IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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HOUSE REPUBLICAN BUDGET RESOLUTION

House Budget Committee Republicans, led by Chairman Paul Ryan (R-WI), have presented their 2012 Budget Resolution. It seeks to accomplish two goals: avert a debt crisis by slashing projected deficits; and permit, even encourage, more rapid economic growth and job creation. It would achieve the deficit reduction by curbing federal spending. It would achieve the higher growth by reducing tax rates and otherwise restructuring the tax system to make it less of an impediment to production and employment. The added growth would also assist in reducing the deficit by raising incomes and the associated tax revenue.

Why the urgency

The Congressional Budget Office projects that federal spending will total nearly $46 trillion over the next ten years under current law. Deficits would be nearly $7 trillion. Government spending would remain above 23 percent of GDP, sharply higher than the post-war historical levels of about 20 percent before 2008. Revenues are projected to increase to nearly 20 percent of GDP, above the historical level of about 18.5 percent, but still leaving a wide budget gap.

The portion of the national debt held by the public (outside of government trust funds) would soar from $9 trillion in 2010 to $18 trillion in 2021, or from 62 percent of GDP to 76 percent, a level not experienced since 1952 as we reduced the debt from the Second World War. These projected deficits would leave the budget vulnerable to very large increases in debt service costs as interest rates return to more normal levels. Higher interest payments on the debt would make it even harder to fund other federal programs. Doing nothing to control the deficits is not an option.

Why this approach

The country faces two basic choices. Should taxes be raised to 23 percent of GDP to support a larger role for the federal government on a permanent basis? Or should spending be eased gradually to about 20 percent of GDP or less to fit within current levels of taxation? The choice is not merely one of arithmetic. If growth of jobs and incomes is one of the objectives, in addition to budget balance, then the choice is obvious. A bigger government means a smaller economy and a poorer population. A smaller government means a bigger economy and a richer population.

Government activity does not add to total output. Rather, it displaces other production. Transferring manpower and material to government use makes them unavailable for other uses. In addition, taxes create dead weight losses that shrink the private sector and reduce incomes and employment further. At higher tax rates, fewer people join the work force; people in the work force work fewer hours; people save and invest less, create less capital, and employ less labor.

Raising taxes to fund a larger role for the federal government would curb total production and reduce incomes. Much of the expected revenue increase would be lost due to a lower tax base. Each dollar of government spending costs the people several dollars of lost income in addition to the dollar of tax paid to the government. If the full price of government spending were revealed, people would want a lot less of it.

By contrast, rolling back or slowing the growth of government spending would allow us to maintain or reduce the current tax burden on production. Merely ensuring that taxes will not rise as threatened would encourage the economic recovery. Reducing tax rates on investment and earnings would go even further to generate additional jobs and raise incomes. That is the best way to "broaden the tax base".

A second problem is that a larger role for government leads to serious inefficiencies. For example, consider the growing role of government in health care. The government is paying for over half of medical care, hiding much of the true cost of the care from the patient. It has also given open-ended tax subsidies for the purchase of private health insurance, in which third party payments also hide much of the cost from the patient. These arrangements have led to over-consumption by the public, and rising costs as the system strains to expand care. Strapped federal and state governments try hold down costs by controlling prices and limiting the services covered. Suppliers respond by refusing to accept Medicare and Medicaid patients, further curbing access to care. Patients lose control over the level and type of care they receive and their choice of doctor.

Curbing spending and reforming entitlements and taxes would alter the economy for the better and would increase people's earnings before and after taxes. Raising taxes to pay for ramped up discretionary spending and unreformed entitlement growth would be futile. The tax rates would have to be increased repeatedly to very damaging levels as entitlements grow over time, and the revenues would be lost to economic stagnation.

The House Republican Budget Proposal

The House Republican Budget Resolution would trim the growth of federal spending by $5.8 trillion relative to the projected current-policy baseline over the next ten years. It would save $1.6 trillion by reducing non-defense discretionary spending limits below 2008 levels, unwinding sharp increases enacted since then, including the surge in emergency "stimulus" spending that was supposedly temporary but is threatening to creep into the budget baseline. It assumes $1 trillion in savings as the war on terror is scaled back, and $1.4 trillion in spending cuts from repeal of the President's health care reforms. The plan trims $1.5 trillion across Medicaid and non-health entitlements. Medicare would have much smaller cuts in the near term. Other saving comes from reduced interest on the debt. The Resolution would forego roughly $4 trillion in tax increases assumed in the CBO baseline, such as expiration of the Bush tax cuts and the taxes in the health reform act. It would trim about $2 trillion from the projected increase in the debt through 2021.

The Budget Resolution cannot dictate specific changes in programs. It can only set numerical budget targets. It is then up to the Committees with jurisdiction over taxes and spending to decide how to alter programs to conform to the budget totals. The descriptive plan accompanying the Budget Resolution offers its vision of one set of program and tax changes that have been costed out and shown plausibly to result in the budget numbers contained in the Resolution. It did so with an eye on the economic growth, employment, and income effects of the proposals. Others have offered proposals of a different nature that might appear to achieve similar deficit reduction, but with less chance of improving the economic outlook.

Under the House Republican Budget Committee vision, the Obama health care reform plan would be repealed. Medicaid would be converted to block grants to the states, with projected savings of $771 billion. The states would be allowed greater flexibility in setting benefits and managing care for their needy populations. Medicare would be reformed to contain costs past the budget window, in 2022 and beyond. It would continue in its present form for people who are currently 55 or older. Those under 55 today would be given premium support payments for the purchase of private insurance. The private plans would be tightly regulated and would have to take all comers regardless of medical condition. The premium support would be scaled to reflect income and medical risk factors to provide extra protection for the poor and people with serious conditions.

The Resolution cannot mandate specific tax changes. Those must be left to the Ways and Means Committee. The Budget Resolution can only set a revenue floor. However, the Budget Committee plan contains a discussion of what the Committee members hope that Ways and Means can achieve. They envision consolidating tax brackets and reducing the top tax rates for individuals and corporations to 25 percent. The rate cuts would be paid for by eliminating deductions and other tax provisions deemed to be distorting, discriminatory, or unhelpful. The reform would be revenue neutral in the traditional "static" sense, not factoring in the revenue gains from growth.

We offer two warnings. First, it would be best for the economy if the revenue reflow from the stronger GDP were acknowledged, and the money used for further reductions in tax obstacles to growth, not to increase government spending. That would constitute revenue neutrality in the dynamic sense, not the static sense.

Second, the tax reform should be careful what it does to the tax base. It should not pay for the rate reductions with tax offsets that would increase the tax biases against saving and investment, overstate or double tax income, or impede ordinary capital formation by creating a net increase in the cost of capital or "service price". (The service price is the rate of return that assets must earn to cover their cost, pay tax on the earnings, and leave the saver/shareholder/investor a minimal after-tax reward for deferring consumption and bearing risk.) The Congress should require the Joint Tax Committee to provide it with an estimate of the effect of any proposed tax changes on the service price before it enacts them. Otherwise Congress will not know whether it is encouraging or discouraging capital formation and job creation.

It is easy to reduce tax rates if one is willing to overstate income, as on this simple tax form:

Line 1: Enter your income.
Line 2: Multiply the amount on line 1 by three.
Line 3: Pay tax at half the old tax rate.

Result: 150 percent of the old tax take at half the rate, unless activity collapses. This is not real tax reform.

The "broad-based" income tax discriminates against saving and investment. Income is taxed when earned. If it is used for consumption, the federal government does not tax it again, except for a few excise taxes. One can buy bread and peanut butter and enjoy a sandwich, or buy a television and enjoy the stream of programming, with no additional federal tax. However, if the after-tax income is used to buy an asset, the federal government taxes the returns (the stream of interest and dividends, capital gains, or small business income) that are the "enjoyment" the asset provides. If the saving is in corporate stock, there is the added layer of corporate income tax. If the savings grow large enough, they may trigger an estate tax at death. Result: one layer of tax on consumption, four layers on saving.

Many provisions in current tax law are designed to correct for mismeasurement of income, or to grant relief for the various types of double taxation of income used for saving and investment that are inherent in traditional broad-based income taxes. Provisions that reduce the income tax biases against saving and investment move us toward a "saving/consumption neutral" tax base, lower the service price of capital, and increase capital formation and wages.

Those provisions include, among others, lower tax rates on capital gains and dividends to offset the double taxation of corporate income, pension and other retirement arrangements to deal with the extra layer of tax on ordinary saving, and expensing or accelerated depreciation provisions that more fully reflect the cost of acquiring plant and equipment than "straight line" depreciation. These are not "loopholes". They are normal policy under a neutral tax system, and not having them would constitute a "negative tax expenditure" relative to the neutral ideal. They are counted as tax expenditures only relative to the broad-based income tax, which accepts the anti-saving tax biases as normal. A clean, pro-growth tax reform would move further toward neutral tax treatment, not away from it.

It would be a mistake to move toward the "comprehensive" income base just to reduce tax rates a few points. For example, a 25 percent tax rate on corporate and individual income is not low enough to warrant treating capital gains and dividends as ordinary income and fully double-taxing the corporate sector. Congress made that mistake in the Tax Reform Act of 1986, and capital gains realizations and revenue collapsed for a decade. Investment and economic growth slowed. There are numerous tax subsidies for otherwise uneconomical activities that could more profitably be ended, such as credits for alternative energy sources that cannot compete on price with traditional fuels, and the open-ended health insurance exclusion.

Conclusion

The House initiative is not likely to pass the Senate, but it could start an important debate about the size of government and its areas of responsibility. It is not enough to reduce the deficit. To achieve growth in the process, it is necessary to reduce the deficit by cutting spending, or the growth of spending.

The House Republican Budget plan goes beyond the deficit reduction recommendations in the Bowles-Simpson Deficit Commission report, and it has the potential to do so in a more pro-growth manner by relying almost entirely on cutting spending. If it were to advance toward implementation, the House Ways and Means Committee would need to be careful to choose its tax changes wisely and check their effect on capital formation to ensure a good outcome for growth.

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