Some Thoughts about the Rubio-Lee Tax Plan

By Veronique de Rugy
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Senators Marco Rubio and Mike Lee have proposed a major tax-reform plan that would eliminate some of the most punitive features of the tax code. The plan, called the "Economic Growth and Family Fairness Tax Reform Plan," would dramatically reduce the punitive double taxation of saving and investment that characterizes the Internal Revenue Code and significantly improves the way business income is taxed. You can read their summary of the bill in the *Wall Street Journal* here, and the details of the bill are here.

For those of us who care about fundamental tax reform, it's just about impossible not to be happy with the plan, since many of the provisions address problems that the free-market movement has highlighted for years. But happy isn't the same as overjoyed. Some aspects of the bill are problematic.

Dan Mitchell of the Cato Institute has a good summary of the most pro-growth elements of the plan:

> A 25 percent tax rate on all business income – This means that the corporate tax rate is being reduced from 35 percent (the highest in the world), but also that there will be a 25 percent maximum rate on all small businesses that file using Schedule C as part of a 1040 tax return.
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> Sweeping reductions in double taxation – The Rubio-Lee eliminates the capital gains tax, the double tax on dividends, and the second layer of tax on interest.
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> Full expensing of business investment – The proposal gets rid of punitive "depreciation" rules that force businesses to overstate their income in ways that discourage new business investment.
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> Territorial taxation – Businesses no longer will have to pay a second layer of tax on income that is earned – and already subject to tax – in other nations.
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> No death tax – Income should not be subject to yet another layer of tax simply because someone dies. The Rubio-Lee plan eliminates this morally offensive form of double taxation.

> In addition, it's worth noting that the Rubio-Lee plan eliminates the state and local tax deduction, which is a perverse part of the tax code that enables higher taxes in states like New York and California.

His whole post is worth reading, here.

My colleague Jason Fichtner and others have written extensively on the need to implement many of these reforms, so this is good news.

That being said, there are two nagging issues that have to be addressed if any of us hope to turn good ideas into law.

First and foremost, we have to deal with the challenge of enacting a very large tax cut in a fiscal environment of large deficits, particularly since the red ink in the budget is expected to grow as a result of retiring baby boomers. I'm much more worried about the rising burden of government spending than about red ink, but the reality is that both congressional rules and political optics will make it very difficult to enact large tax cuts. What's more, while I don't really care about the lack of revenue neutrality in a tax-cutting plan, I believe that to be fiscally responsible, you need a plan that both calls for large tax cuts alongside serious spending cuts. The era of "let's cut taxes and all our fiscal problems will be resolved" is over.

To be sure, both senators are very supportive of spending cuts and genuine entitlement reform, and we also should keep in mind that their tax bill will boost growth and produce revenue feedback (at least in the future). However, if history is our guide, they are not representative of the Republican party as a whole. Cutting taxes is great, but it now needs to be done alongside meaningful spending restraint – meaning serious changes to Medicare, Medicaid, Social Security, and Obamacare subsidies (see the new CBO report, which outlines how entitlement programs are consuming an ever-growing share of the budget). Doing one without the other would just kick the can farther down the road, an exercise that Republicans are very good at.

The second problem with the bill is that many free-market types are underwhelmed (for lack of a better word) by the huge child tax credits in the bill, in particular since the inclusion of those credits is "expensive" in more than one way. For instance, the projected revenue loss is $1.7 trillion over ten years according to the Tax Foundation. I assume this is the reason Rubio and Lee not only aren't proposing a bigger reduction in the top income tax rate, but are even raising marginal tax rates on a significant number of middle-class and upper-middle class households. (The 35 percent top tax rate in the plan takes effect at just $75,000 of income for single households and $150,000 for married households!)

It has been noted before, but it is worth repeating: The opportunity cost of expanding the child tax credit in this way is huge, in terms of the possible tax reforms it crowds out. If their proposed child-tax credit were smaller, Rubio and Lee could have also included a low-rate flat tax, for instance. No matter what we hear about top-marginal-tax-rate reductions not yielding as much return at the current levels as they would if the rates were higher, lowering them would still yield more growth than the child tax credit, which does nothing for growth. If bolstering the economic status of families is the point of all this, the way to go is lower tax rates, not a tax credit. So why not solve 100 percent of the problem rather than 50 percent?

To make matters worse, I don't buy the justification for the size of the tax credit they're proposing. It is one thing to support some sort of child tax credit in the name of the idea that every flat-tax proposal has some zero-bracket amount based on family size, generally based on the principle that households shouldn't be taxed on "necessity" or "poverty level" income. But providing giant credits, based on the premise that children are investments in maintaining entitlement programs and that parents should be compensated for the cost of raising their kids goes way overboard.

According to the senators, the tax credit would compensate for "a parent tax penalty." They compare it to "the marriage tax penalty." But while I think that characterization is a brilliant marketing move on the part of those who think that parents should be rewarded/subsidized, it is also misleading. The marriage tax penalty is real and manifests itself in the form of higher taxes for certain people who get married and file jointly. That's because government taxes the first dollar a married-couple secondary earner earns, often the wife, at her husband's highest marginal rate rather than at the rate the wife's salary warrants. The higher the marginal tax rate, the bigger the penalty.

However, people aren't taxed at a higher rate nor do they pay more taxes the moment they have children. In fact, it is the reverse because of personal allowances. So there is no "parent tax penalty."

And indeed, the senators justify the credit on the grounds that non-parents do not produce future taxpayers to pay for their benefits, even though, like parents, they do pay for current retirees through the payroll tax. I am sorry, but that's messed up. The current system is unsustainable because, among other reasons, the burden is resting on the shoulders of a diminishing number of future taxpayers. But the current entitlement system is also incredibly unfair, yields terrible returns for many current beneficiaries, and even worse returns for future beneficiaries. Subsidizing/rewarding current parents because they have produced the next generation of taxpayers to pay for old-age entitlement programs doesn't make the programs more solvent, nor does it make them fair for future generations. What's more, the evidence that these types of credits will encourage more people to have kids is sketchy at best. The solution to the unfairness and insolvency of these programs is fundamental reform, not a large tax credit.

Now, even if we assume that parents should be rewarded for having produced future taxpayers, there is a much better way to do it than this meddling with the tax code through politically and arbitrarily negotiated subsidies. My colleagues Chuck Blahous and Jason Fichtner, for instance, are critical of the child tax-credit approach and instead suggest adjusting the payroll-tax burden based on the actuarial value-added by children:

> Whenever such policies are enacted, government officials are effectively choosing to redistribute income from the childless toward those who are assuming the burden of raising children, based in part on the rationale of recognizing a burden that child-raisers have assumed to the gain of society at large. Many Americans would take offense at the

> suggestion that the government is, in effect, assigning a dollar value to the raising of children with each such policy adopted. The notion has increased resistance to proposals such as KidSave, which strike many observers as "paying people to have kids." But that is already what is implicitly happening through the income tax code and elsewhere (for example, via the child tax credit). . . .
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> We take as a fundamental philosophical starting point for this inquiry that the objective is not to replicate the vagaries of other federal economic policies in compensating for child bearing via arbitrarily negotiated subsidies. The purpose is instead to determine whether a simple policy adjustment could recognize the quantifiable financing responsibilities that families with children assume on behalf of Social Security. . . .
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> There are reasons, however, why such a policy may make greater sense than current law. It would somewhat broaden the base of federal income taxpayers while at the same time helping the poorest working parents through payroll tax relief. Also, it would more directly tie the benefits of (and incentives for) parenting to what such parenting explicitly does for Social Security finances, in contrast with the more nebulous justifications for various "pro-family" exemptions and deductions in current federal income tax law.

Again, I don't see why we should reward the people who have already produced children, and I find it a little disturbing to try to make a program that is such a bad deal for future generations solvent rather than reforming it entirely. However, their proposal has the merit of being honest about what they are trying to do, and the cost of doing it, and it is more straightforward about trying to achieve the stated goal for parents of all income levels.

Also, if old-age entitlement programs discourage people from having children, as some arguments in favor of child tax credits maintain (not those made by Rubio and Lee, as far as I know), then the solution, once again, is to reform the programs that cause the disincentives in the first place rather than try to vaguely offset them.

Finally, there are tons of reasons to have kids and benefits to doing so. That's why people are still having them even in the face of high costs of child rearing. And while a society with more kids is better than one with fewer kids (bring in immigrants!), the government shouldn't be in the business of subsidizing the production of children any more than it should favor one type of family arrangement over another. That is even truer if the giant credits are based on the premise that children are investments in maintaining entitlement programs.