



A Pro-Growth, Progressive, and Practical Proposal to Cut Business Tax Rates

By Alex Brill

The US tax code has eroded over time with the explosion of endless special provisions, such as distortionary deductions and ineffective credits. Now is the time to take a good look at reforming it. This Outlook outlines six simple—and bipartisan—changes to the tax code that can help the country move toward a tax code aimed towards economic growth and away from complex regulations and political favoritism. While containing the types of compromises necessary for political achievement, this plan provides a pro-growth solution by broadening the tax base and reducing the tax rate on business investment.

With the economy in a lethargic slump, federal deficits running above \$1 trillion per year since 2009,¹ and the federal government on an unsustainable fiscal path, the need to reexamine our convoluted, outdated tax code has never been greater. But the task has also never been harder. Hundreds of special provisions² targeting narrow but powerful interests make cleaning up the tax code a difficult political task. As a result, the code continues to encumber economic growth, slow wage growth, impede innovation, and disadvantage American corporations competing in a global economy.

Many tax economists believe that the ideal way to spur long-run economic growth is a system that taxes all consumption instead of penalizing savings and investment as an income tax does. But although good policy may make good politics, the optimal policy is rarely optimal politics. Lawmakers often must find second-best solutions.

In this *Outlook*, I outline six relatively simple changes to the tax code that, taken together, comprise a big step toward a tax system geared toward greater economic growth instead of political favoritism, social engineering, and industrial policy.

The plan addresses two sources of inefficiency in the current tax code: tax rates that are too high and subsidies that distort resource allocation away from productive use. The plan is able to maintain revenue neutrality while lowering tax rates because it narrows or eliminates some of the largest, most

Key points in this *Outlook*:

- Congress should tackle our economic slump and red ink by reforming the tax code to reflect fairness; neutrality; and, most important, growth.
- Six simple changes would level the playing field for capital investment, simplify the tax system for individuals, and improve our global competitiveness while curtailing distortionary political favoritism, social engineering, and industrial policy.
- Designed to bridge the gap between Democrats and Republicans, the plan maintains revenue neutrality, reduces rates for job creators, broadens the base, and makes the code more progressive without raising tax rates for high-income earners.

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distortionary tax subsidies. The plan is also progressive, raising tax payments from higher-income earners without changing individuals' statutory tax rates.

By design, the plan is a compromise. While I draw many of my proposals from recent bipartisan tax reform plans, Democrats and Republicans would need to give up a few of their core tax policy "talking points." When all is said and done, the tax code would still be far from perfect, but this compromise could be satisfactory to both parties and, most important, would improve long-run economic growth.

A Broad Overview

The principles behind this proposal are simple: reduce tax rates for job creators, limit subsidies that promote excessive leverage, and phase out tax policies that encourage larger state and local governments.

The six changes I propose are:

1. Phase down the corporate tax rate over the decade to 25 percent to promote global competitiveness and foster domestic investment.
2. Curtail the tax inducement for excessive financial leverage and reduce the tax code's bias in favor of debt relative to equity by disallowing 10 percent of C corporations' interest expense deduction.
3. Make permanent the 50 percent bonus depreciation provision now in effect but scheduled to expire at the end of 2012.
4. Encourage the flow of capital from the less productive housing sector into the innovative business sector by gradually limiting the tax benefit for home mortgage interest deductions.
5. Phase out the federal tax incentive for higher state and local taxes by removing the state and local tax deduction.
6. Repeal the alternative minimum tax (AMT) to eliminate its compliance burden.

The Details

Cut the Corporate Tax Rate

At 35 percent, the US federal corporate tax rate is second highest among industrialized countries and more than ten points above the average.³ The plan would phase the rate down to 25 percent over the next decade. A credible

phase-in of a corporate rate cut is more economically efficient than an immediate cut because a phase-in reduces the windfall benefit to investments that have already been made while offering incentives for new investment.

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This significant corporate tax rate reduction would also permit the elimination of Section 199 of the tax code, which effectively provides a preferential 32 percent rate for "qualified domestic production activities" (primarily manufacturing) income. Once the corporate rate is phased down to 32 percent, the plan would repeal Section 199, eliminating both its inefficient preference for manufacturing over other sectors and the complexity of defining and measuring the income eligible for the special rate.⁴

The lower corporate rate would offer numerous benefits. For example, it would mitigate the tax code's impediments to global competitiveness by ensuring our corporate rate is similar to those of other nations. Because much of the burden of corporate taxation falls on workers through lower wages and fewer jobs,⁵ the corporate tax rate cut would boost the weak US labor market.⁶ During the phase-down period, it would also modestly encourage firms to make capital investments more quickly so that they could deduct the depreciation of those investments while the corporate rate is relatively high and realize the income from those investments when the rate is lower.

This proposal is consistent with recent bipartisan tax reform recommendations. The Simpson-Bowles Fiscal Commission report proposed lowering the corporate tax rate to between 23 and 29 percent,⁷ the Rivlin-Domenici Commission proposed a 27 percent rate,⁸ and Ways and Means Committee Chairman Dave Camp recently proposed reducing the rate to 25 percent.⁹

Limit Corporate Interest Deductions

The current tax code encourages companies to issue debt rather than equity because corporations can deduct interest payments but not dividend payments. According to the Congressional Budget Office (CBO), the effective tax rate on debt-financed investment is -6.4 percent, a staggering 42.5 percentage points lower than the 36.1 percent effective tax rate on equity-financed investment.¹⁰ Reducing the corporate tax rate to 25 percent will lessen

the tax advantage for debt, but it makes sense to go further.¹¹ I therefore propose to disallow a deduction for 10 percent of C corporations' interest expense.

There are many economic benefits of moving away from the current policy. The current debt bias creates a dead-weight loss, as companies choose excessive levels of debt. This tax advantage unfairly favors firms that have access to debt financing. In addition, interest deductibility can lead to cross-border debt shifting among multinational firms. Furthermore, excessive leverage induced by the tax subsidy for debt financing may lead to more volatile business cycles and greater risk of a financial crisis affecting the economy.¹²

The President's Economic Recovery Advisory Board in August 2010 also proposed to limit interest deductions to 90 percent, but only for corporate interest payments in excess of \$5 million.¹³ My proposal would apply to all C corporations.

Encourage New Investment

Making permanent the temporary bonus depreciation provision, now slated to expire in 2012, would reduce the cost of new capital investment. This provision allows 50 percent of an investment's cost to be immediately deducted (expensed) rather than depreciated over time. Deducting investment costs sooner gives, in present value, firms greater tax savings because of the time value of money. Partial expensing can spur more investment per dollar of forgone tax revenue than cutting the corporate tax rate because it affects only new investments, not those that have already been made. A permanent policy gives firms greater predictability and ends the distortions that arise when firms time their investments to take advantage of temporary tax policies.¹⁴

Curtail Mortgage Interest Deduction

Current tax subsidies for homeowners primarily flow to high-income taxpayers, are ineffective at promoting homeownership, and significantly distort the allocation of capital. In any given year, the current mortgage interest deduction benefits only the 21 percent of households who itemize their deductions and claim a mortgage interest expense.¹⁵ A high-income taxpayer in the 35 percent bracket receives tax savings equal to 35 percent of his mortgage interest. But a moderate-income taxpayer in the 15 percent bracket receives tax savings equal to only 15 percent of her mortgage interest if she itemizes deductions and no tax savings at all if she claims the standard deduction.

This subsidy encourages taxpayers to buy bigger homes at higher prices, thereby steering their savings from investments in real business toward larger backyards and extra bedrooms.¹⁶ Estimates of the value of the mortgage interest deduction in 2010 ranged from \$80 billion to \$92 billion.¹⁷

Collectively, the set of policies encompassed in this plan steers more capital into the business sector by cutting tax rates and curtailing distortionary deductions.

Although completely eliminating the mortgage interest deduction for new loans might be the most efficient approach, my plan proposes a compromise. The deduction would be converted to a flat 12 percent, nonrefundable credit. Homeowners who pay income tax would get tax savings equal to 12 percent of their mortgage interest, regardless of their tax bracket and whether they itemized. Tax-payers who claim the standard deduction and those in the 10 percent tax bracket would get more tax savings than today, while those in the top brackets would get far less. The magnitude of this change would be significant, as 17 percent of homeowners with mortgages do not currently claim the mortgage interest deduction.¹⁸

The maximum mortgage principal eligible for the subsidy would be reduced over the next decade from \$1 million (current law) to \$500,000.¹⁹ In addition, taxpayers could not take the credit for vacation homes. To mitigate the effect on the sickly housing market, these changes would not apply to existing mortgages.

This tax change would assist moderate-income taxpayers in becoming homeowners but would reduce the subsidy for buying an expensive home. Homeownership may benefit communities by increasing individuals' involvement in the community and local government and incentivizing them to maintain their homes. But encouraging those who would be homeowners anyway to purchase bigger and more costly homes provides no social benefit. Over time, this change would shift capital toward more productive uses and lead to more growth, greater innovation, and higher wages.

This proposal or similar ones were included in recent bipartisan proposals, including the Simpson-Bowles plan and the Rivlin-Domenici plan. In his budget reform proposal, *Back in Black*, Senator Tom Coburn (R-Okla.) endorsed a portion of this reform by proposing to reduce

the cap from \$1 million to \$500,000 and disallowing vacation homes.²⁰

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Phase Out Deduction for State and Local Taxes

This deduction acts as a federal subsidy to state and local governments. It contributes to an overprovision of public goods at the state and local levels and leads states to use taxes that are deductible for federal income tax purposes as opposed to those that are not.²¹ State and local taxes are paid in return for services those governments provide, just as private consumption pays for services private enterprises provide. Private consumption is not tax deductible, so consumption of state and local services also should not be. Additionally, this deduction is largely taken by high-income taxpayers, who are more likely to itemize their deductions and to live in communities with high levels of public service and correspondingly high levels of taxation, so eliminating it would increase the progressivity of the tax code.²²

To accommodate the current state budget pressures, this provision would be phased in over five years. Each taxpayer's state and local tax deduction would be capped at 2 percent of adjusted gross income, and the cap would be reduced to zero over five years.

Repeal the AMT

The AMT is a parallel tax system that was originally intended to ensure that the wealthy pay a "fair share" of taxes despite their use of deductions and loopholes. However, as incomes have risen with inflation, the parameters of the AMT have remained fixed, causing taxpayers' liabilities to increase faster than the growth of their real incomes. In particular, married households and households with children are much more likely to be subject to the AMT.

The increase in the number of taxpayers subject to the AMT has led to significant compliance costs because taxpayers close to the AMT cutoff must calculate their liability under both the standard income tax and the AMT and then pay the greater of the two. This situation has also greatly contributed to taxpayers' uncertainty about their tax liability. Repealing the AMT will decrease

this uncertainty, reduce compliance costs, and limit the burden on households with many children.²³ Other bipartisan fiscal reform plans, including the Simpson-Bowles Commission and the Rivlin-Domenici plan, have also proposed repealing the AMT.

Benefits of the Plan

Collectively, the set of policies encompassed in this plan permit more capital to flow into the business sector. There are three standards by which tax systems can be judged, and this reform offers stark improvements in all areas: distortions across asset and financing type, effective tax rate on investment, and simplification.

The plan lowers effective corporate tax rates. This is the main factor that contributes to international tax competitiveness—effective tax rates determine where firms locate plants, machinery, and therefore jobs. By this metric, the United States is currently extremely uncompetitive, with an effective average tax rate on corporate income 8.5 percentage points above the Organisation for Economic Co-operation and Development (OECD) average. This plan will lower overall US effective corporate tax rates by 7.3 percentage points, according to an analysis using the CBO model, discussed further in the following section.

If the corporate rate cut were financed entirely through base broadening within the corporate income tax, an approach that some have advocated, effective corporate tax rates would remain relatively unchanged. The plan lowers *effective* corporate tax rates because it offsets part of the revenue from the corporate rate reduction by removing tax subsidies and distortions in the individual income tax and does not rely solely on base broadening within the corporate tax.

The plan significantly levels the playing field across financing methods and business forms. Distortions inhibit the ability of capital to flow to the most productive use, and the current tax code is riddled with distortions. Simply by cutting the corporate tax rate, the plan broadly alleviates distortions across different assets, the debt-equity distortion, and the distortion favoring noncorporate businesses over corporations. But the plan takes further steps to narrow these distortions. Repealing the Section 199 deduction for manufacturing income will limit the manufacturing sector's advantage over other sectors.

Replacing the mortgage interest deduction with a lower refundable credit will move assets out of the housing sector into the more productive business sector. Limiting the deductibility of interest expenses will reduce the incentive to issue debt and likely diminish bankruptcy costs in the economy.

The table below demonstrates the changes in effective marginal tax rates on various types of capital income under this plan. As the table shows, the plan reduces the effective marginal tax rate for corporate income from 26.3 to 19.0 percent and narrows the difference in the tax rate on debt- versus equity-financed investment from 42.5 percentage points to 21.4 percentage points. In addition, by adopting a flat 12 percent mortgage interest tax credit, the effective marginal tax rate on these dwellings increases from -5.1 percent to 0.6 percent. Housing remains a tax-subsidized investment relative to the overall tax treatment of capital, but the disparity is reduced.

It should be noted, however, that the proposed reform enlarges the tax rate disparity among corporate assets, with the interquartile range increasing from 12.3 percentage points to 16.1 percentage points. This largely results from the 50 percent bonus depreciation provision applying only to assets with a tax depreciation life less than or equal to twenty years. The restriction excludes most

structures, providing a modest relative advantage for equipment purchases.

The plan lowers compliance costs by moving taxpayers to the standard deduction and repealing the AMT. Repealing the state and local tax deduction, along with changing to the mortgage interest deduction, would allow many more taxpayers to file a simpler tax return without calculating itemized deductions. The CBO has estimated that eliminating the state and local tax deduction would reduce the number of taxpayers who itemize by around 8 percent.²⁴

This is because taxpayers choose to itemize their deductions only if the total value of those deductions exceeds the standard deduction. For example, consider a married couple who paid \$7,500 in mortgage interest and had \$5,000 in other eligible deductions, including state and local taxes, in 2011. If the state and local tax deduction was eliminated and the mortgage interest deduction was turned into a credit, the couple would simply claim the \$11,900 standard deduction and apply the mortgage interest credit instead of itemizing all deductions. This would significantly reduce the paperwork and compliance burden for taxpayers like this couple with total itemized deductions close to the

EFFECTIVE TAX RATES: CURRENT LAW VERSUS PROPOSED REFORM

	Current Law	Proposed Reform	Difference
Effective Marginal Tax Rates (percent)			
Corporate	26.3	19.0	-7.3
Debt-financed	-6.4	3.5	9.9
Equity-financed	36.1	24.9	-11.2
Noncorporate	20.4	19.4	-1.0
Housing			
Tenant-occupied	17.9	18.8	0.9
Owner-occupied	-5.1	0.6	5.7
Measures of Tax Rate Uniformity (percentage points)			
Interquartile range across asset types (corporate)	12.3	16.1	
Difference between equity-financed and debt-financed (corporate)	42.5	21.4	
Difference between corporate and noncorporate	5.9	-0.4	
Difference between tenant-occupied and owner-occupied housing	23.0	18.2	
Difference between business investment and owner-occupied housing	29.3	18.9	

SOURCE: Author's calculations, based on a model in Congressional Budget Office, "Background Paper: Computing Effective Tax Rates on Capital Income: Data: Corrected_ETRs.xls," December 2006, www.cbo.gov/ftpdocs/76xx/doc7698/Corrected_ETRs.xls (accessed January 13, 2012).

amount of the standard deduction. Further, as discussed earlier, repealing the AMT will significantly reduce tax compliance costs.

Budget and Distribution Consequences

This proposal is intended to be revenue neutral according to the estimating methodology of the Joint Committee on Taxation (JCT). While government estimators will likely conclude that the corporate rate cut and repeal of Section 199 would cost \$400–500 billion over the decade and the revenue loss associated with the bonus depreciation provision would be \$300–400 billion, the other changes would offset that amount. The precise phase-in of these proposals could be calibrated to ensure budget neutrality. In general terms and based on work by the CBO, JCT, and the Obama administration, I believe that the limitation on interest deduction for C corporations would raise \$200–300 billion, curtailing the mortgage interest deduction could raise \$250–350 billion, and repealing the state and local interest deduction and repealing AMT would, combined, raise \$200–300 billion over a ten-year budget window.

By allowing resources to flow toward more productive activities, the plan promotes economic growth, yielding additional revenue. For example, a dynamic analysis of a large corporate tax rate reduction the JCT conducted in 2005 found the actual cost of that change, if part of a larger revenue-neutral reform, could be 8.3 percent less than the traditional JCT score for such a policy. More significant macroeconomic and subsequent tax revenue benefits would likely occur beyond the ten-year budget window included in official budget estimates.

Beyond being good economics, easy to draft, and simple to explain, this proposal has one more political asset. It satisfies an ultimatum President Barack Obama delivered in his budget proposal to the Super Committee last year and a theme likely to be reiterated by President Obama in 2012—it raises taxes on the wealthy. Yet Republicans can take comfort that it does not raise statutory tax rates. And although limiting deductions can bring effective marginal tax rates up toward the statutory rate by a modest amount, the efficiency gained from more freely allocating capital across the economy would yield a net positive economic effect. Additionally, unlike the president's proposal to limit deductions for high-income earners, this proposal leaves unchanged the incentive for charitable contributions.

Unfinished Business

This reform makes substantial improvements to the US tax code, but it certainly does not solve every problem. The most important task for policymakers in the years ahead will be to move from income taxation to consumption taxation. This will eliminate the saving disincentive and insulate the tax base from the revenue-sapping effects of international tax competition. Shifting to a consumption tax, even a progressive one such as the Bradford X tax, would further increase long-run growth. However, this plan does not take this far-reaching step.

This plan also does little or nothing to address several issues that need to be resolved in our current tax system:

- 1) The US tax system's rules for taxing foreign-source income should be overhauled. Current rules are complex, encourage firms to locate economic activity and report profits in other countries, and raise little revenue compared to other countries.²⁵ The rate reduction in this plan will reduce firms' incentives to locate activity and report profits in other countries, but additional reforms are needed as well.
- 2) The individual income tax system is extremely complex. According to National Taxpayer Advocate Nina Olson, "If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the 'tax industry' requires the equivalent of more than three million full-time workers."²⁶ This plan will slow the rise of compliance costs, as I have shown, but substantial reductions in compliance costs should be achieved through fundamental tax reform or more aggressive cuts to tax expenditures.
- 3) Tax expenditures abound, and political tax favoritism continues to do harm. The JCT has estimated that tax expenditures cost the federal government more than \$1 trillion every year, and a significant number of those expenditures contribute to inefficient uses of capital. Reforms outlined in this proposal, namely curtailing the mortgage interest deduction and repealing the state and local tax deduction, will sharply reduce the magnitude of tax expenditures, but more remains to be done.

Conclusion

Tax reform can promote economic growth in the United States by improving the allocation of resources within our economy and our ability to compete in a global marketplace. Although advocates of fundamental reform should continue to examine the benefits of more radical changes such as moving the tax system from one based on income to one based on consumption, policymakers can take large and important steps toward a fairer, more neutral, and more pro-growth tax system within the existing confines of the current system.

This proposal is intended to demonstrate that reforms geared at broadening the tax base and reducing the tax rate on investment—two critical components for a pro-growth tax code—can be combined to form a revenue-neutral tax reform package. A proposal of this magnitude will always face significant political challenges, but given the strong public interest in tax reform, now may be the best time to move forward.

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Notes

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