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Chairman Camp's Tax Reform Plan Keeps Debate Alive Despite Flaws

Curtis S. Dubay and David R. Burton

Abstract

House Ways and Means Committee Chairman Dave Camp's long-awaited tax reform plan includes such positive reforms as lowering rates for families and eliminating many deductions and credits that are unnecessary for neutrality. It also modernizes the tax code's treatment of international businesses. However, along with these positive reforms, it includes policies that increase the cost of investing. Chairman Camp was forced to make these trade-offs because he chose to work within the confines of the current system and adhere to a static estimate of revenue neutrality. The plan is slightly pro-growth in the first 10 years but would likely decrease growth thereafter. Despite its flaws, the Camp plan keeps the discussion about tax reform alive and serves as a guide for authors of future plans.

In February, the chairman of the House Ways and Means Committee, Representative Dave Camp (R–MI), released his long-awaited tax reform plan.[1] Chairman Camp and his staff are to be applauded for the tireless work they put into crafting the plan and for the courage they displayed in releasing it in a difficult environment for tax reform.

Discussion and debate about the Camp plan will help to keep tax reform a part of the national conversation. For that alone, Camp and the staff of the Ways and Means Committee deserve much praise. Tax reform is a vital component of the economic policy reforms that are necessary to restore the United States to prosperity.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2890**

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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Key Points

- By keeping the national discussion alive, the Camp plan will make it more likely that tax reform will succeed.
- The plan includes positive policy changes, such as lowering tax rates, eliminating many deductions and credits that are unnecessary for neutrality, and moving to a corporate tax system that would be more competitive internationally.
- The Camp plan does include harmful measures, such as increasing the cost of investing.
- The plan is slightly pro-growth in the 10-year window but likely harms growth after that point because it increases the burden on capital in later years. Using the revenue that would be raised from growth to undo the provisions that hurt investment would improve the plan.
- Future tax reform efforts should not try to repair the broken system; they should start from scratch and insist on scoring estimates that better capture tax reform's true impact on the economy.

Tax System Needs Fundamental Reform

Tax reform should be a top issue for Congress because the current tax system is like an albatross around the neck of the U.S. economy, holding it back from reaching its full potential. When the economy cannot grow as fast it could, all Americans suffer because there are fewer opportunities, fewer jobs, and lower wages. Congress has not reformed the tax code since 1986, and much damage has been done in the intervening 28 years. The tax code is long overdue for fundamental reform.

The current tax system is damaging the economy. On the individual side, the rates levied on work, saving, investment, and entrepreneurship—all basic elements of economic growth—are too high. The top federal income tax rate is 43.4 percent. When combined with state income taxes, this means that taxpayers in many states pay a marginal rate in excess of 50 percent, a major deterrent to engaging in economically productive activities.

Businesses pay tax on the income they earn, and individuals then pay a second layer of tax on capital gains or dividends when businesses distribute those earnings. This double tax further diminishes the amount of savings and investment in the economy.

The current system also picks winners and losers by providing tax preferences to politically favored activities, such as purchasing energy-efficient products or vehicles. The tax system should play no role in tilting markets.

On the business side, the U.S. has the highest corporate tax rate in the developed world. In addition, we are essentially the only country that taxes our businesses on the income they earn in other countries.[2] Moreover, the U.S. delays deductions for investment in equipment and factories much longer than most industrialized countries. Businesses should be able to deduct costs when they are incurred. These three policy mistakes significantly impair the ability of U.S. businesses to compete in the highly competitive global market.

Fundamental Tax Reform Would Maximize Growth. Fundamental tax reform would correct all of these problems, enabling the economy to grow to its potential and resulting in increased opportunity for Americans at all income levels.

The problems with the current tax system arise largely because, in addition to the high rates it levies, it uses a faulty tax base. The tax base is what the tax code taxes; income and consumption are the most common tax bases. A consumption (or consumed-income) base is preferable to an income tax because it prevents the double taxation of investment—a key factor if a tax system is to have the least negative impact on economic growth. The current system uses a hybrid of an income and consumed-income base, creating many instances of double taxation and reducing investment.

Tax reform should be a top issue for Congress because the current tax system is like an albatross around the neck of the U.S. economy, holding it back from reaching its full potential.

Fundamental tax reform would start by deciding which tax base to use. Consumption, or consumed income, is by far the best in terms of promoting prosperity and fairness. Then the new tax code, assuming a consumed-income base, would have the deductions needed to maintain neutrality, including deductions for savings and interest expenses[3] and for the maintenance of a strong civil society—i.e., charitable giving. At the same time, the new tax code would levy a rate necessary for raising the revenue to fund the federal government's constitutional functions.

The rate that such a fundamental tax reform plan would levy would likely be substantially lower than today's tax rates. The Heritage Foundation's New

1. Discussion Draft, "Tax Reform Act of 2014," Committee on Ways and Means, U.S. House of Representatives, 113th Cong., 2nd Sess., February 21, 2014, http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf (accessed March 4, 2014). For a section-by-section summary, executive summary, and various analyses by the Joint Committee on Taxation staff, see "The Tax Reform Act of 2014: Making Today's Tax Code Simpler and Fairer While Creating More Jobs and Higher Take Home Pay for American Workers," Committee on Ways and Means, U.S. House of Representatives, http://tax.house.gov/ (accessed March 3, 2014).
2. Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.
3. Curtis S. Dubay, "The Proper Tax Treatment of Interest," Heritage Foundation *Backgrounder* No. 2868, February 19, 2014, http://www.heritage.org/research/reports/2014/02/the-proper-tax-treatment-of-interest.

Flat Tax follows this approach and has significantly lower rates,[4] as do other broad-based consumption taxes such as the original flat tax,[5] national sales tax,[6] or business transfer tax.[7]

The Camp Proposal

Instead of fundamental reform, Chairman Camp chose another approach: to improve the current system as much as possible and minimize its negative impact on the economy. Such an approach generally requires lowering rates and broadening the tax base. Although it will not result in as much economic growth as fundamental reform, this approach can result in a system that is less of a burden on the economy if enough improvements are made.

This approach usually forces policymakers into trade-offs that must balance pro-growth reforms with reforms that move in the opposite direction, thereby subduing its economic benefits. These trade-offs are especially pronounced when one works within the confines of static revenue neutrality as Chairman Camp did.

Revenue neutrality holds that the reformed tax code will raise the same amount of revenue as the current tax system. This is a sensible political constraint and is understandable when tax revenues are near their historical average as a percentage of the economy. Within the confines of the current tax system, it often means choosing between lowering rates and increasing double taxation or reducing the tax burden on savings and investment but lowering rates only slightly or not at all.

Using a *static* revenue score further complicates reform. Static revenue neutrality assumes that the contemplated tax reform will have no positive economic effects and therefore necessitates higher tax rates within the reform effort than would be warranted if the real-world positive economic effects of sound tax policies were taken into account. Tax reform would be more effective if, instead of focusing so much on revenue neutrality and replicating the current distribution of the tax burden, it focused more on whether tax reform would make most Americans better off and return our country to prosperity.

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Chairman Camp chose to achieve growth by lowering tax rates and making a few other pro-growth enhancements, requiring him to broaden the tax base to make his reform revenue neutral. By accepting the current flawed base and adhering strictly to static revenue neutrality, he was forced to broaden the tax base in many economically counterproductive ways in order to achieve substantial tax rate reductions.

Pro-Growth Policies. The pro-growth changes in the Camp plan are headlined by a reduction in tax rates and the number of statutory tax brackets. The current system has seven tax brackets that range in rates from 10 percent to 39.6 percent. In addition, there is a 3.8 percent Medicare tax on wage and self-employment income over $250,000 ($200,000 for single filers), which also applies to investment income because of Obamacare. As a result, the top rate is 43.4 percent before personal exemption and itemized deduction phaseouts.

The Camp plan would reduce the top tax rate to 38.8 percent and have three marginal brackets. Taxable incomes up to $71,200 for joint returns ($35,600 for single returns) would be taxed at 10 percent. A 25 percent marginal tax rate would be added for those with

4. J.D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.
5. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, CA: Hoover Institution Press, 1995), and Daniel J. Mitchell, "Make Taxes Simple and Fair: Enact the Flat Tax," in Jack Kemp and Ken Blackwell, eds., *The IRS v. The People: Time for Real Tax Reform* (Washington, DC: The Heritage Foundation, 1999).
6. David R. Burton and Dan R. Mastromarco, "Emancipating America from the Income Tax," Cato Institute *Policy Analysis* No. 272, April 15, 1997, http://www.cato.org/pubs/pas/pa-272es.html, and David R. Burton, "The National Sales Tax Alternative," in Kemp and Blackwell, eds., *The IRS v. The People*.
7. Representative Paul D. Ryan, *A Roadmap for America's Future, Version 2.0: A Plan to Solve America's Long-Term Economic and Fiscal Crisis*, January 2010, http://roadmap.republicans.budget.house.gov/plan/#federaltaxreform (accessed March 3, 2014).

taxable incomes greater than these amounts. Finally, an additional 10 percent surtax would be imposed on taxpayers with modified adjusted gross income (MAGI) above $450,000 for joint returns ($400,000 for single returns), creating a third bracket taxed at 35 percent.[8] The plan also retains the 3.8 percent Medicare tax on employee wages and self-employment.[9] Combining the 35 percent rate and the 3.8 percent Medicare tax results in a 38.8 percent top tax rate.

The Camp plan eliminates many credits and deductions that are unnecessary for tax neutrality, including many alternative energy provisions that only serve to distort the energy market. This is a positive step toward a neutral tax code.

The surtax effectively creates a new alternative minimum tax (AMT) for upper-income taxpayers because it applies to MAGI. A wide range of items are added back to calculate MAGI for purposes of the 10 percent surtax, including the standard deduction, all itemized deductions except the deduction for charitable contributions, the foreign earned income exclusion, tax-exempt interest, employer contributions to health plans, defined-contribution retirement plans, and the portion of Social Security benefits excluded from gross income.

Income that is qualified domestic manufacturing income (QDMI) would not be subject to the 10 percent surtax unless, generally, that income is treated as net earnings from self-employment.[10] Taxing retirement savings, municipal bond interest, and employer-provided health insurance could be problematic.[11]

The top rate would apply to pass-through entities (such as S corporations, LLCs, and partnerships) that do not manufacture. Although the rate they would pay under the Camp proposal is lower than under the current system, these pass-throughs (typically small businesses) would pay a significantly higher rate than businesses that pay the corporate income tax. This would be unfair to these businesses and would create problematic incentives when choosing organizational structures.

The Camp plan taxes capital gains and dividends at a top rate of 24.8 percent, which is roughly in line with the current rate after accounting for personal exemption and itemized deduction phaseouts. It does so by exempting 40 percent of taxpayers' capital gains and dividends and then applying their marginal rate to the remainder. It also retains the Obamacare 3.8 percent tax on investment income.[12]

The Camp plan eliminates many credits and deductions that are unnecessary for tax neutrality, including many alternative energy provisions that only serve to distort the energy market. This is a positive step toward a neutral tax code and one that also reduces complexity. The plan also correctly taxes many forms of income that are excluded from taxable income today.

Camp eliminates personal exemptions but expands the standard deduction to $22,000 for families and $11,000 for single filers. This would make filing taxes easier for many lower- and some middle-income taxpayers because it would reduce the number of taxpayers who itemize. The Ways and Means Committee estimates that the percentage of taxpayers who itemize would decline from roughly one-third to about 5 percent—a steep decline.

Camp also eliminates the deduction for state and local taxes. This deduction encourages the growth of state and local governments.[13]

8. "Tax Reform Act of 2014: Discussion Draft, Section-by-Section Summary," Majority Tax Staff, Committee on Ways and Means, U.S. House of Representatives, February 26, 2014, pp. 1–2, http://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf (accessed March 4, 2014).
9. 26 U.S. Code § 3101(b)(2).
10. "Tax Reform Act of 2014: Discussion Draft, Section-by-Section Summary," p. 2.
11. Curtis S. Dubay, "The President's 2013 Budget: More Troubling Tax Increases in the Fine Print," Heritage Foundation *Backgrounder* No. 2704, June 25, 2012, http://www.heritage.org/research/reports/2012/06/the-presidents-2013-budget-more-troubling-tax-increases-in-the-fine-print.
12. 26 U.S. Code § 1411.
13. Curtis S. Dubay, "Tax Reform Should Eliminate the Deduction for State and Local Taxes," Heritage Foundation *Issue Brief* No. 4050, September 19, 2013, http://www.heritage.org/research/reports/2013/09/tax-reform-should-eliminate-the-deduction-for-state-and-local-taxes.

Elimination of the existing AMT and the consolidation of several tax preferences for higher education would simplify the tax law for many families.

Phaseouts Lessen Simplicity. The increase of overall simplicity would have been even greater had Camp not made other changes that added back complexity for both individuals and businesses. Some of that complexity for individuals arises from the phaseout of tax brackets and credits, which would increase *effective* marginal tax rates above the statutory marginal rates for certain income levels.

For example, the earned income tax credit is phased out for those with incomes greater than $20,000 (single) and $27,000 (joint) at a 19 percent rate. This creates a 29 percent bracket for many with incomes between $20,000 and $48,053.[14] The benefit of the 10 percent tax bracket would be phased out by effectively creating a 30 percent tax bracket for those with taxable incomes between $300,000 and $513,600 (joint) and between $250,000 and $356,800 (single).[15]

Thus, the plan has a patchwork of at least seven different marginal tax rates, often with lower marginal tax rates on those with higher incomes. Despite this complexity, it is still an improvement over the current morass of phaseouts in the code. However, fundamental tax reform would ideally create a code with substantially fewer or no marginal effective rate spikes.

The plan reduces marginal tax rates on average and would improve incentives for work and risk-taking. Lower rates for lower income levels would also improve work incentives for families.

Strong Business Reforms. The most pro-growth aspects of the Camp plan are its corporate income tax rate reductions and its international tax provisions. The plan would lower what is now the world's highest rate from 35 percent at the federal level to 25 percent, putting it more in line with the international average. A lower rate would encourage both U.S. and foreign businesses to invest here, resulting in more jobs and higher wages.

Camp's move away from the current worldwide system of taxing the foreign income of U.S. businesses would provide an additional and much-needed boost to domestic investment. His plan would institute a dividend-exemption regime that levied a 1.25 percent tax on the foreign income of U.S. businesses. This change from the worldwide system closer to a territorial one would benefit the economy substantially. Camp and the Ways and Means staff deserve a great deal of credit for including this much-needed reform.

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The Camp plan also preserves Section 179 expensing of capital costs by small businesses, allowing them to deduct up to $250,000 in capital costs each year. This is the proper treatment for all investment, reduces small firms' cost of capital, and aids their cash flow. This is a very positive feature of the Camp plan that should be expanded.

Anti-Growth Policies. By making the joint filing income bracket two times the single filing threshold, the Camp plan eliminates the marriage penalty for many Americans. However, the structure of the new earned income tax credit (EITC) would mean that those who are eligible could be subject to a marriage penalty.[16] Moreover, the 30 percent bracket caused by the phaseout of the 10 percent bracket benefit means that those with incomes above $250,000 could experience a marriage penalty; the 35 percent bracket (due to the 10 percent surtax) means that those with incomes greater than $400,000 would also probably be subject to a marriage penalty. This result is still better than the marriage penalty under the current system.

The Camp plan limits the deduction for mortgage interest. In any tax system, if the interest received by the lender is taxable, then the interest paid by the

14. "Tax Reform Act of 2014: Discussion Draft, Section-by-Section Summary," p. 6.

15. Discussion Draft, "Tax Reform Act of 2014," § 1(e)(3).

16. This is because the credit would begin to phase out at $20,000 for single filers and $27,000 for joint filers and the phaseout percentages are the same for single and joint filers. Thus, two single persons who marry will see their earned income tax credit subject to a greater phaseout unless one of them earns $7,000 or less annually.

debtor should be deductible.[17] Otherwise, the tax system artificially raises the cost of borrowing.

The Camp plan also substantially increases the tax bias against savings and investment. This aspect of the plan would have a substantial negative impact on economic growth that grows with each passing year.

Starting in 2017, the Camp plan increases business taxes by dramatically extending the length of the period over which businesses may deduct the cost of buying machinery or equipment and building factories or other structures. The plan also requires the use of straight-line depreciation. This alternative depreciation system (ADS) would very nearly double the recovery period for many assets. These provisions increase business taxes by $270 billion over 10 years (most of which occurs in later years).

The U.S. capital cost recovery system is already much worse than the Organization for Economic Co-operation and Development (OECD) average, and the Camp plan would make it much worse.[18] The Camp plan would increase the cost of capital placed in service in the U.S., reduce investment, and lower productivity gains. This reduction in the competitiveness of U.S. businesses would grow over time as the adverse impact of less investment and less modern technology accumulated. The Camp plan would return the U.S. to the type of capital cost recovery system that was in place during the Carter era, before President Ronald Reagan's Economic Recovery Tax Act of 1981 corrected the problem by enacting the Accelerated Cost Recovery System.

Research and experimentation (R&E) expenses by businesses should be deductible as incurred, as should all business expenses, but research is unusually important to innovation and job creation. The Camp plan inexplicably singles out R&E expenditures for adverse treatment. It increases business taxes by $193 billion over 10 years by requiring businesses to deduct these expenses over a five-year period. This adverse treatment is mitigated slightly by retaining the R&E tax credit in modified form. The new R&E credit would reduce federal revenues by $34 billion over 10 years.

The Camp plan would require that half of advertising expenses be deducted over a 10-year period. This entirely unwarranted provision would deny businesses the ability to deduct their expenses and thus overstate their taxable income. This provision would increase business taxes by $169 billion over 10 years.

Last-In First-Out (LIFO) accounting for inventories has been a permitted method for inventory accounting since the 1930s.[19] It is simple and prevents business from paying tax on phantom inflationary gains on inventories. It should not be repealed, particularly since higher rates of inflation could return in the future. This provision would raise business taxes by $79 billion over 10 years.

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One of the most egregious violations of sound tax policy in the plan is a tax on systemically important financial institutions (SIFI). The tax, better known as a bank tax, would apply to only a few of the largest banks and other financial firms—those with more than $500 billion in assets. The tax would be 0.035 percent on those banks' assets, assessed quarterly. It would raise more than $86 billion over 10 years. Sound tax policy does not single out particular businesses in certain industries for extra taxation. If there are issues arising because of how other laws affect these banks, those issues should be addressed outside of the tax code.

Slightly Pro-Growth in Early Years. To achieve growth, the economic benefit that comes from the good policy of lowering tax rates must trump the damage done by increasing double taxation. As estimated by the Joint Committee on Taxa-

17. Dubay, "The Proper Tax Treatment of Interest."

18. See Kyle Pomerleau, "Capital Cost Recovery Across the OECD," Tax Foundation *Fiscal Fact* No. 402, November 19, 2013, http://taxfoundation.org/article/capital-cost-recovery-across-oecd (accessed March 3, 2014).

19. Morton Pincus, "Legislative History of the Allowance of LIFO for Tax Purposes," *The Accounting Historians Journal*, Vol. 16, No. 1 (June 1989), http://www.accountingin.com/accounting-historians-journal/volume-16-number-1/legislative-history-of-the-allowance-of-lifo-for-tax-purposes/ (accessed March 3, 2014).

tion (JCT) and The Heritage Foundation's Center for Data Analysis (CDA), the Camp plan is modestly pro-growth in the traditional 10-year budget window.[20]

Because the Camp plan does not implement its adverse capital cost recovery provisions until 2017, there will be an initial rush to invest before the new rules take effect. CDA analysis shows that by 2020, all increases in investment from the rate cuts evaporate and then investment begins to fall rapidly.

It is highly questionable whether the Camp plan will remain pro-growth outside that 10-year window. Growth is boosted in the early years after the plan goes into effect because tax rates are lowered immediately. This strongly boosts work incentives and has a positive impact on economic growth. However, the economic damage from base-expansion policies that increase double taxation and impede investment will slow growth years later when the capital stock is less than it would have been had these changes not been made. It is likely that once those negative effects are fully in place, they will more than offset the positive effects from the modest tax rate reductions and growth will be negative.

According to the JCT's dynamic estimate, the growth effects of Camp's tax reform plan could increase tax revenues between $50 billion and $700 billion[21]—an exceedingly wide range. Assuming revenue came in at the upper end of the range, that money could be used to offset some of the anti-growth policies in the plan. For instance, reversing the most harmful tax increases on investment—the changes in depreciation, amortizing research and advertising expenses, and abolishing LIFO inventory accounting—would reduce revenue by $711 billion. This would make the Camp plan more pro-growth.

Camp also followed the JCT's rationale that extending the roughly 50 tax policies that expire regularly—known as tax extenders—is a tax cut. This required him to generate an unnecessary $1 trillion in his plan. That revenue could also be used to offset anti-growth policies in the plan.

Dynamic Scoring. That the JCT offered a dynamic estimate of the Camp plan is a major victory. Until now, the JCT refused to estimate how the economy would grow with improved tax policy. Thanks to the work of Chairman Camp and his staff, there will now be strong pressure on the JCT to continue offering dynamic analysis of future tax bills.

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The official JCT score of the Camp plan is still the static analysis that assumes there is no improvement in the economy from tax reform; the dynamic analysis is a secondary estimate released in addition to its static score. In future tax reform efforts, it is imperative that Congress use the JCT's dynamic analysis as the official score to provide a more accurate picture of how tax reform will affect both the economy and the budget.

Conclusion

Despite its flaws, the Camp plan will keep the debate about tax reform alive in Washington and around the country. For that, Representative Camp deserves much credit because the economy and the country badly need tax reform.

While the plan is unlikely to become law, it could spark a national debate, eventually leading to fundamental tax reform. Authors of future tax reform proposals should learn from Chairman Camp's effort that maximizing the economic benefit of tax reform is extremely difficult when forced to balance pro-growth rate reductions and other positive reforms with adverse changes that hurt growth.

Structuring such a reform to achieve a pro-growth result requires so many trade-offs that the result is likely to be far from ideal. It is better to start by defining the proper tax base first and then allowing the other facets of the tax system to fall into place. A tax reform plan that followed that approach

20. Rea Hederman, John Ligon, and Rachel Greszler, "Heritage's Macroeconomic Estimate of Camp's Tax Reform Proposal," The Heritage Foundation, *The Foundry,* February 26, 2014, http://blog.heritage.org/2014/02/26/heritages-macroeconomic-estimate-camps-tax-reform-proposal/.

21. Staff report, "Macroeconomic Analysis of the 'Tax Reform Act of 2014,'" Joint Committee on Taxation, U.S. Congress, February 26, 2014, http://waysandmeans.house.gov/uploadedfiles/jct_macroeconomic_analysis_jcx_22_14__022614.pdf (accessed March 5, 2014).

would unequivocally reduce the tax bias against work, savings, investment, and entrepreneurship and promote opportunity, prosperity, job creation, and economic growth.

*—**Curtis S. Dubay** is Senior Analyst in Tax Policy and **David R. Burton** is Senior Fellow in Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*