Can Tax Reform Save the Economy?

The Best Tax Systems Have A Broad Base and Low Rates

Donald Marron

Abstract

In a contribution to the International Economy magazine, Donald Marron offers his perspective on tax reform.

Document date: February 15, 2012
Released online: February 15, 2012

International Economy
Can Tax Reform Save the Economy? The Best Tax Systems Have A Broad Base and Low Rates

America's tax system is a mess. It's needlessly complicated, economically harmful, and often unfair. And it doesn't raise enough money to pay our bills. That's why almost everyone agrees that tax reform should be a top priority. Democrats, Republicans, and independents. Accountants, lawyers, and economists. Elected officials and ordinary citizens. All know our tax system is deeply flawed.

Unfortunately, they don't agree on how to fix it. Some want revenue-neutral tax reform, while others want higher revenues to cut deficits and pay for rising entitlement spending. Some want to fix the income tax, while others want to tax consumption. Some want to cut tax rates across the board, while others would lift rates for high earners.

Public discourse, meanwhile, is hung up on the idea of attacking "loopholes" when the real action is in tax breaks that benefit millions of taxpayers. Tax reform isn't just about corporate jets or carried interest. It's about the mortgage interest deduction, the tax exemption for employer provided health insurance, and generous tax incentives for debt-financed corporate investment. Those policies have major flaws, but they are not loopholes. They reflect fundamental economic and social choices, and they benefit well-defined constituencies.

Tax reform will thus involve a prolonged political struggle, as reformers seek some compromise that can attract enough support to overcome the inevitable inertia against change. That won't be easy, but given our sky-rocketing debt, weak recovery, and flawed tax system, it's clearly worth the effort.

Even as they seek a reasonable compromise, reformers should continue to articulate their visions of an ideal tax system. Mine would reflect five principles. First, the government should raise enough money to pay its bills. That likely means higher revenues, relative to GDP, than we've had historically. Second, it's better to tax bads rather than goods. That means greater reliance on energy and environmental taxes. Third, it's better to tax consumption than income; policymakers should thus limit how much they tax saving and investment. Fourth, the tax burden should be shared equitably both across income levels and among people of similar means who make different choices (for example, renting versus owning a home).

Finally, the best tax systems have a broad base and low rates. Policymakers should thus emphasize cutting tax breaks rather than raising tax rates. Indeed, some rates, like the 35 percent rate on corporate profits, should come down.

To afford such cuts, policymakers should go after the dozens of deductions, credits, exclusions, and exemptions that complicate the code and narrow the tax base, often with little economic or social gain. Many of these provisions have been sold as tax cuts, but are really spending in disguise. They should get the same scrutiny that policymakers devote to traditional spending programs.

Published in International Economy, Winter 2012: pp 49-50. See the entire article as a PDF.

Other Publications by the Authors

- Donald Marron