Insight

Tax Reform and Revenue-Neutrality

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The issue of tax reform and whether it should be revenue neutral continues to arise, but is poorly understood. The bottom line is simple: tax reform must be revenue neutral, properly measured. Only revenue neutral reform will provide permanently improved incentives that bear the test of time.

Let's begin with the careful qualifier, "properly measured." The whole point of tax reform in 2017 is to dramatically energize an anemic economy that is delivering subpar growth in standards of living. So it only makes sense to evaluate the success of a tax reform on the basis of how much faster the economy grows. Since that growth will drive faster revenue growth, it should also be taken into consideration. Translating this means that properly measured revenue neutrality means revenue neutral after dynamic scoring.

But growth alone will not be enough. Permanent, structural reforms — such as a territorial tax, neutral treatment of tangible and intangible capital, and others — will make it more desirable for companies to headquarter, innovate, invest and grow in the United States. But no serious dynamic score has concluded that a proposal would "pay for itself with growth." Tax reform is hard because of the necessity of including base-broadening provisions, but those base-broadeners are essential to get to revenue neutrality.

In 2017, revenue neutrality is the route to permanent tax reform. It is not possible to use reconciliation to pass a tax reform that creates long-term deficits. That means Congress faces a choice: pass revenue neutral reform or sunset the tax changes after a few years. The former gives powerful, unchanging signals for U.S.-centric investment, innovation, hiring and growth. The latter is economic weak tea, will not solve the growth problem, and is unworthy of the legislative effort it will take.

Revenue neutrality is also the route to keeping tax reform. Though 31 years have passed since tax reform last was signed into law, it is even harder to keep tax reform in place than to do it in the first place. The 1986 effort is instructive. Because the federal government ran large (at least for the era) budget deficits, there was pressure for higher revenues. In a few short years, the tax code got opened up and the reform began to steadily unwind.

The Obama Administration bequeathed an unsustainable fiscal situation with ever-rising deficits and debt. If tax reform exacerbates this problem, it will quickly be demagogued as "the problem" and nearly as quickly undone.

Tax reform is the greatest economic policy opportunity of the past 20 years. But to do it right, it needs to be revenue neutral. Growth alone is not enough, temporary tax reform is an economic oxymoron, and digging the grave of an economic triumph during its passage is bad strategy.