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The Rand Paul Tax Plan

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Senator Rand Paul's (R-Ky.) plan for comprehensive tax reform is generally much better than the status quo, but some of its elements could be substantially improved to make it more pro-economic growth. Additionally, the revenue implications of the Rand Plan require a strategic plan for cutting government spending.

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Personal Income Taxation. Titled "fair and flat," Senator Paul's plan's greatest strengths are its ability to solve the compliance issues that plague the current system while also boosting gross domestic product (GDP) growth by slightly less than one percentage point per year. Taxpayers spend around $400 billion and 6 billion hours each year filing returns. Collapsing all marginal tax rates into a single, flat 14.5 percent, will surely reduce the time and resources Americans spend filing taxes. By reducing complexity, the plan also reduces the number of loopholes that can be exploited by the rich to lower their tax burden. The plan would boost economic growth by reducing the tax burden on saving and investment, and by eliminating the marginal tax increase on income from work under the current system.

For individuals, the plan also:

- Eliminates the estate tax, which mainly serves as a form of double taxation on wealth and creates perverse incentives for individuals to consume their wealth rather than invest it as they approach the end of their lives.
- Preserves the mortgage interest rate and charitable deductions.

Although it may be politically infeasible to eliminate the mortgage interest deduction, switching to a mortgage credit would extend the benefits of the tax break to lower income homeowners. A deduction lowers the overall income taxed, while a credit lowers actual taxes paid. The current mortgage interest deduction is regressive because the greatest benefits flow to higher income taxpayers. Currently, families making under $50,000 receive only 3 percent of the dollar value of the deduction.

Distributional Effects. If the plan is assumed to have no economic growth impact, as in a static analysis, the Tax Foundation predicts that it will lead to an increase in after-tax adjusted gross income for everyone except those making under $10,000. If the plan is assumed to have a positive impact, as in a dynamic analysis, the Tax Foundation predicts a rise in adjusted gross income for all filers.

Business Taxation. In a momentous policy change, Paul proposes shifting from an income approach to business taxation to a Value-Added Tax (VAT) system, which he calls a "business-activity tax." He suggests a flat 14.5 percent tax rate.

Other details of the plan include:

- *Up-front expensing of capital.* By allowing businesses to immediately write off capital expenditures, the plan removes the uncertainty that plagues the current depreciation system because current depreciation schedules do not recognize how firms discount future interest and opportunity costs, the tax code reduces the rate of return on investment in capital goods.
- *Removing all tariffs and duties.* Tariffs serve mainly as barriers to free trade, and they disproportionally hurt consumers. By eliminating them unilaterally, the Paul plan has the potential to lower prices for everyone and reduce the uncertainty that comes with short-term tariff holidays. It could also increase economic growth as domestic industry reallocates resources.
- *A new territorial system of corporate taxation.* In a territorial system, corporations would pay taxes only in the country where profits were earned. A permanent switch to this system would encourage American multinational corporations to bring profits earned overseas back to the United States. The quantity of money that is being held overseas is around $2.1 trillion, and it appears that this total is still growing [see the figure].

The Business VAT Model. Although Paul calls his tax a "business-activity tax," it appears that it could be more correctly labelled a VAT, similar to that used in Europe. This means that it is a consumption tax. The way Paul discusses his ideal system, it appears the tax would apply uniformly across industries. However, the VAT comes with its own set of considerations that should be weighed:

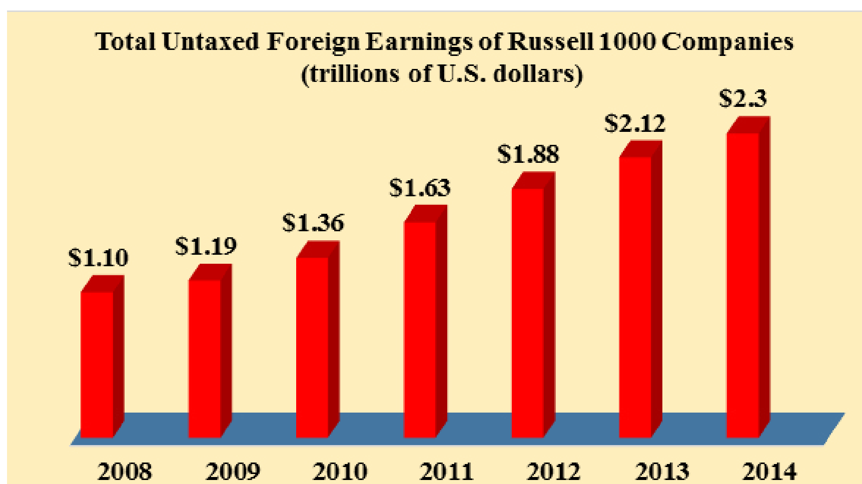
- A VAT encourages investment over consumption.
- By applying the tax uniformly across industries with no special credits and deductions, Paul's VAT will avoid distorting the economy to favor certain industries at the expense of others.
- A VAT avoids many of the compliance issues that arise from retail sales taxes because, in some cases, when an intermediate entity does not pay the tax, the full tax revenue can still be retrieved from the final producer

However, there are some drawbacks to a business VAT tax:

- Studies show the majority of the burden of the tax falls on consumers; thus, to the extent low prices are important to the American economy, a VAT will noticeably raise the price level.
- A VAT lacks transparency, because it is not visible on consumer receipts and it is spread over a wide set of purchases rather than paid out of workers' paychecks.
- VATs are an easy way to generate large amounts of revenue, and a host of experts link the VAT to expansion of the size of government in Europe.

Conclusion. As the Tax Foundation points out, the plan will generate more growth and therefore raise taxable activity. But even these gains, which are substantial, leave a net $1 trillion increase in federal debt over 10 years.

In 2014, Senator Paul proposed a budget plan for the U.S. government that included substantial cuts that would more than compensate for the revenue lost from his tax reform package. Through reforms to specific programs like Medicare, Social Security, NASA and defense, Paul's budget would cut several trillion dollars over 10 years. It also includes budget process reforms that would rein in government spending, including a balanced budget amendment and zero-based budgeting. If Paul stands behind his prior budget plan, then revenue neutrality may not be a problem.



Note: The Russell 1000 is an index on companies consisting of the 1000 highest ranking companies based on market capitalization. The member companies together represent 90 percent of the U.S. equity market.

Source: Data from Audit Analytics. Available at http://www.auditanalytics.com/blog/overseas-earnings-of-russell-1000-tops-2-trillion-in-2013/.

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