Fundamental Tax Reform: An Essential Pillar of Economic Growth

An Assessment of Governor Jeb Bush’s “Reform and Growth Act of 2017”

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Executive Summary

Now more than ever, fundamental tax reform is an essential pillar to an American economic resurgence.

Governor Bush has proposed a radical reform plan to advance growth, economic efficiency, and simplicity by reducing marginal tax rates on businesses and household incomes, cutting the number of Americans on the tax rolls, limiting special interest provisions throughout the tax code, and bolstering incentives for millions of Americans to re-enter or remain in the workforce. If enacted, the plan – particularly with its sharp marginal rate reductions on business income and support for wages and income of middle-income households – would be the most fundamental tax reform since the Tax Reform Act of 1986 under President Reagan.

The Governor's tax plan – when combined with other fundamental economic policy reforms – represents an essential reform to raise economic growth. The plan will drive increased capital investment by businesses and increase the productivity of our economy. Both are essential to raising standards of living over the next generation. It will help create millions more jobs, and lead to significantly higher wages during the next decade.

At its core, the Governor’s proposal abides by sound tax principles: the tax plan funds essential government functions by establishing low marginal tax rates to lessen interference with economic activity, and it removes tax loopholes and special interest benefits which distort economic activity. Application of these principles will increase participation in the labor force by young and old, ensure that American workers have the tools, technology, and support they need to drive productivity and wages higher, and greatly improves the U.S. economic environment for long-term investments and innovation.

We believe that the Governor’s tax plan will create a higher growth economy to help generate sufficient revenues to fund the government’s financial obligations. Employing conservative assumptions, we estimate that the tax reform plan itself will lead to at least five percentage points higher GDP by the end of a decade. The Governor’s regulatory reforms – which will be unveiled separately – will increase GDP by at least an additional three percentage points by 2025. We conclude that the tax and regulatory policies alone will conservatively raise the growth rate of GDP by at least 0.8 percentage points per year during the 10-year forecasting period.

Increased productivity will ultimately increase wages and compensation. We estimate that, as a consequence of the tax and regulatory policies, average annual compensation will increase by 8 percent. Average compensation will increase by $2,750 in year 2020 and $6,200 by 2025. After accounting for the expected wage growth and tax reductions a typical family of four will see their after tax income rise by $3,100 by 2020.

We estimate the tax plan, with conservative assumptions for revenue feedbacks from the Governor’s tax and regulatory policies, will reduce revenues from the current CBO baseline by $1,200 billion over the next decade; about a 3 percent reduction from projected federal revenues over that period. Based on the tax and regulatory policies alone the plan will slow the growth of the debt to GDP ratio by half. The remaining revenue loss would be offset by reasonable, incremental feedback effects from the tax and regulatory reforms, meaningful spending restraint across the federal budget, and growth and feedback effects from Governor Bush’s forthcoming proposals to restrain federal
spending and reform health care policy, the nation’s education system, energy policy, trade, and immigration policy. With these added effects the debt to GDP ratio would decline even further.

While our estimates here only account for tax and regulatory policy, these other proposals will further bolster growth in the direction of the Governor’s goal of 4 percent – a prospect that would add over $4 trillion of revenue to the government coffers.

**State of the U.S. Economy**
Since the economic recovery began six years ago, the rate of economic growth has averaged only two percent per year, the weakest economic expansion since World War II. Participation in the labor force is at its lowest level since 1977. The country is experiencing the worst five-year run for productivity ever measured outside of a recession. And the median wage is growing only slowly.

For individuals and households, the economic performance is insufficient to improve standards of living at a rate to which most Americans are accustomed. And it is at odds with a society that promises opportunity and upward mobility for the next generation. Most Americans rely largely on wage income. The conduct of economic policy during the past several years, however, has favored households with already accumulated large asset holdings.

For businesses, the underlying economy lacks dynamism in output, investment, and employment. Start-up activity outside of a few regions remains poor. Business investment in real assets, such as property, plant, and equipment, is stuck at very low levels. All the while, investment in financial assets, such as share buybacks by corporations, continues to increase substantially.

Neither recent financial market turmoil nor the evident slowing of the global economy presages improvement in the performance of the U.S. economy. No less troubling, the recent conduct of economic policy is doing little to reset expectations higher for long-term growth.

**Policy Choices Past**
The financial crisis itself caused policymakers to undertake extraordinary actions. And these extraordinary actions were supposed to deliver very strong economic growth at a rate of approximately 4 percent during the recovery. In late 2009, for example, the Federal Reserve projected that the real GDP would grow by 3.6 percent at an annual rate in 2010, increase to 4.5 percent in 2011, peak at 4.7 percent in 2012 and 2013, and grow at 3.2 percent in 2014.¹ These growth rates were not without precedent, and the Fed’s forecasting record compares favorably with the Blue Chip forecasts of economists inside and outside of government.²

Instead, output has grown at about half of consensus’ projections from June 2009 until present. The weaker than expected economic performance should cause policymakers to revisit their economic programs and policies. They have not.

In fact, some economists, including those in the current Administration, rationalize the growth rates of the past six years as part of “a new normal,” suggesting that American businesses and households

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¹ Federal Reserve, *Current Economic and Financial Conditions*, December 9, 2009, Available [Here](#).
² For example, in August 2009 the Congressional Budget Office projected that the real GDP would grow by 3.5 percent at an annual rate in 2011, increase to peak at 5 percent in 2012, grow at 4.5 percent in 2013, and grow 3 percent in 2014. (Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 25, 2009, Available [Here](#)).
should lower their expectations. They have re-popularized the term “secular stagnation” to explain away the muted recovery. And they now assert confidently that economies cannot grow robustly after financial crises, even though the financial crisis was well understood when they issued their optimistic forecasts.

Economic recoveries tend to be stronger after deep recessions, and any residual headwinds from the crisis should have long been remedied had pro-growth policies been adopted. Historically, some post-crisis periods are marked by lower economic growth, but we believe that the poor conduct of economic policy bears much of that burden. In particular, the chronic short-termism that often marks the conduct of fiscal, regulatory, and monetary policy must be redressed for economic potential to rise.

**Changing Course**
We disagree with the prevailing view that the economy is doing as well it can. We consider recent economic performance to be a result of bad, growth-defeating economic policies. And we believe that economic policy must be clearly improved in order to avoid the malaise of recent years from harming the future prospects of American businesses and workers.

A more rigorous recovery during the past six years was an opportunity lost. The economy can grow at significantly higher rates than the prevailing pessimism. As shown on the chart below, the economic recovery, such as it is, is an outlier from all such periods since the 1970s.

![Change in Real GDP Per Capita Following Recessions](chart.png)

Notes: Data from U.S. Bureau of Economic Analysis.

The U.S. economy need not be stuck with slow growth. A clarion call for faster economic growth – like Governor Bush’s call for 4 percent growth– is a worthy aspiration. And if fundamental reforms are pursued and enacted in fiscal, regulatory, monetary, immigration, trade, and education policies, U.S. economic growth could well make the next decades among the most prosperous in the nation’s history.
What is needed is a long-term commitment to policies that significantly increase U.S. economic potential. Such a commitment requires a change in course. And such a change is not without precedent to reset expectations about growth.

The economic challenges of the country are readily addressable. In another grave moment for the American economy, George Shultz and his fellow economic advisers began a Report to President-elect Ronald Reagan (November 16, 1980) as follows:

“What sharp change in present economic policy is an absolute necessity. The problems of… slow growth, of falling standards of living and declining productivity, of high government spending but an inadequate flow of funds for defense, of an almost endless litany of economic ills, large and small, are severe. But, they are not intractable. Having been produced by government policy, they can be redressed by a change in policy.”

Those words of nearly 35 years ago have resonance today.

History makes clear that better macroeconomic policies can drive strong economic growth. President Reagan’s agenda – tax reform, regulatory reform, and support of sound monetary policy – are a prominent example. After the deep recession of 1981-82, real GDP growth averaged 4.8 percent in the subsequent six years, more than the double the pace of this recovery to-date.

And Reagan’s reforms, especially the Tax Reform Act of 1986, provided a strong foundation for the economic boom that prevailed during much of the subsequent generation. The 1986 Act served as an important catalyst for the economic boom that followed, generating substantial improvements in incomes, government revenue, and economic growth.

**The Growth Imperative**

Strengthening economic growth is essential to broad-based prosperity. To improve economic growth, the conduct of economic policy must be improved. That entails a better diagnosis of what ails the economy, adoption of a longer-term policy time horizon, and implementation of strong, pro-growth economic policies to increase productivity and expand employment, thereby increasing the economy’s long-run potential.

Productivity increases arise from human capital (labor) and real capital investment in a competitive market. Weaker productivity growth in recent years (approximately half of the average of the 1980s and 1990s) threatens income and living standards. While productivity measurement is imperfect, we believe that improved economic policies can significantly help productivity rates return to at least the average of the 1980s and 1990s.

The reduction in aggregate hours worked – both by those working part-time but who would prefer to work full-time and those who have dropped out of the labor force altogether— also damages economic activity. Economic policies must also be reoriented to increase labor force participation.

**Comprehensive Economic Reforms**

Among policy reforms, we judge that fundamental tax reform will have the largest effect on economic growth in the projection period. But important changes in tax policy should not happen in isolation.
Regulatory reform – including a reinvigorated presidential effort to remove unnecessary, antiquated federal rules, a rigorous, independent benefit-cost analysis of proposed rules, a regulatory directive to ensure that regulations are pro-competition, not pro-incumbent – will enhance economic growth. Like tax policy, regulatory policy affects net returns to investment in physical and human capital. The regulatory proposals, which the Governor has provided to us, are forthcoming. If enacted, they should be highly beneficial to increase employment and productivity.

Other policies beyond tax and regulation (not evaluated in this paper) will further bolster growth in the direction of the Governor’s goal of 4 percent. Federal spending restraint, immigration, trade policy, energy policy, health care reform, and improvements to education and training will prove to be significant contributors to increase the economy’s potential.

We believe that fundamental reforms across these policy areas could increase growth substantially during the next ten years. At 4 percent economic growth, ten-year cumulative deficits would fall by $4 trillion.

For scoring purposes, however, to be conservative, we calculate that the tax and regulatory components of the Governor’s economic plan will strengthen GDP by a total of about 8 percent over a decade, with 5 percentage points coming from the tax reform plan and 3 percentage points from regulatory reforms. On an annual basis, that equates to approximately 0.5 percentage points of higher economic growth per year directly attributable to the tax policy changes outlined in the balance of the White Paper. And an additional 0.3 percentage points of annual growth arising from the regulatory reforms, which we understand the Governor will be outlining in detail in the period ahead.

**A Key Pillar: Fundamental Tax Reform**

Fundamental changes in tax policy are among the most promising policy reforms that can effectively get people back to work, and make them more productive on the job. Few policy changes would have a larger, more beneficial effect on economic activity, income, and employment than real tax reform.

Economists have long emphasized fundamental tax reform as an essential tool to deepen capital accumulation, raise employment, and increase output and incomes. The current tax code’s distortions do the opposite: depressing work, saving, and investment and distorting the allocation of capital across economic activities.

Moreover, the complexity of the tax code encourages rent-seeking by special interests, while raising costs of doing business and increasing frustration of compliance with tax provisions. The narrowing of the tax base to accommodate special interests also leads to the higher marginal tax rates that depress economic activity.

Breaking this dangerous cycle requires reform that reduces marginal tax rates and broadens the tax base. Going further, reform should remove tax biases that discourage investment in the United States and tax incentives that subsidize special interests.

The landmark Tax Reform Act of 1986 illustrates well the benefits of reducing marginal tax rates on business and household income. The reform was made possible by strong, sustained presidential
leadership and notable bipartisan Congressional support. Economists judge that substantial gains in GDP and incomes followed.

The benefits of the 1986 Act, however, dissipated over time. Since the passage of tax reform nearly 30 years ago, more than 15,000 changes have been made to the tax code itself. The complex code—riddled with nods to special interests—is now growth-defeating.

But, tax reformers must take into account important economic shifts since the 1986 Act’s passage. The global competition for corporate capital has intensified. The United States has the highest statutory corporate tax rate in the industrial world (more than 10 percentage points higher than the median among OECD countries, as shown in the figure below).

This higher tax burden has discouraged investment and employment in the United States. U.S. firms are re-domiciling their businesses outside of the United States, including by so-called, corporate inversions, which are increasing in number.

Special interest pleading and crony capitalism have only intensified. The growing number of special preferences and loopholes means that the corporate tax code not only harms economic activity, but also collects much less revenue than advertised. The tax code’s deductions, credits, and exclusions also mean similarly situated taxpayers often have vastly different tax liabilities. These tax expenditures—spending through the tax code—require higher marginal tax rates and distort economic behavior.

In addition, business activity in the non-corporate sector has grown in size and importance, and higher individual marginal tax rates imposed during the current administration raised the tax burden on those businesses’ investment and hiring. Tax rates rose substantially for small businesses and
investors. Many of the President’s other policies also increased marginal taxes on low- and middle-income Americans.

Finally, as the labor force participation rate has dropped significantly, the tax code has disadvantaged many of those who wish to enter the work force or return to it.

With these lessons in mind, a reform ethos of “lower rates and a broadened base” remains essential. Tax reform requires reductions in marginal tax rates on corporate income, reductions in marginal tax rates on business income and earnings from work at the individual level, a tax structure to limit special interest benefits, and an enhancement of opportunity to work. These shifts will raise both productivity and hours worked, and provide opportunities for broad-based prosperity. Fundamental tax reform today should also make America the place to invest in people and capital.

**Consistency of the Plan with Tax Reform Principles**
We believe Governor Jeb Bush’s tax reform proposal is fully consistent with important tax principles.

First, comprehensive tax reform should ensure that the tax code collects the requisite funding while interfering least with economic activity. The tax code should be the least distortionary of labor and capital, consumption and investment. An efficient tax system is essential to maximum sustainable economic growth. Absent strong economic growth, the United States will no longer be a land of opportunity or vitality. Nor will the nation generate sufficient revenues to fund its obligations. The reforms outlined by the Governor are rightly targeted at maximizing economic growth.

Second, the distribution of government revenue should happen principally through the budget and appropriations processes, involving the President and the Congress. Special loopholes, credits and carve-outs embedded in the tax code represent spending by other, less transparent means. It undermines any sense of fair-dealing among citizens. The Governor’s plan to minimize these special preferences, most notably by ensuring any tax expenditures are capped per household and most business tax breaks are eliminated, represents substantial reform.

Third, the tax code should trust Americans – individuals, families, and businesses – letting them keep more of each additional dollar so they may do with it what they see fit. Special government preferences should not be allowed to skew economic choices of households and businesses. Low, marginal tax rates are wholly consistent with this objective.

Fourth, changes to the tax code should be permanent so that households and businesses can know the long-term rules of the road when they make important decisions. The Governor’s plan establishes a new, permanent set of tax rates and rules to provide certainty to decision-makers.

**Assessment of Governor Bush’s Tax Reform Proposal**

The Governor’s proposal, if enacted, will represent the most radical changes to the tax code since President Ronald Reagan.

We consider each of the four major elements of the tax code.
• The Governor’s plan reduces significantly incentive-destroying taxes on individuals and families, while reducing special tax provisions that disproportionately benefit those at the top.

• The Governor’s plan reforms our business tax code to ensure U.S. businesses, small and large, can be at the forefront of economic prosperity in the 21st century.

• The Governor’s plan simplifies the tax code for all Americans to increase prosperity and reduce the cost of complying with the tax code.

• The Governor’s plan ensures that Americans who are able to work have the right incentives to be part of the workforce.

Taxes on Individuals and Families
We believe that the Governor's tax reform proposal for individuals and families will have significantly positive effects on employment, wages, and opportunity for advancement.

By reducing the number of tax brackets from seven to three, and ensuring that the tax rates are low (10, 25, and 28 percent) and permanent, the plan sets the stage for a stronger, more prosperous economic future. These marginal tax rate reductions will increase take-home pay for those who are already working, and will encourage others to rejoin the labor force.

By expanding the standard deduction and limiting deductions, the proposal will also dramatically reduce the need for itemization. We believe that these reforms will decrease the number of itemizers by over 80 percent. That is, this reform will simplify taxes dramatically for these 34 million taxpayers. Tax compliance will be enhanced and tax complexity reduced.

The plan also eliminates the state and local tax deduction. Currently, filers who itemize their deductions may deduct state and local income and property taxes. The tax deduction favors filers in states with higher property and income tax rates. Over 90 percent of tax expenditures related to state and local taxes accrue to filers with adjusted gross income (AGI) above $100,000.3

All remaining itemized deductions (that is “below the line” deductions), with the exception of charitable contributions, will be limited by a binding tax cap. The cap will limit the tax savings that results from itemized deductions to two percent of a filer’s adjusted gross income. Due to the tax code’s progressivity, the design of the cap allows low- and middle-income filers to claim a larger deduction as a share of their income relative to high-income filers. Low- and middle-income filers in the newly expanded 10 percent tax bracket will be able to deduct up to 20 percent of their income, while high-income filers in the 28 percent bracket will be limited to deductions of about 7 percent of their income. The cap has the virtue of allowing the taxpayer to employ any of the remaining deductions that exist in the tax code, but prevents them from being used excessively.

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We believe that spending through tax code forces marginal tax rates far higher. The Governor's plan will significantly curtail annual tax expenditures. The cap serves as important means of allowing substantial reductions in marginal rates to enhance economic growth.

**Business and Investment Taxes**

We believe the Governor's business and investment tax reform proposal will significantly increase capital investment in real assets, bolster productivity of the workforce, increase take-home pay, and make the United States among the best places in the world to do business.

The top corporate tax rate will be reduced to 20 percent (from 35 percent today). The new rate will be lower than the OECD average. We estimate that approximately 50 percent of the gains from changes in corporate tax rates will accrue to labor and the other 50 percent will accrue to capital owners. Many recent studies of the incidence of the corporate tax rate, particularly in an open economy, conclude that labor bears much of the burden of the tax. The tax reduces business investment in the United States, reducing productivity and wages and shifting the burden of the tax from capital to labor.

Other businesses -- formed as S-Corps, LLCs, and partnerships -- will pay taxes according to the reduced marginal tax rates that apply to individuals. The highest tax rate for these “pass-through” entities will be the top individual marginal tax rate of 28 percent. This represents nearly a 30 percent reduction from the existing 39.6 percent rate. We believe that this marginal rate cut for these critically important job creators will jump-start their investments in physical assets and human capital alike.

Businesses, regardless of corporate form, will be able to fully expense all new capital investments, an approach that is consistent with consumption-type taxes. Businesses will have marginal rates apply to their receipts minus the cost of capital expenditures, labor, and materials. We consider this broadly equivalent to a business cash flow tax.

The elimination of a host of special interest tax breaks is a further step forward to removing the corporate tax code’s distortions.

These reforms will simplify the tax code and significantly increase incentives to invest in new machines, equipment, buildings, and other structures.

In our judgment, the absence of private capital investment has been an obstacle to employment. While U.S. GDP rose 8.1 percent cumulatively from late 2007 through 2014, gross private investment was just 4.3 percent higher. The growth in non-residential fixed investment remains substantially lower than the past six post-recession recoveries.

Capital investment will benefit greatly, as business leaders will face a zero corporate tax rate at the margin on new capital investments. Jobs, wages, and productivity will benefit from the expected increase in business investment.

Generally, non-financial businesses will no longer be able to deduct interest payments. Under the current code, debt financing receives favorable tax treatment relative to equity financing. We believe that the Governor’s proposal will create a more level playing field between debt and equity
financing, thereby lessening the prospects of financial instability from high leverage. For financial institutions the same policy would be achieved through comparable reforms.

Under the proposal, firms will only pay taxes on profits earned in the United States, in order to the end the practice of U.S. firms earning money abroad and not bringing in back to the United States. As part of the transition to a territorial tax, firms with deferred foreign earners will face a deemed repatriation tax of up to 8.75 percent. Firms will have ten years to pay the tax.

We believe the reform will both enhance the competitiveness of U.S. firms globally and remove barriers to bringing overseas profits to the United States. The U.S. economy will benefit significantly from a massive inflow of new capital investment.

Governor Bush’s plan would also reduce marginal tax rates on investment income. The current administration increased the top capital gains and dividends tax rate by nearly 60 percent (from 15 percent to 23.8 percent). The top capital gains and dividend rate will be reduced from 23.8 percent to 20 percent. Those who are putting real capital at risk will be able to benefit from the lower rate on capital gains. Interest income will also be subject to a top rate of 20 percent.

Although the plan lowers marginal rates for C-corporations and lessens the double taxation of income, pass-through entities will maintain a tax advantage. For example, $100 earned by a C-corporation will yield $80 after the corporate income tax and $64 after accounting for dividend taxes paid by the shareholder. A non-corporate business owner, meanwhile, will receive $72 in after tax income on $100 earned.

**Simplification**

The Governor’s proposal will make the tax system considerably simpler. Simplification reduces the burden of compliance. It also enhances much-needed trust in the tax system. Similarly-situated taxpayers should have comparable tax liabilities. No longer will certain benefits accrue to those who manage to take advantage of special loopholes.

The proposals provide dramatic increases in simplification of business and household tax regimes. Full expensing, for example, will bring dramatic tax simplification for businesses, eliminating complicated, IRS depreciation schedules. Meanwhile, limiting deductions while reducing rates, will simplify decision-making for individuals and families. The number of taxpayers itemizing—a time-consuming process—will fall from 47 million to 13 million.

The proposals also eliminate several features of the tax code that require additional time and effort to comply. Most notably, the reform will eliminate the alternative minimum tax (AMT) for both individuals and corporations. This change simplifies the code because filers will no longer be forced to calculate their tax liability under two separate tax systems.

The proposal also eliminates the personal exemption phase-out (PEP) and the limit on itemized deductions for high-income taxpayers (Pease). Eliminating PEP and Pease not only reduces the complexity of the tax code, it also reduces the marginal tax rate for affected filers. Unlike Pease, however, the plan’s cap on tax deductions will not increase tax filers’ marginal tax rates.

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4 The exact nature of the deemed repatriation tax will depend on how the foreign deferred earnings are being held.
The plan also eliminates the estate and gift tax. Death should not be taxable event, nor should it add to the complexity of tax policy. The proposal will eliminate the “step-up basis” upon death for capital gains in excess of the current estate tax thresholds. When the gains from these estates are eventually realized, heirs will pay capital gains based on the original basis (so-called “carryover basis”). The tax treatment for bequests to spouses would remain the same as current law.

We believe these changes strongly promote incentives to work, save, and invest while enhancing growth prospects for individuals and businesses.

Getting Americans Back to Work
The reductions in personal income taxes and business taxes will increase productivity, hiring, and encourage more Americans to return to work. There are, however, certain groups that may still face relatively high marginal tax rates that discourage labor force participation. The Governor’s proposal will further reduce marginal tax rates to increase employment throughout the life cycle of workers who might otherwise be unattached to the labor force.

We believe that these changes can increase work opportunities for young people entering work, secondary earners in mid-life, and older workers, all enhancing economic opportunity throughout labor force.

EITC reform
The reform will double the size of the Employment Investment Tax Credit (EITC) for childless workers. This change will effectively mean childless workers will benefit from a zero marginal tax rate when entering the workforce. We believe this change offers a potent supplement to work for those who might otherwise suffer from the employment-dampening effects of mandated, minimum wages. The Governor’s expansion of this program, however, will be appropriately coupled with substantial reforms to mitigate fraud.

Separate filing
The proposal will allow an individual in a married couple with the lower earnings (wage and salary income) to file a separate simple tax return using the tax schedule for single filers. All other household income, deductions, and credits will remain on the tax return of the higher earner. This change will achieve four goals:

• Provides the currently non-working spouse with a zero marginal income tax rate on the first dollar of earnings and reduce rates on additional earnings;
• Eliminates the marriage penalty;
• Potentially lowers the marginal tax rate of the currently employed lower earner; and
• Potentially lowers the marginal tax rate of the higher earner.

Taken together achieving these four goals creates a powerful incentive for increased labor force participation and human capital investment.

Payroll tax relief for older workers
The Governor’s proposal will eliminate the employee portion of Social Security payroll taxes (6.2 percent) for workers at the Social Security full retirement age and above (currently age 67). We believe these workers, who have already long paid into the Social Security system, will benefit both
from a reduced tax-disincentive to work and higher after tax income. And these workers can be more knowledgeable and productive than their less experienced peers.

**Wage Effects**

We expect the tax reform package is expected to raise real incomes and living standards significantly. The higher capital stock raises productivity and wages. In addition, we estimate conservatively that 50 percent of the corporate tax burden is borne by American workers in lower wages. Taken together, the GDP effects and corporate tax reduction on wages will raise average household incomes by at least 6 percent in year 2025.5

Including the lower-bound estimate for the impact regulatory reform will have on compensation, we expect the Governor's economic policies to increase the level of real compensation to workers by 8 percent more than they will otherwise be under existing policies. This is equivalent to an increase in average annual compensation of $2,750 in year 2020, growing to $6,200 by 2025 (constant 2015 dollars). Other policy areas not considered here would further increase compensation.

The tax reform plan will raise take-home pay for millions of Americans. A family of four earning $50,000 per year (and not itemizing deductions) will receive an increase in take-home pay of $1,150. Accounting for the expected wage increases, the net effect will be that, in 2020, the family will have an after-tax income that is approximately $3,100 larger (constant 2015 dollars) than projected under current law.6

**Growth and Budget Effects**

If the proposed tax reform package had zero effect on economic activity – a judgment we consider wholly inaccurate – the static revenue loss is estimated at $376 billion in year 2025. With appropriate phase-ins for the corporate rate reduction, the ten-year budget estimate would be approximately $3,400 billion.7

We believe that the growth effects of the tax plan will be very substantial. The proposal will generate positive impacts on GDP over the long-term. Lower business tax rates and the ability to expense capital investment will increase domestic investment in real assets and increase the capital stock, raising productivity and output. In addition, the lower U.S. corporates tax will redirect foreign investment into the United States. The shift to cash flow-style taxation will promote real investment over financial engineering and share repurchases. The significantly lower corporate income tax rate will also reduce incentives for profit shifting. Lower individual marginal tax rates on earnings from work will increase hours worked. Lower business tax rates and lower individual tax rates will shift capital over time from financial assets to productive business capital, a big plus for productivity.

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5 This calculation also assumes that the ratio of compensation to income would remain at its 2015 levels as a consequence of the plan.

6 With the regulatory and tax policies in place, we expect wages to rise by 4% in 2020 over current projections. This will increase after tax income for family of four by $1,800. The family would also have saved approximately $1,300 under the tax plan without any assumed growth effects for compensation. Combining the static impact of the tax plan with the expected increase in compensation yields an additional $3,100 in after tax income.

7 To be consistent with CBO's 10-year budget period, we assume the tax plan is enacted in 2016. The personal income tax, payroll tax changes, and the estate tax provision is assumed to be enacted for the 2016 tax year. Full expensing would also begin in the 2016 tax year. The corporate income tax reform is assumed to be phased in between 2017 to 2021, with the corporate income tax rate falling by 3 percentage points annually.
On balance, we believe that the tax plan will increase GDP by at least 5 percent by 2025. This is approximately equivalent to higher annual growth rates of 0.5 percent per year. We believe our estimate is conservative. The feedback effects from the tax proposals are estimated at 39.7 percent over the 10-year budget window. If the Governor’s regulatory reforms were also implemented, the combined effect of the two reforms will increase GDP by more than 8 percent by 2025. Under these conservative growth assumptions, the revenue loss from the tax plan will be $1,200 billion during the next decade.

Budget discipline and economic prosperity go hand in hand. A growing economy reduces the financial burden of meeting the government’s funding obligations. Similarly, federal spending restraint is essential to maximizing economic growth.

To fully realize the Governor’s aspiration of four percent economic growth, the Governor’s economic reforms require strong fiscal discipline on the federal budget ledger’s spending side. Without this discipline, increases in the national debt will act as an economic drag on the pro-growth economic policies.

During the past seven years, we have observed a lack of budget discipline. The result: a rapid surge in federal expenditures unprecedented outside of wartime. Although some spending increases were expected during the economic recession, federal outlays have failed to decline since the recession’s end five years ago. Today, the federal government’s annual spending is one trillion dollars more than it was in 2007, the year before the recession began. The spending surge has been fueled largely by a 49 percent increase in domestic spending. The increase has coincided with economically damaging higher tax rates, higher national debt, and a weakened national defense.

Certainly, in light of the one trillion dollars that has been added to annual federal spending since 2007, the existing budget base should not be sacrosanct. Setting the budget base aside, the required budget goal can be achieved by reducing the growth in federal outlays from its current upward trajectory by one percentage point per year. From 2017 to 2025, federal expenditures are projected to increase at an annual rate of 4.2 percent. Limiting the increase to 3.2 percent will produce over $400 billion in budget savings in 2025 and $1.4 trillion in savings between 2017 and 2025. Achieving this limit would still entail federal program spending to increase by 40 percent above its current level, rather than by its currently projected 50 percent.

Where will the spending restraint come from? Among many areas ripe for spending discipline, the Governor has discussed needed entitlement reforms and repealing of the Affordable Care Act. These efforts will not only be important to ensure deficit reduction, but they will also be important means of enhancing economic growth.

**Conclusion**

A fundamental change in the direction of economic policy is imperative. That change begins with tax reform. Today’s economic environment offers an especially opportune moment to change the course of policy so that expectations for higher long-term growth can be re-established. The tax reform package advanced by Governor Bush will raise GDP, employment and wages. And, as part of a more comprehensive economic package, it can raise the rate of economic growth to levels far above the so-called ‘new normal’.
### Appendix A. An Overview of the Reform and Growth Tax Plan

#### Individuals and Families Overview

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<th>Current Policy</th>
<th>The Governor's Plan</th>
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<td><strong>Tax Rates</strong></td>
<td>Seven tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%</td>
<td>Three tax brackets: 10%, 25%, 28%</td>
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<td><strong>Personal Exemption</strong></td>
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</tr>
<tr>
<td><strong>Standard Deduction</strong></td>
<td>$12,600 for married filers</td>
<td>$22,600 for married filers</td>
</tr>
<tr>
<td></td>
<td>$6,300 for single filers</td>
<td>$11,300 for single filers</td>
</tr>
</tbody>
</table>

#### Itemized Deductions

<table>
<thead>
<tr>
<th></th>
<th>Current Policy</th>
<th>The Governor's Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>State and Local Tax Deduction</td>
<td>No Limit</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Charitable Contributions Deduction</td>
<td>Capped at 50 percent of AGI</td>
<td>No Change</td>
</tr>
<tr>
<td>Mortgage Interest Rate Deduction</td>
<td>Limited to interest on first $1 million of debt</td>
<td>Cap the tax value of deductions at 2 percent of AGI</td>
</tr>
<tr>
<td>Other Itemized Deductions</td>
<td>Medical deduction, Casualty, Miscellaneous, etc.</td>
<td></td>
</tr>
<tr>
<td>Personal Exemption Phase-out (PEP)</td>
<td>Personal exemption and itemized deductions phased-out for upper middle class incomes</td>
<td>Phase-outs eliminated</td>
</tr>
<tr>
<td>Itemized Deduction Phase-out (Pease)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal AMT</td>
<td>Filers must determine tax liability under two sets of tax rules</td>
<td>Eliminated</td>
</tr>
</tbody>
</table>

Note: Other provisions include the elimination of estate and gift tax, the option of second earners to file their taxes separately, an expansion of the earned income tax credit for childless filers, and the elimination of the employee portion of the Social Security payroll tax for workers that have reached the full retirement age.

#### Tax Schedules under the Governor's Plan (2015 levels)

<table>
<thead>
<tr>
<th>Rates</th>
<th>Single Filer</th>
<th>Married Filer</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$0 to $32,450</td>
<td>$0 to $64,900</td>
</tr>
<tr>
<td>25%</td>
<td>$32,451 to $85,750</td>
<td>$64,901 to $141,200</td>
</tr>
<tr>
<td>28%</td>
<td>$85,750 and above</td>
<td>$141,201 and above</td>
</tr>
</tbody>
</table>
## Businesses and Investment Overview

<table>
<thead>
<tr>
<th></th>
<th>Current Policy</th>
<th>The Governor’s Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top Corporate Tax Rate</td>
<td>35%</td>
<td>20%</td>
</tr>
<tr>
<td>Top Pass-Through Rate</td>
<td>39.6%</td>
<td>28%</td>
</tr>
<tr>
<td>Foreign earnings</td>
<td>World-wide taxation</td>
<td>Up to 8.75% deemed repatriation tax on prior foreign earnings</td>
</tr>
<tr>
<td>Investments</td>
<td>Complicated depreciation schedules</td>
<td>Full expensing for new investments</td>
</tr>
<tr>
<td>Interest Paid</td>
<td>Deductible</td>
<td>Not deductible</td>
</tr>
<tr>
<td>Interest Received</td>
<td>Taxable</td>
<td>20%</td>
</tr>
<tr>
<td>Corporate AMT</td>
<td>Filers must determine tax liability under two sets of tax rules</td>
<td>Eliminated</td>
</tr>
<tr>
<td><strong>Investment Taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top Capital Gains Rate</td>
<td>23.8%</td>
<td>20%</td>
</tr>
<tr>
<td>Top Dividends Rate</td>
<td>23.8%</td>
<td>20%</td>
</tr>
<tr>
<td>Interest Received</td>
<td>Taxable at Ordinary Rates</td>
<td>20%</td>
</tr>
</tbody>
</table>
Appendix B.

Note: this appendix was added to the white paper on September 30, 2015 following the public release of Governor Bush’s regulatory proposal.

Revenue Estimates for Tax Reform Proposal

All tax changes were modeled for the ten-year budget window beginning in 2016 and ending in 2025. With the exception of phasing-in the corporate tax rate reductions, all policy changes were assumed to be fully implemented in 2016. While we believe that the tax reform proposals will not be implemented until 2017, the earlier date allows for direct comparisons to the Congressional Budget Office’s ten-year budget outlook.

Estimates from changes in the personal income tax code were modeled using the American Enterprise Institute’s Open Source Policy Center tax calculator. The model uses Internal Revenue Service public use files corresponding to data from the 2008 tax year. Modifications to the model were made to include revenue estimates arising from the proposed cap on the tax value of itemized deductions. U.S. Census data were used to estimate the impact of the secondary earner provision, the payroll tax reduction, and the expansion of the EITC to young, childless filers.

Revenue changes from business tax reforms include rate changes, adoption of territorial taxation, removal of interest tax deductibility prospectively, and full expensing of new business assets. A variety of sources were used to estimate the business tax changes. This includes estimates from the Tax Foundation regarding the revenue effect of full expensing, the Office of Management and Budget and the Joint Committee on Taxation’s estimates on the revenue loss from various tax expenditures, and the Congressional Budget Office’s ten-year estimates for federal revenue and economic conditions.

Growth Estimates for Tax Reform

The proposal will generate substantial positive impacts on GDP over the long-term. Lower business tax rates and the ability to expense capital investment will increase domestic investment in real assets and increase the capital stock, raising productivity and output. In addition, the lower U.S. corporates tax will redirect foreign investment to the United States. The shift to cash flow taxation will promote real investment over financial engineering and share repurchases. The significantly lower corporate income tax rate will also reduce incentives for profit shifting. Lower individual marginal tax rates on earnings from work will increase hours worked. Lower business tax rates and lower individual tax rates will shift capital over time from financial assets to productive business assets.

The economic effect from transitioning to a cash flow type-tax or other types of business consumption taxes has been the subject of several academic studies. One review of the literature finds replacing current business income taxes with a consumption tax would increase the level of GDP by 5 to 10 percent.\(^8\)

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In 2006, Treasury Officials estimated the economic effects from the Growth and Investment Tax Plan (GIT), which featured a cash flow tax and personal income tax rate changes. The Treasury found that the GIT would increase GDP by 1.5 to 1.9 percent over the ten-year budget window and up to 4.8 percent in the long run.\(^9\)

There are several reasons why the economic estimates for the GIT would underestimate the likely effect of Governor Bush’s proposal. First, the new proposal would lower tax rates from a higher baseline (e.g. the top individual rate at the time of the 2006 Treasury estimate was 35 percent; it is now over 43 percent). Second, the Reform and Growth Act of 2017 would lower the corporate income tax rate to 20 percent, far lower than the GIT’s 30 percent rate. Moreover, Treasury assumed a closed economy model so it did not account for changes in profit shifting from reductions in the corporate tax rate.

On balance, we believe that the tax plan will increase GDP by at least 5 percent after a decade. This is approximately equivalent to higher annual growth rates of 0.5 percent per year. The dynamic revenue estimates are based on the expected feedback effects from an increase in GDP. This estimate does not account for behavioral effects that affect revenue but have no effect on output. Any impact the proposal has on realizations or the type of compensation received is not included in the dynamic estimates. We expect reducing tax rates on capital gains will increase the amount of gains realized. Likewise, reductions in personal income tax rates will increase the share of compensation that is taxable. These additional effects, not included in our calculation, will offset a portion of proposal’s projected revenue loss.

**Growth Estimates for Regulatory Reform**

Regulation imposes aggregate costs on households and firms by raising prices to consumers, lowering wages to workers, and lowering returns on investments. These costs arise in two principal areas: compliance costs and net societal costs that arise when burdens outweigh benefits. These unnecessary costs tend to be regressive, and also benefit large, incumbent firms at the expense of new entrants and smaller companies.

Many government agencies do not estimate the costs of the rules they adopt, and rarely conduct retrospective analyses to determine the actual costs incurred after rules are promulgated. Academic studies of the costs of particular rules are available, but comprehensive cost estimates are more difficult to obtain. As a result, estimates of the impact of regulations on aggregate economic activity are necessarily subject to less precision than estimated impacts of taxation.

OMB’s Report to Congress on the “Benefits and Costs of Federal Regulations” provides a narrow estimate of the cost of regulation. And it includes only “major” rules issued by executive branch agencies (excluding independent agencies) for which agencies themselves evaluated both benefits and costs in dollars – just 116 of the more than 37,000 final rules adopted between October 1, 2003 and September 30, 2013. The annual costs of these 116 rules were $57 to $84 billion in 2001 dollars.

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(equating to $74 to $110 billion in 2014 dollars).\textsuperscript{10} For the ten years prior (October 1, 1992 through September 30, 2003), annual costs were $35 to $40 billion in 2001 dollars ($46 to $52 billion in 2014 dollars).\textsuperscript{11} Ongoing costs of rules adopted previously are not included. Nor are the costs of duplicative and overlapping rules considered in aggregate. And, in many cases, full measures of societal costs are lacking.

A broader estimate of the cost of economic regulation is estimated from a review of 34 OECD countries from 2006 to 2013. The study is based on the relationship between per capita GDP and an economic regulation index, controlling for a number of other variables. Compared to the mean value of the regulation index for the five highest ranked OECD countries, the additional economic regulation in the United States reduced GDP by $1.439 trillion in 2012 (in 2014 dollars).\textsuperscript{12}

Adding in additional sector-by-sector estimates of the costs of environmental regulations based on an academic study and agency regulatory analyses ($330 billion), a similar estimate of the cost of occupational health and homeland security regulations ($92 billion), and the costs of tax compliance based on the government’s paperwork estimates ($159 billion), the total cost of regulation in 2012 is estimated to be $2.028 trillion (in 2014 dollars).\textsuperscript{13}

Studies of the impact of regulations on U.S. economic growth also indicate the high cost of federal regulations. Jorgenson and Wilcoxen, for example, found that poorly designed environmental regulations from the mid-1970s to the mid-1980s slowed the growth in annual GDP by 0.19 percent.\textsuperscript{14} Davies finds heavily regulated firms have lower labor productivity growth rates than less regulated firms.\textsuperscript{15} Dawson and Seater, examining the impact of all federal regulations, estimate that they have reduced annual GDP growth by two percentage points.\textsuperscript{16}

On balance, we believe that Governor Bush’s regulatory policy reforms would boost annual GDP growth by at least 0.3 percentage points. Dawson and Seater’s estimates suggest that over the long-run, the impact of federal regulations on GDP growth is proportional to conventional measures of the regulatory burden. During the past 25 years, the regulatory burden has increased at an annual 2.4 percent rate.\textsuperscript{17} Halting the growth in the cost of regulations so the total cost does not rise above the $2 trillion estimate above would add substantially more than 0.3 percentage points to economic growth.

Regulation harms the economy when it lessens long-term economic output, thereby failing a rigorous, comprehensive, cumulative benefit-cost analysis. In evaluating its effects on potential

\begin{flushleft}
\textsuperscript{11} https://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2004_cb_final.pdf
\textsuperscript{13} Ibid.
\textsuperscript{17} As measured by the growth rate in the number of pages with Final Rules in the Federal Registry.
\end{flushleft}
growth, unnecessary, duplicative regulation harms the economy, in large part, by dampening its productivity. Returning productivity growth to its pre-recession level would increase economic growth by 0.3 percent.\footnote{From 1950 to 2007, the Congressional Budget Office estimated average potential labor force productivity at 1.86%. The CBO projects potential labor force productivity to be 1.56% from 2015 and 2025. Congressional Budget Office, “An Update to the Budget and Economic Outlook: 2015 to 2025.” August 25, 2015, available at https://www.cbo.gov/publication/45066.}