'Fixing' the Tax Code: Key Principles for Successful, Sustainable Reform

The most basic goal of tax policy is to raise enough revenue to meet the government's spending requirements, preferably with minimal impact on market behavior. The US tax code has long failed to achieve this goal; by severely distorting market decisions and the allocation of resources, it impedes both potential economic growth and potential tax revenue.

The nation's persistently sluggish economic growth and dire long-term fiscal outlook have increased the urgency 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

Washington has research and evidence to help identify and define the principles and goals key to a successful revenue system. Academic research suggests it must be:

Simple. The complexity of the tax system makes it difficult and costly to comply with and 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 and personal situations 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 inspires economic growth and investment and also enhances competitiveness. An environment conducive to growth requires a tax code that provides both near- and long-term predictability.

The Best and Worst Reform Policies

There is broad consensus in academic studies as to which key policies are most likely to promote solid, sustainable economic growth and 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 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.

- 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 Barro, Harvard University, and Charles Redlick, "Macroeconomic Effects from Government Purchases and Taxes," Mercatus Working Paper, July 2010.

- 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 Romer, Former Chair, Council of Economic Advisers and David Romer, University of California, Berkley, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review*, June 2010.

- Combining lower marginal rates with reduced government spending is likely to foster economic growth. Andreas Bergh, Lund University and Magnus Henrekson, Research Institute of Industrial Economics, "Government Size and Growth: A Survey and Interpretation of the Evidence," *Journal of Economic Surveys,* December 2011.

- 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," *The Journal of Political Economy*, June 1995.

- The US corporate tax rate is the highest in the industrialized world. This pushes investment from the United States to lower-tax countries—taking jobs, money, and tax dollars with it. To regain competitiveness, reduce the U.S. corporate tax rate to at-or-below the 25 percent average rate of other OECD nations. Jason Fichtner and Nick Tuszynski, "Corporate Tax Reform: Why the United States Needs to Restructure and Reduce its Corporate Income Tax," Mercatus Working Paper, November 2011.

- 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. Fichtner and Tuszynski (2011).

Broaden 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); 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.

- Tax complexity is expensive; complying with the tax code costs Americans up to nearly $1 trillion annually. Fichtner and Feldman, "The Hidden Costs of Tax Compliance," Mercatus Research, May 2013.

- "[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 M. Pizzola, "A Trillion Little Subsidies: The Economic Impact of Tax Expenditures on the Federal Income Tax Code," Mercatus Research, October 2012.

- 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.

- 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 Burman, Syracuse University Center for Policy

Research, and Marvin Phaup, George Washington University, "Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform," August 2011.

- As the president's Fiscal Commission recommended, tax rates should be flattened and the tax base broadened. Broadening the base so more citizens pay something—even if it's 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 Tax-payers and Tax-spenders: Does a Zero Tax-Price Matter?" Mercatus Working Paper, August 2011.

- The Tax Reform Act of 1986 achieved significant bipartisan support for improving the tax code's efficiency, equity, and simplicity. The law advanced these goals by reducing standard rates, increasing the standard deduction, and ending various tax expenditures that distributed resources to less-efficient production purposes.

  While TRA86 was remarkable for its bipartisan passage and sweeping reforms, it had a key fault: it failed to fix the revenue system's larger institutional problems. Because it "did not establish a principle of opposing tax preferences in general" and failed "to tear down the largest tax expenditures," reforms were clawed back.

  "As a result [of TRA86's failures], the tax code looks even worse today; in 1985 there were only 25 temporary tax provisions; in 2010 there were 141 provisions set to expire by the end of 2012." Successful tax reform will require reforming or eliminating tax expenditures considered politically untouchable in exchange for lowering rates. Fichtner and Feldman (2011).

- 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. Fichtner and Katelyn Christ, "Uncertainty and Taxes: A Fatal Policy Mix," Mercatus Working Paper, December 2010.

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.

- "The long-term budget problem cannot be addressed without spending reductions... [A]ny approach that involves tax increases alone would be prohibitively costly. The CBO estimates that tax rates would have to more than double to address the coming increase in spending." Fichtner, "The 1 Percent Solution," Mercatus Working Paper, February 2011.

- 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.

- "Expenditure based adjustments are…more likely to lead to a permanent reduction in the debt over GDP ratio." Alesina and Silvia Ardagna, "The Design of Fiscal Adjustments," NBER Working Paper 18423, September 2012.

- 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 leads to 'unproductive' or "destructive" entrepreneurship—the diversion of resources away from economically productive activities to the unproductive activity of lobbying for preferential tax-policy treatment. Seth Giertz and Jacob Feldman, "The Economic Costs of Tax Policy Uncertainty," Mercatus Research, November 2012.

- "A tax cut without a spending cut is not a tax cut; it is a tax deferral…. [G]overnment 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 Bush Tax Cuts," Mercatus Research, November 2012.

- Historically, raising taxes increases Congress' incentive to spend and decreases its incentive to cut. Barro and Redlick (2010).

No Double Taxation.

- 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." Fichtner, Testimony before the Senate Finance Committee, January 2012.

- One of the reasons we have a lower tax rate for individuals on capital gains is to reduce the effect of double taxation. Individuals' capital gains income is first taxed at the corporate level, up to 35 percent, then at the individual level of up to 20 percent. Without the lower capital gains rate, people could pay in excess of 48 percent on corporate profits such as those on stocks or dividends. Fichtner and Tuszynski (2011).

- "Increasing the double taxation of corporate income by raising tax rates on capital gains and dividends would dramatically reduce capital formation and wages, and would not raise the expected revenue." Stephen Entin, Institute for Research on the Economics of Taxation President and Executive Director, Testimony before the Senate Finance Committee, September 2011.

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