

# BACKGROUND

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## How Tax Reform Would Help American Families

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### Abstract

*There is widespread support for tax reform, yet Congress and the President have failed to take serious action. Tax reform is one of the most pressing policy improvements that Congress needs to make because the current tax system stifles opportunity for American families. However, American families likely do not know the full extent of the damage the tax system inflicts upon them. This lack of knowledge explains why they do not put more pressure on their representatives to pass tax reform. Those in favor of tax reform need to show families how a properly structured consumption tax would greatly improve their lives. If families knew how much tax reform would benefit them, they would demand more strongly that Washington act.*

Tax reform is one of the vital policy improvements necessary to revive the laboring economy. Despite widespread agreement on this fact, the prospects of Congress passing and the President signing a tax reform bill are low.

One reason for this mismatch between political will and policy importance is a lack of pressure from American families on lawmakers. This is understandable because the arguments for tax reform are too often made in the context of improving economic efficiency, which means little to families struggling to make ends meet. This leaves families wondering how tax reform could benefit them.

To elicit the public demand for tax reform that would compel Washington to act, proponents need to make a better-defined argument for why families would benefit from tax reform. That would give them a tangible reason to push tax reform.

### KEY POINTS

- There is widespread agreement that tax reform is needed to boost the prospects of American families, yet Congress and the President have failed to act.
- The current system inflicts considerable damage on families, but they likely do not know how badly it hurts them, which explains why they do not demand more strongly that Washington pass tax reform.
- A properly constructed consumption tax would increase the incomes of families by 10 percent and unlock opportunities for them.
- Proponents of tax reform need to make the case to families about the direct benefits they would receive from tax reform.
- Once families know how much they stand to benefit, they will ramp up pressure on their elected officials and increase the chances of tax reform finally happening.

This paper, in its entirety, can be found at <http://report.heritage.org/bg2963>

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If American families believe that tax reform would raise their incomes by thousands of dollars a year and increase opportunities for them and their children, they would push their representatives to support tax reform more strongly.

### **Why Tax Reform Is Necessary**

Before families can understand how tax reform would help them, they need to know how the current tax system is hurting them. Many families are unaware of its damaging effects because they are largely hidden from view.

The tax code imposes tax rates that are too high, is biased against saving and investment, and wrongly picks winners and losers. Each of these problems hurts families because they create sizeable disincentives against working, investing, and taking risks—activities that are central to increasing prosperity and establishing security. These activities are also the building blocks of economic growth.

High tax rates on families discourage work, especially from second workers who may wish to enter the workforce. The extra tax they would pay on the additional income combined with other costs—such as child care, transportation, loss of certain tax benefits, less time at home, and other work-related expenses—makes the benefits of taking a job not worth the effort.

Families use savings to pay for down payments on homes, education, retirement, unexpected bills, or anything else that they may desire to buy in the future. High rates discourage them from saving by making spending today more attractive than spending in the future. High tax rates on interest income, dividends, and capital gains discourage families from saving, thereby reducing the amount they can spend in the future by forgoing spending and saving today. When they save less today, families are less secure in the future.

Pass-through businesses, which pay their taxes on their owners' individual tax returns rather than through the corporate tax system, also pay the high rates that families pay. More than 4 million of them have employees.<sup>1</sup> Those with more than 100 workers employ 20 million Americans.<sup>2</sup> The high tax rates

that they pay reduce the amount of earnings that they can reinvest into their businesses. This hurts families because the reduction in investment reduces the number of jobs that the businesses create and the wage increases they give to their workers.

Further reducing investment are the multiple layers of taxes that investors face when contemplating an investment. Much investment is taxed first at the corporate level, where businesses organized as C-corporations pay the U.S. corporate tax rate of 35 percent—the highest corporate tax rate in the world. Investment is then taxed at the investor level through taxes on capital gains and dividends, which are both taxed at 23.8 percent. Combined, these rates mean that investment returns face a tax rate of almost 54 percent, including state taxes.

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That high rate raises the hurdle rate that investors require before making certain investments since they are concerned with their after-tax returns for taking the risk. Therefore, many potential investments fall short of meeting the mark and thus go unmade. The effect on families is the same as when pass-throughs invest less: fewer new job opportunities and forgone wage increases.

Entrepreneurship is essential for maintaining the vitality of the economy. The new ventures that succeed create new jobs and new products that enhance families' lives. High tax rates hamper entrepreneurship because they reduce the incentive for taking the risk of launching a new enterprise. They also reduce the start-up capital that potential entrepreneurs could use to get their ideas off the ground since many entrepreneurs are high-earning workers before starting their businesses. Families suffer because the jobs that these businesses would create never materialize, and the chances of a “next big thing” product coming to market is reduced.

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1. Curtis S. Dubay, “Obama’s Taxmageddon Tax Increase Would Hurt Job Creation,” Heritage Foundation *Issue Brief* No. 3658, July 9, 2012, <http://www.heritage.org/research/reports/2012/07/obama-s-taxmageddon-tax-increase-would-hurt-job-creation>.

2. Robert Carroll and Gerald Pranted, “Long-Run Macroeconomic Impact of Increasing Tax Rates on High-Income Taxpayers in 2013,” Ernst & Young LLP, July 2012, <http://www.nfib.com/LinkClick.aspx?fileticket=OMV7uZczVaM%3d&tabid=1083> (accessed August 8, 2014).

In the almost 30 years since Congress last overhauled the tax code, it has created a multitude of tax preferences (exemptions, deductions, and credits) targeted to confer benefits on favored groups and industries. These tax breaks tilt the market in government-chosen directions, distorting how the market allocates resources. The abundance of preferences aimed to help particular energy sources, such as ethanol, are an example of Congress using the tax code to influence markets. This practice hurts families by inflating prices, limiting choice, and empowering special interests—all of which reduce opportunities for families.

Furthermore, targeted tax preferences can make it more difficult for new businesses to enter certain markets. For example, the tax preferences for renewable energy sources make it more difficult for entrepreneurs to develop a type of energy that does not qualify for the tax preferences. This further reduces the opportunities for families by reducing the dynamism of the economy.

The corporate tax system is also a problem for families. The high rate and the worldwide tax system that the U.S. uses to tax the foreign income of businesses headquartered in the United States reduce investment. The high rate reduces domestic investment by both U.S.-headquartered businesses and foreign businesses, stifling job creation and wage growth. The worldwide system suppresses investment by U.S. businesses in new and growing international markets, which are the key to enhancing their global competitiveness.<sup>3</sup> Reduced foreign investment costs jobs and wage increases domestically.<sup>4</sup>

## How Tax Reform Would Fix These Problems

The central purpose of tax reform is to improve the economy's potential by fixing each of these problems.

**Rate and Base Equally Important.** In tax reform vernacular, the fix is described as broadening

the tax base and lowering rates. This phrasing gives a simplified and mostly correct explanation of what tax reform does, but like many clichés it does not tell the whole story.

Certainly, lower rates are a key component of a successful tax reform plan. However, to maximize the growth potential of reform, the lower rates must be applied to a correct tax base. In tax policy parlance, the tax base must be neutral, which means that it does not positively or negatively influence economic decision making by families, businesses, investors, and entrepreneurs.

Lower rates on an incorrectly broadened base (i.e., one that included investment in capital) would have minimal growth benefits and could be a net drag on the economy if the tax base is structured poorly. To avoid this undesirable outcome, tax reform must expend as much effort in establishing the correct tax base as in lowering rates, preferably establishing a flat rate.

The proper tax base is one that taxes what we take out of the economy, not what we put into it. It does this by taxing consumption, not investment. The traditional flat tax,<sup>5</sup> a consumed-income flat tax,<sup>6</sup> a national retail sales tax,<sup>7</sup> or a combination of these methods (a business transfer tax) are all consumption-based taxes that would achieve this objective equally well. Each of them uses the correct consumption tax base, and their economic effects are identical. They vary only in how taxpayers pay them. A useful way to understand their variations is to think of them as distinct software programs used to execute the same function. They all execute that function equally well, but they interact with their users (i.e., taxpayers) differently.

They all apply one rate to the consumption base, and because they have the proper tax base, they eliminate taxes on saving and investment. They do not tax capital gains or dividends (unless there was no corporate tax and business owners were taxed at the ownership level) or estate tax.

3. Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, <http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers>.

4. Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, Vol. 1, No. 1 (February 2009), pp. 181-203.

5. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, CA: Hoover Institution Press, 2007).

6. 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>.

7. The FairTax is a prominent example.

Furthermore, a well-executed tax reform plan would eliminate economically unjustified tax preferences—those not necessary to maintain neutrality. In fact, it should explicitly seek to abolish policies that Congress intended to benefit particular industries or particular groups.

The best way to ensure that tax reform uses a correct tax base is for Congress to start the process by selecting which of the acceptable tax systems to use. An appropriate tax base, by definition, would not include tax preferences that favor any groups or industries. Congress could then set the rate based on a desired revenue target. Applied to a correct tax base, the rate will most likely be considerably lower than under current law.

**Additional Policy Improvements Needed for Businesses.** On the business side, tax reform should go beyond just lowering the corporate tax rate. While a lower rate is essential to increasing investment, other policy changes are needed to fully alleviate the burden that the current code puts on investment.

The key is to move from the worldwide tax system to a territorial tax system, which taxes businesses only on income earned within the borders of the U.S. Another key is allowing businesses to deduct the full cost of their capital expenses when they incur them, known as expensing, rather than over many years using the cumbersome depreciation schedules currently in effect. Expensing is a key part of establishing a consumption tax base. Finally, tax reform should remove taxes on exports so U.S. products compete on an even playing field in foreign markets.

**Other Considerations.** Congress should also keep in mind certain non-economic objectives when undertaking tax reform. Congress should particularly limit the tax system's adverse impact on the core institutions of civil society including the family and voluntary associations, such as religious and educational institutions, charities, and community organizations.

A complementary aim of tax reform should be to improve simplicity and transparency for families. Tax reform should make it easier for them to file their returns because a consumption-based tax would not be complicated with a maze of credits, deductions, and exemptions that require pages of forms and worksheets to determine eligibility. Enhanced simplicity would also especially help small businesses.

Government spending is on track to grow to unsustainable levels that threaten the security of

families. Tax reform should work to make it easier to reduce the bloated size of government by making the cost of government more transparent to the American people. Because of income and payroll tax withholding and the hidden costs of corporate, employer payroll, and excise taxes, most Americans have little idea how much they are paying to fund the federal government or how proposed policy changes would affect them. Tax reform should make that cost more explicit to taxpayers. Once taxpayers know how much of their hard-earned income goes to fund the federal government, they will be more willing to reduce the size of government to lessen its cost to them.

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### **Constraints on Tax Reform**

Tax reform will not occur in a vacuum. It will be subject to the political pressures that affect all legislation. As a result, it will face certain constraints, which unchecked, could put a damper on the growth effects that tax reform aims to achieve.

The constraint of revenue neutrality is the requirement that the reformed tax system raise the same amount of revenue as the current system. Under the traditional static scoring of tax policy changes by the Joint Committee on Taxation, this constraint could push tax rates higher than they might otherwise need to be. Congress should not use tax reform as a way to increase the overall tax burden. Ideally, tax reform should cap revenue at its historic average measured as a share of the economy.

Political realities will also likely require tax reform be distributionally neutral, which means it does not shift the tax burden as currently constituted up or down the income scale. In practical terms, this means that tax reform should not be used to lower taxes on a particular income group and raise them on another. This constraint would complicate matters because the top 50 percent of income earners pay almost all federal income tax.

A sensible way to alleviate the pressure of this constraint is to begin with a baseline distribution that includes all federal taxes: income tax, payroll

tax, corporate tax, and all others. Such a comprehensive metric would provide a better way to evaluate how the tax reform plan changes the distribution than one that looks only at the income tax. This should also make achieving distributional neutrality easier because income tax accounts for just under half of all federal tax revenue. The other taxes constitute the majority of receipts and are more equally distributed than the income tax.

Forcing a tax reform plan to meet these constraints necessarily limits its effectiveness because anti-growth policies are usually instituted to meet them. Policies to maintain revenue neutrality run the gambit from surtaxes on upper-income taxpayers to denying businesses the ability to expense their capital investments. For distribution neutrality, tax credits for lower-income families are often used.

Since increasing economic growth by raising the economy's potential is the paramount purpose of tax reform, it makes sense to temper these constraints in favor of that core intention. Congress should set a minimum growth constraint by expressing explicitly how much it requires a tax reform plan to increase growth.<sup>8</sup> This will help to balance the anti-growth constraints put on tax reform so that they do not outweigh the central goal.

### **What Tax Reform Should Not Do**

In addition to making the right changes to the tax code, tax reform must refrain from doing some things. For instance, tax reform should not retroactively raise taxes because that is inherently unfair. Often forgotten, however, is that tax reform should not bestow tax windfalls either. Some taxpayers, mostly businesses, accrue deferred tax liabilities and tax assets like unused credits and deductions that they are entitled to use in future tax years. Tax reform should not decrease those liabilities nor increase the value of those assets. Doing so would have little upside for growth since businesses already made planning decisions when they accrued them. Retroactively changing them is an undeserved tax windfall that has no place in tax reform.

In recent years, some lawmakers have devoted a great deal of attention to developing new tax systems that would apply in addition to existing fed-

eral corporate and individual income taxes, payroll taxes, capital gains and dividends taxes, and various excise taxes. These additional taxes include a carbon tax, a value-added tax (VAT), and a financial transactions tax. An additional tax would make complying with taxes even more difficult than it already is. Further, despite protestations to the contrary from those that favor adding new tax systems, Congress would undoubtedly spend the revenue from a new tax to expand the government. This has been the experience in Europe when countries added VATs on top of their income taxes. Tax reform should not add to the already excessive number of federal taxes.

### **How Tax Reform Would Help Families**

Tax reform that established a consumption base and the other policies outlined above would be a significant boon to American families because it would ease the tremendous burden the current system places on them.

A single, low-rate system would make it easier for second earners to enter the workforce. That would raise family incomes, helping them to pay bills and provide a better future for their children.

A tax system with such a consumption base would remove the disincentives to save because it would not tax savings. Families would save more for all the various reasons that they choose to put money away. This would make it easier to buy a new home, afford a good education for their children, handle unexpected expenses, and provide for their retirement.

Of course, families would see those welcome benefits directly on their bottom lines. Although they might not perceive it as directly, they would also profit from a substantial increase in opportunity that would come from increased investment.

Tax reform would make more investments viable than under the current system. Eliminating taxes on investment, reducing the corporate tax rate, and moving to a territorial system would make that increase in investment possible. American families would see their wages rise as a result. They would also see more chances to take better paying jobs as the economy expands because of the surge of investment.

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8. J. D. Foster, "Statement of the U.S. Chamber of Commerce," testimony before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, July 30, 2014, [http://waysandmeans.house.gov/uploadedfiles/foster\\_testimony\\_srm\\_07302014.pdf](http://waysandmeans.house.gov/uploadedfiles/foster_testimony_srm_07302014.pdf) (accessed August 6, 2014).

A new wave of entrepreneurship unleashed by tax reform, coupled with an increase of economic vigor from ending the tax code's practice of picking winners and losers would benefit families, too. More new businesses would open, further increasing opportunities for families, and more new products would enter the market.

Clearly, all of these effects would substantially benefit families. According to the Tax Foundation, the economy could grow as much as 15 percent more over 10 years because of tax reform. After those 10 years, the average American family's wages would be almost 10 percent higher.<sup>9</sup> That would mean an extra \$5,000 in the pockets of families making \$50,000 per year (roughly the median income in the U.S. today).

## Conclusion

Congress has not reformed the tax code for nearly 30 years, and it is long overdue. This is a widely agreed upon premise, yet Congress has failed to act.

The best way to make Members of Congress act is for their constituents to compel them. If the case is made to the American people that their families could benefit by \$5,000 each year, they would be more likely to make the case to their representatives that the time to act is now.

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9. Andrew Lundeen, "Slow Economic Growth Does Not Need to Be the New Normal," Tax Foundation, May 15, 2014, <http://taxfoundation.org/blog/slow-economic-growth-does-not-need-be-new-normal> (accessed September 22, 2014).