POLICY FOCUS

The Biggest Problem with America's Tax Structure

RECIPES FOR RATIONAL GOVERNMENT FROM INDEPENDENT WOMEN'S FORUM

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WHAT YOU NEED TO KNOW

When it comes to collecting government revenue, America relies too much on income taxes and not enough on consumption taxes. Solving this problem is the key to unlocking real, bipartisan tax reform.

Right now, Democrats broadly oppose any tax-reform bill that would increase the federal budget deficit or make the tax code less progressive, while Republicans broadly oppose any bill that would raise income-tax rates or produce extra revenue to finance new spending.

If members of both parties agreed to adopt a national value-added tax (VAT) and combine it with a sweeping overhaul of the income tax, they could implement a genuinely radical reform package that would encourage investment and economic growth without adding to the deficit, creating a more regressive tax code, or inflating the size of government.

America is currently one of the few countries in the world—and the only member of the Organization for Economic Cooperation and Development (OECD)—that does not have a nationwide VAT on goods and services. In fact, both as a share of GDP and as a share of total taxation at all levels of government, we generate less revenue from taxes on goods and services than any other OECD member.

This structural difference matters, because economists have shown that income taxes in general—and corporate-income taxes in particular—hurt economic growth more than consumption taxes.

Thus, rebalancing our federal revenue structure away from income and toward consumption should be a top priority for tax reformers.

Independent Women's Forum encourages a respectful debate about different approaches to improving our tax code. Senior fellows represent their own views, and do not reflect an official position of the organization.

WHY YOU SHOULD CARE

America's overreliance on income taxes is bad for our economy and bad for revenue collection. To understand why, we need to remember that:

- **Income taxes do greater damage to economic growth than consumption taxes.** More specifically, OECD economists have **found** that corporate-income taxes are the "most harmful for growth, followed by personal income taxes, and then consumption taxes."

- **Our individual-income tax is a very inefficient tool for raising revenue.** Even in the late 1960s and 1970s, when the top marginal tax rate was **70 percent or higher**, the amount of revenue generated by the individual-income tax stayed below 9 percent of GDP, and often below 8 percent of GDP, according to the **Congressional Budget Office**. In fact, the only time over the past half-century that revenues exceeded 9 percent of GDP for a sustained period was during the dot-com bubble of the late 1990s and early 2000s.

- **Our corporate-income tax is even more inefficient, and also deeply distortionary.** The current system discourages investment in the United States, incentivizes corporations to shift profits abroad, favors certain industries and companies over others, and fails to raise much revenue.

MORE INFORMATION

Why Tax Reform Is So Hard

"Lower the rates and broaden the base." For decades now, that has been the mantra of American tax reform—a simple and concise way of describing the blueprint for pro-growth, revenue-neutral policy changes.

So why hasn't real tax reform happened since **1986**?

For starters, "broadening the base" is much more difficult than it sounds. While lawmakers bemoan tax complexity and "loopholes" in the abstract, many of the most expensive credits, deductions, and exclusions remain politically popular.

To cite just a few examples: The Urban-Brookings Tax Policy Center **estimates** that, in fiscal year 2018, the single biggest federal tax expenditure will be the exclusion for employer-provided health insurance, which will cost the U.S. Treasury nearly $236 billion. Meanwhile, the deduction for mortgage-interest payments will cost over $68 billion, the Earned Income Tax Credit (EITC) will cost almost $64 billion, the Child Tax Credit will cost over $54 billion, and the deduction for charitable contributions will cost over $51 billion.

If you want to save real money to help lower tax rates, these are the sorts of provisions you need to address. Yet they're also some of the hardest provisions to scale back—mostly because of how many people benefit from them, but also, in some cases, because of legitimate policy concerns. The EITC and the Child Tax Credit, for example, have a proven record of **alleviating poverty**.

Thus, when politicians nominate specific tax preferences for downsizing or elimination, they tend to pick narrowly targeted, "special interest" tax breaks that help corporations or wealthy individuals. The trouble is that, even if all such tax breaks were abolished, it would not produce nearly as much revenue as many lawmakers seem to think. In that sense, the debate over tax expenditures can become a distraction from the larger, structural problems with America's revenue system.

The most important structural problem is our overreliance on income taxes to fund federal spending. Indeed, while 45 states (and the District of Columbia) have a **statewide sales tax**, and 38 states have **local sales taxes**, the United States is the only member of the Organization for Economic Cooperation and Development (OECD) that does not have a nationwide value-added tax (VAT) on goods and services.

Without such a consumption tax, it will be hard for Republicans to slash federal income-tax rates as deeply as they would like—unless they decide to support deficit-financed tax cuts, which would not be responsible, given America's massive long-term budget shortfall.

American Tax Exceptionalism

Rather than focus exclusively on ways to reform the income tax, we should aim to make our entire revenue structure more efficient. That means, above all, rebalancing the tax burden away from income and toward consumption.

In 2015, **taxes on goods and services** accounted for less than 17 percent of total U.S. revenue from all levels of government—the lowest share in the OECD. By comparison, such taxes accounted for over 28 percent of all revenue in Sweden, nearly 33 percent in the United Kingdom, and almost 39 percent in New Zealand. For the OECD as a whole, the average in 2014 (the most recent year for which we have full data) was close to 33 percent.

Personal-income taxes are a different story: In 2015, they accounted for nearly 41 percent of all U.S. revenue—the *highest* share in the OECD outside of Denmark, and well above the 2014 OECD average of around 24 percent.

As for corporate-income taxes, America has the OECD's **highest combined statutory rate**, which discourages investment, yet we also have a rainforest of corporate-tax breaks that hinder revenue collection. In addition, because we force U.S.-based multinationals to pay the 35 percent federal corporate-tax rate on all overseas profits they wish to repatriate, we effectively encourage them to keep their profits abroad.

Consequently, despite America's exceedingly high statutory rate, the amount of revenue we generate from corporate-income taxes—as a share of GDP—is **well below the OECD average**, and well below the amount generated by countries with much lower statutory rates, such as Ireland and Switzerland.

A Model of Inefficiency

For all these reasons—and plenty more—America's current tax structure is a model of inefficiency. "By the standards of most economists," **writes** Eduardo Porter of the *New York Times*, "the United States has one of the most counterproductive tax regimes among advanced nations—one that raises little money yet vastly distorts decisions on investing and saving, and encourages all sorts of trickery to avoid the Internal Revenue Service."

To appreciate just how badly structured America's tax system really is, it's worth reading a landmark 2008 OECD **study** that compared how different kinds of taxes affect economic growth. The study found that corporate-income taxes are the "most harmful for growth, followed by personal income taxes, and then consumption taxes."

This makes intuitive sense. After all, it's much easier for corporations to move their income abroad than it is for individuals to do the same, especially in our increasingly globalized economy. At the same time, it's easier for a person to reduce his or her taxable income—by working less, adjusting investments, or reclassifying certain income—than it is to avoid paying consumption taxes.

That helps explain why the federal individual-income tax is a poor tool for raising large sums of revenue. Over the past 50 years, revenues from the individual-income tax have never once surpassed 10 percent of GDP, and only six times have they reached or topped 9 percent of GDP, according to the **Congressional Budget Office**. Those six years were 1981 and 1982, when inflationary "bracket creep" caused revenues to rise despite a severe economic downturn, and 1998 through 2001, when revenues soared because of the dot-com bubble that eventually burst. In other words, each year was marked by highly unusual—and undesirable—circumstances.

The broader historical record suggests that America's individual-income tax will produce a relatively consistent amount of revenue over time. Even raising the top rate back to 70 percent or higher, which is where it stood **from the mid-1960s through the early 1980s**, probably would not deliver a huge revenue burst. Indeed, the individual-income tax generated roughly the same amount of revenue as a share of GDP (8 percent) in 1974, when the top rate was 70 percent, as it did in 1989, when the top rate was 28 percent, and in 2013, when the top rate was 39.6 percent.

The Path to Real Reform

With all of that in mind, Congress should pursue a genuinely radical tax reform that would simultaneously (1) make America a more attractive place to invest, (2) help U.S.-based companies compete in a globalized economy, (3) help Washington raise revenue more efficiently, and (4) dramatically reduce the number of families and individuals subject to federal income taxes. Lawmakers could achieve those objectives without adding to the deficit, making the tax code less progressive, or inflating the size of government.

The tax reform described above was first introduced by a Columbia law professor and former Treasury Department official named **Michael Graetz**, and it subsequently became the model for the **Progressive Consumption Tax Act** sponsored by Senator Ben Cardin, a Maryland Democrat.

While there are differences between the Graetz proposal and the Cardin bill, both would implement a nationwide VAT and use the new revenue to help establish a $100,000 income-tax exemption for married-couple families (along with a $75,000 exemption for head-of-household filers and a $50,000 exemption for individuals), help reduce the top individual rate and consolidate the number of brackets, help create new tax credits or rebates for lower- and middle-income households, and help reduce the federal corporate-tax rate from 35 percent to either 17 percent (Cardin) or 15 percent (Graetz). Both would also provide a VAT exemption for small businesses with earnings below a certain threshold, and both would tax personal investment income (i.e., capitals-gains and dividend income) at the same rates as regular income.

In 2015, the Tax Policy Center analyzed a version of the Graetz plan and **confirmed** that, with a VAT rate of 12.9 percent, it would be both revenue neutral and distributionally neutral, meaning it would not affect the deficit or change the tax code's progressivity.

No tax reform is perfect, of course. Yet Graetz and Cardin start from the correct premise—that America relies too much on income taxes and not enough on consumption taxes. Their proposals show that we can fix this problem—and create a more efficient, more pro-growth tax system—without busting the budget or making the system more regressive. Members of Congress should take note.

Taxes and Economic Freedom

American conservatives have long feared that adopting a national consumption tax would inevitably lead to a major reduction in economic freedom. The evidence from abroad suggests otherwise.

In the Heritage Foundation's 2017 **Index of Economic Freedom**, there are 16 countries or territories that rank ahead of the United States. Every single one of them, save for Hong Kong, either already has a nationwide value-added tax (VAT) or, in the case of the United Arab Emirates, will be implementing a VAT at the start of 2018. These countries include Singapore, New Zealand, Switzerland, Australia, Ireland, Canada, the United Kingdom, Luxembourg, and the Netherlands.

Five of those nine countries—Singapore, Canada, Ireland, Switzerland, and New Zealand—also rank ahead of America in the sub-category of "tax burden." In other words, the Heritage analysts believe that the Singaporean, Canadian, Irish, Swiss, and New Zealand tax systems impose less of a burden on economic freedom than the U.S. system.

This suggests that, if introduced as part of broader, pro-growth tax reforms, a VAT could actually help *increase* American economic freedom, rather than reduce it.

WHAT YOU CAN DO

You can help promote reforms that would make America's tax structure more efficient and more supportive of economic growth.

- **Get Informed:** Learn more about the tax reforms we need. Visit:
  - Independent Women's Forum
  - The Organization for Economic Cooperation and Development
  - The Urban-Brookings Tax Policy Center
- **Talk to Your Friends:** Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.
- **Become a Leader in the Community:** Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.
- **Remain Engaged Politically:** Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

ABOUT INDEPENDENT WOMEN'S FORUM

Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

We rely on the support of people like you! Please visit us on our website www.iwf.org to get more information and consider making a donation to IWF.

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