Harvard Business Review

REPRINT H03V16
PUBLISHED ON HBR.ORG
AUGUST 22, 2017

ARTICLE
POLICY

The U.S. Needs Tax Reform, Not Tax Cuts

by Eric Toder

Harvard Business Review

POLICY

The U.S. Needs Tax Reform, Not Tax Cuts

by Eric Toder

AUGUST 22, 2017

The current U.S. presidential administration and congressional leadership have spent months talking about tax reform. The next several months will determine whether such a reform will materialize and what it might include. Unfortunately, the prospects for reform are not promising. Instead of reform, we may see a tax cut — and that is not the same thing.

The two central questions in tax policy are how much revenue to raise and how to allocate the tax burden among income groups. The answer to the first question determines how much of the nation's resources will be devoted to public purchases — such as defense, infrastructure, public health, education, and social safety net programs — and how much to private uses.

These are political choices, not just economic ones, though economists can help educate policy makers about the trade-offs they face. We can estimate the budgetary and distributional effects of various tax changes. We can offer our views, sometimes conflicting, on how the level of taxes and their distribution affect economic growth. The ultimate choices among competing uses of resources, however, must reflect public preferences, as determined by our elected representatives in Congress and the White House.

The two political parties are very far apart on these questions. Republicans favor lower taxes and reduced levels of public goods and services, except for defense spending, and believe high-income people should bear a relatively smaller share of the aggregate tax burden than do Democrats. These preferences are reflected in the outlines of tax proposals released in the past year by the Trump campaign, the Trump administration and House Republicans, and the budget proposals of the Trump administration and the House Budget Committee's 2018 budget resolution.

The idea of tax *reform* is to try to avoid these broader political and philosophical conflicts. Tax reform advocates start with a framework in which the amount of tax revenue raised and the distribution of tax burdens are held roughly constant. This does not suggest that the current levels of revenue and the tax burden distribution are necessarily optimal, but does suggest a willingness to work within the larger parameters established by the political system.

Tax reformers focus on improving how we raise a given level of revenue. They seek reforms that treat people more fairly by imposing the same tax burdens on people with equal ability to pay taxes, by reducing distortions that cause businesses and households to make inefficient decisions, and by making it as easy as possible for taxpayers to comply with tax law and for the IRS to administer it.

Reformers acknowledge that there are trade-offs among these objectives of fairness, efficiency, and simplicity. In general, however, reforms can advance all three objectives by reducing targeted tax preferences that favor some taxpayers or economic activities over others, thereby raising the same revenue with lower tax rates applied to a broader tax base.

Although tax reform is not about shifting the tax burden between different income levels, it still creates both winners and losers. Often the winners are diffuse and have little at stake from any single tax provision, while the beneficiaries of tax preferences have a lot to lose from reform and are well-organized and quite vocal. (For instance, getting rid of a tax credit might hurt a few companies a lot but benefit everyone else a little bit.)

Getting tax reform done requires strong political leadership, significant input from government staffers with technical expertise, and development of a public consensus of the need for change. The last major tax reform in 1986 could not have occurred without the strong leadership of President Reagan, the chairs of the Congressional tax-writing committees (Dan Rostenkowski and Bob Packwood), Congressional champions of tax reform such as Senator Bill Bradley and Representative Jack Kemp, detailed staff work by tax policy experts at the Treasury Department and the Joint

Committee on Taxation, and a widespread consensus that tax rates were too high and there were too many preferences that enabled tax shelters and other forms of tax avoidance.

Sadly, the combination of political polarization and one-party control of Congress by a narrow margin makes it very hard to get tax reform today. The Republican majority may try to enact reform without seeking bipartisan buy-in. But the consequent thin support for reform will make it virtually impossible to overcome the opposition of special interest groups who stand to lose from reform.

Instead, what we are more likely to see, based on ideas made public so far, is tax cuts with only partial revenue offsets and the reduction of only the tax breaks that Republicans oppose on ideological or political grounds. For example, Congress may seek to repeal the state and local income tax deduction, which promotes state and local public expenditures and largely benefits residents of states that have voted for Democrats in recent presidential elections. But even this repeal may be difficult to enact, due to objections by Republican members of Congress from high-tax states like California, New York, and New Jersey.

A tax bill that reduces revenue will raise concerns about bigger federal budget deficits and face hurdles from congressional budget rules. Tax legislation will need to be part of a budget reconciliation process to avoid being subject to a Senate filibuster that effectively would require 60 votes for passage. There are ways to get around budgetary rules, including requiring the tax cuts to expire after 10 years, as was done in 2001, or using "dynamic scoring" with excessively optimistic assumptions about how much tax cuts increase economic growth. But these options have their own drawbacks and limitations.

The current political stalemate is unfortunate because the tax system is badly in need of reform. In particular, the rules for taxing corporate and business income have become increasingly out of date, due to the failure of the U.S. tax law to keep up with changes in the business environment in the past three decades, including the growth in international trade and capital flows, the increased importance of intangible assets to businesses, and lower corporate tax rates in all our major trading partners. One creative approach to address these problems, the destination-based cash flow tax in the 2016 House Republican blueprint, has already been abandoned. Another approach would be to shift from corporate-level to shareholder-level taxation, as Alan Viard and I proposed in an HBR article last year. A third would be the introduction of a value-added or a carbon tax to help pay for selected reductions in corporate and individual income taxes.

These and other fundamental reforms remain worth discussing and may re-emerge at a time when the political environment may become more favorable for reform. We faced a similar system in 1986: a tax law that had become increasingly dysfunctional, many reform ideas, and broad skepticism about whether reform was possible. Although the stars for reform are not aligned now, they may be in the future, and there is no reason to give up.

Eric Toder is an institute fellow at the Urban Institute and co-director of the Tax Policy Center.

