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The Dos and Don'ts of Tax Reform

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Congress continues to work toward badly needed fundamental tax reform, and Ways and Means Committee Chairman Dave Camp (R–MI) and Senate Finance Committee Chairman Max Baucus (D–MT) are leading the way. Chairman Camp in particular is carefully and methodically laying the necessary groundwork.

As the congressional tax writing committees move forward on broad structural issues and important technical aspects of tax reform, they should at every step remember tax reform's overarching goal. The purpose of overhauling the federal tax code is to improve economic performance, which would result in more jobs, better wages, more secure retirements, and better economic security.

While other goals such as transparency, simplification, and fairness are also important, only reducing the drain on the economy's vitality and resilience caused by the cumbersome tax code can justify tax reform's effort and correctly guide its success. To ensure that tax reform succeeds in freeing the economy to grow stronger, Congress should follow the four dos and four don'ts of tax reform.

This paper, in its entirety, can be found at
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The Four Dos of Tax Reform.

- **Do lower individual and corporate income tax rates.** Today's high income tax rates on both families and businesses slow economic growth. For families, high rates deter working, saving, and investing. For businesses, they deter hiring, investing, and taking on risk. These behaviors, discouraged by high rates, are the productive activities that create growth. Tax reform must lower rates, in particular the top marginal rates, to improve incentives for engaging in those behaviors if it is to generate stronger growth.

- **Do reduce the bias against saving and investing.** The tax code creates a bias against saving and investing through double taxation. Businesses earn income on which they pay the U.S. corporate tax rate, which is the highest in the developed world. Then individuals pay the 23.8 percent (the 20 percent base rate plus the 3.8 percent Obamacare tax on investment income) capital gains and dividends rate on their share of the businesses' income. The combined rate on business income is over 50 percent. This exorbitant rate of tax discourages investors and businesses from making investments that would create jobs and grow the economy. Tax reform must reduce, and ideally would eliminate completely, this harmful bias against investment.

- **Do repair the tax base correctly.** Often overlooked in tax reform is that defining the tax base (what the tax code taxes) is equally important as lowering tax rates and reducing the bias against

saving and investment. Lowering rates is important, but if lower rates apply to an improper base, then tax reform could have no net benefit for the economy. Worse, if the tax base is structured poorly enough, tax reform could be a net negative for growth.

Eliminating the bias against investment would go a long way towards repairing the base, but more work is necessary to ensure the base is neutral. That means tax reform should eliminate deductions, credits, and exemptions that are not economically justified. And it should eliminate unjustified policies that Congress intended to benefit particular industries like those targeted at aiding particular energy sources.

The best way for Congress to avoid these problems is to start tax reform by defining a proper base first.

- **Do make the cost of taxes more transparent so taxpayers better understand how much they pay to fund the federal government.** An important way Washington can help reduce the size of government to fix our deficit and debt problems is to make the cost of government more tangible to the American people. Because of income and payroll tax withholding and the hidden costs of corporate and excise taxes, most Americans have little idea how much they are paying to fund the massive federal government.

  Tax reform should strive to make that cost 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.

The Four Don'ts of Tax Reform.

- **Don't raise revenue.** In recent months, some in Washington, led by President Obama, have co-opted tax reform and changed its purpose to raising taxes. Tax reform is not a way for Congress to extract more of the taxpayers' hard-earned income. Higher tax revenues run counter to tax reform's central goal of encouraging growth. Using the traditional method of estimating revenue, tax reform should result in the new system raising the same amount of revenue as the current one. Ideally, tax reform should cap revenue at its 18.5 percent of gross domestic product (GDP) historic average.

- **Don't impose retroactive tax hikes or tax windfalls.** Tax reform should not retroactively raise taxes as it 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 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.

- **Don't shift the tax burden up or down the income scales.** Tax reform should not result in any particular income group paying higher taxes, nor should any group pay less. Tax reform is not a venue for class warfare. When determining how a tax reform plan affects tax distributions, lawmakers should consider the distribution of *all federal taxes*, not just the income tax. Focusing just on the income tax would be too narrow since the other federal taxes make up 53 percent of all federal revenue.

- **Don't add new tax systems.** Some lawmakers have devoted a great deal of attention in recent years to developing new tax systems that would apply in addition to corporate and individual income taxes, payroll taxes, capital gains and dividends taxes, and various excise taxes already in place at the federal level.

  These additional taxes include a carbon tax, a value-added tax (VAT), a national sales tax, and a financial transactions tax among others. An additional tax would make complying with taxes even more difficult than it already is. And, despite protestations from those that favor adding new tax systems to the contrary, Congress would undoubtedly spend the revenue a new tax would

raise thereby growing the government. Such has been the experience in Europe after countries there added VATs on top of their income taxes. Tax reform should not add to the already too-big number of taxes the federal government levies today.

Tax Reform Is About Growth. Congress must always remember that tax reform is an integral part of a much-needed growth agenda. If it keeps that in mind, it will have a much greater likelihood of doing tax reform right. Adhering to the broad principles exemplified in the dos and don'ts of tax reform will keep Congress focused on growth as it pursues tax reform.

The Heritage Foundation's New Flat Tax is a prime example of how holding strong to the dos and don'ts of tax reform results in a plan that achieves stronger growth.[1] It should serve as a model for Congress to follow.

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1. 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.