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A TAX HIT LIST FOR THE 113TH CONGRESS

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CONTENTS

A host of tax provision expirations at the end of 2012, the recent presidential election, and the mounting cost and complexity of our nation's tax code have combined to make fundamental tax reform a real possibility for the first time in more than two decades. As a result, conservatives both in public policy organizations and in Congress have been sketching out the framework for an overhaul that would eliminate distorting preferences, lower statutory marginal tax rates, and address uncertainty surrounding perennially extended tax provisions that need permanent resolution.

Conservative taxpayer organizations and think tanks like the National Taxpayers Union, Americans for Tax Reform, the Heritage Foundation, and the Tax Foundation believe that Congress should work to broaden the tax base and lower rates in a revenue-neutral fashion, much the way the landmark 1986 overhaul was achieved. While not perfect, the Reagan-era tax code modifications simplified the system substantially and provided a much better foundation for economic growth. There is talk in Washington of rekindling that bipartisan effort in pursuit of a solution to a tax code that has once again become bloated and unworkable.

While the political makeup of Congress suggests that a bipartisan tax reform would not be easy to secure, the facts underpinning the tax code itself scream of the need for a rebuild. Though the financial burdens imposed by the federal government have fluctuated up and down with changes to the political landscape, the complexity of the code has grown steadily year after year. The National Taxpayers Union conducts an annual study examining the compliance costs imposed by the code, and the results are disturbing.[1] Americans spend more than 6 billion hours and $228.4 billion in labor and out-of-pocket costs just to comply with the code's 14,000,000 words of rules and regulations.

In addition to identifying credits, deductions, and exemptions that could be eliminated in order to lower marginal rates, conservatives should use fundamental tax reform to target unwise tax structures that simply shouldn't exist in a code that promotes growth and job creation. The current code contains several forms of double-taxation that serve to punish investment while encouraging complicated tax avoidance procedures. No matter how politically convenient as a means of raising revenue, these types of policies should be eliminated – along with other distorting preferences – to put our tax system on a more neutral footing.

What follows is a list of R Street's top targets on the "conservative hit list" of tax policies that are structurally unsound and the deserve elimination in any kind of tax reform.

CORPORATE INCOME TAX

While the corporate income tax is politically popular and has strong populist appeal, many economists have called it into question. For example, conservatives such as American Enterprise Institute economist Kevin Hassett and

1. David Keating, "A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens," National Taxpayers Union (April 17, 2012) http://www.ntu.org/news-and-issues/taxes/tax-reform/ntupp130.html

liberals like former Obama advisor Austan Goolsbee have studied the deadweight losses and other distortions imposed by the tax. As a result, policy analysts from across the political spectrum believe that it simply shouldn't exist. It generates an enormous amount of economic dislocation relative to the revenue it raises, while encouraging myriad behaviors that do little or nothing to promote economic growth in the name of legal tax avoidance. Meanwhile, the potential benefits of eliminating it are substantial.

"Every dollar of corporate income tax is ultimately paid by one of three groups of people: employees, customers, or shareholders."

Though obscured by their structure, corporate income taxes are just another form of individual taxation. Every dollar of corporate income tax is ultimately paid by one of three groups of people: employees, customers, or shareholders. Because corporations pass all costs on to these groups, corporate income taxes inevitably lead to some combination of lower wages, higher prices, and lower returns for investors.

Economic literature on this matter is complicated, but some studies suggest that as much as three of every four dollars in corporate income tax costs are borne by a firm's workers, most of whom are not wealthy.[2] Furthermore, labor (and particularly low-skill labor) tends to be the group least able to adapt to the higher costs imposed by corporate income taxes. After all, customers can easily switch their allegiance to a competitor, owners of publicly-traded companies can easily sell their shares in a business, and high-skill workers can more easily find employment elsewhere. Low-skill workers have no such luxury.

2. Mihir Desai, C. Fritz Foley and James R. Hines Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," prepared for presentation at the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference "Who Pays the Corporate Tax in an Open Economy?," (December 2007) http://www.people.hbs.edu/mdesai/PDFs/Labor%20and%20Capital.pdf

Establishing a layer of taxation at a non-individual level makes no economic sense and generates serious distortions. Many large businesses have entire departments dedicated to exploring and implementing various legal tax avoidance strategies. From deferring income to setting up subsidiaries in lower-tax countries in which they place intellectual and intangible property, many companies devote enormous amounts of time and money to activities that are not especially useful in creating long-term economic prosperity. Perhaps more importantly, corporate income taxes encourage the use of debt over equity financing. As Megan McArdle once wrote at *The Atlantic*:

> Debt finance makes companies riskier. But because payments on debt are tax deductible, and dividends are not, companies have a strong incentive to use debt rather than equity finance. The deductibility of debt payments also lowers the required rate of return for new projects, possibly encouraging companies to invest in marginal ideas that aren't really worth it. Without the corporate income tax giving them a 35 percent reduction on their interest payments, they might think twice.[3]

In addition, corporate income taxes are unique in their ability to generate frenzied lobbying activity aimed at altering the code. Our high corporate tax rates encourage businesses and trade associations to engage politically in order to advocate for credits, deductions, and exemptions that are helpful to them. Because many such changes are justifiable individually, Congress begins poking holes in even a recently-reformed tax system almost immediately. Thus continues the cycle of the corporate tax code going from clean to cluttered in just a few decades.

Despite its relative political popularity, the corporate income tax is damaging and misguided. Conservatives in Congress should seek to eliminate it entirely.

DEATH TAX

THE ESTATE TAX – known in conservative circles by the descriptive moniker of "death tax" – is (along with its close cousins, the gift and generation-skipping transfer taxes) among the most odious forms of double taxation in existence. By imposing a levy on dollars that were already taxed at least once when earned by the deceased, the death tax effectively punishes thrift and savings while encouraging consumption.

3. Megan McArdle, "Why We Should Eliminate the Corporate Income Tax," The Atlantic, (October 28, 2010) http://www.theatlantic.com/business/archive/2010/10/why-we-should-eliminate-the-corporate-income-tax/65351/

The death tax has been on target lists for conservative activists for well more than a decade. In the tax cut package Congress passed in 2001, the death tax was put on a path to full repeal by 2010. Several attempts at a permanent repeal have been made in the intervening years, most prominently supported by Rep. Kevin Brady, R-Texas, and Sen. John Thune, R-S.D., Those efforts to rid the country entirely of the death tax have not been successful, leading to a situation where, under current law as it is set to take effect in 2013, any estate valued at more than $1 million will face a staggering top tax rate of 55 percent.

Much like the corporate income tax, this leads to a tremendous amount of estate and gift planning geared entirely toward avoiding a large tax obligation and not toward more productive economic activity. Meanwhile, the policy has created a multi-million dollar lobbying industry [4] that expends huge amounts of energy in pursuit of changes to a tax that currently represents just barely more than one-half of one percent of total 2012 federal revenues.[5] Even if it returns to its inordinately high rate of 55 percent, it will account for just barely more than one percent of revenues next year.

If the goal of the death tax is to raise revenue to pay for essential government services, there are many other taxes that could raise what is a relatively small amount of money with substantially less distortion. The same is true even if, as most conservatives believe, the goal is to facilitate redistribution of wealth. For example, though it would be opposed by virtually all conservatives, a more steeply progressive income tax would achieve much of the "desired" redistribution with a fraction of the economic dislocation imposed by the death tax. Simply stated, there's very little reason to have a hotly disputed, economically damaging tax that doesn't raise much revenue.

TARIFFS

Through 99 chapters and four indices, the Harmonized Tariff Schedule of the United States International Trade Commission assesses import taxes on untold thousands of products brought into the country each day. This absurd exercise, which encompasses activities like distinguishing between cocoa paste that is wholly defatted as opposed to partly or non-defatted, raises just $30 billion in revenue for the federal government, but at substantial cost to American consumers. While tariffs are frequently portrayed as measures to protect domestic employers, they actually serve only to raise prices for Americans while reducing economic efficiency.

Economists, whether conservative or liberal in their politics, agree almost unanimously that freer trade promotes efficiency and offers long-run gains for consumers.[6] This is true even for unilateral action to reduce a country's own tariffs without similar reductions from trading partners, because import taxes manifest themselves in the form of higher prices and reduced availability for domestic consumers. While there is emotional appeal to "protecting" a domestic industry by using tariffs to artificially raise the prices their overseas competitors must charge, economic analysis makes quite clear that such policies are self-defeating and hinder growth.

In the past, tariffs were high in part because of limited understanding of the benefits of free trade but also because the federal government needed a large revenue source. From the country's founding until just before the Civil War, tariff revenue accounted for the vast majority of federal receipts, in some years comprising as much as 98 percent of the budget. In the following 150 years, freer trade and the advent of widespread income and payroll taxation (and a dramatically larger federal government) has led to a reduction in the relative size of tariff revenue, representing just over 1 percent of federal receipts today.

Eliminating tariffs would be a bold step in creating a much freer trade market to benefit American citizens and send an important signal to trade partners that the United States will not engage in damaging protectionism. This would be an especially important step given unfortunate rhetoric from both parties about desires to initiate a foolish trade war with China. Given the relatively small amount of revenue they now bring in, eliminating tariffs would be a courageous step toward a better and more conservative tax system.

CONCLUSION

If done in isolation, eliminating corporate income, estate, and import taxes would put a sizeable dent in federal revenue. While that is a goal that R Street and other conservatives would wholeheartedly endorse in the long term, practical politics suggest that it could only happen in the context of a revenue neutral reform that doesn't add to our nation's staggering deficit.

4. Jonathan Strong, "Report: Giant life insurance lobby key force behind estate tax," The Daily Caller (November 30, 2011) http://dailycaller.com/2010/11/30/report-giant-life-insurance-lobby-key-force-behind-estate-tax/#ixzz2CE3OHz6s

5. U.S. Treasury Department, "Final Monthly Treasury Statement of Receipts and Outlays of the United States Government For Fiscal Year 2012 Through September 30, 2012, and Other Periods," (September 2012) http://www.fms.treas.gov/mts/mts0912.pdf

6. IGM Economic Experts Panel, "Free Trade" poll, (March 13, 2012) http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_0dfr9yjnDcLh17m

Revenue attributable to the corporate income tax fluctuates quite a bit with underlying economic fundamentals, but the President's Office of Management and Budget (OMB) projects that it will raise roughly $242 billion in 2012 after raising just $181 billion in 2011. This accounts for slightly less than 10 percent of expected federal receipts. For some context, that's just a bit larger than the revenue associated with the Federal Hospital Insurance Trust Fund. Estate and gift taxes and tariffs, meanwhile, raise substantially less. OMB expects to raise just shy of $14 billion from estate and gift taxes and just over $30 billion from customs duties in 2012.

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This paper has identified about $287 billion in federal revenue annually that conservatives should be targeting for total elimination in any tax reform package. This amounts to about 11.7 percent of 2012 revenue projections. Some or all of this shortfall would need to be made up with revenue raised elsewhere in the code. To the extent that Congress pursues such options, it should focus on taxes that impose minimal economic damage and are not easily evaded.

Eliminating corporate income, estate, and import taxes would make our current tax system dramatically more free market in nature. Rather than just nibbling around the edges of a fundamentally flawed system, wholesale eliminations of these damaging taxes would constitute a revolutionary reform by American tax policy standards. Corporate and import tax rates of zero would make the United States a premier destination for business investment and a death tax of zero would encourage savings and thrift over legal tax avoidance and consumption. While it is impossible to evaluate the economic impact of such policy changes in the context of this paper, eliminating anti-growth taxes could do a great deal to make America's economy freer and more prosperous.

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