Backgrounder

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# True Tax Reform: Improves the Economy, Does Not Raise Taxes

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**Abstract:** *There is little dispute that the current federal income tax is in real need of an overhaul. The heart of tax reform is to achieve a stronger economy through the adoption of a more economically neutral tax system featuring much lower marginal tax rates. But current discussions of tax reform have been mistakenly caught in the debate over how to cut current and future budget deficits. Proponents of higher spending have sought to co-opt the language of tax reform, especially the renewed aversion to tax loopholes, to disguise their goal of raising taxes. Heritage Foundation tax policy expert J. D. Foster explains why tax reform should stay focused on a stronger economy and not be misused for tax hikes.*

The heart of tax reform is to pursue one overarching goal, to obey one basic rule, and to follow one simple mantra. The overarching goal that makes the whole effort worthwhile is to achieve a stronger economy. The basic rule is that tax reform should be revenue neutral. The simple mantra is that the base must be expanded to become more economically neutral and that marginal tax rates must be lowered. Tax reform could involve adopting an entirely new tax system, but, generally, it means changing the federal tax system while retaining its basic outline. There is little dispute that the current federal income tax in particular is in real need of an overhaul to improve the economy.

## Talking Points

- The current federal income tax is in real need of overhaul. Unprecedented federal budget deficits have led some analysts and policymakers to go to extraordinary lengths to find major tax hikes that Congress would pass, mistakenly calling this goal tax reform.
- The national deficit is exclusively a spending problem. Congress should cut spending, and then turn to long-overdue tax reform in pursuit of a stronger economy.
- The tax code can, and should, also be made much simpler for taxpayers, cheaper for the government to administer, more transparent, and fairer.
- Tax reform must be revenue neutral to separate clearly, substantively and politically, the questions of how much to spend and to tax, and how to tax. Intertwining these questions in any effort labeled tax reform assures that the reform will fail.
- The most comprehensive, most effective reform is outlined in The Heritage Foundation's *Saving the American Dream* plan.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2619*

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The stated goal for tax reform is widely shared, and the mantra often repeated, but some policymakers regularly seek to break the rule. Unprecedented federal budget deficits have led some analysts and policymakers to go to extraordinary lengths to find explicit, major tax hikes that could pass the Congress. These lengths have included a long-cherished value-added tax (VAT), a financial-transactions tax, an income-tax surcharge, an oil-import fee, and a cap-and-tax revenue scheme in environmental garb. These efforts all having come to naught, proponents of raising taxes have retreated to more subtle ploys, such as using the language of tax reform to disguise their tax-hike agenda. They have focused in particular on a widely held public distaste for tax loopholes, guided by a badly executed "tax expenditure" analysis performed by the Treasury Department and the congressional Joint Committee on Taxation.[1] While repeating the ancient mantra of seeking a broader base by closing loopholes or tax expenditures, tax-hike advocates hope to break the rule of revenue neutrality for tax reform, and thereby forgo the economic gains of reform, all to minimize the spending cuts necessary to reduce the budget deficit.

The country's deficit is exclusively a spending problem. Congress should reduce the budget deficit by cutting spending, and should then turn to long-overdue tax reform in pursuit of a stronger economy, subject to a revenue-neutrality rule, and following the mantra of a broader, more economically neutral base and lower tax rates.

## Tax Reform and a Stronger Economy

For tax reform to succeed, whether in bits and pieces or as part of a grand effort modeled after the monumental 1986 Tax Reform Act, the foundation of a successful, enduring reform must first be laid and broadly accepted by the President, congressional leaders, and the nation as a whole. That foundation begins with the intent to strengthen the economy, in the short run if possible, but certainly for the long run. Tax reform should eliminate the existing tax bias in the tax base against saving and investment, eliminate narrowly targeted tax distortions to economic decision making, and lower tax rates as much as possible. A stronger economy means higher wages, better jobs, and improved resilience against the kinds of shocks that lead to recessions.

Improved economic performance is by no means the only reason to pursue tax reform. The tax code can, and should, also be made much simpler for taxpayers, cheaper for the government to administer, more transparent, and fairer. However, each of these goals is a supporting justification for the reform effort, and inadequate to compel Congress and the country to accept the task. Only the promise of a stronger economy, the importance of which is more apparent than usual given the recent recession and languishing recovery, will entice Congress and the nation to start, let alone complete, fundamental tax reform.

Tax reform does not mean finding smarter ways to use tax policy to direct economic decision making. On the contrary, as a general rule the economy would perform better if economic decisions were guided entirely by relative prices presented entirely free of government interference. Consumers and businesses are well familiar with the role of prices in encouraging or discouraging buying and selling, investing or consuming. When the price of gasoline increases, consumers seek to buy less while producers seek to sell more.

It is not, however, the absolute prices that affect the allocation of resources, but rather relative prices. The price of gas at the pump may rise from $4 per gallon to $5 per gallon, but if all prices and wages in the economy rise by a similar proportion, then the relative price of gas is unchanged, and so consumer and producer behavior is unaffected.

In contrast, if the price of gasoline rises from $4 to $5 per gallon and all other prices remain unchanged, then this relative price increase sends

1. "Tax Expenditures," Chapter 17 of *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2012*, at *http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/receipts.pdf* (October 17, 2011), and Joint Committee on Taxation, "Publications on Tax Expenditures," December 21, 2010, at *http://www.jct.gov/publications.html?func=select&id=5* (October 19, 2011).

an important signal to consumers, businesses, and energy producers. Consumers receive the signal that the buying power of their income has dropped and the cost of driving a car just increased. Businesses that directly or indirectly incur significant transportation costs may have to restructure their operations toward less costly production or delivery systems—or raise prices and risk a loss of business. Producers of gasoline will see in this price increase a signal there are gains to be had if production can be ramped up. Altogether, these relative price movements tend to lead to lower demand, more supply.

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Relative prices set by buyers and sellers free of government interference are most likely to reflect the economic forces of supply and demand accurately, thus leading to the best use of the nation's labor and capital resources producing those goods and services with the greatest value. The essential economic consequence of most tax policies (and others, such as regulatory policies) is to distort relative prices and thus diminish both the level of production and the value to consumers of what is produced. Thus, the essential goal of tax reform—improving economic performance—means that tax reform must aim squarely at reaching tax neutrality.

## The Golden Rule of Tax Reform

The golden rule of tax reform is that tax reformers should not try to claim more gold. In particular, tax reform must not be used to disguise a tax increase. Current and projected future federal budget deficits stem from an excess of spending, not a dearth of revenues. In any event, policymakers should keep the decision about how much to spend and tax completely separate from the decision about how to tax.

The growth in federal spending and the resulting budget deficits have led advocates for higher spending to offer a variety of additional taxes that could be levied. The traditional European-style VAT remains popular in some circles, but this has now been joined as an option with a carbon tax, an oil-import fee, and a financial-transactions tax, among others as major sources of new revenue. Consideration of any or all of these taxes is appropriate, though each is likely to be found substantially wanting. Yet the income tax is certainly not the perfect system, either. If any of these alternative systems are proposed, either with or without reforms to the income tax, to raise additional revenues for the federal government, then the entire exercise should be treated as an economically harmful tax hike and nothing more.

On a practical level, tax reform is difficult enough, politically and substantively, without the extra burden of seeking net tax increases in the process. Even when the desire for tax reform is strong, fear of the immediate consequences is real. A complex tax system affects a complex economy in profound and sometimes poorly understood ways. This is true of current law and would be true after tax reform. Some taxpayers will lose tax benefits to which they have become accustomed. Others will benefit directly, and if done well, tax reform will benefit nearly everyone through a stronger economy.

In light of these tensions, for tax reform to have a chance to succeed legislatively and economically, it must be revenue neutral. This, in turn, requires a clear and concise definition of revenue neutrality. The simple, intuitive, and reasonable definition is that the reformed tax system should raise the same level of revenue using traditional scoring methods employed by the Treasury Department and the Joint Committee on Taxation as the current system would raise under current policy.

If reforms to the tax system violate revenue neutrality, then the hoped-for economic benefits would almost certainly be watered down and perhaps lost altogether, while the prospects of passage would be greatly diminished as the natural concerns surrounding tax reform are joined with the broad antipathy to higher taxes.

## Supposed "Spending Through the Tax Code"

The purpose of taxation is to raise revenues for the government to spend. The multitude of deductions, exemption, credits, and special rules in the federal income-tax law are sometimes characterized as "spending through the tax code." In the current budget debates, this has led some to suggest that federal spending could be reduced by eliminating tax loopholes. In most instances this line of argument is deeply and fundamentally flawed, as there are few true examples of spending through the tax code, and many of these involve income-support payments to lower-income citizens. Thus, the only way to cut spending materially is to spend less.[2]

To be sure, parallels exist between the tax-reducing effects of a tax loophole and direct spending. To an extent, a dollar is a dollar, whether gained by paying less tax or receiving more in government spending. Economic effects may also be congruent. A tax incentive to produce fuel from food is just as distorting to economic decision making as a direct payment to the farmer if his products are sold to energy producers.

The key budgetary difference between government spending and a tax loophole is that spending a dollar requires first taxing or borrowing a dollar, or selling an asset to raise a dollar. A tax loophole, however ill-advised or noxious, is a reduction in tax. It deprives government of resources to spend. A tax loophole, then, cannot be both the loss of resources, and a resource to spend.

The issue becomes clearer yet when viewed through the lens of ownership. Income and wealth are the property of the taxpayers unless and until government taxes it. Income and wealth are not inherently the property of a government that benevolently allows citizens to keep a portion, but are instead the property of the taxpayer. The absence of a tax burden on the citizen is not a cost to the government as it is sometimes described. Property must first be transferred from the taxpayer to government before it becomes the property of the government. These issues of timing and precedence are not incidental, but fundamental to correct definitions and clarity in fiscal policy.

## Base Broadening to Achieve a Neutral Tax Base and Rate Reduction

Unless adopting an entirely new tax system, true tax reform revolves around reforming the existing federal tax structure while preserving the level of tax revenues implied by current policy. Since the chief goal is, and should be, improved economic performance, a centerpiece of reform should be significant tax-rate reduction. Tax rates are the most obvious, and often the most consequential elements of a tax system affecting economic performance.

Revenue-neutral, growth-enhancing tax-rate reduction, in turn, depends on broadening the tax base to achieve a neutral tax base—tax policy is as much about *what* is taxed as about the ***rate*** of tax. The importance of economic neutrality is perhaps most easily understood by considering an extreme case: Suppose every dollar earned by a business was subject to tax—no deductions or credits permitted. And suppose every dollar of income, whether wages or capital income, was subject to tax without a single deduction, exemption, or credit. Businesses would then face not an income tax, but a gross receipts tax, while individuals would face a gross income tax. Such a tax system would have an enormous tax base permitting extremely low tax rates to raise the current level of receipts. However, lacking a deduction for business expenses, such a tax would institute an enormous bias against investment, while the heavy tax burden on saving would greatly discourage personal saving of all kinds. Despite a very broad base and very low marginal tax rates, such a tax system would severely violate tax neutrality, and thus would likely weaken the economy despite the lower tax rates.

Many devils hide in the details of crafting a neutral tax base. In particular, many little devils lurk in

2. The one instance in which spending occurs through the tax code is refundable tax credits. To the extent a taxpayer has zero tax liability and is still able to receive the benefit from a tax credit because the credit is refundable, the refundable portion of the credit is equivalent to spending, such as is the case with the refundable portion of the Earned Income Credit (EIC). The EIC is not a tax loophole because it does not reduce tax liability, but it is, by construction, spending through the tax code.

the list of tax expenditures published by the Treasury Department and the Joint Committee on Taxation, and used by many would-be reformers as tax reform's starting point. Many of the little devils do not even appear on the list.

***While it is important to lower tax rates, it is also important to establish a tax base consistent with tax neutrality.***

Those who seek to broaden the tax base today by repealing the enumerated tax expenditures in toto often attempt to hide their breaking of the revenue-neutral rule behind a façade of reform. Those who rely too heavily on the individual items on the list are at serious risk of falling short of the goal of a stronger economy. Either way, the existing tax-expenditure list is as much a liability as an asset to tax reform.

To begin to understand the flaws in the tax-expenditure presentations, one should consider three obvious, glaring omissions. First, an income tax is a tax on personal income, however defined.[3] It is not a tax on *some* personal income. It is a tax on *all* personal income. Therefore, there is no provision for a standard deduction in the definition. According to IRS data, in 2008, nearly 92 million tax filers took the standard deduction, reducing the tax base by nearly $700 billion.[4] Even at an average marginal tax rate of only 15 percent, the standard deduction presents a tax expenditure possibly in excess of $100 billion, making it about the second-largest tax expenditure.[5]

A second enormous tax expenditure missing from the official lists is the personal exemption. An income tax levies tax on all personal income. There is no personal exemption in a strictly defined income tax, yet in 2008 tax filers reduced their taxable income by nearly $981 billion through personal exemptions.[6] At an average marginal tax rate of only 15 percent, a roughly $150 billion tax expenditure is missing from the list.

A third major, missing tax expenditure is of an entirely different character. An income tax is a tax on all personal income *at a single rate of tax*. There is nothing in the definition of an income tax suggesting it should have multiple tax rates. Every dollar that is taxed at less than the top tax rate therefore gives rise to a tax expenditure. Curiously, the Treasury Department reflects the correct approach in its list of tax expenditures associated with the corporate income tax. The federal corporate income tax includes not one rate of 35 percent, but multiple rates depending on the corporation's level of income.[7] Treasury includes the tax revenue forgone at corporate tax rates below 35 percent as a tax expenditure, but does not include individual income tax revenue forgone due to the tax rates below the top individual tax rate.

The central point here is not whether the tax code should include a standard deduction, or personal exemptions, or even multiple tax rates. The central point is that these are all enormous tax expenditures missing from the official lists. The reason they are missing is because many tax policymakers and commentators agree with the original leading proponent of tax-expenditure analysis, Stanley Surrey,

3. Much of the debate about tax policy involves whether personal income includes only labor compensation, such as wages and salaries, or whether it also includes capital income, such as dividends and interest. Much of the debate concerns whether an income tax must necessarily tax savings repeatedly, that is, whether it inherently violates neutrality. This point of contention is not central to this discussion and is therefore set aside.
4. Internal Revenue Service, "Statistics of Income for Tax Filing Year 2008," Table 1.2, at *http://www.irs.gov/pub/irs-soi/08in12ms.xls* (October 17, 2011).
5. The actual amount of tax expenditures associated with the standard deduction would be greater if the effective marginal tax rate were higher, and would be lower to the extent that taxpayers who took the standard deduction would otherwise be able to take fewer other itemized deductions.
6. Internal Revenue Service, "Statistics of Income for Tax Filing Year 2008," Table 1.2.
7. Tax Foundation, "Federal Corporate Income Tax Rates, Income Years 1909–2008," August 17, 2008, at *http://www.taxfoundation.org/taxdata/show/2140.html* (October 17, 2011).

whose work a half-century ago reflected his belief that a modern tax system *ought* to have these features. Yet for the tax-expenditure list to be at all useful as a guide to tax policy, its purpose and approach must be clear and rigorous. It cannot reflect how policymakers believe a tax code *should* appear as a result of policy decisions, but how the tax code would appear before policymakers make additional policy.

As egregious as omitting some large tax expenditures, the official lists errantly include certain tax provisions essential to an income tax constructed according to basic principles. The poster child for errantly identified tax expenditures must be the deduction for home mortgage interest. The issue here is relatively simple. In an income tax, whenever interest income is taxed, to preserve neutrality the tax code should allow a deduction for interest expense. This is true whether the loan allows a business to finance inventory, an investor to purchase stock, or a family to buy a home.

The goal, once again, is neutrality. If the lender bears tax on a loan, then the interest rate charged on that loan must rise. The lender has in mind a minimum, after-tax rate of return on the loan and will not make the loan yielding less than this minimum return. If tax is levied on mortgage interest income, then the mortgage rate must then rise to allow the payment of tax while preserving the minimum return. Yet, if the mortgage rate rises, the tax code would then actively discourage mortgage borrowing, thus violating tax neutrality. The effect of the home mortgage deduction is then not to create a subsidy for home ownership, but to eliminate a tax bias against home ownership by offsetting the higher mortgage rate caused by the tax on the lender's income.

There is, of course, a true tax expenditure in the federal income tax relating to home ownership in the implicit income one receives from being both owner and renter of the same property.[8] In fact, the Treasury tax-expenditure list includes an estimate of $51 billion in lost revenues because the income tax does not capture this imputed rental income. As part of tax reform, Congress should consider means for capturing this income in the tax base to permit a lower tax rate. However, this true tax expenditure is entirely unrelated to, and extremely poorly proxied by, the home mortgage deduction. To understand the latter, consider a taxpayer who owns his home outright, or whose interest payments are insufficient to justify itemizing deductions rather than taking the standard deduction. Such a taxpayer is earning implicit income from being a homeowner, and would be entirely unaffected by the repeal of the home mortgage interest deduction.

***Allowing the economy to continue to underperform for no better reason than tax policy inertia is unacceptable.***

Tax policymakers are well advised to pursue tax reform to improve economic growth based in large part on establishing a neutral tax base and on tax-rate reduction. They should consider carefully how the tax base may be expanded by eliminating tax deductions, exemptions, credits, and special rules to offset the revenue effects of lower rates so the combination is revenue neutral. In particular, they should be careful to avoid creating new distortions through base expansion to fund reduced distortions through rate reduction. Policymakers should be especially leery of using the Treasury's or Joint Committee on Taxation's tax-expenditure analysis as a reliable guide.

## Pro-Growth Tax Reform, Not Tax Hikes in Disguise

Tax reform's goal of improving economic performance is worthwhile and sufficient to warrant the effort. Allowing the economy to continue to underperform for no better reason than tax policy inertia is unacceptable.

Tax reform must be revenue neutral to separate clearly, substantively and politically, the questions

8. The simple point is that a home generates a stream of net income whether it is owner-occupied or rented. But, if owner-occupied, then there is no explicit transaction—no explicit rent paid—to indicate the payment and receipt of income.

of *how much* to spend and to tax, and *how* to tax. Intertwining these questions in any effort labeled tax reform assures that the tax reform will fail. At the same time, it risks allowing purported tax reformers to disguise their true intentions. Those who seek to raise taxes should acknowledge their intentions and propose their tax hikes for debate and discussion.

There are many good options for tax reform that can achieve a stronger economy by reducing or eliminating the tax biases against saving and investment, lowering tax rates, and simplifying the tax system. The most comprehensive, most effective reform is outlined in The Heritage Foundation's "Saving the American Dream" plan.[9] This plan replaces all federal taxes with a simple, single-rate system that adheres closely to the principles of tax neutrality. Whether adopted in whole or used as a guide for a more pro-growth tax system, the Heritage plan provides a sound basis for tax reform.

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9. Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, Heritage Foundation *Special Report* No. 91, May 10, 2011, at *http://www.heritage.org/Research/Reports/2011/05/Saving-the-American-Dream-The-Heritage-Plan-to-Fix-the-Debt-Cut-Spending-and-Restore-Prosperity*.