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Tax Reform Complications

By Richard W. Rahn

TAX CUTS PAY FOR THEMSELVES, BUT IT TAKES TIME

Do you want tax reform? Now, for the difficult questions: What is your definition of tax reform? And what will be the consequences of each of your proposals?

Nearly all serious tax reform advocates call for a reduction in the corporate income tax rate for several very simple reasons: The United States has the highest corporate tax rate in the world among major economies, which drives U.S. companies to move to sunnier tax climes and discourages foreign companies from moving to the U.S. — all of which reduces the number of jobs and economic growth. The corporate tax is correctly regarded by most tax professionals as a terrible tax for more reasons than can be described in this space. Recent studies show that most of the cost of the tax falls on workers in terms of lower wages and benefits.

One impediment to constructive tax reform is the very rules under which Congress operates. Without getting into the complexities of the so-called budget "reconciliation" process, tax reform is limited by a requirement that tax reductions be "paid for" by other tax increases or spending cuts. For decades, many of us have been in the battle to use "dynamic scoring" rather than "static scoring" in determining the "costs" of tax reduction. Dynamic scoring is the attempt to look at the feedback effects of tax changes, such as the number of new jobs and, hence, taxable wages that would be created.

Did the Reagan tax rate cuts pay for themselves in terms of new tax revenue that was created as a result of the additional economic growth generated by the tax changes? Most tax economists on the left have argued "no," and even many Republicans and free-market economists have also argued "no." In an attempt to answer this question a number of years ago, I looked at the projections made by the Congressional Budget Office and the Carter administration officials before they left in 1981 — which forecast much lower levels of real economic growth than actually occurred after the Reagan tax rate reductions. The economic pie grew more rapidly, but the percent going to federal income taxes declined. It took about seven years for the inflation-adjusted economic pie to become sufficiently larger than the forecasts made in 1980-81 to compensate for the tax rate reductions.

The reason the above history is important is that the initial House of Representatives tax proposal contains a provision for a "border-adjustable" corporate tax system (as a partial pay for the corporate rate reductions). In essence, the proposal would eliminate much of the corporate income tax for products that are exported from the United States while not allowing any corporate tax deduction for the cost of imported goods and services. In short, this means that imports would be taxed more heavily than U.S. exports. A major problem with the proposal is that many companies that produce and sell (and thus create jobs) in the United States rely heavily on imported raw materials and components, and such a tax provision could cost them dearly, forcing them to raise prices to American consumers and reduce their U.S. work forces. The tax, as now proposed, would probably be challenged by the World Trade Organization as an unfair subsidy, which might push the tax writers into making it a Value Added Tax (VAT) like the Europeans have, and which is border adjustable according to the rules. A VAT would be a whole new major tax, whose rates are easily raised, as the Europeans have shown, leading to bigger government and more economic stagnation.

Some tax rate reductions, like the capital gains tax, have almost immediate positive economic feedbacks and often pay for themselves in as little as two or three years. Other income tax rate reductions take many years (as the Reagan reductions showed) to totally pay for themselves, even as there were tremendous shorter term benefits in all of the new and higher-paying jobs that were created.

It is important that the tax writers in Congress not let themselves be limited by the Congressional Budget Office and other tax models that do largely static or very limited dynamic tax revenue forecasts. They also need to have sufficient time horizons in their forecast models to allow the full effect of the tax rate reductions to work through the economy. For such purposes, a 10-year forecast may well be appropriate.

Yes, cutting tax rates sharply will add to the deficit in the short run. But if properly structured, it should create many more jobs and even greater total tax revenues in the long run. This will lead to a smaller federal debt burden as a share of gross domestic product, if coupled with real spending restraint. At the same time, taxing imports will only drive up consumer prices, increase costs, and kill jobs for the millions of American businesses, which depend on foreign components and raw materials to run their own businesses.

Finally, the federal budget is so bloated, including massive waste in the Defense Department as was revealed this past week, that an almost unlimited number of spending reduction "pay fors" are available if the new Trump administration and Congress are serious about budget and tax reform.

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