Written by Veronique de Rugy on September 21, 2017

Three Priorities to Guide Tax Reform

Congress is finally tackling the tax code, which is good news because reform is badly needed. Our outdated code is complicated by thousands of credits, deductions and exemptions to individual and corporate interests — and it imposes high rates that inhibit economic growth. However, as we've seen with the failed efforts to repeal and replace Obamacare, getting a consensus among Republican members is easier said than done. It should boil down to three priorities.

First, though overhauling the whole tax code would be great, if the goal is economic growth, reforming the corporate side is the most pressing priority. Everyone knows that the corporate tax system is a punishingly inefficient and large driver of corporate avoidance. Ideally, a reform plan could cut the rate dramatically and move the United States from the highest to one of the lowest rates among industrialized nations. The president has talked about 15 percent, which would make U.S. companies significantly more competitive abroad and at home while dramatically reducing the need for tax avoidance and inversions.

It should also replace "depreciation" with "full expensing." This sounds like a bunch of tedious jargon, but all you need to know is that companies generally aren't allowed to immediately deduct (expense) their investment costs when calculating taxable income and that this creates a bias against business investment. Some exceptions exist and create their own problematic biases because they're targeted toward particular industries or activities supported by politicians. Different rules make for a more complex tax code, encourage lobbying and lead to special privileges for the well-connected. Full expensing would flatten all this out.

These reforms would boost the economy, American competitiveness and job creation the most. A corporate tax reduction would boost standards of living through higher wages, too. That's because the majority of the corporate tax is shouldered by workers, in the form of lower wages.

The second priority? Congress needs a budget. Without that, there's no reconciliation — the process by which Republicans can bypass the need for 60 votes in the Senate. Without that, there's no reform. However, the rules of reconciliation require that tax reform be deficit-neutral outside the 10-year budget window. A lot of the current tension about tax reform is caused by a disagreement about how to meet the deficit-neutral constraint.

A third priority requires that tax reform be paid for. The best way to do that, however, is to restrain spending. We're $20 trillion in debt and heading once again to a $1 trillion deficit, even before the tax cuts. Extending and strictly enforcing the previously bipartisan and quite modest Budget Control Act caps of 2011 until 2025 would pay for tax reform without resorting to new sources of revenue such as the misguided value-added tax, a carbon tax or a border adjustment tax.

Getting rid of genuine loopholes that benefit individuals and corporate interests would also help pay for tax reform. The exclusion for employer-provided fringe benefits, the state and local tax deduction, and the deduction for U.S. production activities are ripe for repealing and could allow for trillions of dollars in tax cuts.

Congress could approve a tax cut that expires after 10 years, of course, but temporary tax cuts are less conducive to growth because entrepreneurs and investors realize that there's no permanent change in incentives to create jobs, income and wealth.

All of this leads to a problem. If Congress and President Donald Trump aren't willing to impose spending discipline and if they're unwilling to tackle a sufficient number of major loopholes, that presumably means there won't be fiscal room to get a large rate cut and expensing.

Politically, it could be easier to push for just a rate cut at the price of expensing, because it's imperative that the corporate rate be dramatically reduced and — let's face it — most people don't even know what expensing is. The bad news is that leaving expensing behind would be a missed opportunity. We know that politics isn't always conducive to good economics, and the good news is that you can't go wrong with cutting the corporate tax rate — but Congress can and should do more than the bare minimum.

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