Order Code RS22242
September 7, 2005

Tax Reform and the Goal of Revenue Neutrality

Gregg Esenwein
Specialist in Public Finance
Government and Finance Division

Summary

The President's Advisory Panel on Tax Reform has been tasked to issue a report with revenue neutral policy options for reforming the federal Internal Revenue Code. The executive order establishing the Advisory Panel specifies neither the baseline nor the time horizon for achieving revenue neutrality.

If the Advisory Panel uses current *law* (the CBO revenue baseline) as its benchmark for revenue neutrality, then the reform proposal will have to raise taxes relative to their current levels by $2.3 trillion over the next 10 years. However, using current law as its benchmark is problematic because current law does not fully take into account anticipated or possible changes to the tax system. If the Advisory Panel includes the effects of these possible changes to the tax system in its baseline for determining revenue neutrality, then its 10-year revenue target would be substantially lower than under the CBO baseline. But relative to the CBO baseline, under this benchmark, the deficit could increase by approximately $2.6 trillion over the next 10 years.

The Advisory Panel has indicated that it plans to recommend repeal of the alternative minimum tax (AMT) for individuals as part of its reform options. Unless the revenue loss from the AMT were fully replaced, the deficit would increase considerably over the next 10 years compared to the CBO baseline. In addition, if the Advisory Panel chooses a five-year time horizon as a benchmark for revenue neutrality, then it would significantly understate the potential long-run (beyond 2010) costs of tax reform. This report will be updated periodically.

On January 7, 2005, President Bush issued Executive Order 13369, establishing the President's Advisory Panel on Federal Tax Reform. As stated in the executive order, "The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury in accordance with this order a report with revenue neutral policy options for reforming the Federal Internal Revenue Code."[1]

[1] U.S. President (Bush), "President's Advisory Panel on Federal Tax Reform," Executive Order 13369, *Federal Register*, vol. 70, no. 008, Jan. 12, 2005. Also available at

(continued...)

Given the requirement that the reform options be revenue neutral, a question naturally arises. What is to be the baseline for determining whether the reform options meet the revenue neutrality requirement? Specifically, is the baseline to reflect current law or potential changes to current law? Depending upon the answer to this question, the revenue neutral policy options for reforming the federal tax system will result in either significant tax increases compared to the level of current taxes or significant increases in the federal budget deficit compared to current Congressional Budget Office (CBO) baseline projections.

The Advisory Panel's Mandate

The President's Advisory Panel on Federal Tax Reform was originally required to submit its report with policy options to reform the federal tax structure no later than July 31, 2005. On June 16, 2005, President Bush amended the executive order and extended the reporting deadline of the panel until September 30, 2005.

The executive order specifically states that the policy options for reforming the federal Internal Revenue Code should simplify the tax laws, provide for a progressive tax system that recognizes the importance of homeownership and charitable giving, and promote economic growth, job creation, saving, and investment. The order states that the reform options should be revenue neutral. It does not, however, specify what constitutes revenue neutrality.

Although not directly addressed in the executive order, the Administration has repeatedly indicated that it also expects the reform options to address the looming problem associated with the alternative minimum tax (AMT) for individuals.[2] The AMT was originally enacted to ensure that high-income taxpayers paid a fair share of the federal income tax.[3] However, the recent reductions in the regular income tax coupled with the lack of indexation for inflation in the AMT have greatly expanded the potential impact of this tax. Temporary increases in the AMT exemptions, which have mitigated its effects, are scheduled to expire at the end of 2005. If this occurs, then the number of taxpayers affected by the AMT will increase from 4 million in 2005 to 19 million in 2006.

---

[1] (...continued)
[http://www.taxreformpanel.gov/executive-order.shtml]

[2] Statements of Council of Economic Advisers Chairman N. Gregory Mankiw, in a Feb. 17, 2005 briefing as reported in the *Daily Tax Report*, Feb. 18, 2005. Also see letter of Aug. 11, 2005, from Robert Carroll, Deputy Assistant Secretary for Tax Analysis, Department of the Treasury, to the Westchester County Board of Legislators as reported in *Tax Notes Today*, Aug. 17, 2005.

[3] See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, and CRS Report RS22100, *The Alternative Minimum Tax for Individuals: Legislative Initiatives and Their Revenue Effects*, by Gregg Esenwein.

It appears that the Advisory Panel has reached a consensus that the AMT for individuals should be repealed as part of the tax reform options that it will present in late September.[4]

The Revenue Baseline: Current Law Versus Possible Policy Changes

Measuring the revenue neutrality of tax reform options requires a baseline projection of revenues against which the reform options can be compared.

CBO produces baseline projections of the budget semi-annually so that policymakers have a common starting point from which to debate policy changes. The purpose of the baseline is to project revenues and outlays under current law over the next 10 years. CBO defines the baseline projection as:

> a benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending. . . . By statute, CBO's baseline projections must estimate the future paths of federal spending and revenues under current law and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes. So for that reason and others, actual budgetary outcomes are almost certain to differ from CBO's baseline projections.[5]

In other words, the CBO baseline is a projection of revenues and outlays under current *law*, absent any changes, over the next 10 years.[6] Based on current law, CBO projects that the cumulative budget deficit over the next 10 fiscal years will be $2.1 trillion.

On the revenue side, the use of current law as the guiding principle means that the revenue projections do not reflect what most observers expect to happen. For example, some federal tax provisions, especially many tax credits, have expiration dates. CBO is required to assume in its baseline projection that all tax measures (unless earmarked to a trust fund) will expire as scheduled, since that represents current law. But most of these expiring provisions have proven very durable, having been routinely extended. Some examples of expiring tax provisions include credits or deductions for clean-fuel vehicles, qualified zone academy bonds, welfare-to-work, medical savings accounts, research and experimentation, and economic development empowerment zones.

Most of the tax reductions contained in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L. 107-16) and the Jobs and Growth Tax Relief

---

[4] "Reform Panel to Recommend AMT Repeal; Revenue Offset, High-Income Issues Open", *Daily Tax Report*, July 21, 2005.

[5] CBO, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, Jan. 2005. [http://www.cbo.gov/showdoc.cfm?index=6060&sequence=0]. Instructions for creating the baseline estimates are contained in the Budget Enforcement Act (BEA) as amended.

[6] Also see CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg Esenwein and Marc Labonte.

Reconciliation Act (JGTRRA, P.L. 108-27) are scheduled to expire after 2010.[7] (The reduction in taxes on capital gains and dividend income from JGTRRA is scheduled to expire after 2008.) However, there has been strong political pressure and Administration support for making some, if not all, of these tax cuts permanent or at least extending them. The CBO baseline projections do not include the revenue loss of extending or making these tax cuts permanent.

Moreover, the CBO baseline revenue projection assumes that the AMT will not be reformed. To counteract the effects of the AMT, Congress has increased the AMT basic exemption and allowed certain personal tax credits to offset AMT tax liability. To minimize the revenue loss, these changes have been enacted for one or two years at a time and are now scheduled to expire at the end of 2005. The CBO baseline assumes that the AMT relief will expire as scheduled, and so the baseline includes the revenue that will be generated under the full effects of the AMT.

These assumptions mean that under the CBO baseline revenue projections, taxes will rise significantly over the next 10 years compared to their levels under current federal tax law as it stands in 2005. The magnitude of this increase can be seen by examining the likely effects of extending current tax policy. For instance, CBO estimates that extending the expiring tax provisions, including EGTRRA and JGTRRA, would reduce baseline revenues by $1.6 trillion over the 2006 to 2015 time period. In addition, CBO estimates that if, in conjunction with extending the expiring tax provisions, the AMT is reformed,[8] then the AMT modifications would cost $642 billion over the same period. In total, extending current tax policy would reduce revenues by $2.3 trillion over the next 10 years.

This means that if the Advisory Panel uses the CBO baseline as its benchmark for revenue neutrality, then the reform proposal will have to raise taxes relative to their current levels by $2.3 trillion over the next 10 years.

If, on the other hand, the Advisory Panel includes in its baseline for determining revenue neutrality the extension of existing tax cuts and AMT repeal, its 10-year revenue target would be substantially lower than under the CBO baseline. In this case, the reform plan would not have to raise taxes relative to their levels under current policy in 2005. It would mean, however, that, relative to the CBO baseline, the deficit would increase by approximately $2.6 trillion over the FY2005 through FY2016 period. This $2.6 trillion increase in the deficit represents the $2.3 trillion in reduced revenues relative to the CBO baseline plus more than $0.3 trillion in additional debt servicing costs.

The implications of these different baselines for measuring the revenue neutrality of tax reform are summarized in the following table.

---

[7] See CRS Report RS21992, *Extending the 2001, 2003, and 2004 Tax Cuts*, by Gregg Esenwein.

[8] CBO defines reform of the AMT as extending the AMT exemption at its higher level and indexing the exemption and AMT tax brackets for inflation after 2005.

Different Baselines for Meeting the Requirement of Tax Reform Revenue Neutrality

Potential effects over FY2005 through FY2016 on:	Baseline	
	Current Law (CBO Baseline)	**Possible Tax Policy Changes Included**
Level of taxes relative to 2005 levels:	Taxes rise by $2.3 trillion.	No change.
Federal budget deficit:	No change from CBO baseline.	Deficit increases by $2.6 trillion — $2.3 trillion tax reductions plus $0.3 trillion additional debt service.

Revenue Neutrality and Repeal of the AMT

As mentioned above, the Advisory Panel has indicated that it plans to repeal the AMT as part of its reform proposals. Determining the actual cost of repealing the AMT depends on which baseline it is measured against. If the baseline is the CBO current law baseline, then the repeal of the AMT would reduce revenues by $611 billion over the FY2006 through FY2015 period.[9] If the baseline assumes that the tax cuts are extended, then the repeal of the AMT would reduce federal revenues by $518 billion over the same period.[10]

If the AMT were repealed, then to keep tax reform revenue neutral would require that revenue raisers equaling approximately $518 to $611 billion would have to be included in the reform proposals.

If the revenue loss from repeal of the AMT were made up through increases in other taxes, there would be no effects on the level of taxes relative to their 2005 levels and no effect on the deficit under either baseline. However, if the revenue loss from repeal of the AMT were not fully replaced, then the relative level of taxes would fall and the deficit would increase under both baselines. Revenues under the current law baseline could decrease by approximately $611 billion for a total deficit of $2.7 trillion ($2.1 trillion CBO baseline deficit plus $611 billion increase from AMT repeal). If the effects of extending the tax cuts and repealing the AMT are included in the baseline, revenues could decrease by some $518 billion for a total deficit of $5.2 trillion ($2.1 trillion CBO baseline deficit plus $2.6 trillion increase resulting from extension of current tax policy plus $518 billion from repeal of the AMT).

---

[9] Congressional Budget Office, CBO Testimony, *The Individual Alternative Minimum Tax*, May 23, 2005, p.8.

[10] See Table 1 in CRS Report RS22100, *The Alternative Minimum Tax for Individuals: Legislative Initiatives and Their Revenue Effects*, by Gregg Esenwein.

Time Horizon Considerations

The time horizon the Advisory Panel chooses for determining revenue neutrality is also of critical importance. From a policy perspective, a 10-year horizon would be more indicative of long-term costs than a five-year horizon. The reason for this difference is straightforward. Over the next five years, the cost of extending expiring tax provisions would be only a fraction (approximately 17%) of the estimated total 10-year cost. That occurs because the major components of the 2001/2003 tax cuts are not scheduled to expire until after 2010. Hence, setting a five-year horizon as a benchmark for revenue neutrality would significantly understate the potential long-run (beyond 2010) costs of tax reform.