Pro-Growth Tax Reform

A pro-growth tax system should be simple, efficient and fair. The U.S. tax code fails on all three counts.

The system is notoriously complex, as individuals, families and employers spend over six billion hours and over $160 billion per year trying to negotiate a labyrinth of deductions and credits, a tangle of different rules for characterizing income, and a variety of schedules for taxing that income. Simply put, the code is too costly and too burdensome.

The code is also patently unfair, as many of the deductions and preferences in the system – which serve to narrow the tax base – are mainly used by a relatively small class of mostly higher-income individuals. Washington should not be in the business of picking winners and losers.

Finally, the U.S. tax structure is highly inefficient, as tax considerations rather than economic fundamentals often distort individual decisions to work, save, and invest, which leads to a misallocation of resources and slower economic growth.

This budget attacks all three of these problems with a set of fundamental reforms drawn from a broad consensus of economic experts and based on the principle that government should never take a dollar from one of its citizens unless that dollar is needed for an absolutely vital national purpose.

It draws on the commonly held view that the key to pro-growth tax reform is lowering tax rates while broadening the tax base – that is, letting individuals keep more of the money they earn, while getting rid of distortions, loopholes and preferences that divert economic resources from their most efficient uses.

The recommendations of the President's Fiscal Commission were clear on this point: lower tax rates are critical to economic growth. The Commission's proposal offered a growth-oriented, simplified code, with individual tax brackets as low as 8 percent, 14 percent and 23 percent – and reduced the corporate tax rate to as low as 26 percent.[1] This budget builds upon the clear bipartisan consensus that lower rates and a broader base are key guideposts for pro-growth tax reform.

In addition, this budget starts, not by asking what is the "right mix" of tax increases and spending cuts to balance the budget, but by asking what is the purpose of government, and then raising only as much revenue as the federal government needs to efficiently fund those missions that rightly belong in its domain, while maximizing economic growth and job creation.

Simplifying the Tax Code for Individuals

Major proposals

- **Reject the President's call to raise taxes. Instead, keep overall revenue as a share of the economy at historical averages between 18 and 19 percent, a level compatible with growth, and – if the spending restraints in this budget are enacted – sufficient to fund government operations over time.**
- **Reform the tax code by consolidating the current six brackets and cutting the top individual rate from 35 percent to 25 percent.**
- **Broaden the tax base to keep revenue as a share of the economy at levels sufficient to fund critical missions that rightly belong in the domain of the federal government (as outlined elsewhere in this budget).**

In 1981, President Ronald Reagan inherited a stagnant economy and a tax code that featured 16 brackets, with a top rate of 70 percent. When he left office in 1989, the tax code had been simplified down to just three brackets, with a top rate of 28 percent. Reagan's tax reforms proved to be a cornerstone of the unprecedented economic boom that occurred in the decade during his presidency and continued in the decade that followed.

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[1] The National Commission on Fiscal Responsibility and Reform. *The Moment of Truth*.

Over time, additional brackets, credits and carve-outs have grown on the tax code like weeds. In the last ten years alone, there have been nearly 4,500 changes made to the tax code. The current version for individuals has six brackets, with a top rate of 35 percent (which is set to climb to nearly 40 percent after the end of 2012). Individuals react negatively toward the tax code partly because it is complex and attempts to steer them toward certain activities and away from others. In addition, there are always a few "surprises" that end up raising their tax bills. One such surprise – the Alternative Minimum Tax (AMT) – was initially designed to hit very high-income taxpayers, but instead ensnares a growing number of middle-class households because of a flawed design.

Creating new brackets and raising top rates is an idea that is often touted as a way to raise revenue by making only wealthy Americans bear a greater share of the burden. Most economists, however, disagree. Economic theory suggests, and most empirical studies prove, that marginal tax-rate hikes – tax increases that reduce incentives to work, save and invest for additional income above a certain cutoff – reduce economic output, while marginal rate reductions increase output, mainly by letting people keep more of each dollar they earn and thereby strengthening incentives to work, produce, and invest in the future.

Lower economic output mutes the revenue effect of top-rate tax increases. Top rates have risen and fallen dramatically in the past, with little overall effect on tax revenue as a share of the economy. The United States has set the top individual rate as high as 90 percent and as low as 28 percent, but income tax revenue has remained fairly steady despite these sharp rate swings.

The biggest driver of revenue to the federal government isn't higher rates – it's economic growth. Growth is the key to fiscal sustainability – and low rates are the key to growth.

Nor are the effects of marginal tax-rate increases confined to wealthy households. Three quarters of the nation's small businesses file as individuals, meaning that higher individual rates make it harder for these vital enterprises to compete. Small businesses are responsible for almost two thirds of the jobs created in the United States in the past 15 years, and almost 50 percent of small-business profits are taxed at the top two rates.[2] [3] Raising these rates means increasing taxes on the most successful job creators in America.

Raising taxes on capital is another idea that purports to affect the wealthy but actually hurts all participants in the economy. Mainstream economics, not to mention common sense, teaches that raising taxes on any activity generally results in less of it. Economics and common sense also teach that the size of a nation's capital stock – the pool of saved money available for investment and job creation – has an effect on employment, productivity, and wages. Tax reform should promote savings and investment because more savings and more investment mean a larger stock of capital available for job creation. That means more jobs, more productivity, and higher wages for all American workers.

The negative effects of high rates on work, savings and investment are compounded when a large mix of exemptions, deductions and credits are added in. Sometimes referred to as "tax expenditures," these distortions are similar to government spending – instead of markets directing economic resources to their most efficient uses, the government directs resources to politically favored uses, creating a drag on growth.

The key difference is that, with spending, the government collects the money first in the form of taxes from those who earned it, and reallocates the money elsewhere. With tax expenditures, government agrees not to collect the money as long as it is put to a government-approved use. Other tax expenditures literally do take the form of spending through the tax code, because they "return" more money than the taxes owed.

Tax expenditures have a huge impact on the federal budget, resulting in over $1 trillion in forgone revenue each year (although the exact definition of a "tax expenditure" is subject to debate.) To put that number in perspective, $1 trillion is roughly the total amount the government collects each year in federal income taxes.

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[2] Headd, Brian. *An Analysis of Small Business and Jobs*. Small Business Administration. Office of Advocacy. March 2010. http://www.sba.gov/advocacy/849/7642

[3] Internal Revenue Service. *Statistics of Income*. "Table 1.4 All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2008." http://www.irs.gov/pub/irs-soi/08in14ar.xls (accessed March 31, 2011).

Eliminating large tax expenditures would not be for the purpose of increasing total tax revenues. Instead, when offset by lower rates, it would have a doubly positive impact on the economy – it would stop diverting economic resources to less productive uses, while making possible the lower tax rates that provide greater incentives for economic growth.

President Reagan's tax reforms inaugurated an era of great prosperity. It is time to reclaim his legacy and once again enact a fundamental reform of the tax code as the final step in rebuilding the foundations for economic growth: spending restraint, reasonable and predictable regulations, sound money, and a simple tax code with low rates.

This budget starts with the proposition that first, Congress must do no harm. It assumes that Congress will not allow massive, across-the-board tax increases to hit the economy in 2013, when current law calls for the tax cuts that were enacted in 2001 and 2003 to expire. And it assumes that Congress will not let the AMT ensnare growing numbers of middle-class taxpayers.

Stop Job-Destroying Tax Hikes by Repealing the Health Care Law

The health-care law enacted last year contained roughly $800 billion in new taxes and tax increases – the result of dozens of changes to tax law that added complexity and unfairness to the code.

- *New taxes on employers make American businesses less competitive.* The new law hits all businesses that do not purchase a one-size-fits-all, federally approved health insurance plan for their workers to pay a large tax penalty as a consequence. Employers and labor groups pointed out that this new tax would result in mass layoffs or in millions of workers losing their coverage. As a result, the administration has granted hundreds waivers to exempt certain businesses and unions from the new law, according to the Department of Health and Human Services. But government should not be granting waivers based on political connections – it should repeal this harmful tax before it does any more damage.

- *Higher taxes on wages and investment income will discourage hiring and eat into America's capital stock.* The new law imposes a 0.9 percent surtax on wages and a 3.8 percent surtax on interest, dividends, and capital gains. Both taxes only apply to filers in the top two income brackets, but as discussed elsewhere in this section, those filers include small businesses employing millions of Americans, and the new taxes on capital will reduce the pool of capital available for investment and job creation.

- *The new "Cadillac Tax" on high-cost employer-provided health plans doesn't resolve the inequitable treatment of health care costs in the tax code.* The new health care law would, starting in 2018, impose a new tax on high-cost, employer-provided health plans. The tax was meant to encourage employers to offer a greater percentage of compensation in the form of wages rather than health benefits. Instead of dealing with the inequitable tax treatment of health-care costs in a straightforward way, by simplifying the code, this tax would add an additional layer of complexity, while being used to fund a new open-ended health-care entitlement.

The U.S. economy needs more jobs, not more job-destroying taxes. The U.S. health-care sector needs more new treatments and cures, not fewer. And U.S. citizens deserve a tax code that does not discriminate between, for example, the self-employed and those employed by large companies. Repealing the new health-care law is the first step toward fulfilling all three of these goals and implementing true patient-centered health care in America.

The new, simplified code outlined in this budget will continue to raise sufficient revenue to fund the government by broadening the tax base, eliminating or limiting as necessary existing tax deductions, exclusions, and other special provisions. These carve-outs have distorted economic activity and necessitated high tax rates that hurt growth. Getting rid of these tax expenditures will make the tax code simpler, fairer and more conducive to economic growth and job creation.

Taken together, these reforms will promote prosperity and help put government back onto a sustainable fiscal path.

Making the Corporate Code More Competitive

Major proposals

- **Encourage economic growth and job creation by lowering the corporate tax rate from 35 percent, which is the highest in the developed world, to a much more competitive 25 percent.**
- **Remove distortions from the code by eliminating or modifying deductions, credits and special carve-outs that leave many companies paying no tax at all.**

The United States currently labors under the highest corporate income tax rate in the developed world. Corporate income taxes create large distortions in economic activity, changing corporate behavior in ways that reduce efficiency and create a drag on growth.

The perverse incentives created by the tax do a lot of damage, yet the tax itself raises relatively little revenue – only 10 percent of the total federal tax take comes from taxing corporate income. A 2005 report from the non-partisan Congressional Budget Office reinforced this conclusion, stating that "distortions that the corporate income tax induces are large compared with the revenues that the tax generates."[4]

The problem with the corporate income tax is that corporations are not taxpayers – they are tax collectors. Taxes on corporate income are borne by shareholders, employees and customers. Investors pay the cost in diminished returns. Workers pay the cost in lower wages. And consumers pay the cost in higher prices.

Workers in particular could benefit from a reduction in the corporate tax rate. Another recent study from the CBO concluded that "domestic labor bears slightly more than 70 percent of the burden" of the corporate income tax.[5]

Instead of making the corporate tax code more competitive by reducing rates across the board, Congress has responded to corporate complaints about this high tax burden by filling the code with loopholes and special carve-outs. The biggest corporations that can afford the best lawyers have figured out how to use the code to avoid paying taxes altogether.[6] It is the smaller companies that suffer disproportionately from an unfair and complex corporate tax code and high corporate rates.

Lowering corporate rates is a reform that is long overdue. This simple policy change would provide an immediate boost to a lagging economy by increasing wages, lowering costs, and providing greater returns on investments in U.S. companies. It would bring the U.S. corporate tax rate closer to the rates of other developed nations, helping American businesses compete in the international marketplace on a level playing field.

This reform would also boost investment flows in the United States and encourage more foreign companies to do business and create jobs in the U.S. economy. It would lessen incentives for U.S.-based multinational corporations to avoid high U.S. taxes by keeping their profits offshore. That would encourage these companies to reinvest their profits and capital in the United States.

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[4]Congressional Budget Office. *Corporate Income Tax Rates: International Comparisons*. November 2005. http://www.cbo.gov/ftpdocs/69xx/doc6902/11-28-CorporateTax.pdf

[5] Randolph, William. "International Burdens of the Corporate Income Tax." *Working Paper Series*, Congressional Budget Office. August 2006. http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf

[6] Kocieniewski, David. "G.E.'s Strategies Let It Avoid Taxes Altogether." *The New York Times*. March 24, 2011. http://www.nytimes.com/2011/03/25/business/economy/25tax.html (accessed March 31, 2011).

This budget would offset lower rates with a broader base, scaling back or eliminating entirely the deductions and credits that have skewed corporate behavior and benefitted the largest corporations disproportionately. Government should not be in the business of picking winners and losers in the market. A single low, fair and simple rate is as good for American businesses as it is for the individual Americans they employ.

This budget, by lowering tax rates and broadening the tax base, follows the same principles that guided the tax proposals contained in the President's Fiscal Commission. But rather than allow government's share of the economy to rise to 21 percent, as the Commission's proposals would allow, this budget includes real spending restraint that enables government's share of the economy to remain below its historical average of 19 percent.

This is important, not because 19 percent is a magic number, but because Washington should not solve its spending problems by taking even more money from taxpayers. American families have had to cut their own budgets in the last few years, and it is time for Washington to do the same. By returning government to its proper roles, this budget brings spending in line with taxes – not the other way around.

In addition to reorienting the tax code with pro-growth incentives, this budget fixes a major problem that has distorted economic activity in the United States: Its reforms are meant to be permanent changes in law, not temporary booster shots or short-term cuts with built-in expiration dates. American families and businesses need – and deserve – certainty and predictability when it comes to taxes, so they can plan for their economic futures.

Keeping families and businesses in a state of uncertainty about taxes is unfair, and it hurts the economy. This budget ends the gimmickry and gives citizens a fair and simple tax code that they can count on.