

Close the ‘Growth Gap,’ Not the Tax Gap

By Amity Shlaes

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Closing the tax gap, simplifying the tax code, and rationalizing taxation of corporations are three of the initial goals stated for the task force. Those goals are valuable, however, only insofar as they permit enduring economic growth. The panelists should evaluate any tax reform proposal in the context of growth. It's hard to imagine any panelist saying he or she would not take growth into account. Still, taxwriting is a mesmerizing art that tends to distract both practitioners and audience from measures that might sustain growth. If the U.S. economy can grow faster, income tax and corporate tax revenues will flow in.

Consider, first of all, the tax gap. To be sure, the federal government needs more revenue to offset expanding federal debt. If capturing more of the revenue already owed to the government will reduce the debt, well and good. If capturing more revenue makes it possible to avoid statutory rate increases, that can also be good. Tax increases restrict growth. Stronger enforcement of regulations already on the books seems like the lesser evil and the process least unfriendly to economic growth.

Still, a tax gap project can be a trap. That's because efforts to haul in revenue due but unpaid rarely succeed to the extent expected. In the hunt for revenue, prosecution of tax evasion soon extends to prosecution of tax avoidance or even a hunt for abuses in formerly accepted practices. What's more, the culture of tax enforcement is a culture that says, "We want to get the slippery rich guy."

The same culture tends to want to increase tax rates. Voters who endorse aggressive tax collection campaigns often also tolerate rate increases on higher earners. Rare is the politician who won't exploit that coincidence to raise rates, even if a rate

increase was not his initial intention. Tax enforcement and tax rate increases end up going together.

The result is a perverse cycle. As Steven J. Davis of the University of Chicago and Magnus Henrekson of the Stockholm School of Economics have shown, high tax rates correlate to large tax gaps: the higher the rates, the larger the shadow economy.¹ To ignore that global pattern is tax provincialism.

What then should the panel do when it comes to the tax gap? The main task is to prevent the topic from taking too much air out of the room. The temptation will be to pursue revenue abroad by recommending increased cooperation with foreign governments or international institutions. Instead of building up policing, the panel might want to focus on increasing the relative competitiveness of the United States. That is, its work should be about making the United States a cash magnet rather than trying to limit the force of cash magnets elsewhere. Draw revenue instead of chasing it.

As for tax simplification, it can be good civics because people trust something they understand. A simpler tax code is one likely to result in better tax compliance. If authorities are going to “dissemble” with tax complexities, goes the logic, the taxpayer may dissemble as well. What’s more, simplification is a virtue in that it reduces uncertainty. Simplification this year adds value because it suggests there will be no big tax reform the following year.

The problem with simplification is that it becomes as much an aesthetic goal as a pro-growth one. Preoccupied with the architecture of their revision, tax policymakers tend to forget about the average investor on the ground. Simplification doesn’t have to come at a cost to that investor, but it often does. For example, a tax simplification that curtails the home mortgage interest deduction makes sense to tax theorists because it broadens the tax base, and base broadening is one of the tenets of tax theology. But in terms of the individual, the shift represents a negative — a

¹Friedrich Schneider, *Shadow Economies of 145 Countries All Over the World: What Do We Really Know?* Center for Economics, Management and the Arts, Basel, 2004. Also see, Steven J. Davis and Magnus Henrekson, *Tax Effects on Work Activity*, National Bureau of Economic Research Working Paper 10509, May 2004.

retroactive change on the deal from government that the buyer thought he was getting. That homeowner will refrain from buying or investing in all areas, not just homes, because his confidence has been shaken. This is true even if other effective tax rates do not change or drop.

On the corporate side, one concern is that reform will have the quality of the recent spending stimulus package. Changes will favor one industry or form of corporation over another. The justification for this will be that some industries are currently disadvantaged, or that breaks for all are too costly in revenue terms. In the short term such unevenness looks all right, but in the longer term instabilities result. The ideal tax reform here would be one that opened the same opportunities to all individuals and industries, domestic or international.

To foster growth, federal taxwriters will also want to consider factors less frequently mentioned. One is state and municipal taxes. A federal tax increase that seems “affordable” is no longer affordable when you consider the increases in state and local levies currently in train. Presumably a “Europeanization” of the U.S. growth rate (that is, a slowing down) is something the panel wants to avoid, but increases in state taxes mean that Europeanization is happening automatically, even without statutory increases in federal taxes.

If the erosion of property rights continues in the United States, foreign investors will stay away. Some forms of property (dollar-denominated investments held by the Chinese) are truly not in the purview of this panel. But many others are; capital gains taxes erode property prospectively. The main thing is to take the role of foreign investors in U.S. prosperity seriously because their absence will cause shortfalls that make the current tax gap look minor.

It sounds odd to suggest that a tax panel address issues that belong to a growth panel. Yet the best tax panel is a growth panel as well. ■