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How to Judge a Tax Plan

By
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Tax reform has become the central issue in the presidential primaries and will likely remain an important issue in the general election. While the plans and proposals will vary considerably in their scope and intent, it is important that they all be judged against a standard set of guideposts or principles that define a sound tax system.

The ideal tax system should do only one thing: raise a sufficient amount of revenue to fund government activities with the least amount of harm to the economy. By all accounts, the U.S. tax system is far from that ideal.

Since 1937, Tax Foundation economists have judged every tax measure against the immutable principles of economically sound tax policy, which say that: Taxes should be neutral to economic decision-making; they should be simple, transparent, and stable; and they should promote economic growth.[1]

From these principles, we have developed 10 basic questions to judge the economic quality of any tax plan or proposal. These questions cover four basic areas:

- The fairness and neutrality of a tax system;
- The complexity of a system and how costly it is to comply with it;
- How the system affects U.S. competitiveness and economic growth; and
- How it affects the stability or volatility of tax revenues.

The largest group of questions deals with fairness and neutrality, since this aspect of our current tax code is widely perceived, perhaps correctly, as the code's most egregious failing. Likewise, complexity and compliance costs are a clear and present annoyance for millions of taxpayers. The remaining questions deal with the momentous and related problems of anemic economic growth and low tax revenues, and illustrate how they too can be blamed, at least in part, on our current tax code.

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[1] See, for example, Adam Smith's formulation in *The Wealth of Nations*, that taxes should a) be in proportion to income, b) remain stable, and c) minimize compliance costs and distortions of economic behavior. http://www.econlib.org/library/Smith/smWN21.html#B.V, Ch.2, Of the Sources of the General or Public Revenue of the Society

How Does the Plan Affect Fairness and Neutrality?

1) Does it make taxes less of a factor in decision-making and reduce social engineering?

How to think about this: Whether the decision is to purchase a home, replace the windows on that home, build a factory, or hire new workers, taxes should play as small a role in decision-making as possible. Unfortunately, our tax code is rife with measures that attempt to induce taxpayers into all manner of activities, from buying hybrid vehicles to investing in historic buildings.

Not only do these measures distort individual and business decisions; they distort the economy as well. For example, businesses have an incentive to take on more debt than necessary because interest expenses are deductible, whereas equity financing is not. Individuals may choose tax-free health care benefits over taxable wages, thus causing over-consumption of health care. The mortgage interest deduction diverts billions of dollars to the housing industry and away from more productive uses, such as investment in ideas and entrepreneurs.

Moreover, the proliferation of these tax incentives has made the IRS an extension of, or rather a substitute for, every other cabinet agency, from Energy and Education to Transportation and Housing and Urban Development. Were we starting from scratch, these would not be the roles we would assign to a tax collection agency.

While some economists may justify the use of taxes to address "market failures" in specific circumstances, such as a tax on emissions to reduce the externalities (costs external to the transacting parties) of pollution, taxes should otherwise simply raise sufficient revenue to pay for necessary government functions.

2) Does it reduce special interest provisions or "loopholes," and minimize the ability of special interests to seek favors?

How to think about this: The estimated budgetary cost of tax preferences – formally known as "tax expenditures," but often called "loopholes" – is over $1 trillion per year, or equal to about 7 percent of GDP. The vast majority of these provisions, totaling roughly $900 billion, are intended to benefit individual taxpayers, whereas roughly $100 billion benefits corporations and business owners.

One cost of these preferences is that they dramatically narrow the tax base and require higher rates to raise the same amount of revenues that a simpler system could with lower rates. Secondly, they inject a great deal of unfairness into the tax system as two taxpayers with similar incomes may pay vastly different amounts of tax based on how they have arranged their affairs to match the preferences in the tax code. This gives people the impression that the system can be gamed and does not apply equally to everyone.

Lastly, the more tax preferences there are, the greater the incentives to lobby for more incentives. A clean tax code will reduce the incentives to carve out preferences in the same way that people are less likely to litter when the streets are clean.

3) Does it tax everyone's income at the same rate?

How to think about this: A single rate tax system is the fairest system of all. It treats all Americans equally, no matter their age, occupation, income, or station in life.

By contrast, the current personal income tax code is highly progressive, which means individuals with different incomes are taxed at different rates; those with higher incomes face higher rates than those with lower incomes. While progressive rates are frequently justified to ensure that wealthier taxpayers "pay their fair share," these rates – and the incomes they apply to – are arbitrary and set by political fiat, not by any economic rationale.

For example, in 1977, there were 26 separate tax brackets for married couples, ranging from a zero rate for those earning up to $11,848 (in today's dollars) to a top marginal rate of 70 percent for those earning over $752,375 (in today's dollars). That system collected 8 percent of GDP in income taxes. The 1986 Tax Reform Act reduced the complex rate structure to two rates, 15 percent and 28 percent, and still raised 8 percent of GDP in income taxes. Now, there are six tax brackets ranging from 10 percent to 35 percent. Today, individual income taxes are 6 percent of GDP.

There is a mistaken perception that a single-rate system cannot protect the poor. This can be addressed with a generous individual or family allowance that shields a certain amount of a taxpayer's income from tax, then applies the single rate to every dollar earned above the allowance.

4) Does it end the double and triple taxation of saving and investment?

How to think about this: Income should be taxed only once, and as close to the source as possible. The current system taxes income multiple times, and often at very high rates. For example, personal income is taxed once by the income tax, and then a second time on the returns of any saved or invested post-tax income. Similarly, corporate profits are taxed first at the firm level, and then a second time when they are distributed as dividends to individuals, or when they are realized as capital gains. Finally, a lifetime of the accumulated savings of a business owner or farmer is taxed a second or third time by the estate tax.

Saving and investment is the key to long-term economic growth, just as it is the key to growing one's net worth. Our tax code's heavy penalties on saving and investing ultimately harm us all.

5) Does it tax business income equally, regardless of organizational form?

How to think about this: Businesses should be taxed equally, no matter what size they are and no matter whether they are owned by an individual or by a large group of shareholders. But the current tax code not only taxes business income differently depending on how the business is organized; it also applies different rules to small and large businesses.

For example, the income of traditional "C-corporations" is taxed first at the business level and then a second time as dividends at the shareholder level. "Pass-through" businesses (including S-corporations, partnerships, sole-proprietorships, and farms) pay their business taxes just once at the individual owner level.

Moreover, lawmakers have also created different sets of tax rules for small businesses as opposed to large businesses. For example, small businesses are often able to expense the purchase of equipment whereas corporations must depreciate those purchases. Also, pass-through businesses pay the individual capital gains rate of 15 percent, whereas corporations pay a capital gains rate of 35 percent – the same as the top corporate rate.

Remarkably, these inequities have pushed the majority of business income into the personal income tax code rather than the corporate code. A fair tax system should tax business entities in the same manner no matter how they are organized while reducing the incentives to arbitrage the tax system.

How Does the Plan Affect Compliance Costs and Complexity?

6) Does it reduce complexity and make the tax code easier to understand?

How to think about this: For most taxpayers, simplicity is an obvious virtue. But in its 2010 Annual Report to Congress, the National Taxpayer Advocate identified tax complexity as the most serious problem facing taxpayers and the IRS, and urged lawmakers to simplify the system.[2]

Simply complying with the federal income tax code costs taxpayers approximately $400 billion each year.[3] About 62 percent of all taxpayers use tax return preparers, but the percentage climbs to about 73 percent for those claiming the earned income tax credit (EITC).[4] Moreover, the complexity of EITC eligibility is a contributing factor to the estimated $10 billion to $12 billion in erroneous overpayments out of nearly $44 billion of total EITC claims in 2006.[5]

These compliance costs do not include the more than $12 billion annual budget of the IRS, nor the costs of the tax courts and litigation. In addition to these hard costs, there is the tax code's impact on people's behavior and the economy – what economists call the "deadweight" costs, or excess burden, of the tax system.

According to a recent Tax Foundation study, the "deadweight" costs of the current individual income tax is not inconsequential, amounting to roughly 11 to 15 percent of total income tax revenues. This means that in the course of raising roughly $1 trillion in revenue through the individual income tax, an additional burden of $110 to $150 billion is imposed on taxpayers and the economy.[6] These are clearly resources that could be put to more productive uses in the economy. Further, this unnecessary complexity and lack of transparency means most taxpayers do not understand how much they are paying in taxes and how that relates to the services that they receive from government. This is a critical element of any well-functioning democracy.

7) Does it improve certainty in the tax code?

How to think about this: People and businesses should be able to make long-term plans without having to worry about large fluctuations in the tax system. Stability is a key element of an economically sound tax system.

While lawmakers have always tinkered with the tax code, the past few years have been worse than usual. For example, since 2003, lawmakers knew that the Bush-era tax laws would expire on December 31, 2010. Yet

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[2] *National Taxpayer Advocate's 2010 Annual Report to Congress*.
http://www.irs.gov/advocate/article/0,,id=233846,00.html

[3] Based on IRS estimates: http://taxfoundation.org/research/show/1962.html

[4] *National Taxpayer Advocate, Report to Congress*: Fiscal 2010 Objectives, June 30, 2009, p. xxii.
http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf

[5] Ibid. p. xix.

[6] Robert C. Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," *Tax Foundation Special Report* No. 170, August 14, 2009.

they waited until the 11th hour to extend them, and only for two additional years, which means taxpayers will have no idea how to plan their affairs beyond December 31, 2012.

The estate tax was the most extreme example. The top estate tax rate went from 45 percent in 2009 to full repeal in 2010. The rate was then increased to 35 percent, but only through the end of 2012. These fluctuations make it impossible for taxpayers to intelligently plan for their estates.

The introduction of short-term tax provisions, such as tax holidays and stimulus measures, only makes life more unpredictable and investment that much riskier. A sound reform plan should eliminate this uncertainty and improve the stability of the tax code.

How Does the Plan Affect Competitiveness and Growth?

8) Does it make the U.S. more competitive and attractive for investment?

How to think about this: Over the past two decades or so, the majority of our major trading partners have been moving toward a fundamentally different model of taxing business income. The basic tenets of this new model are lower tax rates and the exemption of foreign earnings.

In the past four years alone, 75 countries have cut their corporate tax rates to make themselves more competitive. And, as the OECD reports, "there has been a gradual movement of countries moving from a credit [worldwide] to an exemption [territorial] system, at least in part because of the competitive edge that this can give to their resident multinational firms."[7]

The U.S. remains far behind on both of these trends. Not only do we have the second-highest overall corporate tax rate among the leading industrialized nations, at over 39 percent – only Japan has a higher overall rate – but we are one of the few remaining countries to tax on a worldwide basis. Indeed, the U.S. remains the only country in the OECD with a worldwide system and a corporate rate above 30 percent.

As globalization continues and formerly third-world countries become economic powerhouses, investors and businesses have more options in terms of where to invest and grow a business. Capital will flow to places where costs, including tax costs, are low relative to market demand. A sound tax reform plan will make the U.S. tax system more competitive globally and attractive to investment.

9) Does it promote economic growth rather than redistribution?

How to think about this: Many politicians are calling for higher tax rates on upper-income taxpayers. But the economic evidence suggests that this would be very detrimental to the country's long-term economic growth. Indeed, OECD economists determined that high personal income taxes are second only to corporate income taxes in their harmful effects on long-term economic growth. And it will surprise many Americans to learn that the U.S. already has the most progressive income tax burden among the leading industrialized nations.

What that means is that the top 10 percent of U.S. taxpayers pay a larger share of the income tax burden than do their counterparts in any other industrialized country, including traditionally "high-tax" countries such as

[7] *Tax Policy Reform and Economic Growth*, OECD Tax Policy Studies, No. 20, Organization for Economic Cooperation and Development (2010), p. 138.

France, Italy, and Sweden.[8] Meanwhile, because of the generosity of such preferences as the EITC and child credit, low-income Americans have the lowest income tax burden of any OECD nation – less than zero for almost half of tax filers (due to refundable credits).

Standard economic theory and a great body of evidence[9] indicate there is a tradeoff between economic growth and the redistribution of income. This means that the more we try to make an income tax system progressive, the more we undermine the factors that contribute most to economic growth: investment, risk-taking, entrepreneurship, and productivity. This is because high-income earners tend to do much of the saving, investing, risk-taking, and high-productivity labor. In simple terms, the more you tax something, the less you get of it, so taxing high-income earners reduces all the key factors in job creation and economic growth.

A sound tax reform plan will put long-term growth ahead of short-term redistribution.

How Does the Plan Affect Tax Revenue?

10) Does it improve the stability of revenues?

How to think about this: Whatever the size of government the American people decide they want, the ideal tax system should do one thing only: raise a sufficient amount of revenue to fund government activities with the least amount of harm to the economy. As Jean Baptiste Colbert famously wrote, "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing."

However, our current tax system is anything but stable and harmless to the economy. While federal tax revenues have averaged about 18 percent of GDP over the past four decades, they have been particularly volatile in recent years, fluctuating between 15 and 20 percent of GDP. In part this is due to the business cycle, but it is also due to our progressive tax rate system and our over-reliance on tax collections from wealthier Americans, who have highly variable incomes from business and investment sources.

For example, recent IRS data for 2009 indicates the volatility of millionaire incomes and the taxes they generate for the government. Comparing the 2009 data to the pre-recession data for 2007 shows that not only did the number of millionaires fall by 40 percent, but the overall income of millionaires fell by 50 percent. The result for the U.S. Treasury was that 54 percent of the total drop in tax revenues during this period was due to the falling tax collections from millionaires.

Thus, a fiscally sound tax system should have a broad base that is not restricted to volatile sources of income.

Conclusion

The preceding 10 questions were designed to help taxpayers and policymakers judge the economic quality of any tax plan or proposal. An economically sound tax code is one that is conducive to long-term economic growth. By all accounts, our current tax system is undermining the nation's prosperity and long-term growth.

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[8] *Growing Unequal? Income Distribution and Poverty in OECD Countries*, OECD Publishing (2008), p. 112. http://dx.doi.org/10.1787/422013187855. Here income taxes refer to both personal and social insurance taxes.
[9] See, for example: *Tax Policy Reform and Economic Growth*, OECD Tax Policy Studies, No. 20, OECD Publishing (2010), p. 22. Also, "Do Tax Structures Affect Aggregate Economic Growth?: Empirical Evidence from a Panel of OECD Countries," OECD Economics Department working paper no. 643, which finds a negative relationship between progressivity in personal income taxes and economic growth: http://ideas.repec.org/p/oec/ecoaaa/643-en.html

History and economic research suggest that the closer a tax reform plan adheres to the principles of simplicity, transparency, neutrality, and stability, the more it will naturally increase prosperity.

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