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Key Issues in Tax Reform: The "Better Way" House Plan

On June 24, 2016, House Speaker Paul Ryan released the Better Way Tax Reform Task Force Blueprint, which provides a revision of federal income taxes. (For an analysis of the plan, see CRS Report R44823, *The "Better Way" House Tax Plan: An Economic Analysis*, by Jane G. Gravelle.) The plan does not specify all changes that might broaden the base or any transition rules.

Tax Revisions

For the individual income tax, the plan would broaden the base by disallowing itemized deductions except for mortgage interest and charitable deductions, lower the rates (with a top rate of 33% compared to 39.6% under current law), and alter some of the elements related to family size and structure by eliminating personal exemptions, allowing a larger standard deduction, and adding a dependent credit. The current earned income credit and child credit would not be altered. Capital gains, dividends, and interest would be taxed at 50% of ordinary rates; currently, capital gains and dividends are subject to a top rate of 20% and interest is taxed at ordinary rates.

For business income, the current income tax would be replaced by a cash-flow tax, with a top rate of 20% for corporations and 25% for individuals' (pass-through) capital income. A cash-flow tax allows investments, such as purchases of buildings and equipment, to be deducted when incurred rather than through depreciation deductions over time and results in a zero tax rate on new investment returns. The cash-flow treatment would not apply to land and apparently not to inventories. Interest would no longer be deducted. The tax would be border-adjusted (imports taxed and exports excluded), making domestic consumption the tax base, although a recent announcement from congressional leaders and administration officials has indicated that a border adjustment would be dropped in any future tax plan. The border adjustment may not be complete because it would not allow a refund of the export deduction when it creates an overall loss, but rather a carryover of losses with interest. The system would also move to a territorial tax in which foreign source income (except for easily shifted income) would not be taxed. The proposal would repeal the domestic production activities deduction but retain the research tax credit.

The proposal would repeal estate and gift taxes. Although the Affordable Care Act (ACA) taxes are not repealed in the Better Way tax reform proposal, ACA taxes are repealed in the House-passed American Health Care Act.

Effects on Efficiency and Growth

One objective of tax reform is to increase output and efficiency. The plan would achieve efficiency gains, particularly in the allocation of capital by type and industry and in the even treatment of debt and equity finance.

Current effective corporate tax rates on new equity investments are negative or zero for investment in intangibles, around 24% for equipment, and up to 36% on some structures. Overall, including taxes on shareholders and creditors, effective tax rates are around 22% for corporate equity financed investments and a *negative* 44% on debt financed investments; the new plan would result in rates close to zero for both. Similar narrowing of tax differentials would occur for unincorporated businesses.

The plan's estimated output effects appear to be limited in size and possibly negative. The direct effect of lower marginal tax rates on labor supply is limited because the reduction in marginal tax rates is small and largely offset by an increased base that increases effective marginal rates. Capital income effects are also somewhat limited even with the movement to a cash-flow tax (that generally imposes a zero rate) because the current effective tax rate is low, due to current accelerated depreciation and the negative tax rate on debt-financed investment. Growth effects are also limited because most empirical evidence does not support large savings and labor supply responses. As currently proposed, the plan loses significant revenue which, according to some estimates, could more than offset the supply responses because the increased government borrowing would crowd out private capital investment.

The effect on international capital flows is ambiguous as the cash-flow tax, while encouraging equity capital to move from abroad, would discourage inflows of debt. The plan would eliminate many distortions associated with multinational firms, including eliminating the tax treatment that discourages repatriation of foreign source income to the United States and the incentive for firms to invert (shift headquarters abroad) by merging. It would also largely eliminate profit shifting to low-tax countries, although if border adjustments are eliminated, the effect on profit shifting is ambiguous. Although the disallowance of interest deductions and lower tax rates would reduce profit shifting incentives, a territorial tax tends to induce more profit shifting through transfer pricing of intangibles. Without the border adjustment, the incentive to invert would not be entirely eliminated but would be substantially reduced.

Exchange rate adjustments (the dollar should appreciate by 25%) should eliminate any effect of the border adjustment on imports and exports, although how quickly that adjustment would occur is uncertain. If firms cannot merge or otherwise find ways to deal with the lack of refundability of the value of the deduction for exports, the measure would reduce imports.

Distributional Effects

The proposal would have effects on vertical equity (progressivity, or how the tax burden changes as income rises), horizontal equity (how the tax burden changes across families with the same ability to pay), distribution across generations, and international distribution.

Distribution Across Incomes

Studies find that the plan favors high-income individuals, increasing the after-tax income of the bottom 80% of families by 1% or less, while increasing the income of the top 20% by 1% to 4% (depending on the estimate), and the top 1% would have an increase of 5% to 11%.

Horizontal Equity

Calculations suggest that the current tax system, which favors families with children and lower incomes and favors families without children at higher ones, would remain essentially the same. The current pattern of marriage penalties and bonuses would remain similar. Couples without children would primarily experience bonuses (depending on the income shares) except at some high-income levels. Couples with children would experience a mix of bonuses and penalties depending on who can claim the children. Some equity issues would arise from eliminating itemized deductions for extraordinary medical expenses, because these families generally have a lesser ability to pay. Disallowing itemized deductions that are appropriate to measure income, such as casualty losses and employee business expenses, may also be viewed as inequitable.

Intergenerational Redistribution

Unlike an income tax, a cash-flow tax does not affect new investment but rather reduces asset values, thus shifting the burden from younger to older generations. This asset effect is expected to result in a fall in stock market prices and in prices of used assets in general. The estimated fall in the stock market is limited to about 6% because the current corporate income tax has many cash-flow elements and the proposed tax does not extend cash-flow treatment to land and inventories (with full cash flow treatment, the fall would be around 17%). The fall will be smaller initially if transition costs are allowed (such as continuing to depreciate existing assets), but larger if higher statutory rates were used to address revenue costs.

International Distribution and the Border Adjustment

The appreciation in the dollar is expected to cause current foreign holders of dollar-denominated assets to gain as much as $8 trillion in value, whereas foreign holders of U.S. assets could lose as much as $5 trillion. Countries with debt denominated in dollars would have increased burdens.

Revenue Effects

Estimates indicate that the proposal would lose revenue of $2.3 trillion over the budget horizon (assuming ACA taxes are excluded; if they are included the cost would be $3.1 trillion). If the border tax adjustment were eliminated, the cost would increase by an additional $1.2 trillion, although in either case, this amount is effectively borrowed. These costs are unlikely to be much altered by dynamic scoring because, while demand stimulus and increased saving may increase output, the effects would be largely offset or reversed by crowding out.

Administrative and Compliance Issues

Many elements of the blueprint could produce simplification in tax administration and compliance. For the individual income tax, a significant reduction in the share of itemizers, due to the disallowance of most itemized deductions (particularly state and local taxes) and the significant increase in the standard deduction, is an important simplification. The repeal of estate and gift taxes would reduce tax planning. The cash-flow treatment would simplify business accounting although transition rules would continue depreciation deductions, potentially for many years. International tax planning would be simplified and largely eliminated with a border tax adjustment.

New administrative costs would arise, however. Taxing capital income of pass-through businesses (such as proprietorships and partnerships) at a lower rate will require allocation of income between capital and labor income. For individuals in the 33% bracket, there will be an incentive to characterize labor income as capital income.

A variety of new administrative and compliance costs would arise from a border tax adjustment. One tax planning issue would be addressing the inability to use the deduction for exports by mergers with importers, setting up an import brokerage business or leasing investments. Tax planning activities to maximize the value of exports and minimize the value of imports would also complicate tax administration and compliance.

Other Issues

Several other potential issues arise with the plan. Some believe that border tax adjustments would violate rules of the World Trade Organization and bilateral tax treaties. The plan might complicate tax administration for state and local governments because most of these taxes begin with the federal base and use federal tax return information for enforcement. The shift to a consumption tax base will eliminate federal depreciation deductions and make it difficult for state and local governments to continue with income taxes. States also sometimes require conformity in itemizing deductions versus taking the standard deductions, which can have consequences for the number of taxpayers that take state standard deductions. Complications may occur with applying the cash-flow tax to certain types of firms, such as financial firms. Finally, some have argued that the incentives to invest do not arise from a cash-flow tax because financial accounting drives investment and the cash-flow tax is a timing issue that does not affect book profits.

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