The Economics of Tax Policy
and How to Think About Tax Reform
Tax Foundation University 2017, Part 5

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Tax Foundation
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TODAY’S KEY POINTS

BALANCING AMONG:
  GROWTH, DISTRIBUTION, REVENUE, SIMPLICITY

REQUIRES AWARENESS OF TRADE-OFFS, INTERACTIONS, CONFLICTS,

CAUTION IN USING TAX EXPENDITURE LISTS,

DYNAMIC EVALUATING OF TAX PLANS.
The Triangle of Tax Reform Tradeoffs

Revenue Neutral

Distributionally Neutral

Pro-Growth
Tax Reform Goals

- Three common objectives: Growth, Revenue, Distribution.
- These involve trade-offs, at least on a static basis.
- Dynamic gains from growth can smooth distributional effects of the initial tax changes, and restore part of initial revenue loss from a tax cut. How much depends on type of tax change; not all tax cuts are alike in that regard.
Tax Reform Goals

Simplification is a common additional goal.

• Simplification per se (e.g. fewer brackets, deductions) has less to do with growth than with ease of compliance or administration. It makes taxes more transparent and understandable, and reduces concerns about equity and avoidance.

• Nonetheless, saving/consumption neutral taxes are simpler than income taxes, and less destructive of growth. Neutral tax treatment of capital and territorial treatment of international income flows remove much complexity.
Tax Reform Components

**Growth-related**: cost recovery rules, tax rates/brackets, treatment of saving, multiple taxation issues.

**Distribution or Social Policy-related**: exemptions, deductions, credits (regular or refundable).

**Simplification-related**: consolidation of overlapping provisions, deductions, number of brackets, also international tax issues.

**Revenue**: rates, base changes, and offsets.
Tax Systems, Tax Expenditures, and Tax Reform

• Tax reform should begin by asking what type of tax system is to be the goal – a “pure” income tax, a saving/consumption neutral tax, or a hybrid.

• Depending on the answer, some things on the ordinary “tax expenditure” list might be considered for sacrifice, or not. Do not use the list as a menu for offsetting revenue without first asking if the items belong in the desired tax base.
Revenue Offsets, Deductions, and Tax Expenditures

• Do not use tax expenditure lists for scoring, due to timing, transition, and interaction issues.

• Do not include provisions that conflict with other features or objectives of the plan.

• In particular, consider the effect on economic growth of any potential revenue offsets.

• Consider the effect on productivity and wages of any changes in the tax treatment of capital.
The tax expenditure number does not provide a good revenue estimate. It assumes the provision had never been in the code (so all economic adjustments have been made). It ignores the effect on growth of ending the provision, transition effects, and interactions.

- Example, in the TAG model, the long-run static cost of cutting the corporate tax rate to 20% is $183 billion, and of full expensing is $166 billion, both in the 10th year. The static sum is $349 billion. But done together, the 10th-year static cost is $302 billion. The dynamic numbers are gains of $15 billion (corporate cut) and $86 billion (expensing), done separately, but $51 billion done together. Costs are higher in earlier years before growth and before old assets are through being depreciated.
Tax Expenditures Under a Broad-Based Income Tax

• All pensions, deferrals of saving and capital gains, and reduced tax rates on capital gains and dividends, and tax-exempt bond interest would be tax expenditures. Ordinary tax treatment of saving would be the norm.

• Any depreciation faster than “economic depreciation” would be a tax expenditure.

• Corporate tax would be treated as “normal” in the broad-based tax, although in a “pure” Haig-Simons” income tax it would be double taxation (a “negative tax expenditure”).

• Deductions for charitable contributions and state and local taxes would be suspect.
If a saving/consumption neutral tax is considered the “normal” tax system, the list of tax expenditures would be much smaller.

- All pensions, deferrals of saving and capital gains, would be the normal treatment, not tax expenditures. Ordinary tax treatment of saving would be a “negative tax expenditure” (too harsh a tax).

- Any depreciation that falls short of expensing would be a “negative tax expenditure”.

- Corporate tax would be a negative tax expenditure.
Tax Expenditures Under Any System

• Income that is simply never taxed, either when earned or on a deferred basis, would be a tax expenditure under either type of tax system.

• The largest such item is the exclusion of employer-provided health insurance, and other “fringe benefits”.

• See the Tax Expenditure chapter in the 2009 Budget of the United States, Special Analysis section for a detailed analysis of tax expenditures under alternative views of what constitutes a “normal” tax system.
Representative Devin Nunes (R-CA) would reform business taxes. Major elements:

- Corporate income tax rate: 25 percent;
- Top non-corporate business tax rate: 25 percent;
- Full expensing of investment (equipment, plant, structures);
- Territorial tax system;
Economic and Revenue Estimates, Nunes Business Tax Plan

GDP 7.3%

$GDP (annual gain relative to 2015 economy) $1,290

Private Business Stocks (equipment, structures, etc.) 22.1%

Wage Rate 6.0%

Full-Time Equivalent Jobs (in thousands) 1,401

10-Year Static Federal Revenue Estimate, 2015-2024 ($ billions) -$1,638

10-Year Dynamic Federal Revenue Estimate after GDP Gain or Loss, 2015-2024 ($ billions) $631

Source: Tax Foundation Taxes and Growth Model (October 2015 version)
### Distributional Effects of Nunes Tax Plan: Static & Dynamic Analysis

<table>
<thead>
<tr>
<th>All Returns (AGI&gt;0) by Decile Class</th>
<th>Changes in Static After-tax AGI</th>
<th>Changes in Dynamic After-tax AGI</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% to 10%</td>
<td>0.6%</td>
<td>6.8%</td>
</tr>
<tr>
<td>10% to 20%</td>
<td>0.2%</td>
<td>6.4%</td>
</tr>
<tr>
<td>20% to 30%</td>
<td>0.1%</td>
<td>6.4%</td>
</tr>
<tr>
<td>30% to 40%</td>
<td>0.2%</td>
<td>6.8%</td>
</tr>
<tr>
<td>40% to 50%</td>
<td>0.2%</td>
<td>7.2%</td>
</tr>
<tr>
<td>50% to 60%</td>
<td>0.3%</td>
<td>7.4%</td>
</tr>
<tr>
<td>60% to 70%</td>
<td>0.3%</td>
<td>7.2%</td>
</tr>
<tr>
<td>70% to 80%</td>
<td>0.2%</td>
<td>6.7%</td>
</tr>
<tr>
<td>80% to 90%</td>
<td>0.2%</td>
<td>6.5%</td>
</tr>
<tr>
<td>90% to 100%</td>
<td>1.9%</td>
<td>7.2%</td>
</tr>
<tr>
<td>99% to 100%</td>
<td>4.3%</td>
<td>8.5%</td>
</tr>
<tr>
<td>TOTAL FOR ALL</td>
<td>0.9%</td>
<td>7.0%</td>
</tr>
</tbody>
</table>

Source: Tax Foundation, Taxes and Growth Model (October 2015 version).
Senator Ben Cardin (D-MD) proposes lower individual and business income taxes, replacing revenue with a VAT. Major elements:

- **Large family allowance** ($100K joint, $50K single) replaces Personal Exemption, Standard Deduction. Most people would not owe tax.
- **3 brackets:** 15% ($0-$100K); 25% ($100K-$500K); 28% (>500K) for joint filers, half those amounts for single filers.
- **3 deductions:** charitable gifts, state/local taxes, mortgage interest.
- Replace EITC, other credits with rebates for earned income, children.
Senator Cardin’s Progressive Consumption Tax (cont’d.)

- Treat capital gains, dividends as ordinary income but end 3.8% surtax.
- Lower corporate rate to 17%.
- VAT at 10%, subtraction method tax on sales less purchases from other firms. (Must be 14.2% for revenue neutral version.)
### Economic and Revenue Estimates, Cardin Tax Plan vs. Current Law

<table>
<thead>
<tr>
<th></th>
<th>VAT @ 10%</th>
<th>VAT @ 14.2%</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>4.4%</td>
<td>2.6%</td>
</tr>
<tr>
<td>$GDP (annual gain relative to 2015 economy)</td>
<td>$778</td>
<td>$459</td>
</tr>
<tr>
<td>Private Business Stocks (equipment, structures)</td>
<td>15.2%</td>
<td>13.2%</td>
</tr>
<tr>
<td>Wage Rate</td>
<td>6.5%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Full-Time Equivalent Jobs (in thousands)</td>
<td>1,053</td>
<td>-187</td>
</tr>
<tr>
<td>10-Year Static Federal Revenue, 2015-2024 ($ billions)</td>
<td>-$306</td>
<td>-$2</td>
</tr>
<tr>
<td>10-Year Dynamic Federal Revenue after GDP Gain or Loss, 2015-2024 ($ billions)</td>
<td>-$163</td>
<td>$80</td>
</tr>
</tbody>
</table>

Source: Tax Foundation Taxes and Growth Model
## Basics of the GOP “Blueprint” Tax Plan

### Individual Provisions
- Consolidates 7 brackets into three: 12%, 25%, 33%
- Increases standard deduction to $12,000 (S), $24,000 (MFJ) while eliminating personal exemption
- Increases child credit to $1,500, limits refundability to $1,000
- Eliminates all itemized deductions except mortgage and charitable.
- Taxes cap gains, dividends, interest as ordinary income with 50% exclusion
- Eliminates AMT and estate tax

### Business Provisions
- Eliminates CIT, replaces it with a DBCFT
- Allows immediate full expensing
- Eliminates deductibility of net interest on future loans
- Cuts corporate tax rate to 20%
- Eliminates most corporate deductions (except R&D). Eliminates corporate AMT
- Moves to full territorial
- Makes tax system “destination-based”, border-adjustable
- Deemed repatriation tax at rates of 8.75% for cash & 3.5% for assets
- Caps tax rate for pass-throughs at 25%
The Economics of GOP “Blueprint” Tax Plan

- Boosts long-run level of GDP by 9.1%.
- Raises level of capital investment by 28%
- Lifts wages by 7.7%
- Creates 1.7 million jobs.
- Loses $2.4 trillion in revenue over ten years (static)
- Loses $191 billion in revenues over ten years after accounting for growth (dynamic)
Net Ten-Year Economic Impact of GOP Blueprint 9.1%

- 50% exclusion for capital gains 0.30%
- 25% rate for pass-throughs 0.60%
- Repeal estate tax 0.90%
- Consolidate individual brackets 1.50%
- Lower corporate rate to 20%, 1.70%
- Full expensing 5.40%
- Base broadeners -1.30%

Source: Tax Foundation, Taxes and Growth Model
Expensing Component of the “Blueprint”

- Expensing boosts long-run level of GDP by 5.4%
- Raises level of capital investment by 16%
- Lifts wages by 4.5%; creates 1 million jobs
- Loses $2.2 trillion in revenue over ten years (static)
- Loses $881 billion in revenues over ten years after accounting for growth (dynamic)
- Raises revenue and reduces deficit longer term even after accounting for interest on borrowing to cover short run revenue loss
Full Expensing Would Lead to Economic Growth

Static and Dynamic Revenue Estimates of Immediate Expensing of Capital Investment

Source: Tax Foundation Taxes and Growth Model (Oct. 2016)
Budgetary Impact of the Cash-Flow Tax

The business-side provisions break about even (raises about $200 billion over a decade).

$\text{Deemed Repatriation} \quad +$185 \text{ Billion}

$\text{Other Base Broadeners} \quad +$700 \text{ Billion}

$\text{Interest Expense} \quad +$1.2 \text{ Trillion}

$\text{Border Adjustment} \quad -$1.1 \text{ Trillion}

$\text{Dynamic Revenue} \quad +$2 \text{ Trillion}

$\text{Full Expensing} \quad -$2.2 \text{ Trillion}

$\text{Territorial} \quad -$160 \text{ Billion}

$\text{Rate Cut} \quad -$1.8 \text{ Trillion}

$\text{Pass-Through} \quad -$515 \text{ Billion}

Source: Tax Foundation Calculations
Budgetary Impact of the Full Plan

Most of the Dynamic Revenue Comes from Base Broadeners
2016-2025 Dynamic Revenue Estimate by Component, Billions of Dollars

Add in the Individual Income Tax changes, it looks like this.

On net, it loses $192 billion over a decade.

Alternative Revenue Offsets?

• Flip treatment of saving plans to Roth-style.
• Raise payroll tax cap without allowing associated benefit increase for upper income workers.
• NCRS for structures instead of expensing; equal investment incentive but budget cost deferred.
• Phase-ins of Blueprint provisions could save money, but jeopardize near-term growth.
Current Trump Plan

Limited information:
• 15% rate for C-corps and pass-throughs; still lacks full expensing.
• Three brackets, 10%, 25%, 35%; no $ amounts on brackets yet.
• Higher standard deductions.
• Most personal deductions gone, except charitable contributions, mortgage interest. No apparent other offsets.
• Expanded child credit.
Trump Campaign Tax Plan

Details and Analysis of the Donald Trump Tax Reform Plan, September, 2016, by Alan Cole, Tax Foundation Fiscal Fact No. 528

- 15% rate for C-corps and (possibly) pass-throughs;
- Limited expensing (for manufacturing equipment if firm gives up interest deduction).
- Three brackets, 12% ($0-$75K), 25% ($75K-$225K), 33% (>225K) (joint filers; single filer numbers half). Capital gains rates 0%, 15%, 20%, same brackets.
- Higher standard deductions.
- Most personal deductions gone, except charitable contributions, mortgage interest.
- Expanded child credit.
The Economics of Trump Campaign Tax Plan

Assuming 15% top rate on pass-through businesses:
• Boosts long-run level of GDP by 8.2%.
• Raises business capital stock by 23.8%.
• Lifts wages by 6.3%.
• Creates 2.2 million jobs.
• Loses $5.9 trillion in revenue over ten years (static)
• Loses $3.9 trillion in revenues over ten years after accounting for growth (dynamic)

More expensive, less growth than Blueprint.
Why the BAT in the Blueprint?

Three reasons a border adjusted tax may be in our future:

• It broadens the tax base and raises $1.1 trillion in a less economically harmful way than many other revenue sources.

• It protects the U.S. tax base against “erosion” by improving business incentives to earn and report income here.

• It simplifies the business tax system.
One non-reason for a border adjusted tax: It does not “cure” the trade deficit. Consider a full-blown VAT.

- VATS do not normally affect trade balances.
- Foreign VAT’s do not cause the U.S. trade deficit.
- Disadvantages to U.S. manufacturing stem from domestic U.S. tax and regulatory excesses.
- Capital flows set current account and capital account balances.
- Pro-growth tax reform attracts capital, raise the dollar, boosts imports. Effects reverse as future dividend and interest payments to foreigners restore capital flows to normal levels.
VATs and Trade.

Minimal impact:

• Foreign VATs raise the cost of imports and domestic goods equally; so no change in relative cost of their buying U.S. products.

• Exports are not taxed, and sell abroad for the same relative price vs. foreign goods as before; so no change in the cost of imports for U.S. buyers.

• So no reason to either side changes spending habits, or to assume a change in trade.

• European payroll, personal income, and corporate income taxes sum as high as U.S. taxes, even without European VATs. No tax advantage in their exports to U.S.

• VATS by themselves do not normally affect capital flows, so they normally do not affect trade balances.
Not Why the BAT, cont’d.

• The BAT in the Blueprint is not a full VAT. It only falls on the profit side of domestic production, with a deduction for labor costs, but falls on profit and labor costs of imports. This may contribute to issues with the WTO.

• The BAT should still not affect the total trade balance, although it may favor labor-intensive exporters over capital-intensive exporters, and alter the mix of domestic output and imports.

• The net capital flow is the chief determinant of the current account (trade) balance.
Current and Capital Accounts: Sum Must Balance

What we sell:  
Exports of goods & services + U.S. financial instruments & real property

=  

What we buy:  
Imports of goods & services + Foreign financial instruments & real property
Current and Capital Accounts: Equal Size, Opposite Sign

Exports – Imports of goods & services = Financial items sold (foreign loans to U.S.) – Financial items bought (U.S. lending abroad)

Or

Current acct. surplus = Capital account deficit or net capital outflow