

The gathering storm

Tax & spending implications of the federal deficit crisis

April 21, 2011

Agenda

- The challenge
- Framing a deficit reduction effort
- Options to reduce spending
- Tax as a solution?
- Anticipating reform

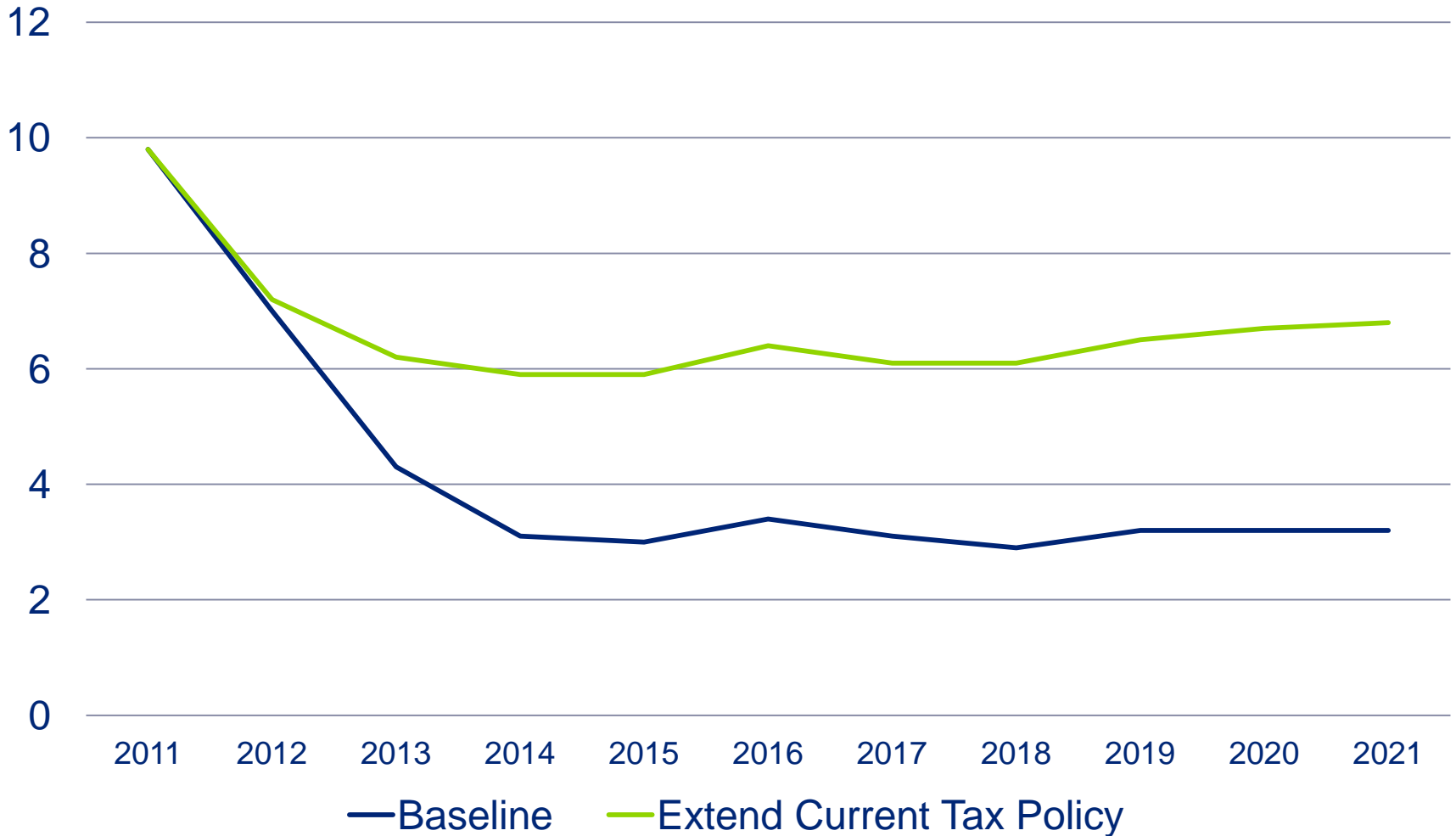
The challenge: Focus on spending

Fiscal challenges ahead

- Unsustainable gap between federal tax revenues and spending if current policies continue
- Unavoidable demographic shifts will strain Social Security and Medicare
- Debt servicing costs will increase sharply if large annual deficits continue to add to publicly held debt

Projected federal deficits

(as a percentage of GDP)



Source: Deloitte calculation from CBO, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*

Baby Boomers ease into retirement

- 76 million Baby Boomers will reach age 65 between 2011 and 2029
- Life expectancy rising
- Birth rates falling

Components of federal spending

- Mandatory
- Defense discretionary
- Nondefense discretionary
- Interest on the public debt

Mandatory spending

- Relates primarily to entitlement programs (Social Security, Medicare, Medicaid, etc.)
- Automatically funded under permanent law
- Projected to rise 60 percent between 2010 and 2020
- Social Security insolvent by 2037
- Medicare insolvent by 2029

Defense discretionary spending

- Determined annually through the congressional budget and appropriations processes
- 20.5% of total government spending in 2008
- Grew faster than any other component of the budget between 2000 and 2009 (9.1% average annual growth)
- Growth rate will slow over the next decade while growth in mandatory spending and interest payments accelerates

Nondefense discretionary spending

- Determined annually through the congressional budget and appropriations processes
- Provides funding for myriad federal agencies and programs, including education, transportation, energy, environment, law enforcement, science/technology, and veterans
- 17.5% of total government spending in 2008
- Projected to comprise a declining share of spending, falling from 19.1% to 13.1% of total government spending between 2010 and 2020

Interest payments on the public debt

- The “cost” of deficit financing
- Even when the Bush tax cuts are assumed to expire after 2012, interest costs are projected to more than double as a share of the economy between 2010 and 2020
- Absent reform, interest costs will skyrocket beyond 2020 as deficits compound and interest rates rise from historic lows
- Short average maturity of current debt poses a real risk

Framing a deficit reduction effort

Budget enforcement tools

- Pay-as-you-go
- Cut-as-you-go
- Budget reconciliation

Pay-as-you-go (PAYGO)

- New mandatory spending or tax cuts must be offset by reductions in other mandatory spending or tax increases
- Exists as a Senate chamber rule; principles were also codified in the Statutory Pay As You Go Act of 2010
- Enforced by “sequestration” of mandatory spending
- Exemptions under PAYGO law
 - “Emergency” spending
 - Permanent extension of 2001 and 2003 low- and middle-income tax cuts (if enacted before December 31, 2011)
 - Medicare physician payment updates through 2014 (if enacted before December 31, 2011)

Cut-as-you-go (CUTGO)

- House rule for the 112th Congress (2011-2012)
- New mandatory spending must be offset only by reductions in other mandatory spending
 - Cannot use tax increases to pay for new spending priorities
- New tax cuts need not be offset
- Likely roadblocks in the Senate and White House
 - Middle ground: Expect tax cuts and new mandatory spending to be offset only by spending cuts, not tax increases

Budget reconciliation

- Reconciliation instructions can be included in a budget resolution passed by Congress
- Directs committees to report legislation that changes law under their jurisdiction to achieve a desired budgetary outcome
- Limited debate; cannot be filibustered in the Senate
- Limitations:
 - Budget Committees cannot control the exact policy to be reported by authorizing committees
 - Broad agreement as to desired policies is a prerequisite to using reconciliation for comprehensive tax and spending reform
 - Budget resolution is not signed by the president

Recent deficit reduction proposals

- Bowles-Simpson (President Obama's National Commission on Fiscal Responsibility and Reform)
- Bipartisan Policy Center – Debt Reduction Task Force
- Rep. Paul Ryan, R-Wis. – A Roadmap for America's Future

Bowles-Simpson

- Overall
 - 2020 Revenues: 20.6% of GDP
 - 2020 Spending: 21.8% of GDP
- Spending
 - Limit discretionary spending to 2011 levels in 2012, 2008 levels in 2013, and thereafter limit growth to half rate of inflation
 - Reform entitlement programs
- Revenues
 - Eliminate all tax expenditures in return for rates of 8, 14, and 23% and corporate rate of 26%
 - Permit “buy-back” of expenditures for higher marginal rates
 - Capital gains and dividends taxed at ordinary rates
 - Territorial tax system

Bipartisan Policy Center

- Overall
 - 2020 Revenues: 21.4% of GDP
 - 2020 Spending: 23.0% of GDP
- Spending
 - Freeze discretionary spending — defense for 5 years, nondefense for 4 years — and thereafter limit growth to rate of inflation
 - Reform entitlement programs
- Revenues
 - Pare back tax expenditures in return for rates of 15 and 27% and corporate rate of 27%.
 - Capital gains and dividends taxed at ordinary rates
 - 6.5% debt reduction sales tax (VAT)
 - Extend 2009 estate tax law (\$3.5 million exemption; 45% top rate)
 - Phase out exclusion for employer-provided health insurance

Rep. Paul Ryan – A Roadmap for America’s Future

- Overall
 - 2020 Revenues: 18.6% of GDP
 - 2020 Spending: 22.2% of GDP
- Spending
 - Limit nondefense discretionary spending
 - Limit total government spending as a share of GDP
 - Semi-privatization of Social Security, Medicare, and Medicaid
- Revenues
 - Option to file under highly simplified system with rates of 10 and 25%
 - Replace corporate income tax with 8.5% “business consumption tax”
 - Interest, dividends, and capital gains not subject to tax
 - 100% immediate expensing of capital expenditures
 - Eliminate estate tax
 - Repeal AMT

Where we are headed — Discretionary spending

- Near-term reductions in discretionary spending
 - Nondefense reductions/eliminations
 - Nondefense contracting
 - Trim federal workforce
 - Transportation spending (Amtrak, high-speed rail, etc.)
 - Energy spending (conservation, research, etc.)
 - Community development block grants
 - Defense reductions/eliminations
 - Defense contracting and R&D
 - Procurement
 - Overseas installations and personnel
 - V-22, F-35, Expeditionary Fighting Vehicle, etc.
- Statutory discretionary spending limits, likely enforced by sequestration of spending

Where we are headed—Mandatory spending

- Social Security
 - Index retirement age for longevity
 - Slow benefit growth for high-earners
 - Increase taxable wage base
- Health care
 - Increased beneficiary cost-sharing
 - Malpractice reform
 - Greater rebates on Medicare Part D prescription drugs
- Other mandatory
 - Reduced farm subsidies
 - Reduced military and civil service retirement benefits

Rep. Paul Ryan's FY2012 Budget

■ Spending

- Reduce, then statutorily limit non-security discretionary spending
- Limit total government spending as a share of GDP
- Reform Medicare and Medicaid to lock-in federal share of costs

■ Revenues

- Tax Reform: Reduce top corporate and individual rate to 25% by modifying tax expenditures (offers no specifics)
- Permanent extension of 2001 and 2003 tax cuts for all taxpayers
- Repeal 2010 healthcare laws and new taxes included within
- Assumes AMT relief is provided
- Permits extension of current estate and gift tax law

President's Deficit Reduction "Outline"

- Announced on April 13th
- Would save \$4 Trillion over 12 years
 - \$2 Trillion in cuts from mandatory and discretionary spending
 - \$1 Trillion in savings related to interest on the debt
 - \$1 Trillion in tax revenue
- Tax recommendations include
 - Call for corporate tax reform
 - Broaden base and lower the rate
 - Revenue neutral
 - Call for individual tax reform that reduces tax expenditures to make permanent BTCs for low and middle income taxpayers
 - Reiteration of campaign proposal to restore Clinton era top rates
 - Unclear on cap gains and dividends

Tax as a solution?

Reform of the current tax system

- Base broadening exercise
- Increasing rates
- Improving taxpayer compliance

Five questions for policymakers

- Should tax reform proceed independently or as part of deficit reduction efforts?
- Should corporate and individual income tax reforms occur simultaneously?
- What overall approach should govern reform?
- What should be the nature and reach of the individual income tax after reform?
- What should be the nature and reach of the corporate income tax after reform?

Tax reform & deficit reduction together?

- Revenue neutral similar to 1986
 - Distribution of tax burdens for individuals largely unchanged
- Raise additional revenue to reduce the deficit
 - Consequences for tax decisions

Corporate & individual tax reform together?

- Consensus that corporate rate should come down
- Factors that make corporate-only approach difficult
 - Significant business activity is taxed at individual level through passthrough entities and sole proprietorships
 - Tax benefits enjoyed by both corporate and individuals could be affected
 - Corporate-only leaves uncertainty for individual tax

What approach should govern reform?

- Reform that lowers rates and broadens the base
 - Generally maintains same level of revenue collection
 - Generally maintains existing distribution of tax burden across income categories
- Fundamental areas of disagreement
 - How much tax should be collected
 - Who should bear what share of the burden

Corporate rate

- Competitors have lower rates
 - Canada at 16.5 percent
 - UK dropping to 24 percent by 2014

Corporate rate

- Competitiveness concerns have driven reform plans:
 - Rangel 2007: 30.5 percent rate
 - Bowles-Simpson 2010: top rate not to exceed 29 percent
 - Wyden-Gregg 2010: 24 percent
 - Ryan 2010: abolish corporate income tax and replace with 8.5 percent business consumption tax
- Lowering corporate rate and eliminating tax expenditures could raise the effective tax rate for some corporate taxpayers

Tax expenditures

- Largest corporate tax expenditures include
 - Section 199 domestic production activities deduction
 - Research and experimentation tax credit
 - Accelerated depreciation
 - Energy incentives for fossil fuels, alternatives, and renewables

Additional new or alternative taxes

- Value-added tax
- Business activity tax
- National retail sales tax
- Energy tax (gasoline or broad-based)
- Carbon tax or auction
- Targeted taxes on specific goods

Perceived advantages of new taxes

- Generate significant revenue at relatively low rates
- Reduce number of existing tax preferences that would have to be curtailed
- Consumption taxes would likely encourage saving and investment
- Border adjustability could encourage U.S. production activities
- Move U.S. tax system into closer alignment with major trading partners

Perceived disadvantages of new taxes

- Too easy to raise revenue: small increases in rate would generate significant tax collection
- Could burden consumption of services, such as health care, education, housing, and insurance, which are already tax-favored
- Would be regressive and disadvantage poor, retirees, and those who consume a large share of their income
- Additional complexity and administrative burdens, especially for small business
- Potential conflict with state and local retail sales taxes

Value-added tax (VAT)

- Over 135 nations impose broad-based VAT or similar consumption tax
- U.S. is alone among major economies in not imposing such a tax
- Credit-invoice method VAT used almost universally
- Applied on a transaction basis, like a sales tax
- In most systems, VAT is imposed at the border on imports but rebated on exports
- Credit-invoice VAT would be administratively burdensome because of monthly invoicing.

Business activities tax (BAT)

- Essentially a subtraction-method VAT
- Computed from the books and records of the business rather than through direct reliance on invoices to prove tax credits.
- Computed and applied at entity level (tax rate applied to tax base of gross receipts less value of all goods and services purchased from other firms)
- Examined in 2007 Treasury study; proposed as part of deficit reduction plans (e.g., Paul Ryan's)
- Critics argue BAT would impose all of the negative aspects of a VAT plus create, in effect, a second income tax computed on a separate tax base.

Other possibilities

- National Retail Sales Tax (NRST)
- Energy taxes
 - BTU tax
 - Carbon tax or auction (cap and trade)
- Excise (“sin”) taxes on targeted consumer products such as tobacco, alcohol, sugar-sweetened beverages

Anticipating reform

Anticipating reform

- Three distinct time periods
 - Current environment
 - Transition phase
 - Post-reform
- Four categories of affected parties
 - Business
 - Owners (shareholders)
 - Employees
 - Products & services

Current environment

- **Business**
 - Model alternative tax scenarios
 - Analyze risk and contingency plan
 - Strengthen forecasting, analytics, and modeling capability
- **Owners (shareholders)**
 - Develop investor communication plan
 - Analyze and communicate financial statement impact of tax reform
- **Employees**
 - Review recruitment and retention policies
 - Consider tax and compensation strategies for execs/employees
- **Products & services**
 - Review tax reform impact on product and service offerings

Transition phase

- Business
 - Utilize benefits available prior to law change
 - Manage timing of tax items to utilize advantages available when rates change
 - Consider opportunities or strategic acquisitions
- Owners (shareholders)
 - Communicate impact of tax and spending changes to investors
- Employees
 - Revise compensation and benefit programs
 - Educate employees on impact of tax changes to business
- Products & services
 - Withdraw products and service offerings no longer effective under new law

Post-reform

- Business
 - Implement information systems and reporting requirements
 - Review and realign choice of entity structure and investment choices
- Owners (shareholders)
 - Review and revise investment portfolio
- Employees
 - Implement redesigned compensation and benefit programs
- Products & services
 - Introduce new products and services
 - Focus on new or expanded markets

Questions?

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