BRACEWELL

BLOG POST

Understanding Reconciliation for Tax Reform

February 24, 2017

There has been a slew of reports, discussions, and even flippant use of the term "reconciliation" in the context of tax reform of late. Among those keeping track of Washington tax policy, reconciliation is generally understood as providing a tool that could allow Republicans to pass tax reform this year through a simple majority vote. And while most in Congress would prefer a bipartisan approach to tax reform, there likely will come a point in time when reconciliation presents the only option left for Republicans to achieve tax reform this Congress. Yet while most of the talk about reconciliation focuses on its advantages for Republicans, the disadvantages of its use are often overlooked.

Below, we explore the origin of reconciliation, its upsides for facilitating action by the majority party, and its downsides for the formation of effective long-term policy.

What is a Budget Resolution?

Reconciliation owes its existence to the Congressional Budget Act of 1974, which established the statutory framework for today's congressional budget process. A concurrent budget resolution is an *agreement* between the House and Senate on a budget for a given period of time. The budget resolution itself is not law. It is not signed by the President, and therefore, cannot be vetoed. The concurrent budget resolution merely amounts to Congress imposing self-restraint, or a guideline, on the management of revenue and spending levels. These guidelines are used by committees as parameters to work inside of when drafting legislation that affects spending or revenue levels.

If legislation drafted by a committee exceeds the spending or revenue parameters prescribed by the budget resolution, a "point of order" (an objection) can be raised by a Senator. The Parliamentarian of the Senate acts as a judge (more like an appellate judge, for the litigators out there) by deciding whether proposed legislation does in fact exceed the agreed-upon budget constraints. Since budgets are time-sensitive due to the desire to get them passed before proceeding to other legislation, they are afforded special expediting procedural rules that differ from the normal rules applied in considering most legislation. Under budget rules, for instance, there are limits on what type of amendments can be offered, the time allowed to debate the resolution, and the necessary votes to pass the resolution—51 instead of the requisite 60 needed to end debate on most legislation.

What is Reconciliation?

To facilitate the enactment of legislation within a budget resolution, resolutions often include "reconciliation instructions" that direct individual committees to develop legislation that changes either revenues (taxes), spending (appropriations), or the debt limit. Reconciliation instructions include specific amounts of revenues or spending to be changed, and the date by which the committee must report the legislation.

While the purpose of reconciliation was to direct committees to come up with legislation in furtherance of budget concerns, Congress has over time increasingly used reconciliation to trigger the use of advantageous procedural rules. The Bush tax cuts in 2001 and 2003 came to pass as a result of reconciliation, as well as a portion of Obamacare in 2010. But it's important to remember that any legislation developed by a committee under reconciliation is cloaked with the same budget procedural rules as prescribed to the broader budget resolution, which is where the limitations come in.

Downsides of Reconciliation; Why You Don't Want to be Called an 'Extraneous Matter'
While reconciliation does provide significant procedural advantages, it also comes with fiscal constraints that limit what Congress can do in developing legislation. The late Senator Byrd perhaps foresaw the potential abuse of reconciliation for passing legislation. Under the Byrd rule, adopted in 1986 and made permanent in 1990, certain restrictions are imposed on "extraneous matters" included in reconciliation legislation. These "extraneous matters" include any item that:

1. Does not change spending or revenue levels, including how revenues are collected.

2. Produces an outlay increase or revenue decrease contradictory to the instructions.

3. Falls outside the jurisdiction of the committee instructed.

4. Produces a change in spending or revenues merely incidental to the budget.

5. Would increase the deficit for a fiscal year beyond the "budget window" covered by the reconciliation measure, typically 10 years (**pay attention to this one**).

6. Recommends changes in Social Security.

If it is determined that the reconciliation legislation includes any of the "extraneous matters" listed above, a Senator may raise a point of order to strike the violating provision. This can be waived, but doing so requires a 60-vote threshold.

For those of you still paying attention, provision #5 above—making legislation expire when the timeframe of the budget itself is over—is the reason why the Bush tax cuts are no longer in effect.

How Senate Reconciliation Might Impact the House Blueprint's Border Adjustment
In broad terms, the House GOP Blueprint shifts our current income-based tax system to more of a consumption-based tax system by focusing on the cash flows of a business. The Blueprint's plan is referred to as a destination-based cash flow tax (DBCFT). This tax system includes a border adjustment, exempting a U.S. company's foreign sales from taxation, and excluding imports from the traditional deduction for the costs of goods sold. The latter effectively amounts to a tax on imports.

The Tax Policy Center, a non-partisan tax think tank, has estimated that the border adjustment will raise $1.2 trillion in first ten years and as much as $1.7 trillion in the following ten years.

Not all economists agree with this estimate and actually think the border adjustment will lose revenue.

As Brookings Institute economist William Gale points out, if effective, the Blueprint's plan would shift our trade deficit to a trade surplus, substantially decreasing imports into the United States in so doing. Because the border adjustment results in taxing imports, and the DBCFT is designed to reduce the amount of imports into the United States, the DBCFT inherently includes a diminishing tax base over time. This will reduce revenues in the long term.

Normally, budget windows cannot exceed the ten-year timeframe typically designated by Congress. If the DBCFT decreases revenues ten years after a tax reform package passed via reconciliation is enacted, the border adjustment could be termed an extraneous matter—or simply forced to sun-set in 10 years, to the chagrin of Republicans hoping to achieve far-reaching tax policy change this Congress.

To conclude, even if the Blueprint does manage to pass out of the House, the road ahead for the Senate to pass it in its current form will be difficult. Assuming the Blueprint is scored as the border adjustment loses revenues outside the budget window and another provision, such as the limitation on interest deductibility, does not offset that loss in revenue, two scenarios are likely to occur. First, it will have to have a sunset date like the Bush tax cuts, or second it will have to be accompanied by an increase in revenues or decrease in spending equaling the decrease in revenues associated with the border adjustment outside the 10-year budget window.