Budget does so by adjusting the [Budget Enforcement Act] baseline to reflect the true cost of extending major tax policies that are scheduled to expire but that are likely to be extended.''

Quite so. Following this line of reasoning, during consideration of ATRA both parties used numbers that suggest they were comparing the effects of policy proposals to a current policy baseline. Therefore, for Republicans and Democrats alike, the fiscal cliff deal amounted to a roughly $620 billion tax increase (compared to current policy) even as JCT scored the bill as a $4 trillion tax cut (compared to what was then current law).

Baselines Post-ATRA

Employing a realistic baseline continues to be important. Much of the disparity between current law and

current policy baselines was mooted by ATRA, which made most of the Bush tax cuts permanent in law while also permanently indexing the parameters of the alternative minimum tax exemption. This narrowed the gap between the two baselines by roughly $4 trillion. But post-ATRA a current law baseline still overestimates revenues the government can expect to collect by hundreds of billions of dollars over the next 10 years; a realistic baseline could be used to unlock a deal on tax reform where both sides achieve their goals.

One need look no further than the president's own FY 2014 budget proposal for evidence of this. As in past years, it uses an adjusted baseline for purposes of scoring the cost of its proposals. While the adjusted baseline has narrowed considerably given passage of ATRA, the administration continues to employ a $161 billion baseline change by assuming permanence of several provisions that were extended for five years in ATRA and are, thus, not permanent in law:

- the American Opportunity tax credit;
- the earned income tax credit expansions; and
- the child tax credit expansion.

Permanence of these provisions in the adjusted baseline allows the administration to assert that they have no cost, reflecting a more realistic baseline.

This makes sense, as far as it goes. But unfortunately the budget request does not capture all relevant provisions that should be included in the realistic baseline.

For example, there are still a number of business, individual, and energy tax "extender" provisions, as well as accelerated cost recovery through bonus depreciation and small business expensing, that are reauthorized annually. Most of these provisions have been on the books, extended without interruption, for a decade or longer. In reality, it is unlikely that Congress will allow these provisions to expire, at least outside of tax reform. Taken together, they account for hundreds of billions of dollars over a 10-year period but are not considered part of permanent tax law. Thus, under a "current law" baseline, their repeal counts for nothing. That makes getting to a revenue agreement much more difficult.

A Path Forward

Congressional tax writers should build upon the example the president has set in his FY 2014 budget by assuming permanence of all long-standing provisions that are subject to sunset on a year-to-year basis. While Congress may (and should) make some of these provisions permanent during tax reform, it is inevitable that many of them will be jettisoned for base broadening purposes, thus raising significant revenue that has currently been lost in the tax reform discussion.

With this common starting point, both sides will find that they are not that far apart from rate-lowering tax reform that raises some revenue for deficit reduction. They can then move beyond political jujitsu and onto the real work of tax reform.

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