Comprehensive Tax Reform: Prospects and Challenges

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Chairman Hatch, Ranking Member Wyden, and Members of the Committee, thank you for inviting me to appear today to discuss issues surrounding broad-based tax reform. The views I express are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

BACKGROUND

There is a broad consensus that the US tax system is in need of reform. The tax system raises more than $3 trillion a year. Almost half (47 percent) comes from individual income taxes, over a third (34 percent) comes from Social Security and Medicare payroll taxes, just under 10 percent comes from corporate income taxes, and about 2–3 percent comes from excise taxes (see figures 1 and 2; note that the small percentage for excise taxes translates into almost $100 billion a year).
The federal tax system has raised aggregate revenues of between 15 and 20 percent of GDP for most years in the last couple decades (see figure 3).
One goal of tax policy is to raise the revenues needed to pay for the good and services the public demands from the federal government. By this measure, the United States is falling short, running persistent budget deficits. The time the federal government ran a budget surplus in the past four decades was in fiscal years 1998–2001, when revenues as a share of GDP were around 19–20 percent. Given the changing demographics, it seems almost inconceivable that the federal budget can be brought into balance at smaller amounts of revenue as a share of GDP. The implication is that fiscally responsible tax reform would likely raise aggregate revenues as a share of GDP above current levels in the longer run. To put it another way, net tax cuts in the medium and long run will worsen the federal fiscal situation. Therefore, responsible tax reform should raise at least as much revenue as current law.

The US tax system was last overhauled in 1986, and the current system, especially as it applies to business income, is woefully out of date. Three decades of changing business practices, increased globalization, changing tax laws in other countries, and expanding aggressiveness in tax-planning activities have led to a system with very many critics and precious few defenders.

Concerns about the business tax system include a maximum statutory corporate income tax rate that is among the highest in the world; special tax provisions that enable many firms to pay an effective tax rate far below the statutory rate; incentives for US-based multinational firms to shift profits abroad and to claim the profits are permanently reinvested there;
incentives for multinational firms (both domestic and foreign-parented) to locate deductions in the United States and income in lower-taxed jurisdictions; incentives for certain firms to organize as pass-through entities in order to avoid corporate-level taxation; and immense amounts of complexity that make compliance difficult and raise questions about the tax system’s administrability and fairness.

But the corporate income tax raises approximately $300-400 billion a year, so it is an important revenue source for the US Treasury. Moreover, it serves as a backstop for other taxes, such as the individual income tax. Maintaining this revenue source while addressing its most glaring inefficiencies is a key challenge for business tax reform.

PRINCIPLES OF TAX POLICY

Tax policy is guided by three basic notions: efficiency, equity, and simplicity. An ideal tax system would advance all three goals to some extent, while recognizing that sometimes the goals conflict. Similarly, a tax reform effort would acknowledge that all three goals are important but would manage trade-offs among them. An efficient tax system would distort economic choices as little as possible while raising the appropriate amount of revenue. Typical characteristics of an efficient tax system are relatively low tax rates, broad bases for taxation, a portfolio of different types of taxes to limit reliance on any single revenue source, and an understanding of the incentives provided by the tax system so policymakers minimize the enticements for taxpayers to reduce their tax bill though otherwise uneconomic actions.

Equity, as applied in tax policy, has two components: horizontal and vertical. Horizontal equity means that taxpayers in similar economic circumstance are treated similarly. In income taxation, this means treating taxpayers with equal incomes equally. Strictly speaking, this would mean that the source of income would be disregarded in determining tax treatment and, ultimately, tax liability. Vertical equity means that tax liability should be distributed in accordance with the ability to pay taxes. That implies that those with larger incomes have a greater ability to pay taxes and therefore should shoulder a larger than proportionate share of the cost of public goods and services. This concept is associated with a progressive tax system, where the average tax rate paid (or average effective tax burden) goes up with a taxpayer’s incomes. As a concept, vertical equity makes more sense when applied to the individual income tax or the entire tax system than when applied to the corporate income tax. The US federal individual income tax is progressive throughout almost the entire income distribution. The overall US tax system is similarly progressive (see table 1).
Simplicity is the third principle of desirable tax policy. The Internal Revenue Service (IRS) regularly assesses the overall burden of the US tax system by the number of hours required to understand one’s tax obligations, keep appropriate records, file the necessary tax forms, and interact with the IRS after filing. Individual taxpayers spend around 2 billion hours a year complying with the individual income tax, and the cost to businesses is estimated to run to over $100 billion annually.

But beyond the hours and dollars, there is a sense among taxpayers and tax policy observers that the tax code is too complex for ordinary Americans to understand their tax obligations and comply with them. This sense of extreme complexity is evidenced by the robust tax preparation and tax software industries, as well as a belief among taxpayers that they are missing out on benefits being claimed by others. A lot of the existing complexity merely reflects the increasingly complex world in which we live. Individuals and businesses can enter into a nearly limitless number of possible economic transactions. These possibilities reflect economic and social complexity, globalization, and long-standing efforts at financial engineering. Congress, however, is complicit in this sense of growing complexity; over the past three decades, increasing amounts of social policy have been run through the tax code. While this can be an efficient way to deliver benefits to particular taxpayers, every one of these provisions carries with it eligibility rules and benefit calculations that can overwhelm taxpayers. This proliferation of tax expenditures itself fosters complexity.

But tax incentives should not be avoided simply because they lead to complexity. In some instances, overriding public policy considerations argue for deviating from one or more of the three major tax policy principles. For example, our economic system by itself may lead to an insufficient amount of activities with important spillover benefits (such as basic research) or to an excessive amount of some activities with negative spillover benefits (like tobacco or alcohol consumption). In these cases, specific provisions in the tax code (such as the research
and experimentation tax credit or excise taxes on alcohol or tobacco purchases) can address under- or over-supply.

It is important to be aware of the trade-offs among tax policy principles. An optimal system will seek to balance out the contributions of each dimension and carefully weigh deviations. When Congress enacted the 1986 Tax Reform Act, it devoted much time, energy, and debate to considering how far to pursue each of these desirable traits in the legislation. Given three decades of incremental movement away from the 1986 agreement on all these policy goals, it is time to refocus on designing a tax system that meets them to the maximum extent possible.

LESSONS FROM PREVIOUS REFORM EFFORTS

Previous tax reform efforts have taught us three lessons:

1. Tax reform is technically difficult. It has many moving pieces. But the essence of reform is viewing these pieces as part of a whole legislative package that meets the over-arching goals of improving on the efficiency, equity, and simplicity dimensions while meeting the overall revenue target for the legislative effort.

2. Tax reform is even more difficult politically. The book Showdown at Gucci Gulch explains how the 1986 Tax Reform Act came together and notes how often-uneasy political alliances were formed to push the legislation to the next step. When undertaking true reform of the “broaden the tax base, lower the tax rate” variety, key constituencies often break along geographic or demographic or industry lines, not partisan ones.

3. This leads to a third lesson, which is that bipartisan tax reform may prove to be durable reform. And this Committee’s long tradition of bipartisan legislating bodes well for playing a leading role in developing a durable consensus on tax reform.

Those undertaking tax reform would do well remember the hierarchy of responses to tax law changes developed by Joel Slemrod (a tax scholar at the University of Michigan). Slemrod notes that it is easier for taxpayers to shift the timing of transactions or their accounting treatment or to undertake paper transactions than to change their underlying economic behavior (Slemrod 1992).

An implication from Slemrod’s hierarchy is that if tax rates are changed (or expected to be changed) on capital gains income, then investors will try to time the realization of gains (Slemrod 1992). We saw this happen in the pattern of capital gains realizations before and after the Tax Reform Act of 1986 and in the acceleration of bonuses and other compensation payments into the year before the 1993 tax law increased tax rates on upper-income Americans and the cap on Medicare payroll taxes was eliminated in 1994.
Similarly, when tax rates or tax provisions change, taxpayers will reorganize entities or undertake financial engineering to maximize their after-tax well-being. Two examples are the shifts from C-Corporations to S-Corporations after the Tax Reform Act of 1986 reduced the top income tax rate on individuals below the rate on corporations, and the shifting of forms of borrowing once the Tax Reform Act of 1986 no longer allowed nonmortgage personal interest as a deductible expense.

A more recent example occurred at the state level when Kansas eliminated all income taxation on income from pass-through businesses in 2012. Over the next couple years, more than 100,000 pass-through businesses were created as Kansas taxpayers rearranged their finances to avoid paying the 5 percent state individual income tax. But the hoped-for increase in actual small business activity did not occur, which provides a cautionary tale.

As Slemrod notes, changes in real economic behavior—labor supply, investment, saving, business output—are least responsive to tax law changes. That doesn’t mean that they cannot happen: some studies indicate a positive labor supply response by single mothers in response to changes in the earned income tax credit (Eissa and Liebman 1996). But it does suggest that some degree of caution is warranted when we hear claims about very large shifts in economic activity in response to tax law changes.

WHAT CAN BE DONE IN TAX REFORM

There are several potential areas where tax reform appears feasible and where large benefits can be gained from undertaking this difficult policy task. In theory, the business tax base can be broadened and the revenue generated used to reduce both the statutory corporate income tax rate and the tax burden on smaller pass-through businesses. For example, the Camp plan and the Obama administration plan presented pathways where the business tax system could be reformed and improved. The Obama administration plan was revenue neutral in the long-run and would have reduced the corporate tax rate from 35 percent to 28 percent.

One issue in need of attention is how to address the taxation of multinational firms in the context of a very globalized economy. The Obama administration plan addressed this issue by creating a hybrid system where US firms would owe no tax on profits of foreign subsidiaries if they faced a tax rate above 19 percent. This was described as a territorial system with a global minimum tax rate of 19 percent. Regardless, you would still need base erosion and mobile income restrictions (like current law Subpart F) to prevent multinational firms from shifting profits from the United States to a lower-taxed foreign jurisdiction. But if the rate differential is lessened, the pressure to undertake these activities is also lessened.
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As noted, it is possible in reforming business taxation to reduce taxes on smaller pass-through entities by expanding access to Section 179 expensing and cash accounting rules, and by providing more generous treatment of start-up and organizational expenses (especially important to new businesses). Since most pass-through businesses are small, these steps will benefit the clear majority of pass-through entities. But since total business activity in the pass-through sector is dominated by a relatively small percentage of firms, these larger firms (and their high-income owners) would likely experience a net tax increase from the base broadening related to business income.

Another area where there may be scope for tax reform that improves the tax system is in rationalizing the numerous incentives for similar activities in the tax code. Today, taxpayers are confronted with several incentives related to paying for higher education; these multiple options may confuse and burden taxpayers and may inhibit their take-up rate. A thorough review of tax provisions related to higher education (tax credits and deductions for tuition, student loan treatment, saving incentives, and income exclusions) could rationalize the tax treatment in this area and make the tax code more efficient, more equitable, and simpler.

A similar effort could prove useful in determining income and expenses for people who participate in the gig or sharing economy. These individuals tend to be classified as sole proprietors and face different tax rules than employees, but may not understand their tax obligations or have enough information from the platform company to comply with the tax law. Legislative steps to improve information sharing and to clarify rules for recognizing income and claiming appropriate expenses could help improve compliance among and reduce burden on millions of taxpayers.

SUMMARY

Congress has the opportunity to undertake significant reforms to the tax code. These reforms can improve the efficiency and equity of the tax system and reduce its complexity. But undertaking tax reform is hard work, and this Committee has embarked on this effort, knowing the difficulties involved. However, these are targets of opportunity where bipartisan tax reform can and should occur. These include business tax reform and streamlining several aspects of the individual income tax. As the Congress and the Administration identify specific opportunities for reform and develop potential solutions, these activities should be driven by data and evidence. The last major tax reform occurred over 30 years ago; it is almost surely time to take up the mantle of reform once again.
REFERENCES


