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Thinking Clearly about Tax Reform

By Richard W. Rahn

CUTTING TAX RATES WOULD BOOST GOVERNMENT REVENUE

President Trump has said he is going to move on to tax reform after the debacle with Obamacare repeal. Is there any reason that we can expect greater success with the tax reform effort? I argue no, unless the rules in the House and Senate are modified, and those in Congress, whose brains are connected enough to distinguish between tax rates and tax revenues, take control.

Fortunately, we have a history, going back to the Coolidge administration in the 1920s, the Kennedy administration in the 1960s, the Reagan administration in the 1980s, and even the second Clinton administration, to give clear lessons about what works when reforming the tax code.

The present tax code has been shaped by many different interest groups over the decades, and they have not gone away. Thus, for any tax reform to succeed, there must be more winners than losers — i.e., a real tax cut for the majority — because the losers always work harder (the squeaky wheel) to preserve their benefits than those who are likely to gain. The current congressional rules require revenue neutrality for tax changes, which is a non-starter for reform, as long as revenue neutrality is defined on a "static basis," which it now is. Have you ever noticed that many of the big-government types who tell us that tax rates and regulations have little effect on incentives or economic growth are the first to argue for higher taxes on cigarettes as a way of discouraging smoking? This observed change in behavior is a "dynamic" effect of a tax change.

As an example of the disconnected brain, many big-government types who imposed high taxes and regulations on their own economies, tend to support Special Economic Zones (SEZs). SEZs are created to give companies special trade or tax and regulatory breaks for investing in a SEZ, because policymakers believe lower taxes and fewer regulations will create more and higher-paying jobs, which is why some 3,000-plus have been created all over the world. For those who wish to learn more about SEZs, I recommend the excellent new book by international economist, Lotta Moberg, "The Political Economy of Special Economic Zones."

New York State has been running TV ads, claiming that it is a good place to do business because it offers special tax breaks for new businesses moving into the state. On one hand, these same people who gave New York some of the highest taxes in the country, in part, on the argument that it would not hurt job creation and growth, are also telling us that special tax breaks will create jobs and growth — talk about brain disconnect. The political leaders in Texas, Florida and a number of other states have better-connected brains because they figured out that not having a state income tax would attract more businesses as well as more and better jobs, and their states would grow faster than the high-tax states. Texas, Florida, Tennessee and the other no-income-tax states have been able to provide all of the government services that people want, often at higher quality. The empirical evidence for this assertion is that people have been moving from high-tax states like New Jersey to the low-tax states for decades.

Before Congress starts on tax reform, it must ditch the rule calling for static revenue neutrality and move to full dynamic scoring (which should account for all of the taxpayer behavioral changes from the tax rate change).

Second, there is considerable empirical evidence that government spending is well above the growth and welfare-maximizing rate, and thus must be cut to reach long-term job creation and income potential. Likewise, many tax rates are well above their long-run revenue, economic growth and welfare-maximizing potential. There is considerable evidence and many good studies from solid researchers in organizations like the Tax Foundation that capital gains tax rates above 15 percent are long-run tax revenue losers and job destroyers.

Congress, as it begins tax reform, should start with the proposition that the corporate tax rate should be no higher than 15 percent in order to be internationally competitive and foster more investment in the United States, and likewise the capital gains tax rate also should be no higher than 15 percent. The individual tax rate should be no higher than 28 percent, as it was under the second Reagan administration; anything higher will be a detriment to long-run growth and welfare. The lawmakers then should attempt to score (i.e., determine how much tax revenue is likely to be realized under such a rate system), using full long-run dynamic analysis, which will give them a target as to how much they can spend. In the short run, deficits will be higher, but lower in the long run, if the spending caps are not exceeded.

For too long, the tax code has been hostage to the spenders. It is time to reverse this, particularly given all of the useless, wasteful and even destructive government spending. Real tax reform requires that spending be adjusted to the expected tax revenue from a non-highly destructive tax system. No more policy brain disconnect.

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http://www.washingtontimes.com/news/2017/mar/27/tax-reform-requires-the-right-solution/

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