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The Simple Economics of Pro-Growth Tax Reform

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Abstract

In contrast to the current federal tax code, a pro-growth tax policy would minimize the tax distortions to the incentives guiding individual decisions. Such a neutral tax would not take sides—intentionally or unintentionally—in influencing the decisions made by individuals and businesses. Such a neutral tax policy would diminish economic performance the least—compared with alternative tax policies. Pro-growth tax reform is an exercise in moving toward a more neutral tax system. The most complete expression of a neutral tax system at the federal level is contained in the New Flat Tax proposed by The Heritage Foundation.

The essential principle for pro-growth tax policy is simply this: Minimize tax distortions to the incentives guiding individual decisions. The simplicity of this guide may surprise because tax policy often appears—and indeed often is—a dauntingly complicated subject. Fundamental tax reform is equally so. Likewise, understanding the operational processes of economic growth daunts economists no less than non-economists. Yet at its core, the critical nexus of these two topics—tax policy focused on preserving a strong economy—resolves into this fairly intuitive principle.

This principle can be expressed more formally as preserving tax neutrality because a neutral tax pushes the economy neither one way nor the other. Thus, it allows individuals and businesses to make the best use of their various and diverse resources, so the economy in general operates as efficiently as possible, producing those goods and services offering the highest value.

Key Points

- While Congress has changed the tax code incessantly in recent years, the last major reform occurred more than a quarter century ago.
- Pro-growth tax policy begins with recognizing how the tax code discourages economic activity.
- The key for public policy, including tax policy, is to allow the economy to make the most efficient use of its resources and thus produce the greatest well-being by leaving the incentives directing individual and business decisions undisturbed.
- Among modern tax systems, the general rule for most neutral tax systems is to tax all income once and only once at the same tax rate.
- Tax distortions arise from three distinct sources: tax rates, the tax base (what is taxed), and tax credits.
- As a rule, low tax rates are important because the tax rate essentially multiplies a tax system's failures to reflect neutrality in the tax base.

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This principle is always relevant because the federal tax system is continually scrutinized and often tweaked, but the combination of a lethargic economy and the rapid rise of formidable new international competitors has made policymakers exceptionally receptive to the possible gains from fundamental tax reform. While Congress has changed the tax code incessantly in recent years, the last major reform occurred more than a quarter century ago. It is long past time for an overhaul, but the overhaul should be guided by sound principles to achieve its objective of fostering a stronger, more competitive economy.

The Proper Perspective Guiding Reform

Lest anyone imagine the need for and advantages of tax reform are newly discovered, Norman B. Ture, the true godfather of supply-side economics, observed circa 1995:

> A growing consensus in the tax policy community is that the existing federal income taxes must be drastically overhauled, if not, indeed, entirely discarded…to achieve a tax system that less impedes economic growth, that is fairer, and that is less complex, less costly to comply with and to enforce than the existing income taxes.[1]

Regrettably, these words penned less than a decade after the last major tax reform remain as on point in 2013 as they were 18 years ago.

It is important to be clear at the outset what tax policy and tax reform can and cannot accomplish. A common misconception is that tax policy can strengthen the economy. While a convenient turn of phrase, the concept that tax policy can "strengthen the economy" can lead to confusion and poor policy. Ture's phrase "a tax system that less impedes economic growth" offers a more correct perspective. This may appear a distinction without a difference, but the difference is essential. While taxes influence the economy's performance as do most public policies, taxes generally diminish performance. Thus, the best tax policy design diminishes economic performance the least. This understanding helps to fend off misguided attempts to manipulate the economy through incentives and subsidies in the tax code designed to achieve artificially stronger performance.

Tax Neutrality and Economic Performance

Every tax system devised causes some distortion to incentives guiding individual decisions. Minimizing these distortions requires a basic analytic framework for recognizing how incentives are distorted. This framework may then suggest which distortions are most harmful and which are least harmful. In addition, the framework may help to test the validity of claims some intentional distortions can improve economic performance.

Every tax system devised causes some distortion to incentives guiding individual decisions.

The simple expression of such a framework is that the tax system should be economically neutral, meaning in effect that the tax system does not intentionally or unintentionally take sides in influencing the decisions made by individuals and businesses.

> A perfectly neutral tax, if one could be devised, would have no excise effect; it would increase in the same proportion all of the prices confronting any entity in the private sector. It would increase the cost of effort in the same proportion as the cost of leisure, of saving in the same proportion as the cost of consumption, of any one consumption good or service in the same proportion as all others, of using labor services in the same proportion as capital services, of any kind of labor or capital service in the same proportion as any other, etc.[2]

Implicit in the pursuit of a neutral tax is a basic proposition about the operation of a market economy: Individuals and businesses will most likely use

1. Norman B. Ture, "Restructuring the Federal Tax System," Institute for Research on the Economics of Taxation, *Policy Bulletin* No. 65, December 15, 1995, p. 1, http://iret.org/pub/BLTN-65.PDF (accessed June 11, 2013).
2. Norman B. Ture, "Supply-Side Analysis and Public Policy," in David G. Raboy, ed., "Essays in Supply-Side Economics," Institute for Research on the Economics of Taxation, February 1982, http://iret.org/pub/SupplySideBook.pdf (accessed June 11, 2013).

their resources to maximize their own benefit and that of the society at large if the incentives they face and that guide their actions are free from the effects of tax or other public policies. This does not say all individual decisions on working, saving, and investing or all business decisions on markets, contracts, and which risks to run or avoid would be perfect if only government's influences were absent. It does say economic decisions, on balance, will produce better outcomes individually and collectively if they are guided by market prices—specifically relative prices—undisturbed by government policy.

The Key Is Prices, Relative Prices

Prices provide the essential signals guiding economic decisions. Higher output prices encourage more production and a shift in consumption toward lower priced goods or services. However, relative prices rather than absolute prices are more relevant to economic decisions. For example:

- A consumer may value two goods essentially identically, but if one costs substantially more than the other, the consumer naturally buys the *relatively* less expensive good.
- A family considering purchasing health insurance will compare the *relative* coverages and costs of various plans in choosing the plan that best meets its needs.
- A worker considering two jobs will weigh many factors including the alternative career ladders, working conditions, commuting distances, and the competing compensation levels before accepting the *relatively* more beneficial opportunity.
- A firm considering an increase in production may choose between hiring more workers or making its current workforce more productive by providing it with newer, more sophisticated tools. The firm then chooses according to whether the additional workers cost more or less *relative* to the newer tools per additional unit produced.
- A parent driving a child to soccer practice may have many possible routes and will choose a route based on many factors, possibly including driving time, safety, stress levels, and other factors. *Relative* "prices" may reflect opportunity costs rather than monetary costs.

A proper tax system that least impedes economic growth will disrupt relative prices to the least extent possible. This is what it means for a tax system to approach neutrality or to minimize distortions.

> Every tax ever designed has the effect of raising the cost of what is taxed compared to the costs of other things. Because every tax has this "excise" effect, every tax changes the signals the market system would otherwise give us about the costs of alternative uses of the resources we have at our disposal. Every tax, therefore, changes the incentives each of us would otherwise confront concerning the most efficient use of our talents, energies, other production capabilities, and time. In the end, the nation ends up with a less satisfying, as well as a smaller, basket of products and services than it would otherwise have available.[3]

The Economy as Combustion Engine

One simple perspective on the operation of the economy and the effects of taxation is to compare the U.S. economy to the essential workings of an internal combustion engine. The essential inputs into the economy are productive capital (factories and equipment) and human capital (workers and their talents, skills, and training). These economic inputs correspond to the gasoline and air injected into an engine's cylinders. Although it rarely operates with such efficiency, at any point in time the engine can be tuned to maximize its output through the injection of gasoline and air in the proper balance.

The analogy continues in that the engine's efficiency improves over time with the introduction of new technology, such as direct fuel injection replacing carburetors and replacing two input valves with four. Further, both the gasoline injected into the engine and the purity of the air improve over time. The gasoline improves through higher octanes and fewer impurities; the air improves by becoming cleaner through better filtering. Correspondingly, the technology imbedded in the economy's productive capital improves over time, as do the educational abilities and flexibilities of the workforce.

3. Ture, "Restructuring the Federal Tax System," p. 5.

In summary, air and gasoline, which improve in quality over time, are injected in specific, optimal proportions into the engine, which itself becomes more efficient over time with new technology. At any point in time corresponding to a given level of technology, the engine can achieve a certain optimal efficiency and produce a certain output. Likewise in the economy, the quality of productive and human capital improves over time, as does the technology of the economy itself. When responding to market signals, labor and capital combine to produce the goods and services providing the most material benefit to consumers and to society in general.

In many respects, taxation diminishes the economy's efficiency. Taxes on labor reduce the supply of labor services, as recent studies by the Congressional Budget Office reaffirm.[4] Thus, by analogy, they restrict the flow of oxygen. Likewise, taxes on capital raise the cost of capital, reducing the demand for capital services—the use of factories and machinery. This is analogous in the combustion engine to an impediment limiting the flow of gasoline.

Tax Distortions in Three Flavors

Tax distortions arise from three distinct sources: tax rates, the tax base (what is taxed), and tax credits. As a rule, low tax rates are important because the tax rate essentially multiplies a tax system's failures to reflect neutrality in the tax base. Even a tax system with a fairly neutral tax base creates an inherent tax bias to the disadvantage of that which is taxed. As noted above, "Every tax ever designed has the effect of raising the cost of what is taxed compared to the costs of other things."[5] Further, even the most diligent Congress is unlikely to legislate a nearly neutral tax base, and subsequent Congresses will almost certainly continue the tradition of incessant tinkering, with almost all of the changes making the tax base less neutral. These resulting flaws in the tax base are rendered relatively harmless if the tax rate is sufficiently low, but become serious impediments to economic efficiency at higher tax rates.

Tax distortions arise from three distinct sources: tax rates, the tax base (what is taxed), and tax credits.

While much tax policy focuses on tax rates—and properly so—the starting point for developing the most neutral tax system possible lies with deciding what to tax: the tax base. Among modern tax systems, the general rule for most neutral tax systems is to tax all income once and only once at the same tax rate. This can be most nearly accomplished by taxing total labor compensation, such as with a comprehensive payroll tax. Alternatively, it can be accomplished by taxing the expenditure of income, such as with a properly defined income tax that includes an unlimited allowance for savings, or through a transactions-based tax, such as a sales tax or a European-style, transactions-based value-added tax (VAT).[6]

In contrast to these relatively neutral tax systems, the classic income tax forming the basis of the federal tax system reflects an inherently flawed definition of income for tax purposes and therefore presents a flawed, highly non-neutral tax base. The crux of the trouble with the income tax as currently conceived is that tax is levied on individuals, but the focus of tax neutrality is not the recipient of the proceeds but the source—the productive resource giving rise to the earnings. Preserving tax neutrality requires

4. See Robert McClelland and Shannon Mok, "A Review of Recent Research on Labor Supply Elasticities," Congressional Budget Office *Working Paper* No. 2012-12, October 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/10-25-2012-Recent_Research_on_Labor_Supply_Elasticities.pdf (accessed June 11, 2013), and Felix Reichling and Charles Whalen, "Review of Estimates of the Frisch Elasticity of Labor Supply," Congressional Budget Office *Working Paper* No. 2012-13, October 2012, https://www.cbo.gov/sites/default/files/cbofiles/attachments/10-25-2012-Frisch_Elasticity_of_Labor_Supply.pdf (accessed June 11, 2013).
5. Ture, "Restructuring the Federal Tax System," p. 5.
6. Tax policy and tax reform do not develop in a vacuum. Given the state of federal tax policy, expectations with respect to tax distribution, and levels of tax collection, neither a federal sales tax nor a VAT offer a practical replacement for the federal income tax and should not be considered as supplements to a federal income tax because this would only facilitate further growth in government. For elaboration on this point, see J. D. Foster, "Why the VAT is Not Pro-Saving," Heritage Foundation *WebMemo* No. 3089, December 22, 2010, http://www.heritage.org/research/reports/2010/12/value-added-tax-why-the-vat-is-not-pro-saving, and Curtis S. Dubay, "Why the VAT Is Wrong for the United States," Heritage Foundation *Backgrounder* No. 2503, December 21, 2010, http://www.heritage.org/research/reports/2010/12/the-value-added-tax-is-wrong-for-the-united-states.

orienting neutrality toward the source of the earnings, not the recipient.

Because the calculation and collection of tax occurs with individuals, accounting offers a beguilingly intuitive approach to defining income as the sum of all that is received in a period by an individual or business. For individuals this is sometimes called the Haig–Simons definition of income.[7] Thus, all labor income such as wages and salary is combined with capital proceeds such as dividend and interest proceeds plus capital gains.

However, this accounting definition of income, centered on the recipient, fails as a guide to tax neutrality because it leads to a clear bias against saving. Income is taxed once when earned as wages or salary, and if saved, it is taxed again and again through the taxation of interest, dividends, and capital gains. This explains why the payroll tax is nearly consistent with tax neutrality, and why modern tax reform systems like the New Flat Tax essentially adopt this approach.[8]

Tax credits are similar to deductions in some respects because they tend to reduce overall tax liability, but they differ in that credits are not involved in defining the tax base. Credits are applied after the base is determined, a rate applied, and a tax liability calculated. Tax credits are generally inconsistent with tax neutrality and are adopted for extraneous, non-tax purposes and thus must be judged against those purposes.[9] Classic examples include the child tax credit, the ethanol tax credit, and the research and experimentation tax credit.

Because calculating taxable income properly generally requires taking certain deductions against income, there will always be debate about what is a proper deduction and what is a tax preference or "loophole." In any event, by any definition the current federal income tax is rife with tax preferences, from the exclusion of employer-sponsored health insurance to the ethanol tax credit.

A natural response in tax reform is to broaden the tax base indiscriminately by eliminating all deductions, exemptions, and credits. The better approach is to seek the correct or economically neutral tax base. Merely broadening the tax base for the sake of a broader tax base or the sake of simplification risks replacing one set of tax biases arising from tax loopholes with another set of biases arising from incorrectly defining what is to be taxed. For example, while income tax generally overtaxes saving, pursuing a broader tax base, as opposed to a more correct tax base, could restrict provisions such as the Individual Retirement Account, which mitigate the anti-saving bias.

Conclusion

Pro-growth tax policy begins with recognizing how the tax code discourages economic activity. The key for public policy, including tax policy, is to allow the economy to make the most efficient use of its resources and thus produce the greatest well-being. This can be achieved by leaving the incentives directing individual and business decisions undisturbed. These incentives are expressed through the relative prices of goods and services. When tax policy distorts these relative prices, it violates tax neutrality, distorting the allocation of resources and thus diminishing economic activity.

Pro-growth tax reform is an exercise in moving toward a more neutral tax system. The most complete expression of a neutral tax system at the federal level is contained in the New Flat Tax introduced in late 2011 as part of The Heritage Foundation's *Saving the American Dream* fiscal policy reforms.[10] The New Flat Tax would replace the entire federal tax system, including the payroll tax and the various excises, with a simple, single-rate tax system adhering closely to tax neutrality. As Congress and the nation work toward federal tax reform, every step

7. For a useful discussion of the correct definition of income, see Arthur P. Hall, "The Concept of Income Revisited: An Investigation into the Double Taxation of Saving," Tax Foundation *Background Paper* No. 17, February 1, 1997, http://taxfoundation.org/article/concept-income-revisited-investigation-double-taxation-saving (accessed June 11, 2013).
8. See J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.
9. Examples of credits that may help to move the tax system toward neutrality are the American Opportunity Tax Credit, which operates in lieu of a more proper deduction for higher education expenses, and the former Investment Tax Credit, which operated in conjunction with depreciation allowances to move the combined effect toward neutrality.
10. See Foster, "The New Flat Tax," and Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, eds., *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, http://savingthedream.org/about-the-plan/plan-details/.

should be taken toward a system like the New Flat Tax.

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