

Thirty Years Without Fundamental Reform: Policy, Politics, and the Federal Tax Code

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Today I will discuss two broad challenges in reforming our Federal tax system. First, the policy challenge: how to reform the system to make it more efficient, simple, and fair, a standard we fall well short of today. And, second, the political challenge: how to actually accomplish that reform, the difficulty of which is clear from the fact that it has now been three decades since we last passed fundamental Federal tax reform.

The Substantive Improvements in the Tax Code in the Last Thirty Years

To be sure, we have made meaningful progress in tax policy over the last thirty years. We have made the tax code more stable by making major individual and business provisions permanent and more sustainable, including last month's agreement to make the Research and Experimentation Tax Credit permanent for the first time since its initial enactment in the early 1980s and indexing the Alternative Minimum Tax for inflation in the fiscal cliff agreement three years ago. By increasing the stability of the tax code, we also increase the efficacy of many of the affected provisions, particularly those encouraging research and clean energy investments that require long-term planning.

We have enacted a curb on the largest tax expenditure, the exclusion for employer-sponsored health insurance, in the form of the excise tax on high-cost health plans, which is scheduled to phase in starting in 2020 and is projected to cut health spending by more than \$40 billion annually and boost wages by more than \$40 billion annually by 2025. And we have reformed another large tax expenditure by facilitating automatic enrollment in 401(k) plans, taking advantage of research in behavioral economics about how best to increase savings, which has likely resulted in millions of additional workers participating in retirement savings plans.

We have also made historic changes to make the tax code more progressive, including higher taxes on high-income households, such that households in the top one percent of the income distribution are paying an effective tax rate about seven percentage points higher than in 1985. We have also substantially increased tax credits for low-income households through the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC), which together lift over 9 million people, including 5 million children, out of poverty each year. Finally, outside of the income tax, since 1986 we have roughly tripled the Federal tax on cigarettes in real terms, deterring more than one million people from smoking and saving countless lives.

To be sure, none of this adds up to the fundamental tax reform that anyone has had in mind. The tax code is riddled with unnecessary complexity, inefficiency, and unfairness. But, in pursuing the broader ideal of tax reform, we should not forget that fundamental tax reform is not necessary and may not even be sufficient to result in large improvements for tens of millions of people.

How to Overcome the Collective Action Obstacle to More Fundamental Reform

In today's discussion, I first want to ask why it has been so hard to get tax reform enacted, and in asking that question, seek any insights that will help us actually get it enacted in the future. As we will see, however, this question is related to—but not identical to—the degree of substantive benefits from tax reform itself.

The classic explanation for the difficulty of passing tax reform is grounded in the logic of collective action: tax reform imposes concentrated costs with only diffuse benefits. The gains for the winners are not large enough to inspire a sustained fight for them, while the losers are acutely aware of their potential losses and mobilize to stop them. Moreover, in the case of tax reform I am concerned that even the winners might not pursue reform as they can be overly focused on losing a salient deduction without factoring in the total change in their taxes that results from the rate reduction it is funding.

How can we overcome this collective action challenge? I can think of three ways:

The first approach requires large coalitions organized around a commitment to a particular substantive view of tax reform—a shared vision that motivates them more than their specific gains or losses. Such coalitions could potentially overcome the various groups of losers that might seek to block the reform. Put differently, a broad popular ideology of taxation could transcend specific financial interests—either concentrated within a single political party or among reformists drawn from across the political spectrum.

A second way to address the collective action problem is to relax the budget constraint and thus circumvent the trade-offs of reform with a plan that creates many more apparent winners than losers. This can be done overtly, such as by deliberately reducing taxes by trillions of dollars as part of a reform package, or it can be done more surreptitiously. Examples abound, including the use of implausible assumptions to generate a misleading dynamic score and timing gimmicks like Roth IRA conversions or depreciation shifts to achieve revenue neutrality in the 10-year budget window while losing billions in the long run. This “cheating” solution to the difficulty of tax reform does not reduce the number of losers it only obfuscates who will ultimately pay the higher taxes or lower benefits needed to finance the reform. Moreover, it is likely that the costs associated with higher deficits over the long run will outweigh any economic benefits associated with the reform. And politically, it is not going to happen—at least under this President.

A third route to overcoming the collective action problem recognizes and emphasizes that the winners from reform can greatly outweigh the losers in an *economic* sense even if the same is not true in a purely *revenue* sense. For example, consider a revenue-neutral tax reform. By definition, such reform produces as many winners as losers when measured in dollars and cents

paid in taxes. But if it also greatly reduces the burden of filing taxes or the inefficient allocation of consumption or the inefficient allocation of labor/leisure time, then the reform could result in more economic winners than losers measured in terms of well-being. Such a program would still face collective action problems on the same logic of diffuse benefits and concentrated costs, but the larger economic benefits can potentially ameliorate this obstacle.

I believe this third route is promising in the case of business tax reform because such reform has potentially substantial economic benefits—benefits like removing distortions in our international tax system that needlessly drive business decisions and reducing debt/equity distortions that interfere with the financing of business activity and increase the fragility of our economy. These benefits could be tangible enough to overcome the concentrated opposition to reform. But I am more skeptical that this logic will be sufficient to enact fundamental individual tax reform. My skepticism is attributable to my somewhat unfashionable belief that the efficiency and simplification gains from individual tax reform are smaller than some conventional wisdom would suggest and are substantially smaller than the impact that individual tax changes can have on the level and distribution of revenue. I will discuss business and individual reform through this lens—that of economic winners and losers rather than revenue winners and losers—in turn.

The Economic Case for Business Tax Reform

The United States has the highest corporate tax rate of any advanced economy in the world, as other economies have consistently cut their rates over the last few decades. At the same time, we have a narrower tax base along a number of different dimensions that sharply lowers our effective tax rate.

This situation creates a number of economic distortions. For example, the tax rate varies widely on different types of investment: debt-financed corporate investment is taxed at a rate nearly 40 percentage points lower than equity-financed investment, and passthroughs on average pay 5 percentage points less than C corporations when individual and corporate-level taxes are combined. As a result of these and other distortions, decisions can be made for tax reasons instead of economic reasons—reducing overall efficiency and economic output for any given level of taxation.

One clearly problematic area is international taxation. The United States purports to have a worldwide tax system that taxes subsidiaries' earnings wherever they are earned. But in practice, we actually have what I call a “stupid territorial” system that collects little revenue from the overseas operation of subsidiaries of U.S. multinationals. Moreover, while collecting little revenue, we still manage to impose substantial distortions by creating an incentive to undertake complex and inefficient tax reduction and capital structure strategies to keep earnings located overseas. It should be possible to design a system that collects more revenue at a given level of distortions or imposes fewer distortions for a given level of revenue or, ideally, some combination of both.

The conversation on business tax reform has advanced significantly in the last decade and it has also converged in important ways. President Obama is the first President in decades to call for a

lower corporate rate. The President's proposed 28 percent rate is similar to the 25 percent in leading Congressional Republican proposals. At the same time, there is broad acceptance that this rate reduction should be paid for by broadening the tax base and reforming the tax structure, making it revenue neutral overall—albeit there is still significant debate over how exactly to define revenue neutrality.

There is also agreement that the United States should replace its worldwide system of taxation with a hybrid system that prevents base erosion and increases the incentives to invest domestically. Such a hybrid system would also let American corporations operate overseas and repatriate earnings without the current system's needless tax-induced obstacles. Under the President's plan, for example, overseas earnings would be subject to a 19 percent minimum tax when earned (with allowances for a basic rate of return and foreign taxes paid), but no additional tax on repatriation.

And there is agreement that corporate tax reform should not come at the expense of small businesses—and instead that we need to focus on *business* tax reform more broadly, not just corporate reform, that reduces and simplifies taxes for small businesses.

But the agreement on a principle for small businesses does not extend to an agreement on the means for implementing that principle. The President's approach would simplify and reduce taxes for small businesses, using mechanisms like Section 179 expensing, building on the expansion that we just made permanent in December. In contrast, a number of Republicans have called for cutting the top individual tax rate so that the top statutory tax rates are the same on both corporate and individual income. Economically, this is unjustified. The right way to think about tax rates is not just in terms of statutory rates at the entity level but in terms of integrated effective rates that take into account that corporate income is taxed at two levels while passthrough income is taxed at one level—which, as I noted, results in a lower effective tax rate for passthroughs than C corporations. Moreover, cutting the top individual rate not only fails to achieve the objectives of tax reform, but would worsen budget deficits and primarily benefit high-income households and even many large businesses. For both economic and political reasons, then, we should disentangle business tax reform from the thicket of issues raised by changes to the top individual income tax rates—issues that I will return to shortly.

If Washington could agree on an approach to business tax reform, the economic benefits from eliminating inefficiencies and distortions in the current system could be strong enough to overcome the classic winners/losers problems. However, for this to occur businesses will need to apply the same dynamic scoring to thinking about their own after tax income that they are always asking us to do for the scoring of the plans themselves. If businesses recognize the benefits for the broader economy and how those benefits will improve their bottom line, we may be able to solve the seemingly intractable problem of enacting business tax reform.

While the third route to overcoming the collective action challenge—ensuring that efficiency gains and thus economic winners are large in number relative to losers—provides a path to business tax reform, I am less optimistic about its potential on the individual side, which I turn to next.

Individual Tax Reform: The Limits of Efficiency and Simplification

In contrast to our system of taxation of business income, I am not convinced that the genuine benefits of tax reform on the individual side—in terms of efficiency or simplification—are nearly large enough to propel a political dynamic where the economic winners overcome the economic losers from reform.

Let me start with evidence about the impact of tax reform on growth. President Bush put together a tax reform commission that reported back a pair of thoughtful plans in 2005 that have many of the conventional elements of fundamental tax reform. One of the two plans, the Simplified Income Tax, can be thought of as something of an upper bound on the growth benefits of individual-focused tax reform. Treasury analysis concluded that such a plan would add 0.0 to 0.4 percent to the level of output after a decade and only 0.2 to 0.9 percent to the long run level of output—which correspond to correspondingly smaller increases in the annual growth rate.

Moreover, measuring growth in isolation is not the right way to evaluate a tax reform package. Consider a person currently working 40 hours per week at \$20 per hour, who as a result of tax reform, shifts to a 45 hour week. In GDP terms, tax reform has resulted in \$100 of additional output per week. But that doesn't mean the worker is \$100 better off. Her time not engaged in market work has declined by five hours, and she could face additional costs for childcare, travel, and other expenses. Conversely, there are changes to the tax code that would not increase growth at all, but would still enhance overall welfare. For example, effectively limiting the health exclusion as the high-cost excise tax does will result in less wasteful spending on health care—increasing the value of the output the economy produces, even if the total amount of output does not change.

One reason that the traditional “broaden the base and lower the rate” tax reform does less for growth than one might like is that, at least when distributionally neutral, it often does less to change the incentives around labor-leisure choices than meets the eye. Consider a hypothetical tax system where everyone is allowed to exclude 50 percent of their income from taxes and then pays a 40 percent tax rate. A reformer that came along with the bright idea of eliminating the exclusion and cutting the rate to 20 percent might aesthetically improve the tax code, but would not actually change the effective tax rate on an additional dollar earned and thus would not alter any incentives at all. This is not just a contrived hypothetical. Eliminating the State and local deduction to pay for a lower rate is functionally identical to this example, and a similar logic applies in substantial measure to provisions like the mortgage interest and charitable deductions which also tend to increase with income just like the State and local deduction does. (If people know they will spend their additional income on tax-preferred goods or services, they can anticipate a lower effective marginal tax rate on their income as a result of these deductions—so swapping an anticipated lower rate for an actual lower rate would result in less of a genuine change than would be expected from looking at the statutory rates alone.)

I do not want to be dismissive of boosts to output measured in the tenths of a percent—I support doing anything we can to expand the size of our economy—and I do believe there are meaningful benefits to thoughtful tax reform not measurable in terms of the size of the economy. But I am not sure that any of these benefits are large enough to overcome the collective action

problem that militates against tax reform, nor am I sure that they are the best focus of attention when there are alternative approaches to tax changes I will discuss in a moment that have the prospect of substantially larger welfare gains.

But what about simplification? Popular discourse sometimes focuses on the number of tax brackets—which has nothing whatsoever to do with complexity. Tax reformers love to talk about how the tax code is rife with tax expenditures, deviations from a hypothetical pure tax system that are analogous to spending money through the tax code. Each year the Treasury produces a list of over 100 individual income tax expenditures, providing fodder for claims that if we just got rid of all of them we could not only substantially cut tax rates but also dramatically simplify tax filing. The awkward challenge, however, is that more than half of the value of these tax expenditures reflects exclusions from income that actually make it easier for individuals to file taxes. Many tax expenditures allow taxpayers to exclude or deduct income that is not received in cash and would be much harder to measure precisely than wages on a W-2. Taxing home production, imputed rent on owner-occupied housing, pension earnings, inside buildup on life insurance policies, and all government benefits would move the tax system closer to many economists' ideal "Haig-Simons" concept of taxable income, but would not make filing taxes any easier.

This challenge stems from the fact that most of the complexity in the tax code derives from efforts to accurately measure an abstract concept of income, not from taking particular deductions or exclusions that cause taxable income to deviate from that abstraction. And there is often a tradeoff between simplifying the measurement of income through exclusions and the purity of the tax base many economists would like to achieve. Many of the biggest deductions, like the mortgage interest deduction, take very little time or effort to claim. Additionally, reforms that reduce or restrict—but do not eliminate—tax expenditures may have a number of merits, but simplification is certainly not one of them.

That is not to say we cannot do more to simplify the tax code in a way that meaningfully eases the tax planning and filing process. But much of that simplification is not going to come from classic base broadening. Rather, it is going to come from steps we can take to improve the filing process, like the legislation that required financial institutions to report the basis on stock (and certain other security) sales to their customers or having universities report to students the information they need to claim their tax credits for education as we did in the Omnibus enacted in December.

The Debate Over Revenue Levels and Distribution in Individual Tax Reform

This somewhat skeptical perspective on the growth and simplification benefits of individual tax reform brings me to the debate over the level and distribution of revenue. While there is an appeal to revenue and distribution neutral tax reform, when it comes to individual reform the largest benefits may come from reforms that change precisely these more controversial features of the tax code. However, whether you agree with me and how you evaluate those benefits depends on what economists call your "social welfare function," or how much weight you put on

different parts of the income distribution, and on your model of the degree to which public investments contribute to overall economic growth.

The President's approach to tax reform places a lot of weight on how the middle class or those working to get into the middle class are doing. Tax changes can have a large direct impact on after tax income. The changes in the Federal tax code since 1986, including the substantial increases to the EITC and CTC enacted under this and prior Administrations, boosted the after-tax income of households in the first two quintiles of the income distribution by about seven percent without even counting any benefits from the additional labor force participation and earnings generated by the expansion of these tax credits. These gains are an order of magnitude larger than the estimated gains from fundamental tax reform, which are generally measured in the tenths of a percent.

Moreover, deficits are economically costly and in the long run infeasible. Curbing deficits more through higher taxes on high-income households, as part of a balanced plan that also includes entitlement reforms, and less through reduced benefits for working families or investments in research and infrastructure that fuel growth is also likely to result in substantially higher after-tax incomes for the large majority of the population.

Of course, once you are talking about the level and distribution of revenues, specific interests matter greatly. And that takes us back to the first path for overcoming the collective action challenge to tax reform I discussed above. For this reason having a coalition of people that believe that a given set of changes is the right way to advance society's interest may be a key motivator of some of the most important changes to the tax system, especially when venturing beyond more technical areas like business tax reform.

The Path Forward on Tax Reform

If a resolution to these often intractable debates—or widespread agreement on the economic merits of a single tax reform plan—is required to make any progress on comprehensive tax reform, the odds of reform may seem quite poor. However, I want to end on a somewhat more positive note as I do think there are some broader areas of agreement, based in part on coalitions that support their own economic benefits but also on broader beliefs and convictions that the changes would represent an overall improvement. Let me list four:

First, I continue to think that revenue neutral *business* tax reform has important benefits and the Administration stands ready to work with Congress on the issue—provided it is genuinely revenue neutral in the long run and is not part of a broader effort to cut the top individual tax rate to confer substantial gains on high-income households.

Second, there are a number of important steps we could take in the tax code where we have common ground. One particularly important example is an expansion of the EITC for childless workers and noncustodial parents, an idea that the President proposed two years ago and Speaker Ryan has adopted. This change will not happen because of the political power of the beneficiaries but because a broader body of research and analysis, correctly, identifies this as a

major issue both for the people affected and, through lack of labor force participation, the economy more broadly.

Third, there has been increasing agreement that we can get additional revenue while improving efficiency through broad-based reductions in tax expenditures for those who derive outsized benefits from tax expenditures under the current system. This is an idea that has been supported by several of the economists who held my position under Presidents Ronald Reagan and George W. Bush, including Martin Feldstein, Glenn Hubbard, and Greg Mankiw. The President's proposal, for example, would limit the value of the major deductions and exclusions to 28 cents on the dollar. This would effectively cap the value of deductions and expenditures for high-income households, reducing the disproportionately large benefits high-income households receive in areas like housing relative to the middle class.

And finally, although there is less political consensus, there is at least broad agreement among economists and other policy experts about an expanded role for so-called Pigouvian taxes that address negative externalities in a simple, efficient, and effective manner. One example of this is the President's proposal to expand and harmonize the taxation of tobacco products to pay for universal preschool. And there is considerably more scope for a broader use of Pigouvian taxes.

In conclusion, I believe there is much we can do to improve our tax code, and that such effort will better serve our country if it is motivated less by the aesthetic purity of the tax code itself and more by serving the most fundamental goals we are really trying to achieve. Thank you very much for your attention to these issues today.