

The Growth Effects of the Nunes Plan to Reform Business Taxation

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Executive Summary

Representative Devin Nunes (R-CA) seeks to reform how the federal government taxes business income. Major elements of his plan are:

- Cutting the corporate income tax to 25 percent;
- Limiting the top tax rate on non-corporate business income to 25 percent;
- Allowing businesses to deduct investment costs when they occur (full expensing);
- Eliminating most business deductions and credits;
- Moving to a territorial tax system like most other developed nations;
- No longer letting nonfinancial businesses deduct interest costs but no longer taxing them on interest receipts; and
- Applying the same tax-rate limitation to individuals' interest income as to their dividend income.

Tax Foundation's economists used the Taxes and Growth Model (TAG) to evaluate the economic and budget implications of the Nunes plan. We did not model the proposal's transition provisions.

Key Findings

- According to the Taxes and Growth Model, the Nunes tax reform plan would increase the size of the economy by 6.8 percent over the long run.
- The plan would increase the level of investment by 20 percent, lift wages by 5.7 percent, and create 1.2 million full-time equivalent jobs.
- On a dynamic basis, the plan would increase federal revenue by \$96 billion in the long run due to increased economic growth.
- The two main drivers of economic growth in the plan are the full expensing of capital investment and the lower tax rate on business income, both of which significantly reduce the tax code's bias against saving and investment.

Introduction

Representative Devin Nunes (R-CA), a ten-year veteran of the House Ways and Means Committee, has crafted a plan to reform how the federal government taxes business income.¹ Convinced that the current rules unnecessarily damage the U.S. economy, Rep. Nunes has been developing his proposal for several years. His stated goal is a better tax system that would lead to greater productivity, more jobs, higher incomes, and improved opportunities for people across the income spectrum.²

We estimated the economic and revenue effects of the Nunes draft proposal using the Tax Foundation's Taxes and Growth Model. The simulation results indicate that the plan would significantly lower tax biases against saving, investment, and entrepreneurship. Because the plan would greatly reduce tax penalties on productive business activities, it would be strongly pro-growth. We estimate the growth dividend would be sufficiently strong that the plan would increase federal revenue in the long term.

The model predicts that the plan, if enacted, would ultimately lift the level of GDP 6.8 percent (\$1.1 trillion annually in 2013 dollars), increase the capital stock (equipment, structures, intellectual property, etc.) by over 20 percent, advance the real wage rate by 5.7 percent, and raise hours of employment by 1.3 percent (the equivalent of over 1.2 million added jobs). The main reason for the growth is that the plan would significantly reduce tax biases against saving and investment.

In a conventional revenue estimate, which assumes tax changes do not alter the economy's total size or growth, the model estimates that the plan would reduce annual federal revenue by \$129 billion (2013 dollars). However, Rep. Nunes has stated that transition provisions, which we did not model, would make the plan revenue neutral during the budget window. In a dynamic revenue estimate which considers tax-induced growth effects, the model estimates that the plan would ultimately increase federal revenue by \$96 billion annually.

If growth is ignored, the plan appears mainly to benefit the top 10 percent of taxpayers. When economic growth is factored in, however, the model estimates that the Nunes proposal would raise the after-tax incomes of taxpayers at all income levels by over 6 percent.

Although Rep. Nunes has stated that many parts of the income tax code are deeply flawed, he decided to focus on business taxes because he feels it will be easier to pass tax reform by taking a step-by-step approach, starting with an area of the tax code that is widely acknowledged to need repair. Additionally, Rep. Nunes thinks that improving the tax treatment of business income will yield a large dividend in terms of a stronger, faster-growing U.S. economy.

1 Lindsey McPherson, *Nunes Business Reform Plan Uses 25 Percent Rate, Full Expensing*, TAX ANALYSTS (JAN. 12, 2015), <http://www.taxanalysts.com/www/features.nsf/Features/261EE930295650DB85257DCB003F75E3?OpenDocument>.

2 For a presentation of Rep. Nunes' longtime goals in his own words, see Devin Nunes, *A Tax Reform to Get Businesses Expanding*, THE WASHINGTON POST, (Oct. 11, 2012), http://www.washingtonpost.com/opinions/a-tax-reform-to-get-businesses-expanding/2012/10/11/2d536956-0f4a-11e2-bd1a-b868e65d57eb_story.html.

The Need for Business Tax Reform

The American Business Competitiveness Act of 2014 addresses several concerns with how the federal government currently taxes business income.

The Current Tax Code's Bias Against Saving and Investment

The income tax discourages investment because it requires businesses to write off many of their capital expenditures over multi-year periods rather than letting the businesses deduct investment costs when they occur. Because of the time value of money, the present value of a stretched out deduction schedule falls short of the actual cost of the investment. A further problem is that multi-year write-offs are inherently complex, especially because an investment's write-off schedule often varies depending on the type of asset and on the industry in which it is used. Special rules designed to soften the anti-investment bias engender further complexity.

Uncompetitive Corporate Tax Rates

The United States has the highest corporate income tax rate of any developed nation. That reduces the ability of U.S. companies to compete domestically and internationally. The combined state and local corporate income tax rate in the United States is 39.1 percent. The other industrialized nations in the Organization for Economic Cooperation and Development (OECD) have an average corporate rate of 25 percent (29 percent if weighted by GDP).³ From 1990 to 2014, the average combined corporate tax rate in other OECD nations fell by 16.2 percentage points, from 41.2 percent to 25 percent. The U.S.'s combined corporate tax rate actually rose slightly due to a 1 percentage point increase in the federal rate.⁴

An Uncompetitive International Tax System

The United States is one of the few nations that taxes its businesses on the income they earn in foreign nations as well as at home (worldwide taxation). Most countries tax businesses on domestic income but not income from foreign operations; they leave that to the countries where the income occurs (territorial taxation).⁵ Worldwide taxation diminishes the international competitiveness of U.S. companies, gives U.S. companies a tax incentive to reorganize abroad, and has the unintended effect of helping foreign companies acquire U.S. companies.⁶

3 Kyle Pomerleau and Andrew Lundeen, *The U.S. Has the Highest Corporate Income Tax Rate in the OECD*, TAX FOUNDATION TAX POLICY BLOG (Jan. 27, 2014), <http://taxfoundation.org/blog/us-has-highest-corporate-income-tax-rate-oecd>. These numbers refer to statutory tax rates. The United States also has one of the highest effective corporate tax rates. See Jack Mintz and Duanjie Chen, *The U.S. Corporate Effective Tax Rate: Myth and the Fact*, TAX FOUNDATION SPECIAL REPORT No. 214 (Feb. 6, 2014), <http://taxfoundation.org/article/us-corporate-effective-tax-rate-myth-and-fact>.

4 Pomerleau and Lundeen, *op. cit.*; and Tax Foundation, *OECD Corporate Income Tax Rates, 1981-2013* (Dec. 18, 2013), <http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013>.

5 Philip Dittmer, *A Global Perspective on Territorial Taxation*, TAX FOUNDATION SPECIAL REPORT No. 202 (Aug. 10, 2012), <http://taxfoundation.org/article/global-perspective-territorial-taxation>.

6 On the last point, if a U.S. company with some foreign operations sells itself to a company based in a nation with a territorial tax system, the foreign operations will no longer be subject to U.S. tax. (The foreign operations will still be taxed in the country where they occur.) Because of this tax difference, the company's after-tax value to the acquiring firm may be greater than its after-tax value if it remained an independent American company.

A Bias in Favor of Debt Financing

The U.S. tax system penalizes companies when they use equity financing instead of debt financing because companies can deduct interest costs as a business expense but they cannot deduct dividend payments. Because of this tax bias, companies rely too little on equity and too much on debt, which reduces their financial flexibility and increases risk.

An Overview of the Nunes Business Tax Reform Plan

The Nunes plan seeks to correct the previously discussed shortcomings of the current tax code through a number of reforms to the business tax system. Its main provisions will now be sketched.

Allows Expensing of Capital Assets

The plan would let businesses claim the full costs of equipment, structures, intellectual property, inventories, and land in the same year they purchase the assets, with immediate deduction of the entire outlay, creating a “cash flow” tax that fully accounts for all the costs of business investment. For example, while current law most commonly requires businesses to write off the cost of an equipment purchase over five or seven years, the Nunes plan would permit the business to recognize the whole cost on its tax return when it incurs the cost. (Section 179 for small businesses and bonus depreciation are two limited forms of expensing that have been in the tax code in recent years, but the Nunes plan would generalize this treatment.) Unused deductions could be carried back up to five years or carried forward with interest. In addition to more accurately measuring business expenses and net income, expensing is much simpler in terms of recordkeeping and computations than the stretched-out write-offs of depreciation, amortization, and capitalization.

Lowers the Federal Tax Rate on Business Income to 25 Percent

Rep. Nunes would cut the federal corporate tax rate, which applies to C corporations, to 25 percent. With state taxes, the rate would fall from 39.1 percent to about 29 percent, still a bit above the average for the developed world. In addition, the plan would limit to 25 percent the top federal income tax rate on “pass-through” businesses, such as sole proprietorships, partnerships, S corporations, and LLCs. Pass-through businesses are not subject to the corporate income tax; their income is “passed through” to shareholders’ tax returns and taxed at the individual level.⁷

⁷ Because the income of C corporations is taxed at the corporate level and again at the individual level (when distributed through dividends or realized as capital gains), the cumulative income tax rate for C corporations would still be higher than for other businesses. If the tax rate on business income is 25 percent and the tax rate on capital gains and dividends is 20 percent, corporate income would face a combined tax rate of 40 percent compared to 25 percent for noncorporate business income.

Shifts to Territorial Taxation

This provision would bring the United States into conformity with most other nations.

Treats Interest More Like Dividends for Tax Purposes

The Nunes plan would not let nonfinancial businesses deduct interest payments, but would not tax them on interest receipts. It would generally not allow individuals to deduct interest payments, except that home mortgage interest would remain deductible, and it would apply the same tax-rate limitation to individuals' interest income as to dividends (top rate of 20 percent). These changes would have a mixed effect on tax biases. On the one hand, because individual savers/lenders would continue to be taxed on interest received, the proposed changes would extend to corporate debt financing the same double taxation at the corporate and individual levels that now applies to equity financing. On the other hand, these shifts would lessen the tax distortion between debt and equity financing.

Eliminates Many Business Tax Deductions and Credits

Numerous tax “breaks” today are designed to partially offset the anti-investment bias of delayed write-offs on capital expenses. They would no longer be needed with expensing, and the Nunes plan would end them. For example, the plan would repeal the domestic production activities deduction. The deduction is intended to bolster domestic manufacturing, which is disproportionately impaired by long depreciation lives. The plan's combination of expensing and lower tax rates would exert a far bigger impact on after-tax rewards and be a more powerful spur to manufacturing, rendering the deduction unnecessary. The plan would also remove some items, such as various alternative energy credits, that are essentially subsidies which might better be delivered through spending programs, not the tax code, if they are provided at all.

Transition Rules

The plan has transition rules that generally fit into one of two categories. In one category are provisions to protect taxpayers during the changeover. For instance, taxpayers could continue to claim write-offs for old assets that have not yet been fully depreciated under old law. In the other category are provisions included for revenue reasons. Two fairly noncontroversial examples are gradual phase-ins for the business rate cut and for the shift to full expensing. Another example is a 5 percent “toll charge” on undistributed foreign earnings. Although it would be an unexpected tax hit, the rate is low enough that most multinationals would probably accept it without much protest in exchange for territorial taxation.

A more controversial revenue raiser is a proposal to bar businesses with over 50 full-time employees from fully deducting their labor costs during the transition. Current law generally permits labor costs to be deducted as business expenses, and that is proper tax treatment. In principle, all business expenses, both capital and labor, should be fully deductible when

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they occur. The restriction, a recent addition to the plan, was likely inserted so that a conventional revenue estimate would score the package as revenue neutral over the budget window.

The Economic and Revenue Effects of the Tax Reform

The Taxes and Growth Model combines a detailed individual income tax calculator with a model of production in the U.S. economy. The tax calculator is calibrated to data from a large, anonymous sample of individual tax returns (the IRS's 2008 Public Use File, which is the latest available). The economic model is calibrated to data from the National Income and Product Accounts.

The Taxes and Growth Model estimates the change in tax liabilities under the new tax rules and examines whether the new rules alter the after-tax rewards for work, saving, and investment at the margin. If the tax changes improve incentives, people will supply more labor and capital in production, which leads to more output and a stronger economy. Conversely, worse after-tax incentives result in a weaker economy. Both labor and capital respond to incentives, but capital (equipment, structures, intellectual property, etc.) is especially sensitive.

In addition to estimating the long-run changes in employment, wages, the capital stock, and production, the Taxes and Growth Model takes account of the feedback on tax collections due to changes in GDP and income to provide a dynamic revenue estimate.⁸

In evaluating Rep. Nunes' proposal, we modeled the economic and revenue effects of:

- Allowing businesses to expense (deduct immediately) their investments in equipment, residential structures, and nonresidential structures;
- Cutting the corporate income tax rate to 25 percent;⁹
- Lowering the top tax rate on noncorporate (pass-through) business income to 25 percent;
- Not letting nonfinancial corporations deduct their interest costs and not taxing them on their interest receipts; and
Eliminating numerous business deductions and credits.

Because of limitations in both the tax data and the model, we were not able to model the transition provisions, the expensing of inventories and land, the interest switch in the case of pass-through businesses, the plan's provisions for financial businesses, the shift to territorial taxation, the administrative costs of adjusting to the new tax rules, or the administrative savings later from a simpler tax system.

⁸ For a fuller discussion of the model, See, Michael Schuyler, *The Taxes and Growth Model—A Brief Overview*, TAX FOUNDATION, (May 6, 2014), <http://taxfoundation.org/article/taxes-and-growth-model-brief-overview>.

⁹ The revenue estimate includes the effect of reduced profit shifting. If the corporate tax rate were cut from 35 percent to 25 percent, companies would have less incentive to shift mobile income abroad. We estimate the positive effect this would have on federal revenue based on our reading of the tea leaves regarding the sensitivity assumed by the Joint Committee on Taxation (JCT). See, Thomas Neubig, *Dynamic Microbehavioral Effects Are Scored*, TAX NOTES 980-987 (Mar. 3, 2014).

The Nunes Plan Would Boost Investment, Wages, and Jobs, and Grow the Economy

Our core finding is that the business tax reforms proposed by Rep. Nunes would benefit workers, business people, and the overall economy. It would generate several years of rapid growth, boosting output, income, and employment to higher levels than the economy would achieve under current law.

As shown in Table 1, the Taxes and Growth Model estimates that the Nunes plan would ultimately lift GDP 6.8 percent (\$1,100 billion annually in 2013 dollars), increase the stock of private business capital by over 20 percent, advance the real wage rate by 5.7 percent, and raise hours of employment by 1.3 percent (the equivalent of over 1.2 million added jobs).

Table 1. The Nunes Plan Would Increase Jobs, Wages, Investment, and GDP

Economic and Revenue Estimates of the Nunes Business Tax Plan vs. Current Law (Billions of 2013 Dollars Except as Noted)	
GDP	6.8%
GDP (\$ Billions)	1,108
Private Business GDP	7.1%
Private Business Stocks (Machines, Equipment, Structures, etc.)	20.6%
Wage Rate	5.7%
Private Business Hours of Work	1.3%
Full-time Equivalent Jobs (in Thousands)	1,228
Static Federal Revenue Estimate (\$ billions)	-\$129
Dynamic Federal Revenue Estimate after GDP Gain or Loss (\$ billions)	\$96
Weighted Average Service Price	% Change
Corporate	-11.4%
Noncorporate	-10.9%
All Business	-11.2%

Source: Tax Foundation Taxes and Growth Model.

The model also estimates that the plan would reduce annual federal revenue by \$129 billion (2013 dollars) according to a conventional revenue score which makes the static assumption that taxes never affect the overall economy's size and growth rate. As mentioned earlier, we have not modeled the transition provisions. Rep. Nunes' office states that a conventional (static) revenue estimate which considered the transitional provisions would score the plan as revenue neutral over the budget window.¹⁰

In a dynamic revenue estimate that takes account of the larger economy, the Taxes and Growth Model calculates that the plan would ultimately increase federal revenue by \$96 billion annually. The explanation for the reversal is that, other things equal, the government collects more revenue when the economy is large and healthy than when it is smaller and sluggish. The feedback is rarely strong enough for a tax cut to be self-financing, but the Nunes plan would be an exception because of the robust growth effects from expensing and from the lower corporate income tax rate.

¹⁰ McPherson, "Nunes Business Reform Plan Uses 25 Percent Rate, Full Expensing," *op. cit.*

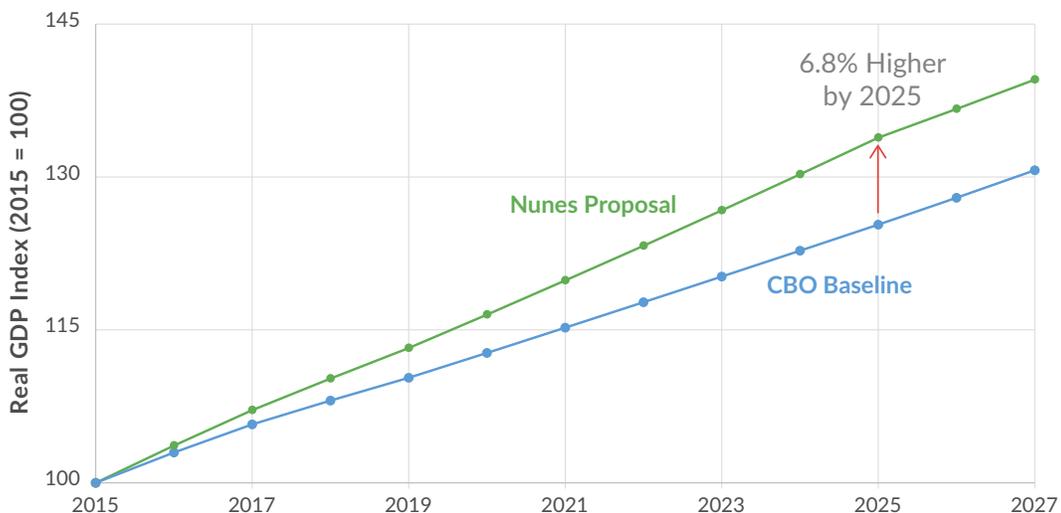


The gains would not come to fruition instantly. The model is long run, and the economy would need several years to respond fully to the lessened tax biases against work and investment. Capital usually requires more time to adjust than labor, but based on rates of capital replacement, most of the added equipment would be put in place within five years and most of the added structures within 10 years.

Chart 1 offers an illustrative adjustment path for GDP. The baseline is the Congressional Budget Office's current-law projection of GDP growth over the next decade (with 2015 set at 100). The higher line represents the Nunes proposal. It is drawn under the illustrative assumption that it would lift GDP growth by an extra 0.68 percent each year during the next decade. At the end of the tenth year, GDP would be 6.8 percent above the CBO baseline. Thereafter, the growth spurt would level off, and the two growth lines would move in parallel, with GDP under the Nunes business tax reform continuing to be 6.8 percent higher than under current law.

Chart 1. The Nunes Tax Reform Plan Would Boost GDP by 6.8 Percent

Illustrative Adjustment Path Of Real GDP To Nunes Business Tax Plan



Note: The CBO Baseline runs through 2025. It is extended through 2027 at CBO's projected 2025 growth rate of 2.1 percent. The Nunes line assumes 0.675 percent more growth each year for 10 years than the CBO Baseline. That produces a 6.8 percent larger economy by the 10th year (2025). Both lines are assumed to grow at the same rate after the 10th year.

Sources: CBO and Tax Foundation

Economic Estimates by Components

The most obvious reason why the Nunes plan would spur growth is it would significantly cut business tax rates, thereby easing tax biases that hold back investment, work effort, and production. The Taxes and Growth Model estimates, for example, that a 25 percent corporate income tax rate, with no other changes in the tax system, would lead to a 6.4 percent bigger capital stock, 383,000 additional jobs, and a level of GDP 2.2 percent higher than would be achieved at the current 35 percent rate.

Expensing would be even more powerful. Letting businesses deduct their investment costs in the same year that the businesses incur the costs greatly reduces the income tax bias against

investment. In addition, expensing is well targeted in the Nunes plan because it would apply prospectively, which means expensing would push the tax system toward more neutral treatment of future investments without the budget cost of lowering taxes on investments already in place. As shown in Table 2, the model estimates that, with no other changes in tax rules, expensing would result in a 15.6 percent larger capital stock, 895,000 more jobs, and a 5.2 percent rise in the annual level of GDP. The Nunes plan wisely resists the temptation to pay for a cut in the highly visible corporate tax rate by slowing down capital cost recovery schedules, which are much less visible but at least as important. (See Table 2.)

Table 2. The Economic Effects of Two Key Components of the Nunes Plan

Economic and Revenue Estimate of a Corporate Tax Rate Cut and Full Expensing vs. Current Law (Billions of 2013 Dollars)		
	Cut Corporate Income Tax Rate to 25 Percent, No Other Changes	Full Expensing,* No Other Changes
GDP	2.2%	5.2%
GDP (\$ Billions)	\$356	\$847
Private Business GDP	2.3%	5.4%
Private Business Stocks (Machines, Equipment, Structures, etc.)	6.4%	15.6%
Wage Rate	1.9%	4.4%
Private Business Hours of Work	0.4%	0.9%
Full-time Equivalent Jobs (in Thousands)	383	895
Static Federal Revenue Estimate (\$ billions)	-\$66	-\$73
Dynamic Federal Revenue Estimate after GDP Gain or Loss (\$ billions)	\$11	\$101
Weighted Average Service Price	% Change	% Change
Corporate	-5.6%	-9.4%
Noncorporate		0.2%
All Business	-3.9%	-8.8%

*This models full expensing of equipment, residential structures, and nonresidential structures. It does not model expensing of inventories and land.

Source: Tax Foundation Taxes and Growth Model.

Distributional Analysis of the Nunes Plan

Just as a conventional revenue estimate does not mirror reality when a tax change would have substantial positive or negative growth effects, so too a conventional distributional analysis may be misleading when growth effects are significant.

Table 3. The Distributional Effect of the Nunes Tax Plan: Static and Dynamic Distributional Analysis

All Returns with Positive AGI Decile Class	Changes in Static Aftertax AGI	Changes in Dynamic Aftertax AGI
0% to 10%	0.0%	6.1%
10% to 20%	0.0%	6.0%
20% to 30%	0.0%	6.2%
30% to 40%	0.1%	6.5%
40% to 50%	0.1%	6.6%
50% to 60%	0.2%	6.7%
60% to 70%	0.2%	6.7%
70% to 80%	0.2%	6.6%
80% to 90%	0.3%	6.5%
90% to 100%	1.4%	7.5%
99% to 100%	2.5%	9.0%
TOTAL FOR ALL	0.7%	7.0%

Source: Tax Foundation Taxes and Growth Model.

As shown in the static column in Table 3, a standard distribution table, which ignores growth effects, would suggest that the Nunes plan would do nothing for the poor, almost nothing for the middle class, and only help the well-off. According to the table's static column, the average gain in after-tax income would be zero for taxpayers in the 10-20 percent decile, 0.2 percent for the 50-60 percent decile, and 1.4 percent for taxpayers in the top 10 percent. (The static distributional estimates reflect changes only in the individual income tax, not the corporate income tax.)

However, the dynamic column illuminates the benefits of faster economic growth. All income groups would gain as the economy expands. Although the distribution of benefits would not be exactly equal, the gains would significantly help people throughout the income spectrum. For example, the after-tax income increases would be 7.0 percent on average, 6.0 percent for the 10-20 percent decile, 7.5 percent for the top 10 percent, and 6.7 percent for the 50-60 percent decile.

Conclusion

The federal government has not overhauled how it taxes business income since the Tax Reform Act of 1986. That was a generation ago. In the intervening years, most other developed countries have lowered their corporate rates and moved toward territorial taxation. As other countries modernize, it has become increasingly obvious that business taxation in this country is out of date, a drag on competitiveness, and in need of reform.

The Tax Foundation's Taxes and Growth Model was used to evaluate the long-term effects of a business-tax-reform plan developed by Rep. Devon Nunes. The plan, once fully implemented, would produce a more efficient tax system with fewer biases against business activity. The result would be significantly faster growth. The Nunes plan would create conditions leading to more jobs, higher incomes, and better opportunities for people across the income spectrum.

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