COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Analysis of the Tax Reform Act of 2014
February 27, 2014

Yesterday, House Ways & Means Committee Chairman Dave Camp released *The Tax Reform Act of 2014*, a comprehensive tax reform discussion draft.

Carefully designed tax reform has the potential to reduce and reform the $1.2 trillion worth of tax preferences in order to lower rates, improve simplicity, reduce economic distortions, increase international competitiveness, promote economic growth, and reduce the deficit. However, doing so requires identifying which of many popular tax expenditures must be eliminated or scaled back.

The draft is by no means perfect, but it takes important steps toward achieving the goals outlined above. It would reduce individual and corporate tax preferences, lower the tax rate on businesses to 25 percent, and cut rates for individuals by replacing the seven rates ranging from 10 to 39.6 percent with three rates of 10, 25, and 35 percent.

<u>We believe the draft is commendable because it:</u>

- Identifies many tough choices and trade-offs necessary for tax reform;
- Promotes economic growth and increases the size of the economy;
- Achieves ten-year revenue-neutrality relative to current law and responsibly addresses expiring tax provisions; and
- Relies on conventional scoring to achieve revenue neutrality, while allowing an additional $50 to $700 billion of potential "dynamic" revenues to be dedicated toward deficit reduction.

<u>We are concerned that the draft:</u>

- Uses all revenues from base broadening for rate reduction and none to slow the unsustainable growth of the federal debt;
- Relies on several one-time revenue sources and timing shifts to pay for permanent rate cuts, meaning that it could actually *increase* deficits in future decades; and
- Dedicates $127 billion to help shore up the Highway Trust Fund when that same revenue is needed to ensure revenue neutrality.

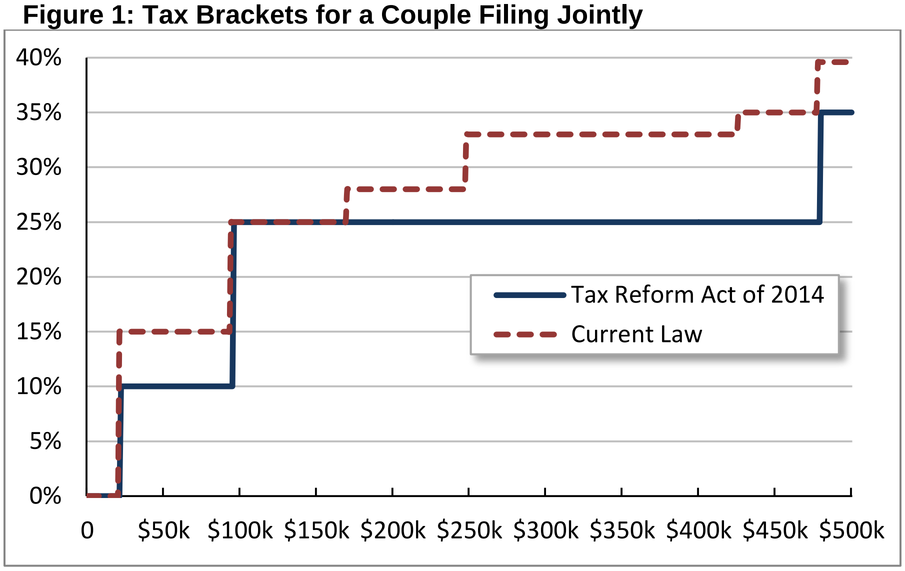
Despite any shortcomings, the draft represents a productive and important step forward. We encourage policymakers to view it as a starting point, and we call on them to build upon these thoughtful reforms to construct a bipartisan tax bill that promotes growth and reduces deficits this decade and over the long term.

Summary of the Tax Reform Act of 2014

Chairman Camp's tax reform draft reduces tax preferences and rates on both the individual and corporate side of the tax code.

On the individual side, the draft repeals the Alternative Minimum Tax (AMT) and reduces the seven rates (ranging 10 to 39.6 percent) to three rates of 10, 25, and 35 percent. The 10 percent bracket phases out for higher earners. Meanwhile, personal and dependent exemptions are eliminated in favor of a larger standard deduction and child credit, both of which phase out for high earners. Capital gains and dividends are taxed as ordinary income with a 40 percent exclusion, leading to effective rates of 6, 15, and 21 percent before counting the 3.8 percent surtax currently in place on high earners.

Figure 1: Tax Brackets for a Couple Filing Jointly



Note: This graph incorporates the standard deduction and personal exemption, which create an effective 0% bracket, but no other tax preferences.

These changes would be paid for in a number of ways. The state and local tax deduction would be eliminated, the mortgage interest deduction would be limited to $500,000 of debt (down from $1 million), and the charitable deduction would be subject to a 2-percent-of-AGI floor. A number of other tax preferences would be repealed and reformed,[1] and many of those remaining – including the mortgage interest deduction and exclusions for employer health insurance and municipal bonds– would have their value limited to the 25 percent bracket.

Encouragingly, the draft also adopts a more accurate measure of inflation known as the "chained CPI" to index various elements of the tax code, which would produce increasing revenues over time. Discouragingly, the draft restricts tax-deferred retirement accounts in favor of Roth-style accounts which are tax exempt when withdrawn instead of deposited; these changes would raise far less long-term revenue than the ten-year score suggests.

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[1] For example the draft includes a comprehensive reform of higher education preferences, a repeal of the dependent care credit, and a freeze in contribution limits for retirement accounts. For more information on some of the reforms in the draft, see the CRFB blogs Camp Offers New Ideas on Financial Products Reform and Rethinking Tax Incentives for Higher Education.

Figure 2: Budgetary Impact of Tax Reform Act of 2014

	2014-2018	2014-2023
Individual Reforms*	**-$174 billion**	**-$588 billion**
Reduce rates to 10%, 25%, & 35%, limit certain tax preferences to 25% bracket, phase out 10% rate	-$232 billion	-$544 billion
Tax capital Gains/dividends with 40% exclusion	$15 billion	$45 billion
Replace personal exemption with expanded and reformed standard deduction and child tax credit, reform EITC	$18 billion	-$16 billion
Modify various itemized deductions	$309 billion	$858 billion
Require 401(k) contributions above half of current limit be placed in Roth-style accounts	$56 billion	$144 billion
Reform education tax preferences	$27 billion	$19 billion
Enact other changes	$76 billion	$237 billion
Repeal Alternative Minimum Tax	-$443 billion	-$1,332 billion
Business Reforms*	**$180 billion**	**$533 billion**
Reduce corporate rate to 25% and repeal AMT	-$234 billion	-$791 billion
Reform accelerated depreciation schedules	$59 billion	$270 billion
Modify net operating loss deduction	$30 billion	$71 billion
Amortize R&E and advertising expenses	$152 billion	$362 billion
Phase out domestic production deduction	$44 billion	$116 billion
Repeal LIFO accounting rules	$6 billion	$79 billion
Reform international tax system	$20 billion	$68 billion
Enact other changes†	$102 billion	$359 billion
Excise Taxes	**$18 billion**	**$58 billion**
Impose .035% tax on large banks	$30 billion	$86 billion
Repeal medical device tax and other changes	-$12 billion	-$28 billion
Total Budgetary Impact	**$24 billion**	**$3 billion**

*For pass-throughs, the rate reductions are captured in individual reforms while base-broadening is captured in business reforms.
†Other corporate tax changes include revenue from tax-exempt entities and tax administration and compliance.

On the business side, the top corporate income tax rate would be reduced from 35 percent to 25 percent, and the corporate AMT would be repealed. To pay for these cuts, the draft would repeal accelerated depreciation and LIFO accounting rules, require amortization of research and advertising expenses, eliminate the deduction for domestic production, and make other changes.

At the same time, the draft permanently addresses many expiring tax provisions, including by making permanent a reformed and less expensive R&E tax credit. The draft also calls for moving to a territorial tax system for multinational companies, along with certain "base erosion" protections to prevent income shifting and a one-time transition tax.

Finally, the legislation calls for repealing the medical device tax and imposing a new 0.035 percent quarterly tax on assets over $500 billion for large financial institutions.

The distribution of taxes paid by income under the draft would stay roughly the same as current law. In the first year, those at the top and the bottom pay slightly more in taxes, while the average tax burden is reduced for those making between $20,000 and $200,000. By 2023, the draft would cut average taxes for nearly everybody, except those with income between $500,000 and $1 million.

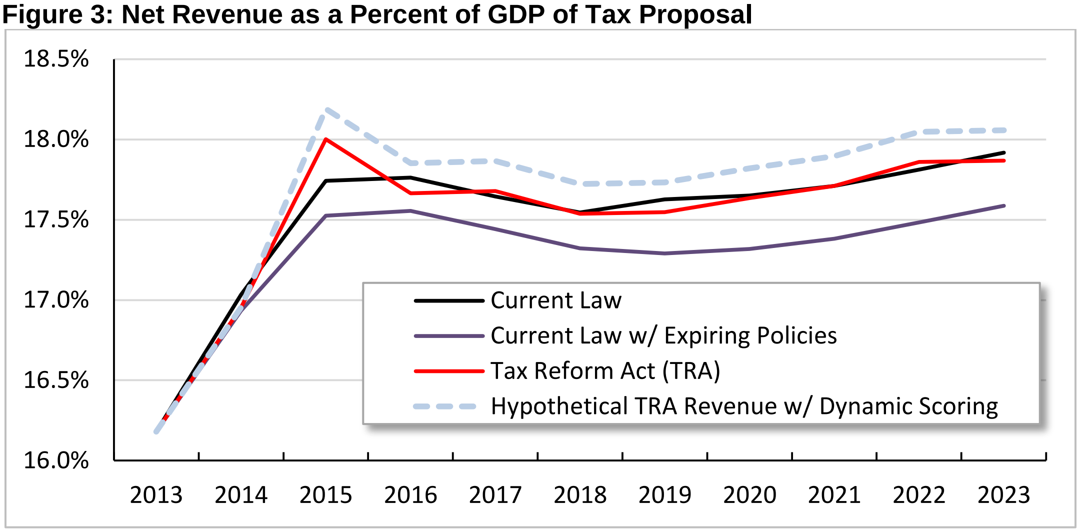
Budgetary Impact of the Tax Reform Act of 2014

Chairman Camp's discussion draft is roughly revenue-neutral over the next ten years, raising nearly $25 billion in the first five years and losing about $20 billion in the second five. In total, the Joint Committee on Taxation (JCT) estimates the proposal would increase net revenues by $3 billion through 2023, though it would lose about $13 billion in 2023.

Although we believe tax reform should generate revenue rather than maintaining current revenue levels, there are many commendable fiscal aspects of this draft. For one, it uses a current law baseline and proposes permanent solutions to most of the expiring and expired provisions in the code. As a result, the draft would raise ***$560 billion*** more than if the tax extenders (excluding bonus depreciation) and refundable credits continued without offsets.

The draft would likely also produce revenue as a result of faster growth. JCT estimates that the draft would increase the size of the economy by between 0.1 and 1.6 percent this decade. As a result, they conclude revenue would increase between ***$50 and $700 billion*** under so-called "dynamic scoring" as compared to the conventional score.[2] By relying on conventional scoring to achieve revenue-neutrality, the draft adopts the fiscally responsible approach of not devoting uncertain dynamic revenue toward rate reduction. If these potential revenues from dynamic effects are realized The result could be a 0.3 to 4.0 percent reduction in the debt to GDP ratio by 2023 – though these numbers are quite uncertain.

Figure 3: Net Revenue as a Percent of GDP of Tax Proposal



Notes: hypothetical revenue with dynamic scoring assumes $375 billion of additional revenue (the mid-point of JCT's estimates) distributed from 2015 through 2023. Revenue levels compared to pre-reform GDP. Current law with expiring provisions assumes the extension of the normal tax extenders and expiring refundable tax credits. Net revenue refers to revenue minus refundable credits.

On the other hand, there are also some troubling aspects of the draft. Not only would it fail to reduce the deficit this decade under conventional scoring, but it would *increase* the deficit in 2023, and we are concerned that it would add to the debt over the long run.

[2] For more information, see our paper [Understanding Dynamic Scoring]

A number of provisions in the legislation – including the one-time transition tax in the international reform, the repeal of LIFO accounting, and the requirement that some retirement savings be put in Roth-style accounts instead of traditional tax-deferred accounts – would generate most of their revenue on a temporary basis. Several other provisions, like changes to cost-recovery schedules, might also raise less revenue over the long-run than in the first decade.

To the extent these changes are used to finance a permanent rate cut, the result could be a significant increase in long-term debt levels. To be sure, some of the changes would raise increasing amounts of revenue over time as a result of being phased in, grandfathering past decisions, or compounding over time (such as in the case of the chained CPI). However, we worry these provisions will not be sufficient to make up for diminishing savings from provisions which only increase revenues temporarily and offset the long-term costs and believe an independent analysis is needed to determine the long-term impact of the legislation.[3]

In addition, the draft dedicates $127 billion from the international transition tax to the Highway Trust Fund (HTF) in order to reduce its shortfall. Although CBO conventions do not count general revenue transfers to the HTF as a cost, transferring money to the HTF would still allow greater spending to occur. Simultaneously using money to achieve revenue neutrality and fund highway spending is akin to double-counting.

Conclusion

The Tax Reform Act of 2014 is a solid and important contribution to the tax reform debate, illustrating the types of tradeoffs necessary to reduce tax rates and simplify the code while still maintaining revenue and distributional neutrality.

The draft substantially reduces the number and size of tax preferences in the code. According to the non-partisan Joint Committee on Taxation, these reductions are sufficient to finance rate reductions and permanent solutions to expensive expiring tax provisions while making other improvements that will both simplify filing and significantly increase the size of the economy.

To be sure, we have several concerns with the discussion draft as written. For example, it dedicates the same revenue toward rate reduction and the Highway Trust Fund. And not only does it fail to reduce deficits this decade, but we fear it would increase them over the long-term.

Still, the difficulty and importance of achieving what Chairman Camp has done in this draft should not be understated. The value to the broader tax reform effort could be tremendous.

Policymakers on both sides of the aisle should engage with Chairman Camp and build on the Tax Reform Act to generate a bipartisan draft that would lower rates, broaden the tax base, promote economic growth, and help to slow the growth of the rising national debt.

[3] For more information, see our paper Looking Beyond the Ten Year Budget Window.

Appendix

Summary of Tax Reform Act of 2014

Area	Current Law	Tax Reform Act of 2014
Individual Income Tax		
Tax Rates	10% | 15% | 25% | 28% | 33% | 35% | 39.6%	10% | 25% | 35% (10% rate phases out at high income)
Standard Deduction	$6.2k / $12.4k	$11k / $22k (phases out at high income)
Personal Exemptions	$3,900, phased out at higher incomes	Eliminated
Child Tax Credit	$1,000/child not indexed for inflation - phased out at higher incomes; more refundable through 2017	Credit increased to $1,500 and indexed for inflation, refundability rate increased; phased out at higher incomes
Earned Income Tax Credit	$500-$6,000 credit, phased out at higher incomes; higher for families with 3 children through 2017	Reduced credit rates to $100-$4,000, phase-outs begin at higher income levels; marriage penalties lessened
College Tax Credit	$2,500 American Opportunity Tax Credit through 2017 ($1,000 is refundable); additional tax benefits available	AOTC Extended permanently, refundability increased to $1,500, income eligibility range reduced; other benefits eliminated
AMT	Alternative tax w/ 26% and 28% rates	Eliminated
Mortgage Interest Deduction	Available to itemizers for up to $1 million of debt	Available to itemizers up to $500,000 of debt; value limited to 25% bracket
Charitable Deduction	Available to all itemizers	Subject to 2% of AGI floor
Health Insurance Exclusion	Available w/ 40% tax on high-cost plans	Value limited to 25% bracket
State & Local Tax Deduction	Available to all itemizers	Eliminated
Municipal Bond Exclusion	Available for public and private bonds	Value limited to 25% bracket; exclusion eliminated for certain private activity bonds
401(k) Retirement Accounts	Up to $17,500 of employee contributions on a tax-deferred or Roth-style basis	Contributions above $8,750 allowed only in Roth-style accounts
Capital Gains and Dividends	Taxed at 0%, 15%, 20% with 3.8% surtax for income above $250K	Taxed as ordinary income w/ 40% exclusion (effective rates of 6%, 15%, and 21%); 3.8% surtax retained
Other Tax Provisions	Various credits, deductions, exclusions, and other preferences available	Dozens of preferences repealed or reformed. Numerous loopholes closed.
Corporate Income Tax		
Rates	Top Rate of 35%	Flat Rate of 25%
Accelerated Depreciation	Accelerated Depreciation (MACRS)	Economic depreciation, basis adjusted to account for inflation
Domestic Production Deduction	9% of income deduction generally available	Deduction phased out by 2017
Inventory Accounting	Last-in-First-Out Accounting allowed	Last-in-First-Out Accounting phased out
Advertising Deduction	Costs fully expensed	Half of costs amortized over 10 years
Research & Experimentation Deduction	Costs fully expensed	Costs amortized over 5 years
Research & Experimentation Credit	4 credits, all expired in 2013	Alternative simplified credit reformed and permanently extended, others repealed
International Tax	Worldwide w/ deferral	Territorial w/ base erosion protections and one-time transition tax
Excise Taxes		
Medical Device Tax	2.3% tax on sale of certain medical devices	Tax repealed
Bank Tax	N/A	.035% quarterly tax on assets over $500 billion

Comparison of Tax Reform Plans

Area	Simpson-Bowles Illustrative Plan	Domenici-Rivlin	Wyden-Coats	Tax Reform Act of 2014
Individual Income Tax				
Tax Rates	12% | 22% | 28%	15% | 28%	15% | 25% | 35%	10% | 25% | 35%
Standard Deduction	Increased 10%	Replaced with refundable work and child credits	Roughly tripled	Nearly doubled
Personal Exemptions	Retained		Retained	Eliminated
Child Credit/EITC	Retained		Retained	Retained and reformed
Education Preferences	Eliminated	Eliminated	Consolidated and reformed	Consolidated and reformed
AMT	Repealed	Repealed	Repealed	Repealed
Mortgage Interest Deduction	Converted to 12% credit; capped at $500K mortgage	Converted to 15% credit; limited to $25K interest	No change	Value limited to 25%; capped at $500K mortgage
Charitable Deduction	Converted to 12% credit; 2% of AGI floor	Converted to 15% matching credit	No change	2% of AGI floor
Employer Sponsored Insurance Exclusion	Capped, phased out from 2018 to 2038	Capped, phased out from 2015 to 2025	Cafeteria plans preference eliminated	Value limited to 25%
State & Local Tax Deduction	Eliminated	Eliminated	No change	Eliminated
Misc. Itemized Deductions	Mostly Eliminated	Floor increased to 5% of AGI	Eliminated	Some eliminated; Some retained with no floor
Muni Bond Exclusion	Phased out for new bonds	Private activity bonds repealed	Replaced with a credit	Value limited to 25%; private bonds repealed
Retirement Savings	Consolidated and capped at $20K or 20% of AGI	Consolidated, capped at $20K or 20% of AGI with 15% credit available to all	Consolidated into new Retirement Savings Accounts and Lifetime Savings Accounts	401(k) contributions required to be "Roth-style" above half current limit; contribution limits frozen; other reforms.
Capital Gains and Dividends	Taxed as ordinary income (top rate 28%)	Taxed as ordinary income (top rate 28%)	Taxed as ordinary income with 35% exclusion (top rate 22.75%)	Taxed as ordinary income with 40% exclusion (top rate of 21%)
3.8% Investment Surtax	Retained	Repealed	n/a	Retained
Step-up Basis for Capital Gains	Eliminated	Eliminated	No change	No change
Other Tax Expenditures	Most tax breaks eliminated	Most tax breaks eliminated	Several tax breaks eliminated	Dozens of tax breaks repealed or reformed
Corporate Income Tax				
Rates	28%	28%	24%	25%
Depreciation	Economic depreciation	No change	Alternative Depreciation Schedule	Economic depreciation, adjusted for inflation
Domestic Production Deduction	Eliminated	Eliminated	Eliminated	Phased Out
Inventory Accounting	LIFO and LCM eliminated	LIFO and LCM eliminated	LCM eliminated; LIFO modified	LIFO and LCM eliminated
Other Tax Expenditures	Eliminated	Mostly eliminated	Many eliminated	Many eliminated
Interest Deduction	No change	No change	Only deduction in excess of inflation allowed	No change
Advertising Deduction	No change	No change	No change	Partially amortized
International Tax	Territorial	No change	Worldwide	Territorial w/ base erosion protections
Bank Tax	None	None	None	.035% quarterly tax on assets over $500 billion