The Hidden Cost of Federal Tax Policy

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INTRODUCTION

What Are the Goals of Tax Policy?

The most basic goal of tax policy is to raise enough revenue to meet the government's spending requirements in the way that has the least impact on market behavior.[1] But the US tax code has long failed to meet this aim: by distorting market decisions and the allocation of resources, the tax code hampers job creation and impedes both potential economic growth and potential tax revenue. This book does not distinguish tax provisions in terms of "good" or "bad" policy. Instead, it sets forth a general framework for evaluating any tax provision and delineates key problems existing within the tax code today.

To increase employment and expand their economies, most developed countries are both reducing their corporate tax rates and restructuring their tax systems to make them simpler. The United States appears to be taking the opposite approach. Dozens of tax provisions set to expire every year are extended repeatedly in a seemingly endless cycle. This process is evidence of the tax code's complex and temporary nature—two faults that increase both uncertainty and costs for American people and businesses. As we discuss in chapter 1, the costs of tax compliance

may be nearly a trillion dollars annually in cumulative accounting costs, economic losses, and lobbying expenditures.

Although the need for major tax reform is widely recognized, there is no consensus—either between or within the political parties—on the specific elements of reform. To move the debate forward, policymakers need to understand the goals of successful tax reform and what steps to take to achieve those goals.

Clearly, the nation's economic and fiscal situation has increased the motivation—and the urgency—to reform the federal tax revenue system, along with the federal government's other unsustainable institutions and practices. But what would an ideal tax code look like?

Luckily, policymakers need not fly blind when it comes to defining the principles and goals key to a successful revenue system. Academic research suggests that a successful system should be simple, equitable, efficient, permanent, and predictable. We explore these themes in the chapters that follow.

Some have claimed the Tax Reform Act of 1986 (TRA86) is model legislation for what future tax reform should be. TRA86 was remarkable for its broad bipartisan support in Congress and for its sweeping reforms. But because the legislation failed to fix the revenue system's large institutional problems, the reforms were clawed back almost immediately. As a result, the tax code looks even worse today. For example, in 1985, there were only 25 temporary tax provisions; in 2010, 141 provisions were set to expire by the end of 2012.[2] Chapter 2, "What Can Be Learned from

the Tax Reform Act of 1986?," provides key insights into why the act was considered one of the most successful tax reforms in US history—and also one of the biggest failures. One key lesson is that keeping 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.[3]

One thing policymakers should not do is raise tax rates. There is much research to support the negative consequences of raising tax rates on economic growth. Research by Christina Romer, former chair of President Obama's Council of Economic Advisers, and David Romer, an economist at the University of California–Berkeley, suggests, "A tax increase of 1 percent of GDP reduces output over the next three years by nearly 3 percent."[4] Furthermore, according to research by Harvard University economist Jeffrey Miron, "Both macroeconomic and microeconomic perspectives suggest that [higher] taxes slow economic growth, thereby limiting the scope for revenue gains."[5] To regain competitiveness, the United States should reduce its corporate tax rate to 25 percent at most, the average rate of other Organisation for Economic Co-operation and Development countries. Chapter 3, "Why Should Congress Restructure the Corporate Income Tax?," examines trends in international corporate tax rates and discusses why the United States needs to lower the corporate tax rate to increase competitiveness.

Those who advocate for higher taxes on business should note two things. First, the statutory corporate

tax rate in the United States is among the highest in the industrial world—a factor that encourages businesses to move to lower-tax countries, taking jobs, money, and tax dollars with them. Second, a tax on corporations is actually a tax on labor. A Congressional Budget Office working paper finds that "domestic labor bears slightly more than 70 percent of the burden of the corporate income tax."[6] Chapter 4, "Why Do Workers Bear a Significant Share of the Corporate Income Tax?," concludes that key pieces of the burden in today's modern open economy are borne by labor rather than by the owners of capital.

As discussed in chapter 5, "How Does the Corporate Tax Code Distort Capital Investments?," the current US tax code is complex—carved up by special interests and full of distortionary tax rates that treat similar activities unequally. Unequal taxation inefficiently distorts consumer and investor decisions, which can be damaging to the economy. These problems are particularly egregious regarding the tax rules applied to corporate capital investments. The tax code requires that most new purchases of capital, such as machines and buildings, be deducted from total revenue over the course of many years. This provision is called *depreciation*, or *capital cost recovery*. Unequal tax rates develop across industries because of disparities in when the tax is paid. A one-dollar investment today can be reduced to as little as 37 cents of its real write-off value, thereby diminishing the profitability of investments.[7] As shown in chapter 5, moving away from complex depreciation schedules toward full expensing can be

one of many necessary tools to move toward a better tax system.

Consumer advocates view the mortgage interest deduction (MID) as a benefit for lower- and middle-income taxpayers.[8] Yet in chapter 6, “Why Should Congress Reform the Mortgage Interest Deduction?,” data are presented that show that fewer than 9.8 percent of tax filers earning less than $50,000 claim the MID, and this group comprises the very same households that would gain the most from the sociological benefits of homeownership. In fact, most of the dollar benefits from the MID go to high-income earners whose average tax benefit from the deduction is nearly nine times greater than that of households earning $50,000 to $100,000. The chapter concludes that reforming the MID is essential to both increasing homeownership and properly aligning the deduction’s policy goals with actual outcomes.

Allowing any tax provisions that favor one group or activity over others only puts the government in the position of picking winners and losers. Chapter 7, “How Do People Respond to the Marriage Tax Penalty?,” provides a key example of unequal taxation among couples whose only differing characteristic is their marital status. For low-income taxpayers, the marriage tax penalty is a formidable barrier to the social benefits of marriage, while married high-income taxpayers are often discouraged from working.

History has shown that tax reforms seldom last when special interests have substantial incentives to lobby Congress for tax breaks. This book concludes

that the current US tax code is detrimental to the economy. The US tax system severely 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 government to discriminate among taxpayers by picking winners and losers. Provisions and reforms that level the playing field should be promoted over rules that discriminate.

NOTES

INTRODUCTION: WHAT ARE THE GOALS OF TAX POLICY?

1. It should be noted at the outset that 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 25, 2011.
2. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986 before the United States Committee on Finance*, 111th Cong., 2nd session (September 23, 2010) (testimony of Randall D. Weiss, managing director of economic research, The Conference Board, New York, "How Did the 1986 Tax Reform Act Attract So Much Support?").
3. Jason Fichtner and Katelyn Christ, "Uncertainty and Taxes: A Fatal Policy Mix," Mercatus Working Paper 10-74, Mercatus Center at George Mason University, Arlington, VA, December 2010.
4. Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review* 100, no. 3 (June 2010): 763–801.
5. Jeffrey Miron, "The Negative Consequences of Government Expenditure," Mercatus Working Paper 10-55, Mercatus Center at George Mason University, Arlington, VA, September 2010.

6. William C. Randolph, "International Burdens of the Corporate Income Tax," Working Paper 2006-09, Congressional Budget Office, Washington, DC, August 2006.
7. 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," Background Paper 67, Tax Foundation, Washington, DC, April 2013.
8. Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in *Tax Policy and the Economy*, ed. James M. Poterba, 37–82 (Cambridge, MA: MIT Press, 2003).

CHAPTER 1: WHAT ARE THE HIDDEN COSTS OF TAX COMPLIANCE?

1. The Joint Committee on Taxation lists 60 different federal tax provisions (excluding temporary disaster relief provisions) that were scheduled to expire in 2011. An additional 41 provisions were scheduled to expire in 2012. See Joint Committee on Taxation (JCT), "List of Expiring Federal Tax Provisions 2011–2022," JCX-1-12, Washington, DC, January 6, 2012. Some of these provisions were extended for an additional five years under the American Taxpayer Relief Act of 2012.
2. Congressional Budget Office (CBO), "The Budget and Economic Outlook: Fiscal Years 2013 to 2023," Washington, DC, February 2013, table 1-1, 9.
3. The bulk of the remaining tax revenue generated comes from social insurance and retirement taxes, which accounted for 36 percent of total revenue collected in 2011. See Office of Management and Budget, "Receipts by Source as Percentages of GDP: 1934–2017," table 2.1, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist02z1.xls.
4. Taxpayer Advocate Service, *National Taxpayer Advocate 2010 Annual Report to Congress*, vol. 1 (Washington, DC: IRS, 2010), 4.
5. See Seth H. Giertz and Jacob M. Feldman, "The Economic Costs of Tax Policy Uncertainty: Implications for Fundamental Tax Reform," Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, November 27, 2012. See also Kevin M. Murphy, Andrei Shleifer, and Robert W. Vishny, "The Allocation of Talent: Implications for Growth," *Quarterly Journal of Economics* 106, no. 2 (1991): 503–30.
6. Authors' calculations based on IRS, "Tax Gap for Tax Year 2006," January 6, 2012.