BACKGROUNDER

No. 3000 | MARCH 9, 2015

The Lee–Rubio Tax Plan's Business Reforms Are Tremendously Pro-Growth

Curtis S. Dubay and David R. Burton

Abstract

Senators Mike Lee (R–UT) and Marco Rubio (R–FL) recently released a tax reform plan that amply succeeds at the core mission of tax reform, which is to improve economic performance. It does so largely because the business portion of the plan is the best business reform to come from Congress in recent memory. The individual side is a modest improvement. Its centerpiece is a greatly expanded Child Tax Credit. Credits do not enhance growth. Expanding the credit, instead of lowering rates further, is a missed opportunity for additional growth. The plan will help tax reform to become a reality by keeping the debate alive and adding to it.

Key Points

- The Lee–Rubio tax reform plan would significantly improve economic growth compared with the current system.
- Growth would come mostly from the plan's business tax reforms because it would lower the rate to the international average, tax only domestic income, and allow businesses to deduct the cost of capital investments immediately.
- The individual side of the plan takes modest steps in the right direction, but has substantial room for improvement.
- The centerpiece of the individual side is a large increase in the Child Tax Credit. Credits do not improve growth. The revenue lost to the credit would be better used to enhance economic growth by lowering tax rates further.
- Other changes, such as fixing a flaw in the plan's mortgage interest deduction and eliminating the personal credit, would also make the plan better.
- The Lee–Rubio plan will help to make tax reform a reality because it will keep the debate alive and contribute to it.

The primary purpose of tax reform is to enhance economic growth by expanding the economy's potential. Based on initial analysis, the tax reform plan recently released by Senators Mike Lee (R–UT) and Marco Rubio (R–FL) amply succeeds at this core purpose, mostly by substantially improving the tax treatment of businesses. On the individual side, the plan takes steps in the right direction, but leaves room for improvement.

Lee and Rubio did not release the full details of their plan. Those details, when released, could alter the analysis below.

Business Tax Reforms Tremendously Pro-Growth

The biggest reason the tax code is holding back the economy is the antiquated way that it taxes businesses. The U.S. has the highest corporate tax rate in the developed world as defined by the 34 countries in the Organization for Economic Co-operation and Development (OECD). The U.S. is also the only major country in that group that

This paper, in its entirety, can be found at **http://report.heritage.org/bg3000**

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

taxes its businesses on their income earned in other countries.[1] Moreover, the U.S. capital cost recovery system is much worse than the OECD average.[2] The high tax rate, worldwide taxation, and poor treatment of capital investment reduce investment. Less investment reduces job creation and productivity improvement, and it suppresses wages of U.S. workers.

Corporate Tax Rates. The Lee–Rubio plan fixes these issues. It sets the rate on all businesses (C corporations and pass-throughs) at 25 percent. Some businesses with lower income would pay a 15 percent tax rate. It also creates a territorial system through a dividend-exemption regime, similar to what Representative Dave Camp (R–MI) proposed when he was Chairman of the House Ways and Means Committee.[3]

The average corporate tax rate of the other developed nations in the OECD is approximately 25 percent.[4] The Lee–Rubio plan would put the U.S. close to that average. This would help to increase investment by U.S. and foreign firms inside the U.S. More investment would improve the productivity of American workers, create more jobs, and raise wages. Lowering the rate below that of other developed nations would create even more jobs and raise wages higher.

A territorial system would increase investment by U.S. firms abroad, which would also boost their investment domestically. This would also boost job creation and wage growth.

Double Taxation. Double taxation in the current system is another problem that holds the economy back. Businesses pay taxes on their income, and their owners (shareholders) pay a second layer of taxes on dividends and capital gains. This raises the effective tax rate on capital. Lee–Rubio would fix this problem by eliminating the second layer of tax. Shareholders would not pay tax on their capital gains or dividends. This would further lower the cost of capital and boost investment.

Capital Cost Recovery. The Lee–Rubio plan builds on these pro-growth changes by abolishing the growth-depressing manner in which the tax code allows businesses to deduct the cost of capital investments. Currently, businesses face a cumbersome system of depreciation that forces them to deduct from their income certain percentages of their capital costs over many years.

The concept of depreciating assets wrongly leaked into the tax code from financial accounting, which is concerned with determining the financial value of a business. Tax accounting should measure actual business receipts and outlays and should not necessarily follow the conventions of financial accounting.

When accounting for the cost of capital for tax purposes, businesses should be able to deduct the full cost of assets at the time that they purchase them. This is known as expensing. Anything short of expensing, such as current depreciation rules, raises the cost of capital and creates a bias against investment by forcing businesses to delay deducting their capital expenses,[5] sometimes for as long as 39 years.[6] This creates cash flow problems and, because of the time value of money, makes investments in plants, machinery, equipment, and structures more costly. A higher cost of capital reduces investment.

Lee–Rubio scraps depreciation in favor of expensing and would therefore reduce the cost of capital, substantially increase the capital stock, improve productivity, and further enhance job creation and wage growth.

1. 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.
2. 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 February 27, 2015).
3. Curtis S. Dubay and David R. Burton, "Chairman Camp's Tax Reform Plan Keeps Debate Alive Despite Flaws," Heritage Foundation *Backgrounder* No. 2890, March 14, 2014, http://www.heritage.org/research/reports/2014/03/chairman-camps-tax-reform-plan-keeps-debate-alive-despite-flaws.
4. Tax Foundation, "OECD Corporate Income Tax Rates, 1981–2013," December 18, 2013, http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013 (accessed February 27, 2015). On a GDP weighted basis, the OECD average corporate tax rate for 2013 is 32.5 percent while the U.S. average corporate tax rate is 39.1 percent.
5. J. D. Foster, "The Simple Economics of Pro-Growth Tax Reform," Heritage Foundation *Backgrounder* No. 2816, June 19, 2013, http://www.heritage.org/research/reports/2013/06/the-simple-economics-of-pro-growth-tax-reform.
6. Internal Revenue Service, "How to Depreciate Property," January 28, 2014, pp. 31–55, http://www.irs.gov/publications/p946/ch04.html#en_US_2013_publink1000107524 and http://www.irs.gov/pub/irs-pdf/p946.pdf (accessed February 27, 2015).

Treatment of Interest. Interest is a facet of taxation that often causes problems for lawmakers. Under an income tax, if interest income is taxable to lenders, it should be deductible for borrowers so that taxes do not artificially affect lending or borrowing decisions. The code can also keep taxes out of lending and borrowing decisions by not taxing interest income and denying a deduction to borrowers.[7] Lee–Rubio chooses the second option. Given the large number of non-taxable lenders, this choice would likely raise a substantial amount of revenue for additional rate reduction.

Together, these reforms to business taxation are the correct way to reform the system. They would certainly increase economic growth substantially. For instance, one estimate finds it would increase the size of the economy by 12 percent to 15 percent compared with what would happen in the absence of the reform.[8]

Congress and President Barack Obama have been discussing possibly pursuing business-only tax reform. If they choose that route, the business part of the Lee–Rubio plan should be the type of system that they implement.

Individual Reforms Move in the Right Direction, But Could be Stronger

On the individual side, the reforms in the Lee–Rubio plan are positive, although not as strong as on the business side. The plan reduces the top rate from 39.6 percent to 35 percent.[9] Instead of the current system of seven tax brackets, the Lee–Rubio plan has just two. Incomes under $150,000 ($75,000 for single filers) would be taxed at 15 percent. The 35 percent rate would apply to all income above that level. A lower top rate will increase incentives to work and save, which will boost growth.

The other major change on the individual side is a significant expansion of the Child Tax Credit (CTC). Today, parents receive a tax credit of $1,000 per child, which phases out over $110,000 ($75,000 for single filers).

Lee–Rubio adds an additional $2,500 per child CTC that would be creditable against parents' income and payroll taxes and would not phase out. The existing CTC would not change and therefore would continue to phase out. For taxpayers under the existing phase-out level, the combined CTC would be $3,500 per child, which is 250 percent larger than under current law.

The greatly expanded CTC is the centerpiece of the individual side of the plan, but it represents an enormous missed opportunity. The new $2,500 credit would use a substantial amount of revenue that the plan could have otherwise used to lower rates. The top rate, therefore, could have been much lower than 35 percent. The amount of forgone revenue reduction depends on how much the Joint Committee on Taxation (JCT) estimates the expanded CTC would reduce revenue.

Credits, such as the CTC, have no impact on economic growth.[10] Lower rates improve incentives for working, saving, investing, and taking entrepreneurial risk, the basic components of economic growth. They do so by lowering the tax-imposed bias against work, savings, investment, and entrepreneurship. The slightly lower top rate will only slightly increase these incentives. If the Lee–Rubio plan lowered rates further instead of expanding the CTC, those incentives would increase substantially more, making the plan more pro-growth.

Exacerbating the problems with the CTC is a $4,000 per family ($2,000 for individual filers) credit that takes the place of the standard deduction and personal exemption. All tax filers could claim the credit. It creates a zero-percent tax bracket as the standard deduction and personal exemption do now. Like the CTC, this credit has no impact on growth

7. 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.
8. Michael Schuyler and William McBride, "The Economic Effects of the Rubio-Lee Tax Reform Plan," Tax Foundation, March 9, 2015.
9. Tax reform should repeal the state and local tax deduction, as Lee–Rubio does. See 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. However, because the plan repeals the state and local tax deduction, the federal marginal tax rate reduction is lessened by the effective marginal rate increase of state income taxes.
10. Curtis S. Dubay, "Congress Should be Cautious About Expanding the Child Tax Credit," Heritage Foundation *Issue Brief* No. 4241, June 26, 2014, http://www.heritage.org/research/reports/2014/06/congress-should-be-cautious-about-expanding-the-child-tax-credit.

and similarly squanders an opportunity for additional rate reduction.

The most important thing that Congress could do to help middle-class families is to adopt public policies that would foster a return to prosperity and improve incomes. Reducing marginal tax rates is a more effective means of helping families than higher child tax credits.

Other Issues

Tax reform plans are generally revenue neutral, meaning that they raise the same amount of revenue as the current system. Although the details are largely unspecified, the Lee–Rubio plan eliminates many deductions, credits, exemptions, and exclusions on both the business and individual sides of the tax code. Nevertheless, the Lee–Rubio plan would likely be a substantial tax cut, even taking into account its very positive impact on the economy and the consequent expansion in the tax base.[11] Cutting taxes is good, especially during periods when revenues are expected to surpass their historical average—as they are in the current budget window.[12] However, the plan probably reduces revenues below that average.

Lee–Rubio could replace some of that revenue by fixing a flaw in the plan. It keeps the mortgage interest deduction (MID) in a modified manner that it does not specify, even though it does not tax interest income. The current MID is not a subsidy for homeowners given that lenders pay tax on the interest income that they earn. However, it would become one under Lee–Rubio because lenders would no longer be taxed on their interest income. To resolve this problem, Lee–Rubio could either eliminate the MID or tax mortgage lenders on the taxable mortgages that they issue.[13] Either option would eliminate the subsidy that the plan creates and lessen the size of the tax cut. However, because the plan sensibly eliminates interest deductions and does not tax other forms of interest income, it is easier to take this approach with mortgage interest.

For married filers earning between $150,000 and $405,100 ($75,000 and $405,100 for single filers), the Lee–Rubio plan would increase their marginal tax rates compared with current law because they are in a tax bracket with tax rates below 35 percent. Higher marginal rates are a disincentive to work and save. These taxpayers' average tax rate may be lower than under current law if they have children, but the rate that they would pay on additional income would rise. Adding rates between 15 percent and 35 percent in this range would lessen the effect, but would decrease revenue further.

Conversely, for taxpayers earning between approximately $75,000 and $150,000 ($37,000 and $75,000 for singles), Lee–Rubio is a marginal rate cut. Combined with the enormous CTC, many taxpayers in this range would pay substantially lower taxes. Lee–Rubio could mitigate the revenue lost from the combined rate reduction and large child credit by adding rates above 15 percent in this range. Taxpayers would still have lower marginal rates, and the extra revenue would further reduce the large tax cut.

Additional revenue could also be gained by scrapping the personal credit.

Keeps Debate Moving

The business side of the Lee–Rubio plan is the best business income tax reform plan that has been proposed in Congress in recent memory. The individual side is a modest step in the right direction, but leaves much room for improvement. The business tax reforms are so positive that, taken as a whole, the plan would dramatically improve the economy and the incomes of American families.

The Lee–Rubio plan would also increase interest in tax reform and show the way on business tax reform. It will help to make tax reform a reality when there is a President in office who wants to lead the effort.

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

11. In other words, the plan probably reduces federal revenues even using dynamic scoring methodology. For more background on dynamic scoring, see Dan R. Mastromarco, David R. Burton, William W. Beach, eds., *The Secret Chamber or the Public Square? What Can Be Done to Make Tax Analysis and Revenue Estimation More Transparent and Accurate* (Washington, DC: The Heritage Foundation, 2005).
12. Congressional Budget Office, *The Budget and Economic Outlook: 2015 to 2025*, January 2015, https://www.cbo.gov/sites/default/files/cbofiles/attachments/49892-Outlook2015.pdf (accessed February 10, 2015).
13. The plan contemplates a separate system for determining the taxable income of a financial institution. However, no details were provided.