# *The Hidden Cost of*
# Federal Tax Policy

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# Key Principles for Successful, Sustainable Tax Reform

The most basic goal of tax policy is to raise enough revenue to meet the government's spending requirements while having the least impact on market behavior.[1] But as the chapters in this book have shown, the US tax code has long failed to meet this aim: By distorting market decisions and the allocation of resources, the tax code distorts behavior, hampers job creation, and impedes both potential economic growth and potential tax revenue.

Although agreement on the need for tax reform appears to be widespread, there is no consensus—between or within political parties—on specific elements of reform. But academic research highlighted in this book suggests that a successful tax revenue system should have the following characteristics:

- *Simplicity*. The complexity of the present tax system makes compliance difficult and costly. Congress should make the tax code as simple and transparent as possible so as to increase compliance and reduce associated costs.
- *Equity*. The existing tax code is riddled with policies intended to benefit or penalize select

individuals and groups. These policies result in immeasurable unintended consequences. Fairness is subjective, but any attempt to attain income tax fairness would at least reduce the number of provisions in the tax code that favor one group or economic activity over another. The federal government should not be in the business of picking winners and losers.

- *Efficiency*. Because the tax code alters market decisions in areas such as work, saving, investment, and job creation, it impedes economic growth and reduces potential tax revenue. An efficient tax system must provide sufficient revenue to fund the government's essential services but have minimal impact on taxpayer behavior.
- *Permanency and predictability*. The negative effects of the current tax code result not just from what it does today but also from what it may do in the future. Such uncertainty deters economic growth. An environment conducive to growth (and thus increased revenue as a result of a larger economy) requires a tax code that provides both near- and long-term predictability. Temporary tax provisions should be avoided. Instead, the focus should be on ways to increase economic growth, saving, and investment, keeping in mind that a larger economy will result in larger tax revenue.

There is broad consensus across academic research as to which tax policies are most likely to promote solid, sustainable economic growth and tax revenue—and which policies are most likely to fail. The following principles stand out:

- *Lower the rates of taxation*. Extensive economic research has found this most basic effect: the more you tax capital or labor, the less you get of both. The research also makes clear that incentives matter. Successful tax reform will lower both individual and corporate tax rates.
- *Avoid double taxation*. For economic efficiency, it is important that income be taxed once and only once. There is much concern that those who report significant earnings from capital gains or dividends are taxed at a lower rate than those who have only earned income. But this way of thinking fails to accurately reflect the incidence of the corporate income tax, which is increasingly borne by workers as our economy continues to rely on free trade and open markets.
- *Broaden the tax base and eliminate loopholes*. One of the key principles to successful fiscal reform is to move away from a spending system that depends on an easily manipulated income tax system. Tax reform should lower rates, broaden the tax base, and eliminate loopholes. Such changes will increase stability and lead to greater economic growth, added employment, and perhaps even increased tax revenue.
- *Reduce bad incentives*. Predictable tax policy is essential to long-term economic growth. Generally, policymakers should avoid temporary tax provisions, especially when trying to correct

> or rectify a permanent problem. Furthermore, allowing any provisions that favor one group or activity over another only puts the government in the position of picking winners and losers.

History has shown that tax reforms seldom last when special interests have substantial incentives to lobby Congress for tax breaks. Making the tax code as simple—by taxing a broad base at the same low rate—and as transparent as possible will help reduce the ability and incentives to reverse future tax reforms.

The current tax code is detrimental to our economy. Our tax system distorts market decisions and the allocation of resources. It hampers job creation and impedes both potential economic growth and potential tax revenue. Tax expenditures also set up a system that allows the federal government to discriminate among taxpayers by picking winners and losers. Provisions and reforms that level the playing field so that everyone plays by the same rules should be promoted over those that discriminate. Only by removing the distortions of the current tax code can the United States realize its economic potential.

29. Ibid., 230.
30. Ibid.
31. Feenberg and Rosen, "Recent Developments in the Marriage Tax," 7. This example is specific to a couple in which each earner receives $10,000 per year in income with two dependent children after the 1993 tax reform act.
32. Dickert-Conlin, "Taxes and Transfers," 221.
33. Bar and Leukhina, "To Work or Not to Work?," 2.
34. Eissa and Hoynes, "Explaining the Fall and Rise in the Tax Cost of Marriage," 683.
35. Ibid., 685.
36. Bar and Leukhina, "To Work or Not to Work?," 3.
37. Ibid., 14.
38. Alm and Whittington, "Shacking Up or Shelling Out," 16.
39. Joint Economic Committee, "Reducing Marriage Taxes: Issues and Proposals," Washington, DC, May 1998.
40. A form of income splitting already exists in the United States. However, it applies only to owners of profitable small corporations paying themselves under categorizations of employee salaries and bonuses. Some researchers argue that the expanded brackets for joint filers are a form of income splitting. This chapter refers to potential income splitting in the context of direct proportionality to the "single" tax bracket.
41. Stephen Matthews, "Trends in Top Incomes and Their Tax Policy Implications," OECD Taxation Working Paper 4, Organisation for Economic Co-operation and Development, Paris, November 3, 2011, 37.
42. Joint Economic Committee, "Reducing Marriage Taxes," 8.
43. Whittington and Alm, "Tax Reductions, Tax Changes, and the Marriage Penalty," 472.
44. Eissa and Hoynes, "Explaining the Fall and Rise in the Tax Cost of Marriage," 685.

## CONCLUSION: KEY PRINCIPLES FOR SUCCESSFUL, SUSTAINABLE TAX REFORM

1. As noted in the introduction to this book, meeting the government's spending requirements is not a mandate to raise taxes to higher levels to support even higher levels of government spending. Although good tax reform will increase economic growth and such growth will increase tax revenue to some extent, the United States spends more money than it collects

and needs to reduce its spending. Discussions on how the federal government should reduce spending are outside the scope of this book, but interested readers looking for ideas can start here: Jason Fichtner, "The 1 Percent Solution," Mercatus Working Paper 11-05, Mercatus Center at George Mason University, Arlington, VA, February 2011.