Moving Forward with Bipartisan Tax Policy

By

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Tax Foundation Working Paper No. 5

Tax Foundation
2001 L St. NW Suite 1050
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February 12, 2009

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U.S. tax policy is urgently in need of reform. Our tax system is overly complex and has failed to keep pace with changing economic conditions. The current economic crisis has led to an escalating budgetary shortfall, which will exacerbate the already significant fiscal challenges facing the country. Moreover, looming changes written into the tax law will require Congress to make major decisions regarding the tax code. On December 31, 2010, most of the tax cuts passed in 2001 and 2003 ("the Bush tax cuts") will expire. In the meantime, the Alternative Minimum Tax will fall on tens of millions more American families. And the federal estate tax is scheduled to disappear completely in 2010 before reappearing in 2011. If these changes were permitted to take effect, which is unlikely, they would lead to sudden and significant changes in effective tax rates, after-tax wages, returns to capital, and the distribution of the tax burden. Congress needs to act, not simply to move towards a more stable tax system but to create a tax system adequate to the demands of the twenty-first-century economy.

Under current law, the tax system is also set to raise more revenue. Since the end of World War II, federal revenues have averaged roughly 18 percent of GDP. They are expected to fall to 17.5 percent of GDP for fiscal year 2010 (in large part due to the current economic weakness) and then rise to 19.5 percent in fiscal year 2012, the year after the Bush tax cuts expire, and to 20.2 percent by 2018.[2] These increases may be welcome to some because they will bring revenues more in line with federal spending, which has averaged 21 percent of GDP over the past 25 years. Others will argue that spending should be reduced to match the historical revenue average.

Regardless of whether the tax cuts are extended, the gap between spending and revenues is projected to increase dramatically in the coming decades due to the effects of an aging population and rising per capita health care costs. Whatever disagreements there may be between those on the right and those on the left about the appropriate size of the federal government, the "correct" level of revenues is that which adequately covers the cost of government spending programs—if not year by year, then over the longer run. The unavoidable economic costs of raising revenue can and should be minimized by creating a tax structure that tries to minimize inefficiencies.

There is also a difference of opinion along the political spectrum over how progressive the tax code should be. Currently, the top 20 percent of earners pay nearly 75 percent of

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[2] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 8, 2009.

all federal taxes, while the lowest 20 percent pay only 0.4 percent.[3] Many left-leaning observers think the tax code should be more progressive—particularly in light of growing income inequality in the United States. Others on the right argue that there is already a tremendous amount of redistribution in both the tax and spending sides of the budget and that the negative incentives and distorting effects resulting from additional levels of progressivity could have a harmful effect on the economy and on living standards.

Federal policymakers face a choice: they can either continue to operate in a "reactive" mode, proposing tax legislation haphazardly, resorting to temporary fixes, and acting hastily when tax legislation is due to expire, or they can take a "proactive" stance, instituting farsighted reforms that will lead to an efficient and fair tax system for the long term.

Although the authors of this paper have divergent viewpoints as to the appropriate role and size of government, we agree that the current tax system is inadequate: it raises revenue inefficiently and is not well equipped to handle the challenges of the twenty-first century economy. We agree that the federal government should take the following steps:

- Create a more transparent and straightforward tax code
- Promote saving by shifting toward a progressive consumption tax
- Rethink tax expenditures
- Update U.S. business income taxes
- Implement an environmentally motivated tax policy

We believe that a productive discussion of tax reform must start where tax and budget policy considerations intersect. We agree on a number of changes that should be made to the tax code to improve its efficiency and transparency. And, most importantly, we believe tax reform has to be undertaken on a bipartisan basis if it is to be politically acceptable, economically sensible, and long lasting.

A Bipartisan Tax Policy

In thinking about how the tax system should be reformed, we first need to remind ourselves of the major goals of taxation: to raise a given amount of revenue in a manner that is as efficient (least economically distortionary), as fair (in terms of the distribution of the tax burden among different types of people), and as simple (in costs of administration, enforcement, and compliance) as possible. Given the current fragility of the U.S. economy, we might add that the tax system should also promote both short-term economic stability and long-term economic sustainability.

[3] The Tax Policy Center, http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=1390&topic2ID=40&topic3ID=41&DocTypeID=2

Despite our diverse perspectives on fiscal policy, we believe that achieving bipartisan tax reform is possible by adhering to the following broad principles and general prescriptions:

1. ***Stimulate, But Don't Squander.*** When it comes to tax policies pursued in the name of short-term "fiscal stimulus," the rule should be "first, do no harm." Countercyclical fiscal policy designed to stimulate demand-side economic activity should be pursued with consideration to how it will affect prospects for longer-term, supply-side economic growth. Stimulus that is or becomes permanent needs to meet clear long-term objectives and not be a backdoor mechanism for implementing permanent deficit-financed policies.

2. ***Broaden the Base, Lower the Rates***. Given the severe fiscal challenges confronting the nation, it is critical that we reform our tax system to provide a more efficient and reliable source of revenue. This calls for a broadening of the tax base in exchange for lower tax rates in general.

3. ***Reduce Economic Distortions Caused by Taxes***. For any given amount of revenue, achieving more uniform taxation of economic activity—by filling in the "holes" in the existing tax base and creating a more level playing field between the various forms of economic activity—will improve the economic efficiency of the tax code and reduce the distorting effects of taxes on household and business decisions.

4. ***Encourage National Saving.*** We could take an incremental approach to improving our national saving rate by creating better incentives within the existing tax system. Given our very low national saving rate, however, we should consider taking bolder action, moving our hybrid income/consumption tax system toward a full-fledged consumption-based tax, which is inherently less biased against saving**.**

5. ***Make the System More Transparent, Reducing Avoidance.*** The broader the tax base and the fewer the special preferences given to certain types of businesses, individuals, or activities, the simpler the tax system will be to understand and comply with, and the more likely it will be perceived as fair. The more transparent the tax system (and the more difficult tax avoidance is to conceal), the more trust taxpayers will have in government, and the more willing they will be to pay their taxes.

6. ***Maintain the Progressivity of the Tax System.*** Although income inequality has certainly grown over the past several decades, we are not able to define an "appropriate" level of fairness regarding the distribution of the tax burden. What we can say is that the current tax system is progressive by any objective standard and that achieving additional progressivity through a more graduated tax rate schedule carries with it real economic costs. Given the significant increase in

income inequality in recent decades, efforts to make the tax code more progressive should be undertaken with these costs in mind.

Policy Recommendations

Create a More Transparent and Straightforward Tax Code

An essential goal of tax reform must be to create a tax code whose principal purpose is to raise the revenues needed to support the federal government in a relatively straightforward and transparent manner. Such a tax code would be much simpler than the current tax code and therefore more easily understood by the taxpaying public (in principle if not in detail), and it could be designed to expose tax avoidance or evasion, thus possibly reducing the "tax gap." This would engender more confidence on the part of taxpayers that the system is basically fair—that others are paying their share and avoidance or evasion is being detected. Increased respect for the tax system is critically important to the health of our democracy since, aside from voting, paying taxes is the only direct contact most Americans have with their government.

Any tax system will affect economic activity, but the effects should be at the broadest possible level—encouraging overall investment versus investment in a particular type of activity, saving generally versus savings of a particular type, and charitable giving in general versus giving to favored causes.

Much of the complexity and opaqueness of our current tax code comes from tax expenditures (which we address below). A tax code that favors particular industries or sectors of the economy, or particular social goals, increases economic distortions. It also undermines respect for the tax system and greatly complicates its administration. A more transparent and simpler tax code could significantly increase the stability of the tax system, making it a more reliable source of revenue. Just as important, a more stable and dependable tax system would allow businesses and individuals to plan their finances with greater certainty.

Further policy changes are needed to improve compliance. Ours is a self-assessment tax system, which means that taxpayers compute and report their own taxable income and tax liability. For the most part, this task is completed with no oversight or review by the IRS. Almost all tax returns are accepted as filed. Complex and arcane tax provisions have led to a dramatic and well-publicized increase in the number of avoidance or evasion techniques promoted or aided by tax professionals of all stripes. Tax reform should not only reduce the complex provisions that invite such schemes but also clarify the responsibilities and duties of tax professionals.

For example, where a taxpayer is penalized for engaging in a structured tax avoidance scheme, a similar penalty should be imposed on the outside advisors and promoters. More broadly, the existing ethical rules published by the Treasury Department (Circular 230) should impose clear duties on tax professionals to investigate the facts supporting unusually large tax benefits claims, much like the SEC requires of counsel filing registration statements on behalf of clients.

Finally, action is required to deal with the Alternative Minimum Tax (AMT) and the upcoming expiration of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (the Bush tax cuts). There appears to be a clear political commitment to altering the AMT. Congress should end the practice of passing temporary annual patches and permanently reform the tax (or eliminate it completely) in a revenue neutral manner. One option would be to eliminate the AMT in conjunction with repeal of the current deduction for state and local taxes. Congress should also determine which of the expiring tax cuts it plans to keep in place and make them permanent in a revenue neutral manner. Given the large sums at stake, and the other significant changes that will have to be made to the rest of the budget, paying for these changes might be more effectively accomplished as part of a broader tax and spending reform program.

Promote Saving through the Tax Code by Moving Toward a Progressive Consumption Tax

One of the economically harmful characteristics of the current income tax is that it penalizes saving in favor of consumption. The tax penalty on saving reduces capital accumulation. When workers have less capital to work with, they become less productive, which lowers real wages throughout the economy relative to what they would have been. Research suggests that a shift to a consumption-based tax[4] could increase the size of the U.S. economy by as much as 9 percent in the long run, although some studies show smaller gains.[5] This is the main reason many economists have long embraced a shift toward consumption-based taxes.

It is the case that a consumption tax needs to be imposed at a higher tax rate than an income tax. This is a reflection of the larger tax base under an income tax, which includes the return to saving, while a consumption tax does not. But this does not mean that the higher tax rate under a consumption tax is more distorting, nor that that the higher tax

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[4] There are a number of different ways of taxing consumption. The most obvious approach is a national retail sales tax. But other consumption-based taxes include a value-added tax, the so-called Bradford X-tax, and a consumed-income tax. All of these alternatives have identical tax bases, but differ with respect to who (e.g., businesses or individuals) remits the tax to the government.

[5] See Alan J. Auerbach, “Tax Reform, Capital Allocation, Efficiency and Growth,” in *Economic Effects of Fundamental Tax Reform*, ed. Henry J. Aaron and William G. Gale (Washington, DC: Brookings Institution Press, 1996), 29–73 (which estimates long-run output gains of 3.2 percent to 9.7 percent from various proposals to replace the income tax with a consumption tax); President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* (Washington, DC: Government Printing Office, November 2005), 190, available at www.taxreformpanel.gov/final-report/ (which estimates a 6 percent long-run increase in output from the progressive consumption tax that it considered); and David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, “Simulating Fundamental Tax Reform in the United States,” *American Economic Review* 91 (June 2001): 574–95 (which reports long-run output gains ranging from less than 2 percent to more than 6 percent for various consumption-tax proposals).

rate erodes all of the economic benefits of taxing consumption. Indeed, as a general rule, a consumption tax that raises the same amount of revenue as an income tax will generally be less distorting and more conducive to economic growth.[6]

Nevertheless, a shift toward a consumption-based tax has raised several concerns. First, flat-rate consumption taxes are regressive because lower-income households tend to consume most of their income, while higher-income households do not. Second, a consumption tax raises serious transition issues because it imposes a one-time, lump-sum tax on existing capital. This may raise important intergenerational fairness issues because the elderly tend to hold a disproportionate share of the capital stock.[7] But eliminating that transitional wealth tax also would largely eliminate the efficiency advantages of a consumption tax.

There are ways to improve the regressive design of certain consumption taxes. The 2005 President's Panel on Reform of the Federal Tax System designed a distributionally neutral Bradford X-tax that imposed progressive rates on a consumption base. The X-tax imposes a business tax level tax on a firm's cash flow with a deduction for employee compensation and a household level tax on compensation. The bifurcated structure of the tax allows progressivity through a graduated tax schedule on workers' compensation. The Tax Panel also retained many of the tax preferences of the existing income tax, while refocusing their benefits toward low-income households. As the existing preferences reduce the tax base by roughly 40 percent relative to a comprehensive consumption tax base, there is considerable room to address progressivity.

The economic case for moving toward taxing consumption rather than income is convincing, though we believe it is only politically viable if is distributionally neutral. We see two possible approaches for shifting toward a consumption tax while stopping short of replacing the entire federal income tax system. First, changes could be made to the existing tax base to further reduce the tax on the return to saving and investment. An often underappreciated feature of the current tax system is that it is a hybrid income/consumption system. Tax-free savings accounts (e.g., individual retirement accounts, 401(k)s, and defined benefit pension plans) and accelerated depreciation introduce substantial elements of consumption tax treatment into the current tax base.

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[6] To see this, one needs to consider what each tax taxes and distorts. An income tax distorts the choice between current consumption and leisure, and future consumption and leisure. The latter distortion arises because an income tax taxes future consumption that occurs through saving (i.e., savings today that is later consumed). In addition, the income tax distorts the choice between consuming today and consuming tomorrow (this is just the tax penalty on saving under an income tax). A consumption tax also distorts the choice between consumption (both current and future) and leisure. What is not often recognized in this type of analysis is the fact that an income tax distorts the decision between future consumption and leisure (just as an income tax). Even though the consumption tax is imposed at a higher tax rate, only under rather strong assumptions would a consumption tax not be more efficient than an income tax. For a discussion of these assumptions see, for example, Alan Viard, "McMahon Off Base on Consumption Tax," *Tax Notes*, April 10, 2006; and David A. Weisbach, "The Case for a Consumption Tax," *Tax Notes*, March 20, 2006.

[7] This concern may be overstated to some extent because a substantial portion of the existing capital stock has already benefitted from consumption-type aspects of the current tax system, such as accelerated depreciation, and already trades at a discount.

Roughly 35 percent of household financial assets receive consumption tax treatment, and the effective marginal tax rate on business investment is only 25 percent, as compared to the 35 percent statutory tax rate.

Second, a consumption tax, such as a value-added tax (VAT), could be implemented with the revenue used to reduce the distorting features of the current income tax. For example, the Treasury Department estimates that a value-added tax of between 5 to 6 percent would raise enough revenue to replace all business income taxes. Alternatively, the revenue from the VAT could be used to fund a combination of deep reductions in the corporate tax rate and reductions in the double tax on corporate profits, and to address the regressive nature of such a tax through changes in the income tax base. Transition relief is not a crucial issue because the changes envisioned would either be incremental or involve a relatively small consumption tax.

Rethink Tax Expenditures

Tax expenditures—which in many instances may be described as spending programs run through the tax code—are one of the fastest-growing areas of the budget. The many tax credits, deductions, exemptions, and exclusions make up a huge portion of government-directed resources, and are one of the areas of the budget most in need of reform. Indeed, as shown in Figure 1, the various special provisions reduce the size of the tax base by nearly 45 percent relative to the comprehensive income tax base.[8] Repeal of all of these special provisions would allow a 34 percent across-the-board reduction in tax rates.[9]

Tax expenditures are typically used to encourage certain types of behavior—everything from saving to having children to home ownership. Before the 1986 tax reforms, tax expenditures were mainly directed toward corporations. Now, they are largely directed toward individuals and in support of social policies. Tax expenditures appeal to politicians because they can claim that they are cutting taxes while achieving desirable social outcomes and economic goals, but they have many shortcomings.

First, they are extremely costly and greatly complicate the tax code. The close to 200 tax breaks listed in the federal budget cost the government close to $1 trillion annually in lost revenue—in some years they cost more than the entire discretionary budget. And it is the many tax breaks, rather than the tax rates, that make the tax code so difficult for taxpayers to navigate.

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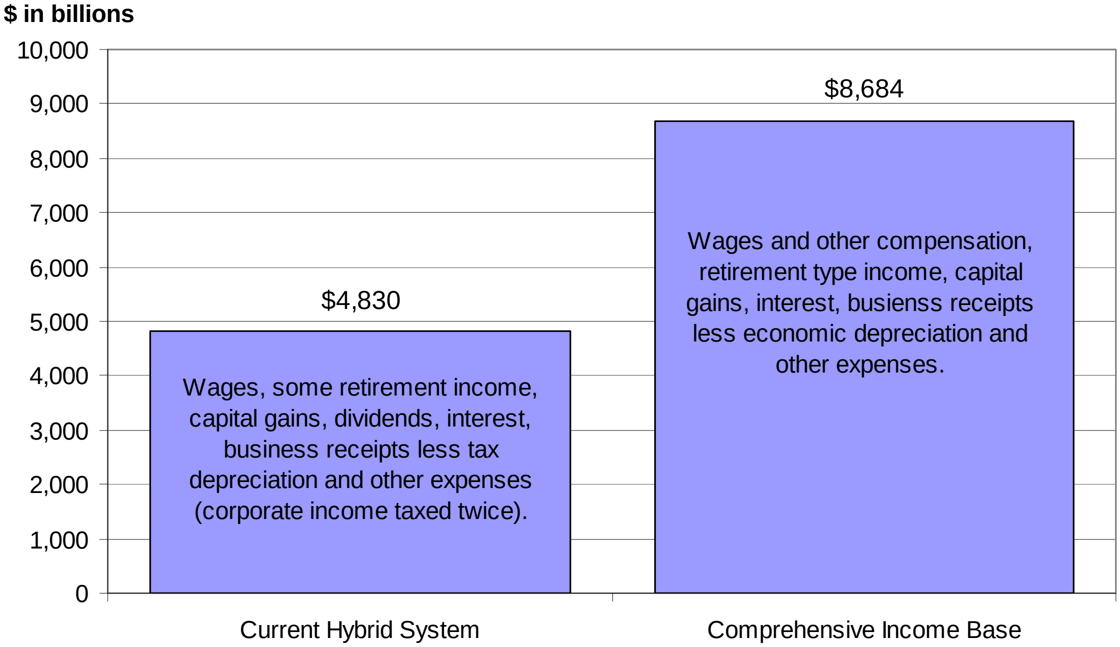
[8] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, DC: Government Printing Office, November 2005), 23, available at www.taxreformpanel.gov/final-report/.

[9] Ibid., 52. For example, the top 35 percent tax rate could be lowered to 23 percent and the bottom 10 percent tax rate could be lowered to 6.6 percent.

Fig. 1: Comparison of the current income tax base to a comprehensive income tax base, 2001



Source: President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, DC: Government Printing Office, November 2005), 23, available at www.taxreformpanel.gov/final-report/.

Second, when tax expenditures are created, they generally do not receive the same level of scrutiny that a comparable spending program would. The focus is almost entirely on the cost and distribution of the tax break, not on the more fundamental questions of whether there is a role for government in this type of program or whether the incentive is the most effective means for achieving a given goal. Further, once these tax programs are in place, they do not receive the same level of oversight as other spending programs. So while Department of Housing and Urban Development programs are subject to oversight and must be reauthorized on a regular basis, the home mortgage interest deduction and other housing programs that are run through the tax code do not receive nearly the same level of scrutiny.

Finally, most tax expenditures are regressive. Those that are designed as exclusions, exemptions, or deductions disproportionately benefit higher income taxpayers because of their higher tax rates. Although this regressivity at the margin is more than offset by the overall progressivity of the tax system, most voters (and many politicians) are unaware that it exists.

More to the point, many of these provisions shrink the size of the tax base, accrue disproportionately to higher-income individuals, require higher tax rates generally to raise the same amount of revenue, and require a more graduated tax rate schedule to achieve a given distribution of the tax burden. These high tax rates, which distort economic decision making and waste economic resources, are needed to "pay for" tax expenditures whose benefits are often dubious. The ability to pass off spending programs as tax cuts gives legislators an incentive to craft government programs in complicated, nontransparent, regressive ways without the normal level of scrutiny or oversight. We believe that reforming the system of tax expenditures—eliminating many and reformulating others—would vastly improve the tax code. A number of tax expenditures are in particular need of reform.

The exclusion for employer-provided health insurance, for instance, exempts employees from paying taxes on the value of the health insurance they receive from their employers. This policy amounts to a tax subsidy averaging roughly $350 billion a year through the next decade—more than 10 percent of federal revenues.[10] It would be desirable to either reduce the value of the exclusion—a policy supported by economists on both the left and the right—or eliminate it entirely. The current policy creates an incentive for employers to provide too much compensation in the form of health insurance and too little in the form of basic wages, which are taxed. It favors those who receive health insurance from their employers over those who purchase it on their own. And it ties up resources that could be better utilized elsewhere within the health care market or in other areas.

We also favor capping or reducing the home mortgage interest deduction. The current deduction, which allows homeowners to deduct the value of their interest payments on mortgages of up to $1 million, distorts economic decision making by favoring housing over other forms of consumption and investment, and homeowners over renters, and by encouraging the purchase of larger homes.[11] Some of the benefits may also be passed along—though higher prices—to homebuilders and mortgage brokers—explaining why they so actively lobby to save this tax deduction. Although changes would have to be phased in, with particular sensitivity to the current housing situation, bringing the value of the home mortgage interest deduction down from the $1 million level to something closer to the average house value in the United States would eliminate many of the existing distortions.

It would also be desirable to transform a number of existing progressive exemptions and exclusions into tax credits. For example, turning existing provisions that are structured as tax deductions for education, or the personal exemption, into tax credits would mean that all taxpayers would receive the same benefit regardless of their level of income.

Overall, tax expenditures should be treated more like spending programs. Those that are outdated or are no longer achieving their purposes should be eliminated. There are many overlapping programs that should be consolidated and redrawn. There will certainly be

[10] "Estimating the Revenue Effects of the Administration's Fiscal Year 2008 Proposal Providing a Standard Deduction for Health Insurance: Modeling and Assumptions," Joint Committee on Taxation JCX-17-07 (March 24, 2007), Table 1, 20, available at www.jct.gov/x-17-07.pdf. This estimate includes the exclusion for both income and payroll tax purposes. About two-thirds of the subsidy arises from the income tax exclusion, while the remaining third arises from the payroll tax exclusion.

[11] The effective cap is actually somewhat higher, at $1.1 million, because taxpayers may also deduct interest on up to $100,000 in home equity debt.

disagreement about whether to use the freed-up revenues to offset the costs of new spending programs, lower other taxes, or reduce the deficit, but there is little doubt that reforming and reducing the number of tax expenditures would improve the basic structure of the tax code.

Update U.S. Business Income Taxes

The U.S. business tax system is also in need of reform. U.S. business taxes are increasingly out of line internationally, which may affect the competitiveness of the United States and its attractiveness to investors. In the mid-1980s, the United States dramatically reduced its statutory corporate tax rate and became, by some standards, a low-tax-rate country. However, most other countries have since reduced their corporate tax rates, leaving the United States with the second highest statutory corporate income tax rate among member nations of the Organisation for Economic Co-operation and Development (OECD). Moreover, other countries continue to reform their business tax systems. Nine OECD member nations—including Canada, Germany, the United Kingdom, Italy, Switzerland, Spain, New Zealand, and the Czech Republic—lowered their corporate tax rates between 2007 and 2008.

This trend is not limited to the statutory corporate tax rate. Indeed, the decline in the statutory corporate tax rate abroad is emblematic of broader changes in foreign business tax systems. More comprehensive measures of tax rates, such as the effective marginal tax rate,[12] which include other aspects of business tax systems such as the value of tax depreciation schedules and investor-level taxes, tell a similar story (see Figure 2). (The rate at which investment is written off or depreciated, investor level taxes, and reliance on consumption taxes, also affect a nation's competitiveness.)

Relative to the large developed economies of the G-7 nations, with which the United States has substantial trade flows, the United States has an effective marginal tax rate on investment well above the average. For the broader group of OECD nations, which includes a number of nations with smaller economies, the United States has an effective tax rate at about the average. But what is particularly alarming is the trend depicted in Figure 2, where the relative position of the United States has deteriorated. While the effective marginal tax rate on investment has fallen on average by 30 percent to 40 percent elsewhere, it has remained largely unchanged in the United States.[13]

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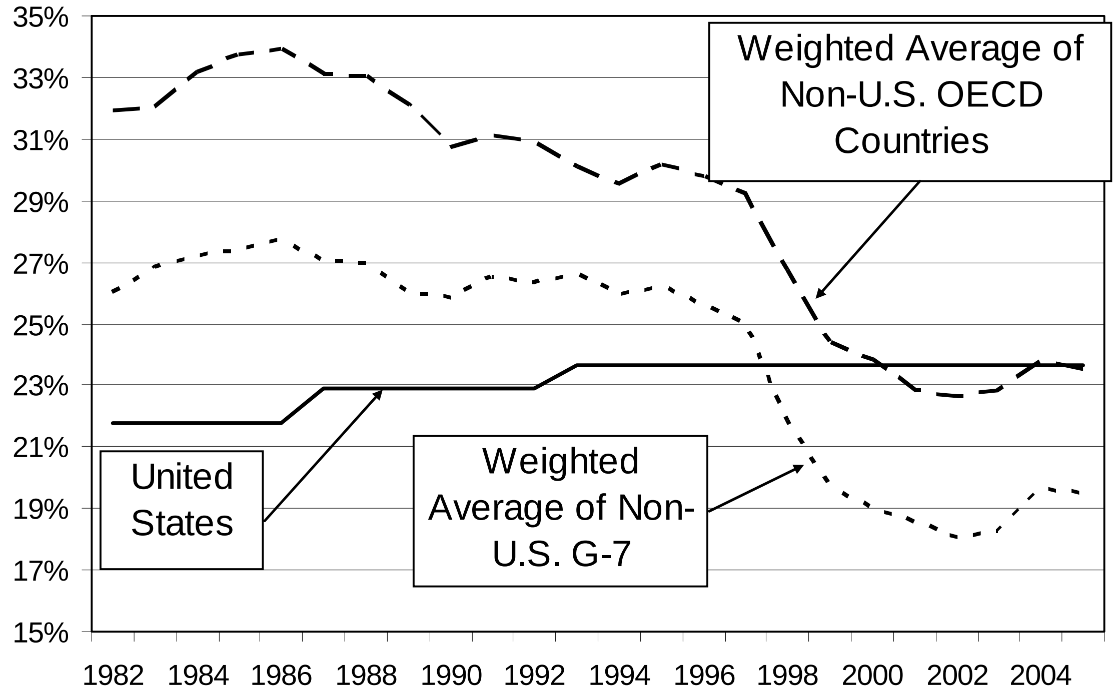
[12] The effective marginal tax rate, derived from an estimate of the cost of capital, shows the share of an investment's economic income needed to cover taxes over its lifetime in order to compare the investment climate across countries.

[13] A variety of nontax factors, such as labor productivity, education levels, basic infrastructure and transportation networks, access to markets, and the regulatory environment, are also important to a nation's competitiveness. Absent clear evidence that the United States has made major gains among the nontax factors, its competitiveness has likely been adversely affected by its failure to keep pace with the business tax trends abroad.

Fig. 2: The falling effective marginal tax rate abroad.



Source: Institute for Fiscal Studies (www.ifs.org) and the Organisation for Economic Co-operation and Development (www.oecd.org).

Although it remains unclear precisely to what extent corporate taxes affect real wages and living standards, current research suggests that real wages are sensitive to corporate taxes. The intuitive thinking behind this research is that taxes tend to be borne by the least mobile factor of production (e.g., labor or capital). In the global economy, capital is highly mobile, while labor is not. According to a study by the Congressional Budget Office, in an open economy framework as much as 70 percent of the corporate tax may be borne by labor.[14] Another empirical study suggests that between 45 percent and 75 percent the corporate tax is likely borne by labor.[15] Other studies show that the countries that have reduced corporate tax rates the most have tended to have the largest gains in real wages.[16] Thus, a substantial share of business taxes tends to be reflected in real

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[14] William Randolph, *International Burdens of the Corporate Income Tax*, Congressional Budget Office Working Paper Series, 2006–09, August 2006.

[15] Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," International Tax Policy Forum, December 2007.

[16] Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffin "The Incidence of Corporate Income Taxes on Wages," mimeograph, University of Warwick, September 2007; Kevin Hassett and Aparna Mathur, *Taxes and Wages*, American Enterprise Institute for Public Policy Research, Working Paper Number 123, June 2006; Alison Felix, "Passing the Burden: Corporate Tax Incidence in Open Economies," Ph.D. diss., University of Michigan, 2007, ch. 1.

wages rather than in the return to capital. Corporate tax rates have the effect of reducing capital accumulation, which lowers labor productivity and, ultimately, real wages and living standards.

The lesson for us is that the United States should place less emphasis on business income taxes for financing government. Policies that lower the effective marginal tax rate on investment the most per dollar of revenue may well provide the biggest "bang for the buck." Faster write-off of business investment, which limits tax relief to future investment and to the expected normal return, may be the most economically efficient policy. But, lowering the statutory corporate tax rate, which reduces the tax on the return to both new and existing investment, and on the full return to investment, may also reduce incentives for firms to shift profits and expenses across countries to minimize their taxes.

More uniform treatment of business activity would also help improve economic performance. When one type of investment is taxed more heavily than another, capital flows to the low-taxed activity. Unless there are clear policy objectives and economic benefits, capital will not be allocated to its most productive use. Nonuniform treatment arises in a number of areas under the current business tax system. First, there are numerous tax provisions that provide special tax treatment to specific types of activities. These special provisions narrow the tax base and require higher statutory tax rates generally. A recent Treasury study found that the top statutory tax rate could be reduced from 35 percent to 31 percent by repealing all of these special tax provisions. Retention of any of these special provisions should require that a clear and convincing case be made as to their economic benefits.

Second, the U.S. tax system imposes a double tax on equity-financed corporate investment. Corporate income is first taxed at the corporate level and then again when either paid out to shareholders as dividends or retained and later realized as capital gains by investors. As shown in Table 1, this double tax leads to substantially high effective marginal tax rates in the corporate sector (29.4 percent), compared to similar investment in the noncorporate sector (20 percent). The result is a tax bias against investment in the corporate form and a misallocation of capital between the corporate and noncorporate sectors that reduces output. The double tax also affects corporate dividend policy, which can have important implications for corporate governance.

Most developed nations have provided relief from the double tax by integrating their individual and corporate tax systems in various ways.[17] The United States took a partial step toward reducing the double tax in 2003 by lowering the taxes on dividends and capital gains. Nevertheless, a substantial double tax remains that could be addressed by further reduction in dividends and capital gains tax rates or some other equivalent approach.

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[17] The major approaches for eliminating or reducing the double tax include a dividend exclusion or lower tax rate for investors, allowing a credit for corporate level taxes (imputation credit system), or allowing a corporate deduction for dividends (dividend deduction system).

Table 1: Unequal Treatment of New Investment by the Current Tax System

	Effective Marginal Tax Rate (%)
Business	25.5
Corporate Business	29.4
Asset type	
Equipment	25.3
Structures	34.2
Financing	
Debt-financed	-2.2
Equity-financed	39.7
Non-corporate business	20.0
Owner-occupied housing	3.5
Economy-wide	17.3

Source: U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 26, 2007, Table 4.1, 34.

Third, and related to the double tax issue, is the very unequal treatment of debt and equity finance under the U.S. tax system. While the return to equity-financed investment may be taxed once, or perhaps twice if the investment is made through the corporate form, as shown in Table 1, the return to debt-financed investment is subject to a negative effective marginal tax rate (that is, it is subsidized). Why do the negative effective tax rates arise? First, interest expenses are deductible at the business level. Second, even though interest income is fully taxable to individuals, by some estimates roughly 50 percent of debt holders are tax exempt or lightly taxed (e.g., pension plans or other tax-free saving plans/accounts, or foreigners). The result is a very substantial tax bias toward debt-financed investment and against equity-financed investment. This bias leads to a misallocation of capital and may increase the risks to the economy. This may be a particular problem during periods of economic weakness, such as during the current financial crisis, where highly leveraged firms are more likely to be susceptible to bankruptcy and financial distress.

Substantial changes are needed to remedy these imbalances in the U.S. business tax system. We should consider lowering the corporate tax rate, broadening the tax base and permitting faster write-offs of business investment. A lower corporate tax rate would also reduce the tax bias toward debt-financed investment, and the distortion between investments made in the corporate and noncorporate sectors. Restricting the deductibility of interest would more directly address the imbalance between debt and equity finance.

Replacing the corporate income tax (or all business income taxes) with a VAT-type tax would simultaneously address all of these imbalances. The corporate income tax could be replaced with a 5–6 percent value-added tax.[18] This approach could dramatically lower the business tax rate: the statutory tax rate would fall from 35 percent to the 5–6 percent tax rate on a firm's cash flow, and the economy-wide effective marginal tax rate would fall from its current level of 17 percent to 8 percent.[19] It could also eliminate all special tax provisions and would have the effect of allowing all business investment (i.e., equipment, structures, inventories, and land) to be expensed or written off immediately. Finally, a value-added tax would also equalize the tax treatment of debt and equity by removing all financial transactions from the tax base (i.e., both interest income and interest expenses).[20] Alternatively, a partial approach could be taken, with a 2 percent to 3 percent VAT replacing half of current business income taxes.

One of the criticisms of this approach, however, is that a value-added tax would also deny the deductibility of wages and other employee compensation at the firm level, which would directly increase the tax on labor. This is one of the reasons that value-added taxes are viewed as regressive. However, if business income taxes do in fact reduce real wages, this criticism may be overstated because one tax borne by labor would be replaced by another tax also borne by labor.

Implement an Environmentally Motivated Tax Policy

In addition to creating a tax code that is more economically efficient, with a broader base and lower rates, we believe we should generally treat different forms of economic activity more uniformly by reducing the "holes" (exemptions, deductions, and credits) in the existing income tax base that distort economic decision making (see the discussion of tax expenditures above).We can also think "outside the income tax box" by adding items and activities to the taxable base in ways that would allow their taxation to actually enhance, rather than reduce, the efficient allocation of resources. It is under this second category that environmentally motivated taxes fall.

Nearly all economists, of all political and ideological persuasions, agree that in some special cases where there is private market "failure" government policies that intentionally alter relative prices can improve the allocation of resources. In the case of activities generating "negative externalities," a "corrective tax" on such activities can internalize the social costs that are otherwise external to private-market decisions; i.e., the tax can "correct" the mismatch between private and social marginal costs.

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[18] U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007, 27.
[19] Ibid., 32.
[20] Financial services should be included in the tax base of either an income or consumption. The taxation of financial services, however, can be complicated because of the "implicit fees" imbedded in interest rate spreads, and generally would require a special regime to prevent over or under taxation of consumers and businesses.

Many environmentally harmful activities produce negative externalities, because such activities degrade the quality of public goods, or generate public "bads," without imposing a corresponding private cost or charge on those engaging in the activities. Environmental quality is "consumed" but goes unpriced; as a result, relative to what would be optimal for society, excessive degradation of environmental quality occurs. Because the adverse consequences of environmentally harmful activities typically stretch far into the future over many generations, another reason social costs exceed private costs is because most private-market decisions are shortsighted and do not account for costs and benefits over such a distant horizon.

A particular type of "corrective tax" that has been held in high regard among economists for many years, and has more recently gained the interest of policymakers, is the carbon tax. Emissions of carbon dioxide (CO_2) contribute to global warming (a public "bad"), but the private market underprices products with a high carbon content. A tax based on carbon content could help align social ends with private costs, leading to a more efficient mix of energy consumption, reduced carbon dioxide emissions, and a slowdown in global warming. Such a tax would also have a potentially broad base and therefore even at relatively low rates could raise substantial amounts of revenue that could be used for deficit reduction or reducing inefficient taxes.

Creating a market for carbon, whether labeled a "tax" policy or a "permits" policy, is our recommended approach to environmentally motivated revenue policy. In the last (110th) Congress, significant progress was made on bipartisan legislation for a carbon cap-and-trade program, where permits for the right to use carbon-based fuels (and emit CO_2) would be distributed to producers (either free or by auction), and a tradable market for the permits would create a market price on carbon. Note that an auctioned-permits policy is equivalent to a carbon tax policy if the quantity of auctioned permits is set so that the market-clearing price is equal to the size of the tax, and if the auction proceeds go to the government. In practice, there will be uncertainty about how to set either the "right quantity" or the "right price": the tax policy must set the price, and the permits policy must set the quantity. Under either approach, these are policy choices that can be adjusted along the way. We think it is essential not to give away too much of the value of the new carbon market to producers, which would both eliminate the potentially valuable uses for the revenue (i.e., reducing other distortionary policies) as well as limit the government's ability to adjust the policy's distributional effects.

Of course, designing and implementing a broad-based carbon tax is uncharted territory for the United States and in fact for the rest of the world, especially with respect to the trade-offs involved in setting the tax base (between comprehensiveness and administrative ease) and scheduling/phasing-in the tax rates (between economic effectiveness versus political palatability).[21] Some experts prefer a "cold turkey" approach, introducing the carbon tax without any special provision for transition, because it maximizes the "anticipation effect," which encourages businesses to start "behaving

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[21] Gilbert Metcalf and David Weisbach, "The Design of a Carbon Tax," *Harvard Environmental Law Review*, forthcoming 2009.

better" immediately.[22] Others agree that a bold and certain carbon policy should be announced as quickly as possible, even if not immediately implemented, to allow businesses to make their longer-term plans and investments with clear and strong price signals in place.[23]

The lack of global experience with comprehensive carbon taxes as well as the much greater familiarity with permit systems in the United States as a market-based environmental policy tool (and reluctance to adopt a major new "tax") have led some environmental policy experts to recommend a hybrid approach to reducing CO_2 emissions—a cap-and-trade permits (or "allowances") program with a "safety valve" price mechanism. Under such an option, policymakers would set a cap on carbon emissions and allow firms to buy and sell allowances among themselves, but an upper limit on the market price of those allowances would also be established. If the allowances proved scarce enough that the market price were bid up above this upper limit, the government would sell as many additional allowances as necessary (release the "safety valve") to bring the market price back down to that limit. Even if the initial allowances were distributed freely to producers, the hybrid policy could be adjusted over time to move closer to the tax policy by gradually setting tighter caps and correspondingly increasing the fraction of allowances auctioned off by the government. With relatively inelastic demand for allowances, safety-valve prices could also be gradually increased to raise more revenue while achieving pricing that is closer to the social optimum.

The potential revenue from a carbon tax is substantial: the Congressional Budget Office recently estimated that the range of carbon policies now being debated suggests a market value of carbon allowances of between $50 billion and $300 billion annually.[24] It should be noted, however, that a properly designed carbon tax, while improving things from an environmental standpoint (by reducing activities that produce CO_2 emissions), would have a negative effect on overall economic output. One recent study estimated that a cap and trade program would reduce output in the long run by between 0.3 percent and 0.9 percent.[25] To compensate for this decline, revenues from the carbon tax should be used for policies that enhance growth. We believe that a portion of the revenue from a carbon tax should be used to reduce other, more distortionary, taxes, such as those on labor or capital income.[26]

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[22] Ibid.

[23] Richard D. Morgenstern, "Get Tough on Emissions without Hurting Economy," *The Hill*, December 16, 2008.

[24] Peter R. Orszag, "Issues in Designing a Cap-and-Trade Program for Carbon Dioxide Emissions," CBO Testimony before the Committee on Ways and Means, U.S. House of Representatives, September 18, 2008.

[25] See, Energy Information Administration, "Energy Market and Economic Impacts of S. 2191, the Lieberman-Warner Climate Security Act of 2007," U.S. Department of the Energy, April 2008, Table 4, 37. This reflects a range of estimated effects of the Lieberman-Warner Climate Security Act (S. 2191) in 2020. The range of estimates reflects different technological assumptions, the ability to use international offsets to meet allowance requirements, and various other factors.

[26] Recent estimates of industry effects suggest that such a "modest" tax (of around $25 per metric ton of CO_2) would generate significant cost increases (on the order of 10 percent) for only a few industries (such as petrochemical manufacturing and cement) and only in the "very short run" where output prices cannot be changed and profits therefore fall accordingly. The research concludes that although the short-run output

In addition to the potential negative effect of a carbon tax on economic growth, another common concern about a carbon tax or cap-and-trade program is the distribution of its burden. A carbon tax will generally raise the prices of goods and services, with after-tax prices rising the most for those goods with the highest carbon content. In some respects, a carbon tax may mimic a broad-based consumption tax—a tax that tends to be "regressive" in incidence because lower-income households consume larger fractions of their income.

Efforts to mitigate the regressivity of a carbon tax should be implemented through the overall tax system, particularly the income tax, rather than through exemptions built into the carbon tax itself. This is both because the carbon tax is an "indirect" tax levied on businesses and the carbon content of energy sources they use, not a "direct" tax on households (and hence is too blunt an instrument for redistributive policy), and because exempting certain parts of the carbon tax base for distributional reasons would dilute the tax and thus reduce its economic benefits.

The Political Moment for Bipartisan Tax Reform

The new administration clearly has a lot on its plate, including developing an effective economic stimulus package, dealing with the banking and housing crises, and taking steps to address the unsustainable fiscal situation facing the country. Wisely, it has already indicated that it plans to include fundamental tax reform as part of its approach to fixing the economy and addressing the long-term budgetary imbalances.

It is relatively easy to agree about some of the major problems plaguing the tax system, as well as the principles—simplicity, transparency, efficiency, and equity—that should drive reform. It is more difficult, however, to come up with specific policy proposals, particularly when bipartisan support is essential to a successful reform package. We believe that the approach and specific policies laid out here can serve as an excellent starting point for developing a comprehensive, bipartisan proposal that would vastly improve our tax system.

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reductions would be relatively large in such industries, over time, as firms adjust inputs and adopt new technologies, these industries would rebound (some, virtually completely). See Mun S. Ho, Richard Morgenstern, and Jhih-Shyang Shih, "Impact of Carbon Price Policies on U.S. Industry," Resources for the Future discussion paper (RFF DP 08-37), November 2008.