



## **“FIXING” THE TAX CODE: KEY PRINCIPLES FOR SUCCESSFUL, SUSTAINABLE REFORM**

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The fundamental goal of tax policy is to raise enough revenue to meet the government’s minimal spending requirements without significantly changing behavior in a market economy. The US tax code has long failed to achieve this goal; by severely distorting market decisions and the allocation of resources, it impedes potential economic growth and reduces potential tax revenue.

The nation’s persistently sluggish economic growth and dire long-term fiscal outlook<sup>1</sup> have increased the urgency of the need to reform the federal revenue system. But what does successful, sustainable tax reform look like? What are its key elements? And what would it achieve?

### **THE GOALS OF SUCCESSFUL TAX REFORM**

Policymakers need not fly blind when it comes to defining the principles and goals key to an effective revenue system. Academic research suggests a tax system must be:

**Simple.** The complexity of the tax system makes compliance difficult and costly. Complexity also encourages tax avoidance. A simpler and more transparent tax code promotes compliance and increased revenues.

**Efficient.** The tax code impedes economic growth by distorting market decisions in areas such as work, saving, investment, and job creation. An efficient tax system provides sufficient revenue to fund the government’s essential services with minimal distortion of market behavior.

**Equitable.** Americans of all income levels believe the tax code is unfair. This perception is largely fueled by the code’s “loopholes”—or provisions intended to benefit or penalize

select individuals and groups. “Tax fairness” should reduce or eliminate provisions that favor one group or economic activity over another, especially among equal-income earners.

**Predictable.** Tax certainty is a necessary condition for robust economic growth and investment, and it enhances competitiveness. An environment conducive to growth requires a tax code that provides both near- and long-term predictability.

## ACHIEVING SUCCESSFUL TAX REFORM

There is broad consensus in academic studies as to which foundational policies are most likely to promote solid, sustainable economic growth and result in stable tax revenues. There also is broad consensus as to which policies are most likely to fail.

**Lower Rates.** Economic research repeatedly proves this most basic effect: the more you tax capital or labor, the less you get. It also makes clear that incentives matter. Successful reform should lower current individual and corporate tax rates.

- “Both macroeconomic and microeconomic perspectives, moreover, suggest that [higher] taxes slow economic growth, thereby limiting the scope for revenue gains.” *Jeffrey Miron (Harvard University), “The Negative Consequences of Government Expenditure,” Mercatus Working Paper, September 2010.*<sup>2</sup>
- There is a negative tax multiplier of  $-1.1$ ; taking money out of the economy through taxation costs the economy more than the actual dollar amount taken out. *Robert J. Barro (Harvard University) and Charles J. Redlick, “Macroeconomic Effects from Government Purchases and Taxes,” Mercatus Working Paper, July 2010.*<sup>3</sup>
- The consequences of raising taxes on economic growth: “a tax increase of 1 percent of GDP reduces output over the next three years by nearly three percent.” *Christina D. Romer (former chair, Council of Economic Advisers) and David H. Romer (University of California, Berkeley), “The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks,” American Economic Review, June 2010.*<sup>4</sup>
- Higher corporate income taxes reduce business experimentation—a key driver of economic growth. *Alexander Ljungqvist, Liandong Zhang, and Luo Zuo, “Sharing Risk with the Government: How Taxes Affect Corporate Risk-Taking,” NBER Working Paper, December 2015.*<sup>5</sup>
- Further increasing the nation’s corporate tax rate would result in some combination of lower wages, fewer jobs, higher prices for consumers, and lower returns on investment. *Jason J. Fichtner and Jacob M. Feldman, The Hidden Cost of Federal Tax Policy, Mercatus Center at George Mason University, 2015.*<sup>6</sup>

- High tax rates encourage avoidance and evasion.  
*Martin Feldstein (Harvard University), “The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act,” Journal of Political Economy, June 1995.*<sup>7</sup>

**Broaden the Base, Eliminate Loopholes.** One of the keys to successful fiscal reform is to build a stable system that is neither dramatically affected by economic change nor easily manipulated. Tax reform should lower rates, broaden the tax base, and eliminate loopholes.  
*Barro and Redlick (2010).*<sup>8</sup>

*Jason J. Fichtner and Jacob Feldman, “When Are Tax Expenditures Really Spending? A Look at Tax Expenditures and Lessons from the Tax Reform Act of 1986,” Mercatus Working Paper, November 2011.*<sup>9</sup>

- A key step in tax reform is to properly define the base. The tax base, the sum of all things which are subject to tax, “should be economically neutral, meaning in effect that the tax system does not intentionally or unintentionally take sides in influencing the decisions made by individuals and businesses.” The current income tax system falls far short of this ideal.

*J.D. Foster, “The Simple Economics of Pro-Growth Tax Reform,” Heritage Foundation Backgrounder, June 2013.*<sup>10</sup>

- Tax complexity is expensive; complying with the tax code costs Americans up to nearly \$1 trillion annually.

*Jason J. Fichtner and Jacob Feldman, “The Hidden Costs of Tax Compliance,” Mercatus Research, May 2013.*<sup>11</sup>

- Tax expenditures should be eliminated. They “add complexity to the code, don’t achieve the desired results, benefit the wrong people, and encourage ‘gaming’ by those in a position to take advantage—typically the well-connected or well-to-do, who can afford accountants who understand all the provisions.”

*Jeremy Horpedahl and Brandon Pizzola, “A Trillion Little Subsidies: The Economic Impact of Tax Expenditures in the Federal Income Tax Code,” Mercatus Research, October 2012.*<sup>12</sup>

- Loopholes severely distort market behavior, influencing behavior based on tax preferences rather than the best and most productive economic decisions. “These preferences narrow the tax base, reduce revenues, distort economic activity, complicate the tax system, force tax rates higher than they would otherwise be, and are often unfair.”

*Donald Marron (Urban-Brookings Tax Policy Center), “Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction,” Testimony before the Senate Committee on the Budget, February 2011.*<sup>13</sup>

- Spending through the tax code masks the true size of government and “can lead to higher taxes, larger government, and an inefficient mix of spending.”  
*Leonard E. Burman (Center for Policy Research, Syracuse University) and Marvin Phaup (George Washington University), “Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform,” NBER Working Paper, August 2011.*<sup>14</sup>
- Spending through the tax code also narrows the base, and it is often ineffective. The tax code is not intended or designed to be a spending program. The Earned Income Tax Credit—which many have proposed to expand—is a good example of the problem. “The EITC has a high error and fraud rate, and for most recipients it creates a disincentive to increase earnings.” There are more efficient, effective, and transparent ways to provide low-income wage support.  
*Chris Edwards and Veronique de Rugy, “Earned Income Tax Credit: Small Benefits, Large Costs,” Cato Institute Tax and Budget Bulletin, October 2015.*<sup>15</sup>
- As President Obama’s bipartisan National Commission on Fiscal Responsibility and Reform recommended, tax rates should be flattened and the tax base broadened. Broadening the base so that more citizens pay something—even if it is very little—will help ensure people feel both the benefits and the costs of government spending.  
*Bruce Yandle (Clemson University) and Jody Lipford (Presbyterian College), “The Relationship between Taxpayers and Tax Spenders: Does a Zero Tax-Price Matter?,” Mercatus Working Paper, August 2011.*<sup>16</sup>
- The last major federal tax reform, the Tax Reform Act of 1986 (TRA86), achieved significant bipartisan support for improving the tax code’s efficiency, equity, and simplicity. However, TRA86 had a key fault: it failed to fix the revenue system’s larger institutional problems. By failing to eliminate the largest tax expenditures or “establish a principle of opposing tax preferences in general,” reforms were clawed back. “As a result, the tax code looks even worse today,” with more than 70 temporary special-interest provisions, compared to only 25 in 1985.  
*Fichtner and Feldman (2015).*<sup>17</sup>
- Congress tends to quickly undo reforms that reduce its ability to use political influence to benefit special interests (in the case of the tax code, either through spending or tax breaks). By keeping the tax code as simple—by taxing a broad base at the same rate—and transparent as possible, politicians’ ability to incrementally reverse reforms will be limited.  
*Jason J. Fichtner and Katelyn Christ, “Uncertainty and Taxes: A Fatal Policy Mix,” Mercatus Working Paper, December 2010.*<sup>18</sup>

**Spending Reductions, Not Tax Increases.** Predictable tax policy is essential to long-term economic growth. But tax certainty cannot be achieved without addressing the driver of fiscal uncertainty: unsustainable levels of spending and the deficits and debt it creates.

- “Chronic deficits [are] caused by overspending rather than insufficient taxation.”  
*Peter T. Calgagno and Edward J. López, “The Evolution of Federal Budget Rules and the Effects on Fiscal Policy,” Mercatus Working Paper, November 2015.*<sup>19</sup>
- The long-term US fiscal gap cannot be addressed with tax increases alone. The true US debt is 16 times larger than what the government reports. To eliminate the \$210 trillion shortfall, the government would have to “immediately and permanently [raise] all federal taxes . . . by 58 percent.” Continuing to delay the problem only increases the magnitude of the burden and shifts more of it onto future generations.  
*Laurence Kotlikoff and Adam N. Michel, “Closing America’s Enormous Fiscal Gap: Who Will Pay?,” Mercatus Working Paper, June 2015.*<sup>20</sup>
- There is a growing academic consensus that “spending-based fiscal adjustments are not only more likely to reduce the debt-to-GDP ratio than tax-based ones but also less likely to trigger a recession.”  
*Alberto Alesina and Veronique de Rugy, “Austerity: The Relative Effects of Tax Increases versus Spending Cuts,” Mercatus Research, March 2013.*<sup>21</sup>
- “Expenditure based adjustments are . . . more likely to lead to a permanent reduction in the debt over GDP ratio.”  
*Alberto Alesina and Silvia Ardagna, “The Design of Fiscal Adjustments,” NBER Working Paper, September 2012.*<sup>22</sup>
- Economic literature increasingly finds that policy uncertainty itself has negative implications for the economy—reducing investment, consumption, employment, and growth and possibly prolonging a weak recovery. Tax-policy uncertainty also diverts business resources away from economically productive activities to the unproductive activity of lobbying for preferential tax-policy treatment.  
*Seth H. Giertz and Jacob Feldman, “The Economic Costs of Tax Policy Uncertainty,” Mercatus Research, November 2012.*<sup>23</sup>
- “A tax cut without a spending cut is not a tax cut; it is a tax deferral. . . . Government borrowing will crowd out, or displace, private consumption and investment, reducing the effectiveness of the tax cut.”  
*Matthew Mitchell and Andrea Castillo, “What Went Wrong with the Bush Tax Cuts,” Mercatus Research, November 2012.*<sup>24</sup>
- Historically, raising taxes increases Congress’s incentive to spend and decreases its incentive to cut.  
*Barro and Redlick (2010).*<sup>25</sup>

**No Double Taxation.** The corporate income tax double-taxes corporate profits, which are also taxed as capital gains and dividends. Increasing either rate “would dramatically reduce capital formation and wages, and would not raise the expected revenue.”

*Stephen J. Entin (then president and executive director, Institute for Research on the Economics of Taxation), Testimony before the Senate Finance Committee, September 2011.*<sup>26</sup>

- Transparency is necessary for the tax code to be perceived as fair. “There is much concern that those who report significant earnings from capital gains or dividends pay a lower tax rate than those with ordinary income. But this fails to accurately reflect the incidence of the corporate income tax.”

*Jason J. Fichtner, Testimony before the Senate Finance Committee, January 2012.*<sup>27</sup>

- The lower tax rate for individuals on capital gains reduces the effect of double taxation. Individuals’ capital gains income is first taxed at the corporate level, then a second time at the individual level. The higher rate under double taxation disincentivizes savings and investment, which are necessary components of economic growth. *Jason J. Fichtner and Nick Tuszynski, “Why the United States Needs to Restructure the Corporate Income Tax,” Mercatus Working Paper, November 2011.*<sup>28</sup>

- “Domestic labor bears slightly more than 70 percent of the burden of the corporate income tax.”

*William C. Randolph, “International Burdens of the Corporate Income Tax,” Congressional Budget Office Working Paper, August 2006.*<sup>29</sup>

- Eliminating the corporate income tax could produce “major economic benefits and welfare gains in the U.S.” Economic modeling shows dramatic increases in “investment, output, and real wages, making the tax cut self-financing to a significant extent.”

*Hans Fehr et al., “Simulating the Elimination of the U.S. Corporate Income Tax,” NBER Working Paper, December 2013.*<sup>30</sup>

- Some have proposed a type of “value-added tax” (VAT) to replace the current corporate income tax. In principle, a VAT could be a good alternative to the corporate income tax because it moves toward the ideal of taxing consumption rather than income. But there is significant risk in layering an additional tax on top of the already burdensome and complicated system.

*N. Gregory Mankiw, Matthew Charles Weinzierl, and Danny Ferris Yagan, “Optimal Taxation in Theory and Practice,” Journal of Economic Perspectives, 2009.*<sup>31</sup>

- Among key concerns with a traditional VAT are: intergenerational inequities, a cumbersome administrative structure that would impose large compliance and administrative costs, and the potential to slow economic growth. Further, like

all business taxes, a VAT is ultimately passed on to individuals. The indirect tax burden is obscured by increased complexity, which decreases transparency.  
*Randall G. Holcombe, “The Value Added Tax: Too Costly for the United States,” Mercatus Working Paper, September 2010.*<sup>32</sup>

**International Competitiveness.** The United States has fallen behind its trading partners, and almost every other industrialized country, by not updating its tax code for a global twenty-first-century economy.

- The US corporate tax rate is among the highest in the industrialized world. This pushes investment to lower-tax countries—taking jobs, money, and tax dollars with it.  
*Fichtner and Tuszynski (2011).*<sup>33</sup>
- The United States is one of just a few countries that tax the worldwide income of domestic businesses, a situation that drives companies offshore (often taking the form of an “inversion”) and slows economic growth.  
*Jason J. Fichtner, Courtney S. Michaluk, Adam N. Michel, “Locking Out Prosperity: The Treasury Department’s Misguided Regulation to Address the Symptoms of Corporate Inversions While Ignoring the Cause,” Mercatus on Policy, December 2015.*<sup>34</sup>
- In response to corporate inversions, patent boxes are commonly proposed to keep businesses from moving highly valuable intellectual property and associated economic activity offshore. While patent boxes would increase tax code complexity, they would not “increase innovation, job creation, or tax revenue.”  
*Jason J. Fichtner and Adam Michel, “Don’t Put American Innovation in a Patent Box: Tax Policy, Intellectual Property, and the Future of R&D,” Mercatus on Policy, December 2015.*<sup>35</sup>
- The US corporate tax system also discourages capital investment by requiring that business purchases—such as farm equipment and manufacturing plants—be depreciated over arbitrary timelines, adding unnecessary complexity.  
*Jason J. Fichtner and Adam Michel, “Options for Corporate Capital Cost Recovery: Tax Rates and Depreciation,” Mercatus Research, January 2015.*<sup>36</sup>
- To be competitive in the international marketplace, the United States should lower its corporate tax rate to 15 percent. The last major change to the US tax code occurred almost 30 years ago, and the United States now ranks third to last among our OECD peer nations in the Tax Foundation’s International Competitiveness Index.  
*Kyle Pomerleau and Alan Cole, “2015 International Tax Competitiveness Index,” Tax Foundation.*<sup>37</sup>

- “Full expensing,” which allows businesses to write off all expenditures in the year they are purchased, would encourage job creation and economic growth by treating all business expenditures, including labor, equally.  
*Fichtner and Michel (2015)*.<sup>38</sup>
- Moving toward territorial taxation, which taxes profits only in the country where they were earned, would help retain and attract business investment. “This is not a risky move; OECD countries around the world have already heeded the warning signs and implemented reforms.”  
*Fichtner, Michaluk, and Michel (2015)*.<sup>39</sup>

## LINKS

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