Tax Reform (again)

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Eakinomics: Tax Reform (again)

Longtime readers of Eakinomics understand a few basic facts: (a) this is in large measure a form of personal therapy, (b) I care deeply about a principled tax reform that will improve the incentives to invest, innovate, hire, and pay better in the United States, and (c) every day brings an assault on (b) that requires (a). In that spirit:

1. I've had it with poorly formulated, shallow critiques of taxes and growth. There are two ways that economies grow. The first is "easy"; put back to work the unemployed workers and idle factories as in a business cycle recovery. This is the role of tax cuts — almost any cut will work — as "stimulus." To the extent that it works it is by causing household to "consume" — i.e., spend — more. Other than getting the timing right, this is a low-degree-of-difficulty policy ideally suited to handout politics.

The second kind of growth is to take an economy that is fully utilizing it resources — like the United States right now — and provide incentives to accumulate greater resources and capacity to produce. This involves the opposite incentive, namely to spend less, save more, and invest in equipment, technologies, business models, and workers' skills so that the economy is bigger in the future. This is a highly disciplined exercise that places an emphasis on deferment of gratification and is an anathema to handout politics. This is the exercise in which the United States should be engaged.

Casual intermixing of the two provides no insight whatsoever. See here and here.

As a corollary, treating all tax reforms as the same is equally nonsensical. The Tax Reform Act of 1986 was a tax increase on corporations used to finance large marginal rate cuts on individuals. It had anti-growth increases in the taxes on the return to saving, investment and innovation. It put the United States at odds with global norms and is the main reason that reform is so necessary in 2017. The two exercises should never be equated.

2. Discipline is part of the tax reform. The good news is lower rates and the harder part is broadening the base. But the litmus test is the overall impact, including improved growth. One should never negotiate on a provision-by-provision basis by pretending that somehow individuals are "harmed" when the entire reform is not considered. Stop it.

3. International tax rules are central to the reform effort. The current code provides incentives for U.S. firms to prefer foreign production over domestic, park large amounts of overseas earnings offshore, and find legal ways to shift profits from the United States to lower-tax jurisdictions abroad. But at the same time, there are multinationals with foreign headquarters that have subsidiaries in the United States (thank goodness; inbound foreign direct investment is important to the U.S. economy). The current code provides disincentives for them to be in the United States at all and to legally shift any profits they can to lower-tax jurisdictions. Bemoaning the circumstances of U.S. firms while demagoguing foreign subsidiaries in the United States makes no sense.

Tax reform is an opportunity to fix both sides of the equation so that — regardless of the ownership — there are incentives to invest in the United States, hire workers in the United States, pay high wages in the United States and — yes — pay taxes on earnings in the United States. Dollars are dollars and the tax code should be neutral with regard to the owner of those dollars.

Tax reform in 2017 is truly an historic opportunity; let us hope that Congress and the Administration rise to the opportunity. Thanks, I feel better.