

Tax Reform In An Era Of Deficits

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Abstract

Tax reform should focus on three goals: 1) reducing needless complexity, 2) reducing backdoor spending through the tax code, and 3) reforming rules for taxing saving and investment to make our tax law more suitable for a globalized economy. This note summarizes steps that should be taken and how recent recommendations by the President's Economic Recovery Board, the National Taxpayer Advocate, the President's Fiscal Commission, and the Bipartisan Policy Center provide a road map for future changes.

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The retirement of the baby boomers over the next 20 years will create enormous pressures on the federal budget. Current tax and spending policies are unsustainable. We will either have to cut substantially benefits for older Americans – the largest component of the Federal budget – or raise more revenues.

There is no political consensus on the correct mix of spending cuts and tax increases, but it is hard to imagine any politically acceptable solution that will not include some increase in revenues as a share of GDP. Unfortunately, our tax system is too complex, includes within it too much hidden spending and is incompatible with a globalized economy. Simply raising rates on existing tax bases will only make matters worse. If more revenue is to be raised, we need a better tax system. The main components of such a reformed system would be:

Less needless complexity

In a complex economy like ours, it is impossible to have a simple tax system that is also fair and even-handed in its treatment of taxpayers with similar incomes. But our tax law is much more complicated than it needs to be for any rational purpose.

For example, we don't need multiple and overlapping incentives for higher education and retirement saving and we certainly don't need to require taxpayers to calculate their taxes two different ways (the regular tax and the alternative minimum tax) just to limit a few tax breaks.

The President's Economic Advisory Board, the IRS Taxpayer Advocate and others have advanced numerous good ideas for simplification within the existing tax structure. Congress should enact simplification, even if they can't yet address the larger budget issues.

Fewer tax expenditures

The individual and corporate income taxes are riddled with special tax breaks that favor some forms of consumption, subsidize selected investments, or provide special treatment for favored taxpayers. These provisions represent a form of backdoor spending.

For example, instead of providing a grant from the government for the purchase of hybrid cars, we allow individuals to claim a credit on their tax return and pretend this is a tax cut instead of a form of spending that makes government bigger in reality, while appearing smaller. Some of these tax breaks promote worthy social and economic goals, but if we viewed them properly as spending that makes everyone pay higher rates, we could find plenty of room for cuts.

Taxation of saving and investment.

The United States tax system is not designed for a world in which capital moves easily across international borders. We need to shift more of the burden of taxation from saving to consumption and tax more income based on the residence of individuals instead of where investments are made or where companies incorporate. Doing this will involve some combination of lower corporate and individual income tax rates,

elimination or reduction of tax breaks for U.S. individual shareholders, and introduction of a new broad-based tax on goods and services consumed in the United States.

These changes would promote saving and investment and make our tax system more compatible with those of our major trading partners. Through a combination of rebates for low-income taxpayers and closing preferences benefiting high-income taxpayers, we can keep the tax system as progressive as it is today or more so. The President's Fiscal Commission (without a new consumption tax) and the debt reduction task force of the Bipartisan Policy Center (with a new consumption tax) have recently illustrated two ways to lower rates, raise more revenue, and keep the tax system at least as progressive as it is today.

Tax reform will be hard. But it can be done. The time to start is now.

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This post is part of an ongoing series on tax reform ideas. Where do you stand? Come back regularly to be a part of the national debate.

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