Getting to True Tax Reform in 2017: A Better Way

Jason J. Fichtner, Adam N. Michel, Veronique de Rugy, and Angela Kuck
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The fundamental goal of tax policy should be 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 economic growth and reduces tax revenue.

The nation’s persistently sluggish economic growth and dire long-term fiscal outlook have increased the urgency of the need to reform the federal revenue system. However, true tax reform is about more than cutting tax rates; it requires thoughtful reforms to lower administrative burdens and lessen economic distortions.

The most notable current example of concrete steps toward tax reform is the House Republican Tax Reform Task Force Blueprint, “A Better Way.” The Blueprint, whose broad strokes follow the general contours of an ideal tax reform, is a noble first pass at comprehensive reform, although some proposals still deserve substantive debate about whether they should be included in any final reform legislation.

This paper outlines the key goals of successful tax reform and applies them to specific policy proposals. The first two sections discuss the economic benefits of lowering tax rates and addressing chronic excess spending rather than accepting the false narrative that tax reform necessitates finding new revenue sources. In the following sections we discuss the extent to which proposed reforms beneficially broaden the tax base and eliminate true tax privileges, while managing the income tax’s penchant for double-taxing some forms of saving and investment. We conclude by placing US tax reform in the context of the international tax system, which has largely left the current American system of high tax rates behind.

THE GOALS OF SUCCESSFUL TAX REFORM

Before diving into the details of any specific reforms, it is helpful to review the basic agreed-upon pillars of an “ideal” tax code. Academic research suggests that a successful revenue system should 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 current 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”—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 others, 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 short- and long-term predictability.

There is broad consensus across academic research about which key public policies are most likely to promote solid, sustainable economic growth and which policies are most likely to fail. Furthermore, instead of focusing on ways to increase revenue, policymakers should focus on ways to create tax policy that encourages economic growth through private-sector activity, saving, and investment; a larger economy will result in larger tax revenue. Focusing solely on increasing revenue is misguided. The United States needs a more coherent and sustainable revenue system.

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 resulting deficits and debt.

The Washington mantra for revenue-neutral tax reform is misleading in that it forces policymakers who would otherwise support pro-growth tax
reforms into making a false binary choice. Fixing America’s broken revenue system does not require finding new revenue sources. Moreover, sustainable tax reform can be *deficit neutral* without being *revenue neutral*.

Certain types of business and capital tax reforms may lose some revenue in the short run, but as the economy grows, revenue will increase, offsetting much or even all of the near-term losses. Proposals such as expensing and lower corporate tax rates generally fall into this first category. In addition, as will be discussed below, there are billions of dollars in special carve-outs and privileges in the tax code that narrow the tax base and distort economic decision-making. Although eliminating some of these provisions may result in a net tax increase for certain taxpayers, any tax reform should eliminate true privileges without hesitation.

It should be recognized that not all pro-growth tax reforms will pay economic dividends in excess of the lost revenue, but this should not leave lawmakers searching for new or different forms of revenue. Policymakers should instead turn their attention to the other side of the ledger and address spending reform. It is an uncomfortable fact that chronic deficits are the symptom of overspending rather than of insufficient taxation. Additionally, 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.”

Tax reform can be accomplished without adding to the national debt and without creating new taxes somewhere else to pay for the reform. By following the simple principles of a good tax system and by expanding reform discussions to include Washington’s spending problem, true tax reform is possible.

**LOWER RATES**

Exhaustive 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 will lower current individual and corporate tax rates.

One thing the government should *not* do is raise tax rates. A substantial body of research demonstrates the negative consequences to economic growth of raising tax rates. Research by economists Christina Romer (former chair of President Obama’s Council of Economic Advisers) and David Romer suggests, “A tax increase of 1 percent of GDP reduces output over the next three years by nearly three

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percent.” According to research by Harvard University economist Jeffrey Miron, “Both macroeconomic and microeconomic perspectives suggest that [higher] taxes slow economic growth, thereby limiting the scope for revenue gains.”

Corporate

For those advocating higher taxes on business, it is important to note two things. First, the US corporate tax rate is among the highest in the industrialized world; this increases businesses’ flight to countries with lower tax rates, taking their jobs, money, and tax dollars with them. Second, and perhaps more importantly, a tax on corporations is actually a tax on labor—everyday people. Businesses ultimately pass their tax burdens on to individuals. A Congressional Budget Office working paper finds that “domestic labor bears slightly more than 70 percent of the burden of the corporate income tax.” Because people, not businesses, ultimately pay taxes and because capital is increasingly mobile, most of the corporate income tax falls on workers through lower pay and less generous benefits.

By most accounts, the corporate tax is inefficient because it double-taxes income and penalizes business activity. The case for completely repealing the corporate income tax is compelling. A National Bureau of Economic Research working paper finds that eliminating the corporate income tax produces “major economic benefits and welfare gains in the U.S.” The paper’s modeling further shows dramatic increases in “investment, output, and real wages, making the tax cut self-financing to a significant extent.” Other researchers have also shown significant growth dividends from lowering or eliminating the corporate income tax.

8. Fehr et al., “Simulating the Elimination of the U.S. Corporate Income Tax.”
Responsibly repealing the corporate income tax would require the addition of off-setting provisions to discourage counting labor income as corporate income and to maintain the necessary neutral treatment of pass-through corporations.\(^\text{10}\)

Looking just at the top-line rate, the Blueprint provides a good middle ground for reform by lowering the corporate income tax rate to 20 percent. For a politically sustainable reform of the corporate income tax, this is a great start, although an even larger reduction would help the United States get ahead of other countries that have recently lowered their corporate income tax rates.\(^\text{11}\)

**Individual**

The popular refrain “the more you tax something, the less you get” also applies to labor income. So on principle, individual income tax rates should be kept as low as possible to avoid labor market distortions.

Additionally, the income tax has been shown to be a poor policy tool for addressing income inequality. Research from the Brookings Institution indicates that “a significant increase in the top income tax rate wouldn’t substantially alter income inequality.”\(^\text{12}\) This is largely because federal income taxes are already highly progressive. Households in the lowest income quintile paid an average federal tax rate of about 3 percent. The middle and top quintiles paid about 13 and 26 percent, respectively. The top quintile paid almost 70 percent of federal income taxes.\(^\text{13}\)

The Blueprint consolidates the current seven tax brackets into three: 12, 25, and 33 percent. Under this system, the top marginal rate is lowered from 39.6 percent. Lowering marginal rates is important for economic growth, and having fewer tax brackets simplifies tax administration. Lowering marginal rates reduces the disincentives many people face for engaging in economic


\(^{11}\). See, for example, the United Kingdom, which recently lowered the corporate income tax rate to 20 percent and will continue to lower the rate until it reaches 18 percent, starting April 2020. HM Revenue & Customs, “Rates and Allowances: Corporation Tax,” Gov.uk, last modified April 1, 2016.


activity—for example, allowing a marginal worker, such as a stay-at-home parent, to enter the workforce part-time without facing potentially steep tax penalties. The economic literature supports our normative position that governments should take as little of their citizens’ money as possible and should always strive to reduce costs before increasing taxes.

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 by policymakers on behalf of special interests. Taxes should have a broad base in order to tax all types of activity more equally, rather than singling out certain types of firms or individuals. A broad-based tax has the additional feature of providing more stable revenues for the government. If a substantial portion of tax revenue comes from a small number of individuals or businesses, an economic downturn may unnecessarily reduce revenue collection.

One way the tax base is systematically narrowed is by carving out special interests or privileged activities. In the corporate tax code, these carve-outs include things like the R&D tax credit, the deduction for US production activities (Section 199), and the credit for certain railroad track maintenance. The individual tax code subsidizes larger homes through the mortgage interest deduction and more expensive college tuition through education tax credits.¹⁴

These special carve-outs are called tax expenditures because they can sometimes act like direct government spending. However, not all so-called tax expenditures are spending through the tax code. The current system wrongly labels as tax expenditures many important corrections that remove economic distortions inherent in an income tax system. These corrections promote the neutral treatment of consumption and savings, facilitating economic efficiency. A true tax expenditure grants a privilege through the tax code.¹⁵

The individual and corporate cost of tax compliance is estimated to be as high as nearly $1 trillion annually, driven in part by special carve-outs for

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privileged individuals, firms, and activities. Each new provision is written by legislatures, interpreted by regulators, and litigated in court—often adding little clarity to the law. Interpreting and complying with each page of the tax code is a complex and unforgiving task requiring a bevy of lawyers and accountants and a specialized tax court.

All true tax expenditures, defined as favoritism in the tax code, 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.”

As written, the Blueprint goes a long way toward eliminating loopholes and favoritism in the tax code, but more work needs to be done. On the corporate side, the plan calls to generally “eliminate special-interest deductions and credits in favor of providing lower tax rates.” The one special provision that explicitly remains is a credit for research and development expenditures. Evidence from other countries and economic research on the credit as currently designed suggest that the R&D tax credit’s unseen costs undermine its predicted benefits. This credit should therefore be eliminated along with the rest of the special-interest deductions, credits, and exemptions.

Proposed reforms on the individual side are not so straightforward. The Blueprint consolidates the five basic family tax deductions into two, simplifying the disparate rules governing each; maintains the earned income tax credit (EITC); and calls for an unspecified simplification of the various education subsidies. The Blueprint also “reflects the elimination of all itemized deductions except the mortgage interest deduction and the charitable contribution deduction.”

There is a substantial body of economic research that supports the elimination of the home mortgage interest deduction (MID) and higher-education

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19. If it must be kept, our research from 2015 recommends four substantive changes to increase the credit’s effectiveness and decrease some of the associated costs. See Jason J. Fichtner and Adam N. Michel, “Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2015).
subsidies. The MID is often characterized as a privilege for middle- and high-income homeowners, but it is mainly a subsidy for the real estate industry that correlates with larger home sizes—and larger commissions on home sales—because the tax gains to homeowners are largely offset by increases in home prices. The MID also encourages home debt, not necessarily home ownership. Subsidies for college tuition are also largely passed on to colleges and universities because of the tuition increases made possible by the subsidies.

On the other hand, the proposal in the Blueprint to eliminate the state and local tax deduction that subsidizes higher taxes and spending at the local level, while exporting much of the tax jurisdiction’s higher tax burden to taxpayers in other states, is encouraging. Further, certain credits and deductions, such as the child tax credit, the EITC, and deductions for charitable contributions, have mixed results meeting stated policy goals and show evidence of being both poorly targeted and poorly administered. These credits and deductions could benefit from some of the reforms hinted at in the Blueprint.

NO DOUBLE TAXATION

For economic efficiency, it is important that income be taxed once and only once. 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 concern fails to accurately reflect the incidence of the corporate income tax.

Currently, corporate profits are generally subject to “double taxation,” whereby firm profits are taxed first at the corporate level and then again at the individual level. One of the reasons for a lower tax rate for individuals on capital gains is because capital income received by individuals was already taxed at the corporate level up to 35 percent. Hence, if a corporation first pays the maximum statutory tax rate of 35 percent on each $1 of profit, leaving $0.65 of retained profit to be either distributed as a dividend or realized as capital gain, then applying the individual’s 23.8 percent tax rate (the statutory 20 percent top marginal

rate, plus the 3.8 percent surtax on net investment income) to the $0.65 leaves only $0.495 out of the original $1, resulting in a combined top marginal effective tax rate of about 50.5 percent on capital investments.\textsuperscript{25}

Thus, we can see that increasing the rate on capital gains and dividends would further raise the effective tax rate on investment, dramatically reducing the incentive to invest, which would slow capital formation and wage growth. Additionally, the behavioral response to higher tax rates would decrease the expected static revenue projections.\textsuperscript{26}

The Blueprint outlines three reforms that would reduce the burden of double taxation on capital formation. First, it proposes lowering the top capital gains rate to 16.5 percent (structured as a 50 percent deduction of net capital gains, dividends, and interest income). Second, it proposes eliminating the estate and generation-skipping taxes, which tax lifetime earnings—earnings that have already been taxed, sometimes multiple times—and which further discourage capital accumulation. Third, the Blueprint maintains some form of the various tax exclusions for saving (Roth and traditional IRAs, 401(k) accounts, and pension plans). Although each of these tax treatments for savings is often characterized as a tax expenditure or dubbed a “loophole,” these tax exclusions for saving are necessary corrections to the income tax’s penchant for double-taxing saving and investment.\textsuperscript{27}

A more complicated issue is the Blueprint’s treatment of the deductibility of business interest payments. The proposal allows a deduction for interest expense against interest income, but it disallows the current, more general interest deduction to otherwise reduce taxable income.\textsuperscript{28} The current tax treatment of interest deduction keeps debt-financed investment from undergoing an additional layer of taxation.\textsuperscript{29} However, this creates a bias in favor of debt financing

\textsuperscript{25} We have not included the Pease limitation on itemized deductions because it generally acts more as a surtax on income, but the addition of this tax increases the effective rate by about one percentage point.


\textsuperscript{27} Jeremy Horpedahl, “The Tax Exclusion for Retirement and Pension Plans” (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, 2013).


\textsuperscript{29} For tax neutrality, interest that is deductible by the borrower should be taxed as income to the lender. An additional layer of tax is created if the deductibility of interest is denied to the borrower but interest income is still taxable as income to the lender. If interest is not allowed as a deduction to the borrower, in order to be tax neutral, the interest income should not be taxable to the lender.
and against equity financing because the same project faces two different effective tax rates depending on how it is financed.\textsuperscript{30}

Eliminating the interest deduction would allow for the equitable treatment of debt and equity financing under the corporate income tax.\textsuperscript{31} But it would also add an additional layer of taxation from debt-financed investment. Changing the treatment of debt in the tax code could also have significant ramifications for the business structures of banks and other financial institutions that rely on interest as both a tax planning strategy and a legitimate business purpose.

The root of the problem is the inherent double taxation that is built into the income tax system. The preferred way to remedy the problem of interest deductibility is to tax corporate income only once by eliminating the tax either at the corporate level (by eliminating the corporate income tax) or at the shareholder level (by removing the tax on capital gains and dividends). Given the political constraints tax reform faces, the proposed elimination of the standard interest deduction, combined with a significant corporate rate reduction and expensing, is an imperfect but reasonable idea that is certainly worth further consideration.

**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 21st century economy. The US corporate tax rate is among the highest in the industrialized world, and the United States is one of very few countries that attempt to tax the worldwide income of domestically headquartered businesses.\textsuperscript{32} This pushes investment and US companies offshore (often taking the form of an “inversion”) to countries with lower tax rates—pushing jobs, money, and tax dollars out, too.\textsuperscript{33}


\textsuperscript{31} However, this would introduce a bias in favor of financing with a business’s own income in the pass-through sector. Stephen J. Entin, “Addressing Poor Arguments against the Interest Deduction” (Tax Foundation, Washington, DC, 2016).


\textsuperscript{33} Jason J. Fichtner, Courtney S. Michaluk, and 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, Mercatus Center at George Mason University, Arlington, VA, 2015).
The worldwide tax systems employed by the United States tax all income of domestically headquartered businesses, including income earned by subsidiaries operating abroad. Firms are allowed to defer paying taxes on “active” foreign income that has not yet been repatriated. While some refer to deferral as a tax “loophole,” deferring taxes on foreign income until repatriation is an attempt to mirror a territorial tax system and allow US firms to effectively compete abroad. Moving to a territorial system where foreign-sourced income is exempt from US taxation would increase economic growth and improve tax simplicity and efficiency.

Taxing income where it is earned levels the playing field, so operations in one jurisdiction are taxed at the same rate, regardless of parent ownership. Under a territorial system, corporate profits can flow to their highest-value use, helping expand the economy. The US system of worldwide taxation locks corporate profits out of the US economy, forcing corporations to either reinvest or park the profits abroad while they wait for a lower US corporate tax rate. The tax penalty paid on repatriated earnings keeps an estimated $2 trillion of US corporate profits permanently reinvested overseas.34

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 and economic distortion to the return on capital investments. “Full expensing,” which allows businesses to write off all expenditures in the year they are purchased, encourages job creation and economic growth by treating all business expenditures, including labor, equally. Moving toward full expensing and territorial taxation would help retain and attract new business investment.35 This is not a risky move; Organisation for Economic Co-operation and Development countries around the world have already implemented one or both of these reforms, leaving the US economy behind.36

Instead of simply lowering the rate and moving toward a territorial corporate income tax system with full expensing, the Blueprint proposes a destination-based cash flow tax with a border adjustment. The proposed cash flow tax would allow businesses to immediately deduct all expenses from revenue, including

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34. “Overseas Earnings of Russell 1000 Tops $2 Trillion in 2013,” Audit Analytics, last modified April 1, 2014.
capital investments and labor.\textsuperscript{37} To keep the US tax from being levied on consumption in other countries, the tax would be “border adjusted,” or removed from exports and added to imports. In effect, this means imports would be taxed and exports would receive a form of tax subsidy.

Many proponents believe that this system is more efficient than an income tax and mistakenly view it as a less economically distortionary form of consumption tax, similar to a European-style value-added tax.\textsuperscript{38} The efficiency claims of proponents rely on several key assumptions that are required for the tax to be nondistortionary. Mainly, the border adjustment must be implemented completely, and international currency markets must fully adjust (the dollar would need to appreciate by 25 percent).\textsuperscript{39} Because such a large currency adjustment is unlikely, this system creates an unnecessary economic gamble.\textsuperscript{40}

Academic research has consistently shown major benefits to economic growth and efficiency from lowering the corporate income tax rate and moving toward a territorial system and full expensing. These changes should be the focus of any corporate tax reform proposal.

CONCLUSION

As policymakers further develop their tax reform agenda for 2017, it is helpful to learn from the past. Predictable tax policy is an essential component to long-term economic growth, and temporary tax provisions should generally be avoided, especially when trying to correct permanent problems.

The last major US tax reform, the Tax Reform Act of 1986, was remarkable for its bipartisan passage and sweeping reforms. But because the legislation failed to fix the revenue system’s large institutional problems, reforms were clawed back almost immediately. As a result, the tax code looks even worse today.\textsuperscript{41} History has shown that tax reforms seldom last when special interests have large incentives to

\begin{itemize}
  \item \textsuperscript{37} Land is not included as a deductible asset.
  \item \textsuperscript{38} However, the deduction of labor costs significantly narrows the tax base and may change the incidence of the tax, with the result that the tax actually does not fall completely on consumption. For a discussion of this point, see John H. Cochrane, “Corporate Tax (or Is It?) Reading List,” \textit{Grumpy Economist}, February 1, 2017.
  \item \textsuperscript{39} See description by Kyle Pomerleau, “Exchange Rates and the Border Adjustment” (Tax Foundation, Washington, DC, December 15, 2016).
  \item \textsuperscript{40} For a more thorough discussion of these points, see Jason J. Fichtner, Veronique de Rugy, and Adam N. Michel, “Border Adjustment Tax: What We Know (Not Much) and What We Don’t (All the Rest)” (Mercatus Policy Primer, Mercatus Center at George Mason University, Arlington, VA, 2017).
  \item \textsuperscript{41} Jason Fichtner and Jacob Feldman, “Lessons from the 1986 Tax Reform Act” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2011).
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lobby Congress for tax breaks. Keeping the tax code as simple and transparent as possible—by taxing a broad base at the same low rate—will help reduce the ability and incentives to reverse future tax reforms.42

The United States has an infamously dense and complicated tax code that is in dire need of simplification. The current tax code is detrimental to the economy. The tax system severely distorts individual and business decisions and the allocation of their respective resources; it hampers job creation and impedes both economic growth and tax revenue.

The House Republican Tax Reform Task Force Blueprint provides an overall good plan to reform the tax code. The plan excels by eliminating hundreds of special tax privileges for both individuals and corporations, simplifying tax administration and broadening the tax base. However, there are a few additional tax provisions left that should also be removed or reformed, most notably the MID and incentives for R&D and education. The plan lowers the rates on individual and corporate income and works to reduce the double taxation of investment. The novel proposal of a border adjustment tax presents an unnecessary risk to the US economy and should be avoided. The proposed border adjustment should be recognized as little more than a new source of revenue because it is not a pro-growth reform.43 Policymakers should focus on more conventional and pro-growth reforms going forward.

43. Kyle Pomerleau, “Details and Analysis of the 2016 House Republican Tax Reform Plan” (Fiscal Fact No. 516, Tax Foundation, Washington, DC, July 2016). See Pomerlau’s table 5 for the 10-year revenue and economic impact of the Blueprint by provision. The border adjustment taxes are estimated to have negative 0.4 percent GDP growth.
ABOUT THE AUTHORS

Jason J. Fichtner is a senior research fellow at the Mercatus Center at George Mason University. He has previously served in several positions at the Social Security Administration, as senior economist with the Joint Economic Committee of the US Congress, and as senior consultant with the Office of Federal Tax Services of Arthur Andersen in Washington, DC. Fichtner earned his PhD in public administration and policy from Virginia Tech. He serves on the adjunct faculty at Georgetown University’s McCourt School of Public Policy, the Johns Hopkins School of Advanced International Studies, and Virginia Tech’s Center for Public Administration and Policy, where he teaches courses in economics, public finance, the public policy process, public management, and public budgeting processes.

Adam N. Michel is a former program manager for the Spending and Budget Initiative at the Mercatus Center. He received his MA in economics from George Mason University, where he is currently pursuing his PhD, and his BA in politics from Whitman College. He participated in the Mercatus Graduate Fellowship and previously worked at the Tax Foundation as a federal tax policy intern. Michel has also worked as a research associate at the Competitive Enterprise Institute.

Veronique de Rugy is a senior research fellow at the Mercatus Center at George Mason University and a nationally syndicated columnist. Her primary research interests include the US economy, the federal budget, homeland security, taxation, tax competition, and financial privacy. She has testified numerous times before Congress on the effects of fiscal stimulus, debt and deficits, and regulation on the economy. Previously, de Rugy has been a resident fellow at the American Enterprise Institute, a policy analyst at the Cato Institute, and a research fellow at the Atlas Economic Research Foundation. Before moving to the United States, she oversaw academic programs in France for the Institute for Humane Studies–Europe. She received her MA in economics from the Paris Dauphine University and her PhD in economics from the Pantheon-Sorbonne University.

Angela Kuck is the deputy director of the Spending and Budget Initiative and the director of policy communications for the Mercatus Center at George Mason University. She works to connect Mercatus scholars and research with policymakers and the media. Before joining Mercatus, Kuck spent more than a decade working for the US Congress, serving as communications director for the House of Representatives Committee on the Budget. Kuck graduated from the University of Cincinnati with a BA in political science.