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# What Might Tax Reform Look Like?

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### Abstract
"When it comes to tax reform, it has been most consistently successful when lower rates are coupled with reduced complexity and closed loopholes."

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# What Might Tax Reform Look Like?



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In the wake of the Republican failure to repeal or otherwise modify the Affordable Care Act, it is increasingly likely that tax reform may be the next target on the Republican agenda. If you've been reading along for the last few days, I've been trying to lay a foundation of understanding of our current tax system that will make it easier to think about some of the plans that have been proposed to accomplish these reforms.

**The TL:DR Version of the Last Two Articles**

Whether you've been keeping up with the last couple articles or not, there are a few essential lessons that we should learn about our tax system and efforts to reform it. Reflecting on our tax system, I've pointed out that the U.S. has traditionally taxed a pretty consistent portion of our Gross Domestic Product (GDP), and our methods of doing so have a tendency to grow increasingly complex over time, both in terms of rates and special exemptions and deductions. At the same time, our taxation of businesses takes a very different form from most of the rest of the world.

When it comes to tax reform, it has been most consistently successful when lower rates are coupled with reduced complexity and closed loopholes. Because of the tendencies of our system to narrow the tax base over time, most reform efforts have also had the goal of broadening the tax base to impact a broader spectrum of taxpayers. Lastly, the complicated nature of our tax system and the limits of IRS capacity recommend that reform seek to simplify the tax system, particularly for individuals with primarily wage-based income.

**Does the Prescription fit the Diagnosis? Evaluating the Republican Plans**

Currently, there are two major plans for tax reform: the general plan sketched out by President Trump and the more comprehensive initiative proposed by House Republicans. At 4 pages compared to 35, respectively, it's obvious which plan is more detailed, but does either plan do a good job of addressing the concerns mentioned above, and, if so, does one do so better than the other? To evaluate this issue, we need to briefly consider what each plan sets out to do.

President Trump's plan is much more simple than the House Republican plan. Basically, it involves a significant reduction in taxes, cutting the highest individual rate to 25% (a 14.5 percentage point drop), slashing corporate taxes to a max of 15%, and eliminating the estate tax altogether. This is partially offset by phasing out an unspecified number of deductions for the wealthy and by a "repatriation tax" that attempts to force corporations to move foreign income back to America. Overall, this plan is a hefty cut to federal revenue, with projections estimating it will reduce receipts by $2.6–9.5 trillion over the next decade.[1]

Speaker Paul Ryan and the House Republicans have a more detailed and complicated proposal. Their plan involves more modest cuts to individual rates, with the top individual rate falling to 33% (a 6.5 percentage point drop). The corporate income tax would be cut to 20% and changed in form to a consumption-oriented tax, and this plan would also eliminate the gift and estate taxes. This plan would offset these reductions by substantially reducing the number of available deductions, eliminating the capital gains rates[2] , and doing away with personal exemptions. This plan would still reduce federal revenue, but by a more modest estimated range of $191 billion to 3.1 trillion over the next decade.

So there's the basics of the plans. How do they line up with the issues I've identified in the articles over the last two days?

**The Trump Plan: (Don't) Tax and (Still) Spend**

Trump's tax plan, as much as we can trust the outline that he produced while on the campaign trail, hits a few of the important points, but it misses many critical issues. It certainly simplifies the tax code, and it does broaden the tax base to some degree, but the plan does not address important concerns like the difference between the way the U.S. and most other nations' tax corporations. Simply lowering the corporate rate does not necessarily eliminate the incentives for corporations to shift income overseas, and the imposed "repatriation" tax is a heavy-handed and inelegant way to address that issue.

Most significantly, however, the Trump plan is to slash revenues while continuing to spend like everything is normal. In the past year, receipts of approximately $3.3 trillion fell short of the $3.9 trillion budget. Trump's plan cuts federal revenue by up to a third, while Trump's proposed budget plan makes effectively no change to federal spending. Trump may proclaim himself "the king of debt," but the country has far too much of that already. Regardless of how you feel about Trump's tax cuts or his budget plan, it's objectively clear that following both paths at once is a recipe for disaster.

**The House GOP Plan: Too clever for its own good?**

The House GOP plan does a much better job of addressing the key issues in tax reform; however, President Trump's low tolerance for complexity may spell the doom of this plan. From my perspective, this is a bit of a shame because the GOP plan, while not reducing taxes by a huge amount[3] , significantly changes *how* taxes are administered in a way that makes several sensible reforms.

Looking back at the last two articles, we can see how the GOP plan addresses several key tax reform ideas as they apply to individuals. Addressing the tendency for creeping complexity, the GOP plan cuts the number of tax brackets from seven to three. It also significantly reduces administrative complexity by cutting down the number of itemized deductions, removing complicated Alternative Minimum Tax (AMT) calculations, and combining a number of targeted benefits, such as those tied to families. This is capped by a proposal for a significantly simplified "postcard filing" that should make anyone who has slaved away over detailed returns breathe a sigh of relief. Similarly, elimination of the estate tax and tweaks to savings incentives will help to roll back the tendency to promote consumption that often creeps into the tax code.

The biggest change, however, comes with the complete overhaul of corporate taxation. As I mentioned previously, the rest of the world primarily taxes businesses based on the value that they add at each stage of production. That is, you pay taxes on the goods you buy, then you can take a credit on those taxes paid as you pass those goods down the chain of production.[4] The GOP plan tweaks several features of the corporate tax to transform it into what is essentially a value-added tax that allows for the deductibility of wages. While this plan faces issues in passing muster with the World Trade Organization, it has several features to recommend it, including removing incentives to move corporate assets offshore and encouraging capital investments while no longer distorting decisions between debt and equity financing. The changes are substantial and complex, but this total overhaul in the way America taxes businesses is probably one of the most important and needed features of the tax reform plan.

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## Footnotes

1. The large range on the estimates is due to both right- and left-leaning analysis as well as whether the number accounts for macroeconomic growth due to lower taxes. ↩

2. The plan taxes investment income as ordinary income, but it does allow exclusion of half of the profit received, effectively halving the tax paid on this type of income. ↩

3. Projections run from around 10% down to less than a 1% reduction, depending on macroeconomic effects. ↩

4. If this still sounds complicated, see William Gales' excellent simplified example based on buying a loaf of bread. ↩