TAX FOUNDATION Since 1937

October 30, 2013
No. 400

Fiscal Fact

Twelve Steps toward a Simpler, Pro-growth Tax Code

By
William McBride, PhD

After years of slow economic growth and a burgeoning tax code, many in Congress and elsewhere have recognized that now is the time for tax reform. Unfortunately, the political process is often at odds with reform, because it tends to protect the status quo, including the tendency to use the tax code to implement industrial and social policy rather than using it simply as a way to raise revenue. Meanwhile, the U.S. tax system has become less and less competitive as the rest of the world works to reform their tax codes. If the U.S. is to regain its standing and return to robust economic growth, it will need to first acknowledge the areas of the tax code that are the least competitive and most problematic in terms of complexity. The following are twelve steps that should be taken toward a simpler, pro-growth tax code.

1. Cut the Federal Corporate Tax Rate

The combined U.S. statutory corporate tax rate is the highest in the developed world at 39.1 percent (35 percent federal rate plus an average of state and local rates). The U.S. corporate tax rate was competitive in the 1990s, but tax competition has left us behind in the intervening years. The average corporate tax rate among developed countries is now 25 percent.[1] The best course of action is to reduce the federal corporate tax rate from the current 35 percent to 20 percent or lower so as to be competitive even after state and local taxes are included.

2. Improve Capital Allowances

U.S. businesses are generally not allowed to immediately deduct the cost of investments in buildings, machines, and other equipment. Instead, businesses must write these investments off over years or even decades.[2] Stretching out these deductions reduces the incentive to invest. Furthermore, relative to other

---

[1] The simple average of corporate tax rates in OECD countries outside the U.S. is 25 percent, while the average weighted by GDP is 29 percent.

[2] Stephen J. Entin, *The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System*, TAX FOUNDATION BACKGROUND PAPER NO. 67 (Apr. 24, 3013), http://taxfoundation.org/article-ns/tax-treatment-capital-assets-and-its-effect-growth-expensing-depreciation-and-concept-cost-recovery.

developed countries, the U.S. requires a longer-than-average delay for these cost recovery deductions.[3] As a result, the U.S. effective corporate tax rate, which factors in these deductions, is among the highest in the developed world according to most studies.[4]

Since these effective rate estimates are backward looking, they have not taken into account many of the recent statutory tax rate reductions abroad, particularly Japan's lowered tax rate, which leaves the U.S. with the highest statutory tax rate and probably the highest effective tax rate in the developed world. The solution is to lower the U.S. effective corporate tax rate both by lowering the statutory corporate tax rate and by shortening asset lives so that businesses are free to grow and invest.

3. Move to a Territorial Tax System

While most countries largely exempt foreign income of corporations from domestic taxation, the U.S. taxes this income at the highest rate in the developed world.[5] The U.S. is one of only six developed countries that continue to tax on a worldwide basis as opposed to territorial. This puts U.S. businesses operating abroad at a distinct disadvantage, since companies based in other countries only pay tax where the profits are earned, while U.S. companies must also pay an additional tax if they bring their profits home. The solution is to do what most of the developed world has already done: switch to a territorial tax system.

4. Reduce Shareholder Taxes

Shareholder taxes on capital gains and dividends are a double tax on corporate profits, and the U.S. has some of the highest shareholder taxes in the developed world. This year's biggest tax increases were on capital gains and dividends, which are now taxed at a top federal rate of 23.8 percent, while state and local shareholder taxes push the combined top tax rate to 27.9 percent. California has the highest combined tax rate on capital gains in the U.S. at 33 percent, which is the second highest in the developed world.[6] Dividend taxes rank similarly high. Many countries do not tax capital gains, including China and India, and

---

[3] Oxford University Centre for Business Taxation, Katarzyna Bilicka & Michael Devereux, *CBT Corporate Tax Ranking 2012* (June 2012).

[4] *Id. See also* Duanjie Chen & Jack Mintz, *Corporate Tax Competitiveness Rankings for 2012*, CATO INSTITUTE TAX AND BUDGET BULLETIN NO. 65 (Sept. 2012), http://www.cato.org/sites/cato.org/files/pubs/pdf/tbb_65.pdf; Phillip Dittmer, *U.S. Corporations Suffer High Effective Tax Rates by International Standards*, TAX FOUNDATION SPECIAL REPORT NO. 195 (Sept. 13, 2011), http://taxfoundation.org/article/us-corporations-suffer-high-effective-tax-rates-international-standards; William McBride, *GAO Compares Apples to Oranges to Find Low Corporate Effective Tax Rate*, TAX FOUNDATION TAX POLICY BLOG, July 2, 2013, http://taxfoundation.org/blog/gao-compares-apples-oranges-find-low-corporate-effective-tax-rate.

[5] William McBride, *New Zealand's Experience with Territorial Taxation*, TAX FOUNDATION FISCAL FACT NO. 375 (June 19, 2013), http://taxfoundation.org/article/new-zealands-experience-territorial-taxation; PWC, *Evolution of Territorial Tax Systems in the OECD*, prepared for the Technology CEO Council (Apr. 2, 2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf; Phillip Dittmer, *A Global Perspective on Territorial Taxation,* TAX FOUNDATION SPECIAL REPORT NO. 202 (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation.

[6] Kyle Pomerleau, *The High Burden of State and Federal Capital Gains Taxes,* TAX FOUNDATION FISCAL FACT NO. 362 (Feb. 20, 2013), http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-taxes.

many other countries do not tax dividends, such as Slovakia and Estonia, while many others credit shareholders for taxes paid at the corporate level.[7] To make America more competitive, and increase the incentives to save and invest, it is imperative that shareholder taxes, as well as taxes on interest, come down from current levels.

5. Lower Tax Rates on Pass-Through Business Forms and other High-Income Filers

In the U.S., more than half of all business income is taxed under the individual income tax code, not the corporate code. These businesses are partnerships, S corporations, and sole proprietorships whose profits are passed through to owners' tax returns. Further, most pass-through business income is taxed at the top marginal tax rate, which is nearly 50 percent including federal and average state and local rates and above 50 percent in some high-tax states.[8] No other developed country has such a large share of businesses and business income subject to such high individual tax rates.[9] This reduces the incentive for these businesses to invest in the U.S.

Furthermore, high individual income tax rates discourage other important economic behavior, such as high-productivity labor and the human capital investment that is usually required to become highly productive and highly compensated. Essentially, high individual income tax rates punish successful businesses, entrepreneurs, risk-takers, innovators, investors, and hard workers who have educated themselves and developed skills that are valuable to others.

6. Eliminate Estate Taxes

Estate taxes are an additional layer of tax on saving and investment after taxes on wage income, corporate income, and shareholder income.[10] Because estate taxes are usually triggered by death, they are known as death taxes, and polls indicate they are among the least popular taxes of all. The Bush tax cuts reduced and then eliminated the federal estate tax in 2010, but it was reinstated the following year. Estate taxes are designed to reduce wealth accumulation by families. However, in practice it results in less wealth for society as a whole, as resources are lost in the transfer of the wealth via a "leaky bucket." Indeed, estate taxes are an

---

[7] OECD, *OECD Tax Database*, *Corporate and capital income taxes*, http://www.oecd.org/tax/tax-policy/oecdtaxdatabase.htm#C_CorporateCaptial.

[8] U.S. Department of the Treasury, Office of Tax Analysis, Matthew Knittel et al., OTA Technical Paper 4: *Methodology to Identify Small Businesses and Their Owners* (Aug. 2011), http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf; Kyle Pomerleau, *Individual Tax Rates Impact Business Activity Due to High Number of Pass-Throughs*, TAX FOUNDATION FISCAL FACT NO. 394 (Sept. 3, 2013), http://taxfoundation.org/article/individual-tax-rates-impact-business-activity-due-high-number-pass-throughs; Gerald Prante & Austin John, *Top Marginal Effective Tax Rates by State and by Source of Income, 2012 Tax Law vs. 2013 Tax Law (as enacted in ATRA)* (Feb. 3, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176526.

[9] OECD, Center for Tax Policy and Administration, *Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire*, tables 1-3, http://www.oecd.org/tax/tax-policy/39597756.pdf.

[10] David Block & Scott Drenkard, *The Estate Tax: Even Worse than Republicans Say*, TAX FOUNDATION FISCAL FACT NO. 326 (Sept. 4, 2012), http://taxfoundation.org/article/estate-tax-even-worse-republicans-say.

extremely leaky bucket, since they are rather easily avoided through tax planning, resulting in little tax revenue. For instance, the federal estate tax raises less than 0.5 percent of all federal tax revenue, which is less than the cost of compliance, according to many studies.[11] Instead, estate taxes mainly serve to support a cottage industry of tax planning—resources that could be better used in the productive economy. Further, for those unlucky taxpayers who are caught off-guard, the estate tax represents a final penalty for saving and investing. As such, full repeal of estate taxes at the federal and state level would boost saving and investment and add some clarity, certainty, and fairness to the tax code.

7. Eliminate the Alternative Minimum Tax

The Alternative Minimum Tax (AMT), like the estate tax, was meant to address inequality by ensuring that high-income earners pay a minimum rate of tax. However, also like the estate tax, it does not work very well. Because it has its own set of deductions and other preferences, it results in a great deal of variation in tax rates across taxpayers, even among those subject to the AMT. Thousands of high-income earners still end up paying no federal income tax. Ultimately, it just introduces more complexity and compliance costs to the tax code as millions of filers must calculate their taxes once under the regular code and then again under the AMT. It raises little revenue relative to the compliance costs it creates. One of the best ways to simplify the code is to repeal the AMT and instead reduce the unjustified tax preferences in the regular code that allow so much variation in tax rates across filers.[12]

8. Eliminate PEP and Pease

The Personal Exemption Phase-out (PEP) and the Pease limitation of itemized deductions are two more provisions that aim to reduce the incomes of the rich and do it in a complex and convoluted way. Instead of merely raising the statutory tax rate on individual income, which in itself harms incentives to work and invest, these provisions introduce the extra economic harm of extremely complex rules that reduce transparency in the law and cause marginal tax rates to go up over a certain range of income and then come down again. Depending on circumstances, these provisions can effectively add 6 percentage points or more to the top marginal tax rate, resulting in a variable and difficult to predict penalty on work and investment. These provisions should be eliminated.

9. Eliminate "Obamacare" Taxes

For the sake of simplicity, more than anything else, the taxes contained in the Patient Protection and Affordable Care Act (ACA) should be repealed. There are more than twenty separate taxes, all of which are

---

[11] Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes,* 45 NATIONAL TAX JOURNAL 119 (June 1992); Douglas Bernheim, *Does the Estate Tax Raise Revenue? in* 1 TAX POLICY AND THE ECONOMY 113-138; Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes*, NEW ENGLAND ECONOMIC REVIEW 3-28 (Nov./Dec. 1988).

[12] William McBride, *A Brief History of Tax Expenditures*, TAX FOUNDATION FISCAL FACT NO. 391 (Aug. 22, 2013), http://taxfoundation.org/article/brief-history-tax-expenditures.

poorly structured and difficult to comply with, and they increase the federal tax burden by more than $1 trillion over ten years.[13] Most of these taxes fall hard on particular businesses, such as the medical device tax[14] and the tanning tax, or on businesses that employ more than fifty full-time workers, such as the employer mandate. Others prop up favored businesses, such as the individual mandate that forces consumers to buy private health insurance.[15] The biggest burden is the 3.8 percent tax on saving and investment, which will do nothing for healthcare but will certainly harm economic growth.[16] The exchange subsidies are to be run through the IRS as massive refundable tax credits, but it remains to be seen if the IRS is up to the task, particularly given the high rate of fraud in other refundable tax credits.[17] The rules for subsidy eligibility are complex and could result in significant gaming of the system. The ACA was supposed to be a healthcare system, but it became a vehicle for taxing particular industries, favoring others, while hurting incentives to save and invest.

10. Eliminate Corporate Welfare in the Tax Code

In addition to ACA favors, the tax code is littered with numerous corporate welfare programs meant to spur certain industries or activities, such as the various credits and deductions related to renewable energy and energy-efficient products like hybrid vehicles, appliances, and windows.[18] There are also preferences for manufacturers, the housing industry, credit unions, and insurance companies. These carve-outs cost roughly $38 billion per year, in terms of lost income tax revenue, but this does not count the cost of complexity and compliance, which favors businesses with large tax departments.[19] Nor does it count the considerable money and resources spent lobbying for these subsidies, which largely benefits Washington, D.C. at the expense of the rest of the economy. The solution is to identify and eliminate the narrow business preferences that are not aimed at legitimate business cost recovery.[20]

---

[13] William McBride, *Obamacare Taxes Now Estimated to Cost $1 Trillion Over 10 Years*, TAX FOUNDATION TAX POLICY BLOG (July 26, 2012), http://taxfoundation.org/blog/obamacare-taxes-now-estimated-cost-1-trillion-over-10-years.

[14] Kyle Pomerleau, *The ACA Medical Device Tax: Bad Policy in Need of Repeal*, TAX FOUNDATION FISCAL FACT NO. 364 (Apr. 9, 2013), http://taxfoundation.org/article/aca-medical-device-tax-bad-policy-need-repeal.

[15] William McBride, *Obamacare "Penalty Tax" Now Estimated to Hit 6 Million Mostly Low- and Middle-Income Americans*, TAX FOUNDATION TAX POLICY BLOG (Sept. 19, 2012), http://taxfoundation.org/blog/obamacare-penalty-tax-now-estimated-hit-6-million.

[16] Stephen J. Entin, *Simulating the Economic Effects of Obama's Tax Plan*, TAX FOUNDATION FISCAL FACT NO. 339 (Nov. 1, 2012), http://taxfoundation.org/article/simulating-economic-effects-obamas-tax-plan.

[17] William McBride, *A Brief History of Tax Expenditures*, TAX FOUNDATION FISCAL FACT NO. 391 (Aug. 22, 2013), http://taxfoundation.org/article/brief-history-tax-expenditures.

[18] Ari Natter, *Credits to Spurt Renewable Energy Sources Seen Set to End: Taxes*, BLOOMBERG BUSINESS WEEK, (Sept. 30, 2013), http://www.businessweek.com/printer/articles/601156?type=bloomberg.

[19] William McBride, *A Brief History of Tax Expenditures*, TAX FOUNDATION FISCAL FACT NO. 391 (Aug. 22, 2013), http://taxfoundation.org/article/brief-history-tax-expenditures.

[20] Stephen J. Entin, *The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System*, TAX FOUNDATION BACKGROUND PAPER NO. 67 (Apr. 24, 3013), http://taxfoundation.org/article-ns/tax-treatment-capital-assets-and-its-effect-growth-expensing-depreciation-and-concept-cost-recovery.

11. Eliminate Refundable Tax Credits

Refundable tax credits, tax credits that exceed the recipient's income tax liability, are the fastest growing tax breaks in the federal tax code.[21] The Earned Income Tax Credit (EITC), which started in the 1970s as a modest supplement to the working poor, has grown through multiple legislative expansions to about $60 billion per year. The Child Credit started in the mid-1990s and has also grown to about $60 billion per year. The American Opportunity Tax Credit began in 2009 and now exceeds $20 billion per year. The EITC has the largest refundable portion, about $55 billion per year, making it the largest federal cash assistance program, exceeding both Supplemental Security Income and Temporary Assistance for Needy Families. While these tax credits may have laudable goals, running them through the tax code has some serious drawbacks. One problem is that they are a once-a-year windfall for recipients, which makes them less helpful for income security or work incentive purposes and more of a target for fraud and abuse.[22] The Treasury Department estimates that about 25 percent of EITC payments are made in error, representing about $15 billion per year.[23] Another problem with these tax credits is that they are phased out over some income range such that they discourage work and saving at the margin for millions of workers.[24] Finally, refundable credits contribute to the current precarious fiscal arrangement in which nearly half the population pays no federal income tax, and many receive money from the IRS, while a shrinking minority shoulders the lion's share of the federal tax burden.[25] The solution is to move such social welfare spending out of the tax code and place it under a spending agency subject to the annual appropriations process.

12. Maintain or Improve Other Provisions that Protect Savings and Investment

In addition to accelerated depreciation and preferential rates on capital gains and dividends, there are a number of provisions which fundamentally move the tax code in the direction of a saving-consumption neutral tax base.[26] These include widely used retirement account vehicles such as 401(k)s and IRAs, which were created to eliminate the double taxation of retirement savings. All savings should receive such

---

[21] William McBride, *A Brief History of Tax Expenditures*, TAX FOUNDATION FISCAL FACT NO. 391 (Aug. 22, 2013), http://taxfoundation.org/article/brief-history-tax-expenditures.

[22] *See*, *e.g.*, Government Accountability Office, Beryl H. Davis, *Improper Payments: Remaining Challenges and Strategies for Governmentwide Reduction Efforts*, GAO-12-573T (Mar. 28, 2012), http://www.gao.gov/assets/590/589681.pdf.

[23] Treasury Inspector General for Tax Administration, *The Internal Revenue Service is not in Compliance with Executive Order 13520 to Reduce Improper Payments* (Aug. 28, 2013), http://www.treasury.gov/tigta/auditreports/2013reports/201340084fr.pdf.

[24] Michael Schuyler & Stephen J. Entin, *The Economics of the Blank Slate: Estimating the Effects of Eliminating Major Tax Expenditures and Cutting Tax Rates*, TAX FOUNDATION FISCAL FACT NO. 378 (July 26, 2013), http://taxfoundation.org/article/economics-blank-slate-estimating-effects-eliminating-major-tax-expenditures-and-cutting-tax-rates.

[25] Will Freeland & Scott A. Hodge, *Tax Equity and the Growth of Nonpayers*, TAX FOUNDATION SPECIAL REPORT NO. 200 (July 20, 2012), http://taxfoundation.org/article/tax-equity-and-growth-nonpayers. *See also* Will Freeland, William McBride, & Ed Gerrish, *The Fiscal Cost of Nonpayers*, TAX FOUNDATION SPECIAL REPORT NO. 203 (Sept. 19, 2012), http://taxfoundation.org/article/fiscal-costs-nonpayers; Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2008 and 2009* (July 10, 2012), http://www.cbo.gov/publication/43373.

[26] William McBride, *A Brief History of Tax Expenditures*, TAX FOUNDATION FISCAL FACT NO. 391 (Aug. 22, 2013), http://taxfoundation.org/article/brief-history-tax-expenditures.

treatment, whether it be used for retirement or non-retirement purposes such as education, housing, business formation, etc. This would go a long way toward raising the chronically low savings rate in the U.S., giving workers more income security through the ups and downs of a typical career and giving investors more access to scarce capital.

Conclusion

The U.S. has an opportunity to become competitive again, at least in terms of tax policy. This will require lowering the tax burden on saving and investment, in some cases drastically. For instance, the U.S. has the highest corporate tax rate in the developed world and will need to drop it 15 points to match the average developed country and probably more to match the ongoing efforts abroad to lower the corporate tax burden. Other areas where the U.S. is increasingly uncompetitive include the tax treatment of capital cost recovery, foreign earnings, non-corporate business income, shareholder investment income, and estates. Reforming these taxes to better match our competitors would encourage more business investment, more hiring, and higher wages.

These reforms would also simplify the tax code and reduce the burden of compliance. The best way to simplify the tax code is to completely eliminate the most complex parts, including estate taxes, the Alternative Minimum Tax, PEP and Pease, and taxes arising from the ACA. Further, various corporate and social welfare programs run through the tax code should be removed from the tax code for the sake of simplicity as well as fiscal responsibility.

All together, these reforms would simplify the tax code, boost investment, and make the U.S. more competitive. The ensuing economic growth would generate substantial tax revenue as well, mainly from the growth of individual incomes. Finally, economic growth and a simpler tax code would benefit Americans across the income spectrum, particularly those who are currently unemployed.

National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045

202.464.6200
www.TaxFoundation.org