Tax reform can’t be about picking winners and losers

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September 25, 2017

To some federal policymakers, income tax reform means little more than reshuffling tax burdens between different groups. Some policymakers want higher taxes on the top 1 percent, while others want to put more money in the pockets of the middle class.

Neither approach is right.

True tax reform is not about picking winners and losers, but about reducing the overall damage caused by taxation, thus generating faster economic growth and more opportunities for everyone. Policymakers should focus on three key features of the tax system to guide their pro-growth efforts.

First, they should address marginal tax rates, which are the rates imposed on additional working, investing and entrepreneurial efforts. Cutting the corporate tax rate would spur investment in factories and machinery, thus boosting productivity and wages. Cutting individual income and capital gains tax rates would reward work and support fast-growing small businesses.

Policymakers should target the highest tax rates for the biggest cuts because the damage from taxes rises sharply as rates rise. Economists call the damage “deadweight losses.” Former Council of Economic Advisers head Greg Mankiw explained: “It is a standard proposition in economics that the deadweight loss of a tax rises approximately with the square of the tax rate. … If we double the size of a tax, the deadweight loss increases four-fold.”

That means that our 40 percent corporate tax rate (including state taxes) is four times more damaging than a 20 percent rate. It also means that with seven individual brackets in the tax code ranging from 10 percent to 40 percent, it is more important to cut the top rates than the bottom ones. So Republicans are right to target the corporate rate for a deep cut, while also aiming to reduce top individual rates.

A second feature of the tax system to consider is tax base mobility. Reducing tax rates on the most dynamic tax bases creates the largest benefits. Cutting marginal tax rates on middle-income wage earners would induce some modest increase in their work efforts. But cutting rates for high earners such as entrepreneurs, executives, venture capitalists and doctors would create a strong response because these individuals usually have more ability to adjust their working, hiring and investing efforts.

While some politicians seek punitive tax treatment for the top 1 percent, that group responds the most strongly to tax changes, and their increased efforts under tax reform would generate broad-based growth benefits.

No tax base is more mobile in today's economy than the corporate tax base. Because of globalization, even small changes in the corporate tax rate cause large cross-border movements of investment and profits. Recognizing that dynamism, most countries have slashed their corporate tax rates, with the average rate in industrial countries falling from more than 40 percent in the 1980s to just 24 percent today.

The capital gains and estate taxes also have dynamic tax bases. As with the corporate tax, reducing the rate would cause a large expansion in the tax base. Liberals claim that cutting the corporate, capital gains and estate taxes are giveaways to the rich, but the strong behavioral responses to these taxes means that reductions boost the economy while losing the government little, if any, money as the tax base expands.

A third feature of the income tax system to consider is tax base neutrality. Reforms should repeal unneeded deductions, exemptions and credits that steer resources away from their highest-valued uses. Policymakers, for example, should repeal the mortgage interest deduction, which steers excess resources into housing and away from other investments in the economy.

Reforms should also promote the neutral treatment of savings and investment, which means removing the current income tax bias against those activities. For businesses, neutrality can be achieved by allowing the immediate expensing of capital purchases. For individuals, neutrality can be achieved by creating Universal Savings Accounts, which would allow after-tax deposits into accounts that have tax-free accumulation and withdrawals.

President Trump and congressional Republicans are generally on the right track with their tax reform proposals so far. All GOP leaders favor marginal tax rate cuts, and most are supportive of reforms to encourage savings and investment.

The challenge for Republicans will be in scaling back unneeded breaks such as the mortgage interest deduction. The more special breaks they can repeal, the more budget room they will create for the crucial tax-rate reductions that would benefit all Americans by growing the economy and lifting worker wages.

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