

# Our Tax Code Is Broken

*By Scott Hodge*

**T**he U.S. tax system is in desperate need of simplification and reform. Over the past two decades, lawmakers have increasingly asked the tax code to direct all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, save more for retirement, purchase health insurance, buy a home, replace the home's windows, adopt children, put them in daycare, take care of Grandma, buy bonds, spend more on research, purchase school supplies, go to college, invest in historic buildings, and the list goes on.

The relentless growth of credits and deductions over the past 20 years has not only knocked half of all American households off the tax rolls, it has made the IRS a "super agency," engaged in policies as unrelated as delivering welfare benefits to subsidizing the manufacture of energy-efficient refrigerators. Were we starting from scratch, these would not be the functions we would want a tax-collection agency to perform.



Ironically, but perhaps not surprisingly, the sectors suffering the biggest financial crises today—health care, housing, and state and local governments—all receive the most subsidies through the tax code. The cure for what ails these parties is to be weaned off the tax code, not given more subsidies through such things as the First Time Homebuyer's Credit, Premium Assistance credits, or more tax free bonds.

While tax cuts will always curry more favor with voters than creating new spending programs, Washington needs to call a truce to using the tax code for social or economic goals. Indeed, the tax base has become so narrow that trying to accomplish more social goals via the tax code is like pushing on a string.

Washington can actually do more for the American people by doing less. The solution lies in fundamental tax reform—as has been suggested by parties as diverse as Chairman Paul Ryan and President Obama's National Commission on Fiscal Responsibility and Reform, chaired by Erskine Bowles and Alan Simpson. As many studies have shown, Americans could be taxed at lower rates—and the government could raise the same amount of revenue—if the majority of tax expenditures were eliminated.

That said, the primary goal of fundamental tax reform should not be raising more money for government. The primary goal should be improving the nation's long-term economic growth and lifting American's living standards.

Path breaking research by economists at the Organisation of Economic Cooperation and Development suggests that the U.S. corporate and individual tax systems are a major detriment to our nation's long-term

economic growth. In a major study, they determined that high corporate and personal income tax rates are the most harmful taxes for long-term economic growth, followed by consumption taxes and property taxes.

Unfortunately, the United States has the second-highest corporate income tax rate among industrialized nations and *the* most progressive personal income tax systems among industrialized nations.

The economic evidence suggests that cutting our corporate and personal income tax rates while broadening the tax base would greatly improve the nation's prospects for long-term economic growth while helping to restore Uncle Sam's fiscal health. More importantly,

these measures will lead to higher wages and better living standards for American citizens. And that should be the number one priority of any tax policy.

Let's consider corporate and individual tax reform one at a time.

### **CORPORATE TAX REFORM CAN IMPROVE U.S. COMPETITIVENESS AND LIVING STANDARDS**

When it comes to corporate taxes, the United States has a Neiman Marcus tax system while the rest of the world has moved toward a Wal-Mart model of corporate taxation. In contrast to our high-rate, narrow-base, and worldwide model of corporate taxations, the basic tenets of this new model are lower tax rates, a broader base, and the exemption of foreign earnings.

In just the past four years alone, 75 countries have cut their corporate tax rates to make themselves more competitive. And, reports the OECD, "there has been a gradual

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movement of countries moving from a credit [worldwide] to an exemption [territorial] system, at least in part because of the competitive edge that this can give to their resident multinational firms.”

The United States remains far behind on both of these trends. Not only do we have the second-highest overall corporate tax rate among the leading industrialized nations at over 39 percent—only Japan has a higher overall rate—but we are one of the few remaining countries to tax on a worldwide basis.

Two of our largest trading partners—Canada and Great Britain—have already taken steps to make themselves more competitive. For example, Great Britain lowered its corporate tax rate on April 1, 2011, from 28 percent to 26 percent as a first step toward the goal of having a 23 percent rate in 2014. On January 1, 2011, Canada lowered its federal corporate tax rate from 18 percent to 16.5 percent. In 2012, the rate will fall to 15 percent.

Canada and Great Britain—as well as Japan—have also moved toward a territorial or exemption form of taxing the foreign profits of their multinational firms. Indeed, of the 34 OECD member nations, 26 have either a full territorial system or exempt at least 95 percent of foreign earnings from repatriation taxes.

The United States remains the only country in the OECD with a worldwide system and a corporate rate above 30 percent.

While some critics charge that U.S. corporations pay far less than the statutory tax rate because of the plethora of credits and deductions, a review of IRS data shows that the effective U.S. tax rate for all corporations averaged 26 percent between 1994 and 2008. The effective U.S. tax rate varied across years, ranging from 27.5 percent in 1999 to 22.8 percent in 2008.

However, these figures account only for U.S. income taxes paid on domestic profits and repatriated foreign earnings. When foreign taxes are included—U.S. corporations pay \$100 billion annually in income taxes to other governments on their foreign profits—the overall tax rate on large multinationals is close to the U.S. statutory rate of 35 percent. Averaged for all corporations, the overall effective corporate tax rate is between 32.1 percent and 33 percent.

The benefits of making our corporate tax system on-par with the rest of the world’s systems cannot be understated.

Here are just a few of the benefits of corporate tax reform:

### **Cutting the U.S. Corporate Tax Rate**



**Will Help Put the Country on a Long-term Growth Path.** Economists at the OECD determined that the “corporate income tax is *the* most harmful tax for long-term economic growth,” not only because it increases the cost of domestic investment, but also because capital is the most mobile factor in the global economy, and thus the most sensitive to high tax rates.

Indeed, the report found that “Corporate income taxes appear to have a particularly negative impact on [gross domestic product] per capita.” Lowering statutory corporate tax rates, they determined, “can lead to particularly large productivity gains in firms that are dynamic and profitable, i.e.

those that can make the largest contribution to GDP growth.” OECD economists speculate that these are the firms that rely most heavily on retained earnings to finance their growth. Higher taxes mean fewer retained earnings, which means less growth.

**Cutting the Corporate Tax Rate Will Lead to Higher Wages and Living Standards.** In a world in which capital is extremely mobile but workers are not, most studies find that workers bear 45 percent to 75 percent of the economic burden of corporate taxes. In one such study, R. Alison Felix, an economist at the Federal Reserve Bank of Kansas City, used cross-country data to study the effect of corporate taxes and their interaction on the gross wages of workers. Felix found that “labor’s burden is more than four times the magnitude of the corporate tax revenue collected in the U.S.”

According to her model, a one percentage point increase in the average corporate tax rate decreases annual gross wages by 0.9 percent. Translated to U.S. corporate tax collec-

tions and wages, this result means that a \$10.4 billion increase in corporate tax collections would lower overall wages by \$43.5 billion.

The overwhelming body of economic evidence suggests that cutting the U.S. corporate tax rate will benefit U.S. workers through higher wages, which translate into higher living standards.

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## **INDIVIDUAL TAX REFORM CAN BOOST ENTREPRENEURSHIP, PRODUCTIVITY, AND GROWTH**

President Obama has consistently called for higher tax rates on upper-income taxpayers. But the economic evidence suggests that this would be very detrimental

to the country’s long-term economic growth. Indeed, OECD economists determined that high personal income taxes are second only to corporate income taxes in their harmful effects on long-term economic growth. And it will shock many Americans to learn that we already have the most progressive income tax burden among the leading industrialized nations.

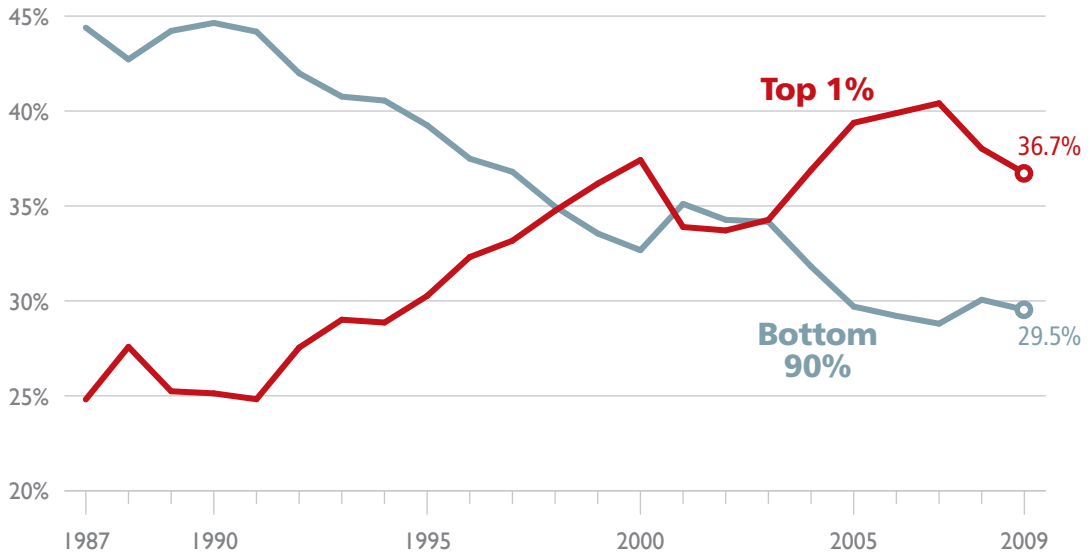
What that means is that the top 10 percent of U.S. taxpayers pay a larger share of the income tax burden than do their counterparts in any other industrialized country, including traditionally “high-tax” countries such as France, Italy, and Sweden. Meanwhile, because of the generosity of such preferences as the Earned Income Tax Credit and child credit, low-income Americans have the lowest income tax burden of any OECD nation.

Indeed, the study reports that while most countries rely more on cash transfers than taxes to redistribute income, the U.S. stands out as “achieving greater redistribution through the tax system than through cash



# Top 1% Pays Higher Share of Income Taxes than the Bottom 90%

Share of Total Income Tax Revenue, by Income Group



Source: Internal Revenue Service.

transfers.” Remarkably, the most recent IRS data for 2009 indicates that nearly 59 million tax filers—42 percent of all filers—had no income tax liability because of the credits and deductions in the tax code.

Contrary to Warren Buffett, the share of the income tax burden borne by America’s wealthiest taxpayers has been growing steadily for more than two decades. The figure above compares the share of income taxes paid by the top 1 percent of taxpayers to the share paid by the bottom 90 percent of taxpayers.

The figure shows that, as of 2008, the top 1 percent of taxpayers paid 38 percent of all income taxes, while the bottom 90 percent of taxpayers paid just 30 percent of the income tax burden. By any measure, this is the sign of a very progressive tax system.

The economic evidence is quite clear that there is a “non-trivial tradeoff between tax policies that enhance GDP per-capita and equity.” The more progressive we make an

income tax system, the more we undermine the factors that contribute most to economic growth—investment, risk taking, entrepreneurship, and productivity.

**Individual Tax Reform Must Go Hand-in-Hand with Corporate Tax Reform.** It may surprise people to learn that the corporate tax system is no longer the primary tool by which we tax businesses in America. More business income is currently taxed under the individual tax system than under the traditional corporate income tax system. It is also interesting to note that for the first time in the history of the tax code the top corporate tax rate and the top individual rate are the same—35 percent. These are key reasons why the individual and corporate tax systems should be reformed together. The neutrality principle dictates that the tax code not bias the way corporate and non-corporate businesses are taxed.

**America’s “Rich” Are Our Successful Entrepreneurs and Business Owners.** While some people dismiss the effect of high tax



rates on business by citing the fact that only 2 percent to 3 percent of business owners pay tax in the top two brackets, the more economically relevant question is how much business income is earned by those in the top tax brackets.

Only about 16 percent of all private business income is earned by taxpayers with adjusted gross incomes (AGI) below \$100,000. Another 16 percent of private business income is earned by taxpayers with AGIs between \$100,000 and \$200,000.

However, fully 68 percent of private business income is earned by taxpayers with AGIs above \$200,000—the target range of President Obama’s proposed tax rate increases. Some 35 percent of all private business income is earned by taxpayers with AGIs above \$1 million.

Another way of looking at the distribution of business income is to see how many taxpayers at the highest tax brackets have business income. According to Tax Policy Center estimates, more than 74 percent of tax filers in the highest tax bracket report business income, compared to 20 percent of those at the lowest bracket. More than 40 percent of private business income is earned by taxpayers paying the top marginal rate.

While these high-income business owners may be relatively few in number, the data makes it very clear that increasing top individual tax rates would directly impact America’s successful private business owners and entrepreneurs.

**Cutting Individual Tax Rates Can Boost Productivity and Economic Growth.** After extensive study of the impact of tax reforms on economic growth across the largest capitalist nations, OECD researchers determined that “a reduction in the top marginal [individual] tax rate is found to raise productivity in industries with potentially high rates of enterprise creation. Thus reducing top marginal tax rates may help to enhance economy-wide produc-

tivity in OECD countries with a large share of such industries.”

Indeed, OECD researchers find that lower tax rates and higher productivity gains translate into higher economic growth:

For example, consider the average OECD country in 2004, which had an average personal income tax rate of 14.3% and a marginal income tax rate of 26.5%. If the marginal tax rate were to decrease by 5 percentage points in this situation, thus decreasing the progressivity of income taxes, the estimated increase in GDP per capita in the long run would be around 1%.

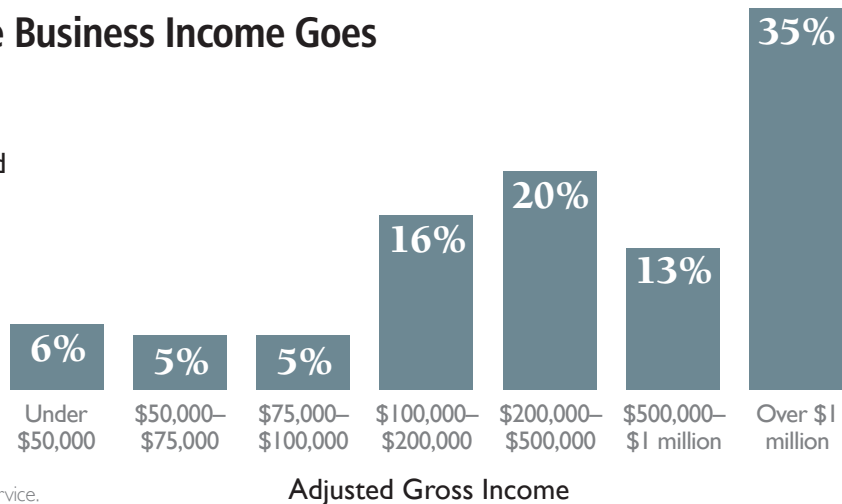
With our large entrepreneurial and non-corporate sector, such studies suggest that the United States could see substantial productivity and GDP gains from lower personal income tax rates.

**Tax Reform Will Reduce Complexity and Dead-weight Costs to the Economy.** In its 2010 Annual Report to Congress, the National Taxpayer Advocate identified tax complexity as the most serious problem facing taxpayers and the Internal Revenue Service, and urged lawmakers to simplify the system. Tax compliance costs taxpayers an estimated \$163 billion each year. The corporate tax system alone costs American businesses about \$40 billion per year—roughly equal to the cost of hiring 800,000 workers at \$50,000 each.

According to a recent Tax Foundation study, the “deadweight” costs, or excess burden, of the current individual income tax is not inconsequential, amounting to roughly 11 percent to 15 percent of total income tax revenues. This finding means that in the course of raising roughly \$1 trillion in revenue through the individual income tax, an additional burden of \$110 to \$150 billion is imposed on taxpayers and the economy.

## Where Private Business Income Goes

Share of All Private Business Income Reported on Individual Tax Returns, by Income Group in 2008



Source: Internal Revenue Service.

Tax reform can lead to greater economic growth by liberating taxpayers, businesses, and investors from these burdensome compliance and deadweight costs.

### CONCLUSION

The U.S. tax system is in desperate need of simplification and reform. To be sure, with the deficit now topping \$1.5 trillion, many lawmakers may look at eliminating tax “loopholes” and simplifying the tax code as an opportunity to raise more revenues. But increasing the share of the economy going to tax collections should not be the goal of tax reform. The goal should be to promote long-term economic growth and better living standards for the American people.

But there is a real tension in the United States between the desire for a simpler tax code and one that ensures fairness and equity. To be sure, tax reform that broadens the base while lowering marginal tax rates could create the appearance of giving “tax cuts for the rich,” an anathema to many.

We need a new way of thinking about equity in the tax code. We should strive to build consensus around these basic concepts:

- An equitable tax system should be free of

most credits or deductions and not micromanage individual or business behavior.

- An equitable tax system should apply a single, flat rate on most everyone equally. That way, every citizen pays at least something toward the basic cost of government.
- An equitable tax code should be simple—which would save all of us time, money, and headache.
- An equitable tax code should have dramatically lower rates than we have today—in the mid-20 percent range by most accounts, a level that would still raise the same amount of revenue.

Such a tax code would generate a more predictable and stable revenue stream to fund government programs as opposed to the roller coaster revenues we have today.

And, most importantly, such a tax code would be conducive to long-term economic growth, which is one of the keys to fixing the long-term fiscal crisis facing the country.

*Mr. Hodge is president of the Tax Foundation. This article is excerpted from his testimony delivered before the Committee on the Budget of the U.S. House of Representatives on September 14, 2011.*

