# 5. Fundamental Tax Reform

***Congress should***

- enact a five-year tax cut of at least $2 trillion; the tax cut bill should
  - repeal the Bush and Clinton tax increases of 1990 and 1993, thus returning to two income tax rates, 15 and 28 percent;
  - abolish the capital gains and estate taxes;
  - create a $25,000 per household tax-free universal savings account; and
  - index the income tax brackets for real income growth so that tax liabilities do not rise faster than Americans' incomes;
- not allow states to unfairly tax the Internet;
- end the withholding tax;
- send an annual tax disclosure form to all taxpayers;
- require a two-thirds supermajority vote to raise taxes;
- enact an alternative maximum tax for individuals and businesses; the MAXTAX should be set at 25 percent of gross income and replace the filer's income and payroll taxes;
- replace the income tax with a national sales tax and close down the Internal Revenue Service; and
- refund taxes to Americans if tax revenue grows faster than personal income.

America's tax system reduces freedom and economic growth. Federal taxes are far too high. The Tax Foundation reports that median-income families now forfeit 38 percent of their earnings to federal, state, and local taxes. This is the highest level of taxation since the end of World War II and the highest peacetime tax burden in U.S. history. In the six years that Republicans have controlled Congress, the federal tax burden has risen steadily from 18 to 20 percent of gross domestic product, as shown in Table 5.1. Tax receipts will have risen by $700 billion from 1994 to 2000. If the Republicans are the tax-cutting party, so far there is no evidence of it.

The first fiscal policy priority for the 107th Congress must be to enact a substantial tax cut—$2 trillion or more over five years. That would bring the federal tax burden down closer to historical levels and ensure that surpluses were not spent. Next, the 107th Congress should totally replace the tax code with a simple single-rate tax system. Our strong preference is to entirely eliminate the income tax and move to a 15 percent national sales tax. But any movement toward a low flat-rate tax system that simplifies the code and ends the punitive tax treatment of savings and investment would be extremely beneficial for the U.S. economy and would reduce the federal government's intrusion into the lives of Americans.

## *Tax Cuts in an Era of Budget Surpluses*

The surging U.S. economy has produced an unprecedented tidal wave of federal tax receipts in recent years. Since 1998 federal revenues have risen by more than 10 percent per year. Taxes as a percentage of personal income catapulted from 21 to 25 percent over the past decade. Those data raise the question: Where are the GOP's vaunted tax cuts? The simple answer is that because of automatic tax-raising measures built into the tax code, Republicans have allowed steep increases in the tax burden.

***Table 5.1***
***The Rising Tax Burden under the Republican Congress***

| | Total Federal Revenue | |
|---|---|---|
| Year | $ (billions) | % of GDP |
| 1994 | 1,258 | 18.1 |
| 1995 | 1,352 | 18.5 |
| 1996 | 1,453 | 18.9 |
| 1997 | 1,579 | 19.3 |
| 1998 | 1,721 | 19.9 |
| 1999 | 1,827 | 20.0 |
| 2000 | 1,956 | 20.4 |
| 1994–2000 increase | 698 | |

The surge in tax payments, not restraints on government spending, has been the primary explanation for the balanced budget beginning in 1998—the first in 30 years. If the economy does not slide into a recession, and if Congress holds down spending growth to 4 percent per year as required by the 1997 budget agreement, the federal budget surplus over the next five years (2000–2005) will approach $2 trillion. Only half of that surplus is surplus Social Security funds.

There are three justifications for a large tax cut in 2000. First, given the mounting budget surpluses now on the political horizon, a $2 trillion tax cut can be enacted without returning to deficits. In fact, a $2 trillion tax cut would still allow Congress to retire some of the national debt every year. For the past 20 years Congress has refused to cut taxes, arguing that budget deficits made tax cuts fiscally unaffordable. But now that we are in a regime of budget surpluses, surely there is no remaining excuse for not reducing the enormous tax burden.

Second, given that this is an era of peace and the United States has declining military expenditures, a 38 percent tax burden is unwarranted. High taxes may be necessary during wartime, but certainly not during a period of peace. Americans are still paying Cold War tax rates, even though the Cold War ended more than a decade ago. It is time to repeal the Cold War taxes and provide Americans with the kind of peace dividend tax cut that has followed virtually every other war in U.S. history.

Third, we can be certain that, if taxes are not cut substantially, Congress will spend every dime of the projected tax surplus. In their national platform, the Democrats proposed $1.6 trillion in new spending over the next decade. Surplus tax revenues will almost certainly invite new spending and expensive new entitlements to health care, day care, and education. That is precisely the kind of reckless fiscal behavior that created large deficits in the 1970s, 1980s, and 1990s.

The 106th Congress's record on tax cuts was mixed. In 2000 it passed a bill to remedy the marriage penalty and another to abolish the death tax. (President Clinton vetoed both.) Yet, even after federal lawmakers realized that tax surpluses would amount to at least $2 trillion over the next five years, congressional Republicans could agree to only a five-year tax cut no larger than $235 billion in 1999 and even less in 2000. Under the best-case scenario, the government would have been permitted to keep at least 88 percent of the cash windfall.

Taxpaying workers got back only a pitiful 12 cents on every dollar of surplus taxes. That is like purchasing a new car and discovering that you paid $500 too much. So you go to the dealer and inform him of the overpayment, and the dealer agrees to write you a check for $60. As a matter of simple tax justice, every penny of tax overpayment should be returned to the taxpayers—not 12 percent, or 50 percent, or even 80 percent. All of it belongs to the taxpayers.

To repeat, a $2 trillion five-year tax cut would still allow Congress to balance the budget and reduce debt in every one of the next five years. It would not preclude "saving Social Security" through individual investment accounts. Finally, if the government-downsizing recommendations in Chapter 27 are approved, a much larger tax cut could and should be enacted.

## Tax Cut Options

In deciding how to cut taxes by $2 trillion, Congress should be guided by one overriding criterion: Every tax cut should be consistent with basic principles of fundamental tax reform. Those principles include

1. taxing income at a low and flat rate,
2. ending the punitive tax treatment of saving and investment,
3. making taxes visible to taxpayers, and
4. simplifying the tax code to the fullest extent possible to reduce compliance costs.

Congress should avoid the type of tax cut enacted in 1997, which included hundreds of pages of additions to the Internal Revenue Code, tax phase-ins, credits, new deductions, and in some cases higher effective marginal tax rates.

We believe that all or some combination of the following tax relief measures should be adopted in 2001.

### *Repeal the Bush and Clinton Tax Increases of 1990 and 1993*

When Ronald Reagan left office, the U.S. tax system was much fairer and simpler than it is today. The Tax Reform Act of 1986 had closed most unjustified loopholes and had collapsed income tax rates into two brackets—15 percent and 28 percent. But under Presidents Bush and Clinton, the tax code was complicated almost every year, and the positive achievements of the 1986 Tax Reform Act were erased. The two biggest policy mistakes of the 1990s were the 1990 and 1993 Bush and Clinton tax increases, which raised the top tax rate first to 31 percent and then to 39.6 percent. Higher rates have meant less economic growth, more deductions and credits, and higher costs for complying with the Internal Revenue Code. Congress should repeal the income tax hikes of 1990 and 1993 and return to a two-rate tax system of 15 and 28 percent. If those tax increases were reversed, there would still be money left for debt reduction.

### *Index Income Tax Brackets for Inflation and Real Income Growth to End Real Bracket Creep*

In 1982 Ronald Reagan wisely indexed the income tax brackets for inflation. Now real income bracket creep should be ended by indexing tax brackets for inflation plus real income growth. Real income tax bracket creep means that over time more and more Americans are pushed into the 28 percent tax bracket, the 31 percent bracket, the 36 percent bracket, and so on. In 1998, for example, worker incomes rose by a respectable 6 percent, but tax receipts were up 10 percent. The primary culprit is real bracket creep. Milton Friedman proposed indexing brackets for real income growth many years ago and recently reiterated his support for the policy in the *Wall Street Journal.* This policy loses very little revenue in the short term. But the tax savings multiply dramatically over time because of the insidious compounding effect of real bracket creep. This is also an important step toward a flat-rate tax system.

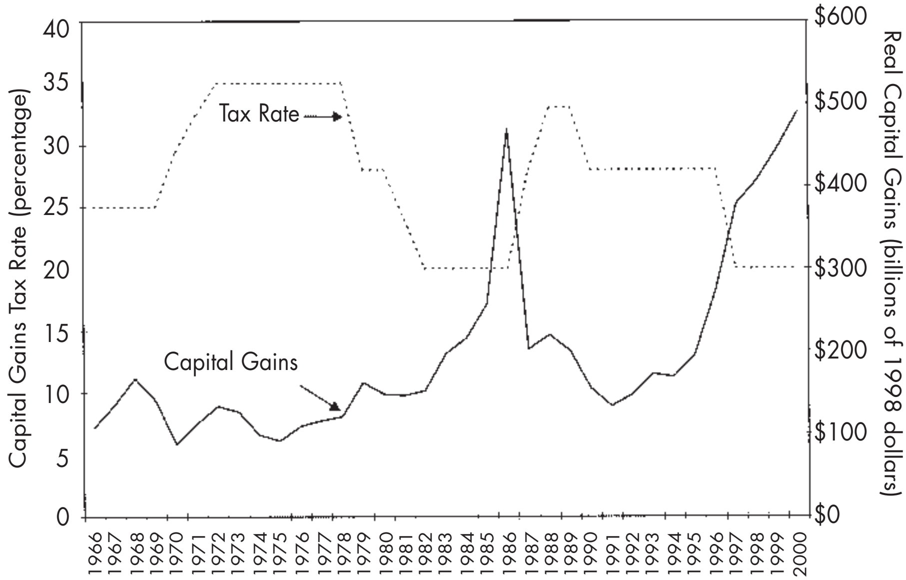
### *End the Capital Gains Tax*

The optimal rate of tax on capital gains is zero. Abolition should be the goal. One step in that direction would be to lower the rate to a uniform 15 percent. That would lower the cost of capital in the United States, thus spurring new business start-ups and new capital investment spending—both of which are critical to long-term economic growth and higher wages.

A capital gains tax cut would also lose almost no revenues and might even increase tax receipts. In 1996, the year before the last capital gains tax rate cut, the total amount of net capital gains on assets sold was less than $190 billion. A year later capital gains had mysteriously doubled to $382.5 billion. (The capital gains tax cut was retroactive to May 1997.) Capital gains tax receipts jumped from $50 billion in 1996 to more than $100 billion in 1999.

A nearly 30 percent reduction in the capital gains tax has doubled revenues. That is consistent with the last 40 years of evidence on capital gains taxes. Every rate increase has led to less revenue for the government. Every capital gains rate cut has led to more (Figures 5.1 and 5.2).

**Figure 5.1**
**Capital Gains Tax Rate versus Total Capital Gains**




SOURCES: Congressional Budget Office and U.S. Department of the Treasury.

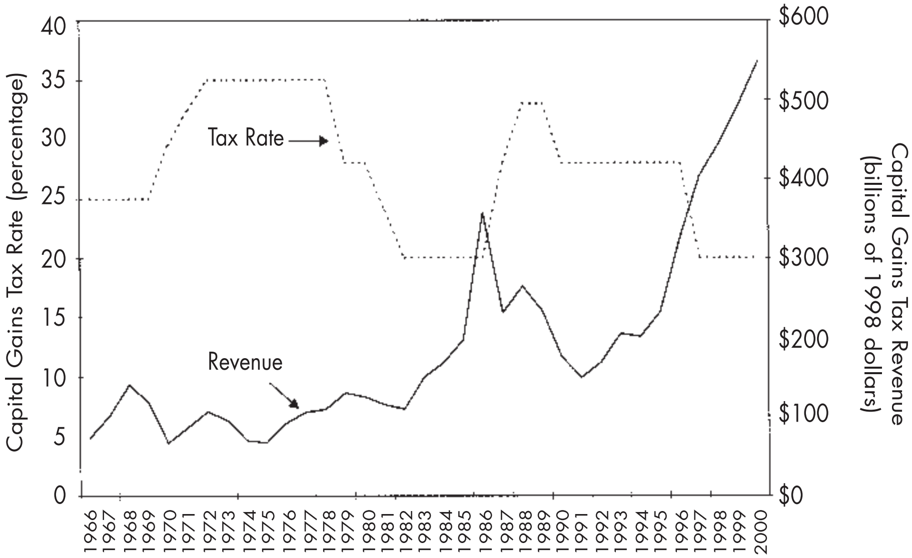
How is that possible? The capital gains tax is a *voluntary* and easily avoided tax. When the tax rate is high, investors simply delay selling their assets—stocks, properties, businesses, and the like—to keep the tax collector away from the door. When the capital gains tax is cut, asset holders are inspired to sell. Moreover, because a lower capital gains tax substantially lowers the cost of capital, it encourages risk taking and causes the economy to grow faster, thus raising all government receipts in the long term. So the torrent of new revenues into the government coffers is really no mystery at all. In fact, it was entirely predictable.

Increased incentives for risk taking and new capital investment at the lower 20 percent tax rate are boosting tax revenues. That would likely also be the case with a 15 percent rate.

### *Eliminate the Estate Tax*

The U.S. estate tax is even more indefensible than the capital gains tax. The tax today brings in only $25 billion a year—or just 1.4 percent of total federal revenues. Yet taxpayers spend many times that amount of money on estate planning to avoid paying the tax. The major victims of

**Figure 5.2**
**Lower Rates = Higher Revenues:**
**Capital Gains Tax Rate and Revenue Raised**




SOURCES: Congressional Budget Office and U.S. Department of the Treasury.

the estate tax, which can reach the confiscatory rate of 55 percent, are owners of small businesses, farmers, and others with medium-sized estates. Often family businesses have to be dismantled or sold to meet estate tax obligations. A 1993 study by economist Richard Wagner of George Mason University calculated that the federal government would collect more tax revenue over time, and accumulated wealth would be put to much more productive uses, if Congress simply abolished the estate tax altogether. Ideally, the estate tax should be abolished and replaced with nothing. But a compromise position would be to end the gift and estate taxes and then tax bequests as ordinary income to the recipients.

### *Create a Universal Tax-Free Savings Account of $25,000 per Household and Allow Withdrawals for Expenditures on Education, Health Care, and Retirement*

One major goal of public policy in Washington over the next 5 to 10 years is to get the federal government out of education, health care, and retirement (i.e., Social Security). The federal government's meddling in the private marketplace in each of those areas has not helped solve the crisis but rather has exacerbated it. When Americans save for education, health care, or retirement, the funds placed in such accounts should not be taxed.

## *Making Taxes More Visible and Harder to Raise*

In addition to the economic criteria listed above for a sound tax system, there are at least two other principles of taxation that should be followed. First, taxes should be visible to the citizenry so voters are fully aware of how much they are paying and can assess whether they are getting their money's worth from government. Second, taxes should be raised only when there is a clear and compelling justification for higher levies. In keeping with those principles, Congress should establish three new rules governing federal taxation.

### *End the Withholding Tax*

The withholding tax was introduced in 1943 as part of the war effort to facilitate the collection of taxes at a time when even clergymen and Disney's Mickey Mouse were enlisted by the U.S. government to increase Americans' tax payments. Legislators spoke openly of taxes that needed to be "fried out of the taxpayers." One senator cheered the provision as a way to "get the greatest amount of money with the least amount of squawks."

Withholding was of dubious constitutionality during wartime, but during normal times it is clearly an excessive and insidious power of government. The central objection to withholding is that it is the ultimate hidden tax. People don't miss what they don't see. Many Americans even regard their refund checks as a gift from government. Income taxes should be paid monthly, or at the end of the year, by the earner's writing a check to the IRS, as proposed by Rep. Cliff Stearns of Florida. That would allow Americans to consider regularly whether they are getting their money's worth from government.

### *Send an Annual Tax Disclosure Form to All Taxpayers*

Each year when the IRS sends its tax forms to American families, it should be required to send a tax disclosure form listing all federal taxes and estimating all state taxes paid by the family in the previous year. The taxes listed would include federal income taxes; Social Security taxes (both employer and employee share); and state income, sales, and gas tax estimates. That also would allow Americans to see how much they pay each year for government.

### Require a Supermajority Vote to Raise Taxes

The U.S. Constitution with its ingenious system of checks and balances enumerates many occasions when a supermajority—not just a simple majority—is required to change the law. For example, a vote of two-thirds of both houses is required to override a presidential veto. A two-thirds vote of both houses is also required for Congress to propose an amendment to the Constitution. A two-thirds vote of the Senate is required to ratify treaties and to convict an impeached federal official. A two-thirds vote should also be required for raising taxes.

Several states, including Arizona, California, and Nevada, have adopted measures requiring that any tax increase by the legislature must pass by a two-thirds vote in both houses. Such a measure is needed on the federal level. It should apply to *all* tax increases, not just income tax hikes. A two-thirds vote requirement for tax increases would allow Congress to raise taxes during times of war or national crisis but would help prevent the routine tax hikes that have been enacted to fund governmental expansion in Washington over the past 20 years. The four largest tax hikes since 1980—in 1982, 1983, 1990, and 1993—all would have failed if this rule had been operative.

## Taxation of Electronic Commerce

Congress should establish a clear nexus standard and definitions—based on physical presence—to determine when companies can be required by a state to collect sales or use taxes and reject all international efforts to draft American businesses as tax collectors for foreign governments.

E-commerce has exploded over the past several years. In the United States alone, approximately 39 million people made a purchase online in 1999—more than four times the number of Internet shoppers in 1997. Online retail sales are estimated at somewhere between $15 billion and $20 billion for 1999 and are projected to reach at least $144 billion by 2003. Many state and local governments worry that they are not getting their proper cut of those sales. The problem, in their view, is a series of Supreme Court decisions that block states from compelling an out-of-state business to collect taxes unless that business has "nexus"—a significant connection to the taxing state. Thus, sales taxes often aren't collected on Internet purchases made from an out-of-state business.

Contrary to the claims of state and local officials, current federal rules do not exempt e-commerce from taxation; those rules simply prohibit certain means of collection. The federal government should continue to prohibit states from imposing tax collection duties on out-of-state businesses by establishing a uniform national jurisdictional standard for taxing e-commerce based on the substantial physical presence test. Such a standard would reaffirm traditional principles of tax fairness, preserve rate competition among states, and avoid years of contentious litigation.

There are at least three important reasons to retain and perhaps strengthen the current nexus standard. First, there is no impending revenue crisis: the roughly $20 billion in 1999 business-to-consumer online sales represented less than 0.3 percent of total consumer spending. And while e-commerce has been growing, state tax revenues have soared. There is simply no evidence that e-commerce is undermining the ability of states to provide legitimate government services.

Moreover, in-state sales will continue to be a dependable source of tax revenue. Because local stores cater to a customer's desire for a hands-on experience, offer immediate gratification, and do not charge for shipping, they will probably always dominate retailing. In addition, shopping is for many people a pleasurable social experience that cannot be duplicated online. Thus, Internet sales won't destroy "real" retailers, just as catalog sales haven't. The human factor still drives shopping, and that will likely always be true.

The second and most compelling reason to limit state taxing authority over remote transactions is fairness. When a local business collects sales taxes, there is a clear link among taxes paid, services provided, and legislative representation. Local firms benefit from police and fire protection, roads, waste collection, and other services, so it's proper that they help cover those costs. Remote sellers don't enjoy any of those services, and shipping companies already pay taxes to cover their use of public goods. To force a wholly out-of-state business to collect taxes would be "taxation without representation," pure and simple.

It is also important to note that local businesses are tasked only with collecting taxes for the state where they are physically located (origin-based taxation), while e-commerce firms are being asked to collect taxes for every state where their customers live (destination-based taxation). Obviously, the latter is a much costlier proposition—and is thus not a level playing field. The bottom line is that only a state where a business is located should have the right to compel sales tax collection.

Third, the current nexus standard promotes tax competition among the states. E-commerce gives everyone the opportunity to live on a virtual border—to take advantage of the fact that no state, although it is free to do so, currently taxes its exports or voluntarily collects use taxes for other states. Like a real border, the Internet can be a potent safety valve that guards against excessive taxation. E-commerce allows consumers who have found it difficult to travel out of state to take advantage of tax competition for the first time.

It is important to note that nothing currently prevents a state from instructing e-commerce retailers within its borders to collect sales taxes on all sales, regardless of the ultimate destination of the product—exactly as brick-and-mortar sellers do. State officials are hesitant to do this because they fear that businesses might decide to locate in other states with lower taxes. They call that a "race to the bottom," but it's really just healthy tax competition.

Legislation to codify and clarify the nexus standard articulated in *Quill v. North Dakota* (1992) would help businesses to know exactly when they are liable for sales taxes, just as federal law now does for income taxes. Greater certainty would help to avoid years of pointless lawsuits. Moreover, a uniform nexus standard would not adversely impact states' efforts to simplify their tax systems or encourage voluntary collection by businesses. At minimum, Congress should commit to do no harm by rejecting any option that effectively raises taxes—that results in more money for states and less for taxpayers. In other words, simply authorizing states to compel use tax collection from out-of-state businesses should be rejected out of hand.

Ultimately, more equal tax treatment of all forms of commerce may be desirable. However, that should not mean abandoning traditional principles of tax fairness. Congress must not allow a phony revenue crisis to justify passage of new taxing authority for states that would achieve fairness only by treating all businesses badly.

## Overhaul the Tax Code

All of the above recommendations would lower tax burdens and incrementally reduce the distortions of the federal tax system. But they should be viewed as only temporary steps toward a complete replacement of the Internal Revenue Code.

The U.S. income tax system is unsalvageable. Reps. Dick Armey of Texas and Billy Tauzin of Louisiana are right that we have to repeal the tax code and start all over. Congress has "reformed" the tax system 32 times in the past 40 years—or once every 1.3 years, on average. The code remains as unwieldy today as ever. Hundreds of thousands of small businesses pay more in tax preparation costs than they pay to the government in taxes. For the past six years Republicans in Congress have pledged to simplify the tax system, but there has been no action. Repealing the Internal Revenue Code and starting over should be one of the top two or three priorities of the 107th Congress.

### *Defects of the Current Tax System*

The current federal income tax system undermines our economy and our civil society in a variety of ways.

First, high income tax rates are discouraging savings, investment, and work. It was never supposed to be this way. The very first income tax in 1913 had rates ranging from 1 to 7 percent—with the highest rate applying only to Americans who had incomes equivalent to $5 million or more in today's dollars. As early as 1917, the start of World War I, the rate was raised to 67 percent, although it fell after the war. In 1944, during World War II, the rate was raised to 94 percent. In other words, the government took 94 cents of every additional dollar earned and the worker kept 6 cents. Today, the top tax rate stands at 39.6 percent.

Some economists resist the notion that high tax rates are economically harmful, but it was President John F. Kennedy who eloquently warned of the perils of soak-the-rich tax policies some 30 years ago when he unveiled his own tax cut plan:

> An economy hampered with restrictive tax rates will never produce enough revenue to balance the budget, just as it will never produce enough jobs.

The economic evidence suggests that nations with flat and low marginal income tax rates outperform countries with steeply progressive tax systems. Economists at the World Bank, hardly a bastion of supply-side orthodoxy, examined evidence dating back to 1870 and discovered "a negative association between economic growth and . . . the marginal tax rate." The world's fastest growing economy over the past 25 years, Hong Kong, has the lowest marginal tax rates (15 percent maximum) on labor and capital.

Economist Dale Jorgenson has quantified the potential wealth gains from fundamental reform of the tax system. He calculates that moving to a flat-rate tax on consumption that raises as much revenue as the current income tax system would increase economic growth by more than $200 billion. That means that the United States could move to a more rational tax system that raised the same amount of revenue as the current tax system and still raise the income of the average American household by some $2,000 a year.

A second defect of the tax system is that it has become a labyrinth of complexity. Jack Valenti, president of the Motion Picture Association of America, has complained: "No other nation relies on such a cluttered mess of rules and regulations that are both contradictory and abrasive. We have given birth to a priesthood of lawyers and accountants who gravely inspect the entrails of our tax system and then charge outrageous prices for the knowledge they alone possess."

Just how unfathomable is the tax system? David Brinkley, in his 1993 memoirs, cited this example from an instruction booklet for taxpayers:

> Subparagraph B in Section 1 G 7, relating to income included on parents' returns, is amended (1) by striking $1,000 in clause i and inserting twice the amount described in 4 A ii and (2) by amending subclause capital (II) of clause small ii. . . .

That tortured language is surely not English. It is perhaps comprehensible to a small handful of lawyers on Capitol Hill and well-paid accountants and tax attorneys. But it is gobbledygook to most other Americans. Brinkley wrote before the 1997 tax bill, which added hundreds of new pages to the tax code and nearly tripled the number of lines on just one tax form, Schedule D for capital gains.

For a 1995 hearing before the House Ways and Means Committee on the U.S. income tax system, the chief tax counsel for Mobil Oil Corporation brought to the House office building a six-foot-high stack of bound papers that weighed 150 pounds. They were Mobil Oil's tax forms for fiscal year 1993. It cost Mobil an estimated $15 million and more than 100 full-time man-years just to figure how much tax they owed. Mobil is not unique. In 1994 the IRS received nearly 1 billion Form 1099s as part of the government's effort to track income from dividends, interest, and other forms of business income.

Political scientist James L. Payne, author of *Costly Returns,* has calculated that American workers and businesses spend at least 5.4 billion man-hours a year figuring out their taxes. That is more man-hours than it takes to build every car, van, and truck manufactured in the United States. Estimates of the dead-weight economic loss attributable to the complexity of the tax system range from $75 billion to $200 billion a year, or as much as $2,000 for every household in America.

The *average* fee for preparation of a tax return is now almost $200. IRS data confirm that in 1992 more than 50 million individual returns were done by tax preparers at an average fee of $200. *Money* magazine discovered in 1991 that 70 percent of the members of Congress on the two major tax-writing committees—House Ways and Means and Senate Finance—could not figure out their own returns and used professional tax preparers. All told, Americans spend about $30 billion a year for the services of tax accountants and lawyers. Those services do not add to the nation's wealth; they deplete it. It is no wonder that economist Brian Wesbury found in a 1998 study that the stock value of the three major tax preparation firms in the United States—including H&R Block—had risen by almost twice the Dow Jones industrial average. These are good times to be a tax lawyer or an accountant.

Perhaps the most troublesome consequence of our present income tax system is the enormous investigative and prosecutorial powers we have conferred on the IRS. During the 1997 IRS oversight hearings, hundreds of aggrieved citizens with IRS horror stories were joined by IRS auditors, who themselves were so fearful of their employer that they would testify only behind curtains to protect their identities—very much reminiscent of a Mafioso trial. Fear and intimidation have long been the IRS's most reliable collection tools. And for far too long a Congress whose only charge to the IRS has been "just get the money" has adopted a "don't ask, don't tell" policy toward IRS harassment.

The Republicans in Congress deserve credit for passing in 1997 an IRS reform bill that ended some of the abuses of the IRS. That law has made two improvements. First, it reverses the burden of proof, placing it on the shoulders of the IRS, not the accused taxpayer. In all of American jurisprudence, only in tax court has the presumption of innocence been disregarded. And second, the law established 70 new taxpayer rights including the prohibition of IRS seizure of homes without a court order.

But the IRS has hardly been defanged. Since 1995 Congress has approved a 10 percent budget increase for the IRS—to $8.5 billion—and an increase in enforcement personnel. Without a search warrant, the IRS still has the right to search the property and financial documents of American citizens. Without a trial, the IRS still has the right to seize property from Americans—and it does so routinely. In fact, in July 1998 an independent audit of the IRS found that the agency seized property improperly in more than one in four cases.

What investigative reporter David Burnham concluded about the IRS several years ago remains regrettably true today: "The IRS is twice as big as the CIA and five times larger than the FBI. The IRS controls more information about more Americans than any other governmental agency. . . . With its unequaled authority to seize property and its unparalleled access to financial records, the IRS has become the nation's single most powerful instrument of social control."

No other institution is as great a threat to our civil liberties as the IRS. Congress has tried to transform the IRS into a kinder, gentler agency. But the truth is that IRS abuses will assuredly continue as long as we retain a flawed income tax system.

### *The 25 Percent Maximum Tax*

The leading tax reform proposal before Congress for the past five years has been Dick Armey's 17 percent flat tax. There is no question that a flat tax would be hugely beneficial in terms of reduced compliance costs and increased economic growth.

Why is an idea that is so unambiguously in the national interest completely stalled politically?

The answer is that the political hurdles have proven nearly insurmountable. The flat tax tries—in one swing of the ax—to topple every well-funded special-interest lobby in Washington, from tax attorneys, to life insurance agents, to realtors, to mortgage bankers. Each of those groups will spend—and in some cases already has spent—fortunes to protect the hundreds of billions of dollars of tax favors and loopholes they have successfully carved out of the tax code.

The home mortgage interest deduction, the charitable deduction, and the deduction for employer-paid health care are three of the most sacred-cow tax write-offs in the Internal Revenue Code. They are so embedded in the current economic structure and political culture that trying to eliminate them is almost certainly an act of futility—and perhaps political suicide.

The good news is that tax reform is not conditional upon forcing Americans to give up deductions. The politically strategic way to hold every American harmless in the tax reform is to establish an alternative maximum tax of 25 percent. Here is how the MAXTAX plan would work: Starting in 2002, every American would have the opportunity to opt out of the current tax system and instead pay a combined payroll and income tax of 25 percent of gross income. (Many millions of Americans now pay an average income and payroll tax rate of more than 25 percent.) The post-card alternative maximum tax return (Figure 5.3) would have only

***Figure 5.3***
***The 25 Percent MAXTAX Form***

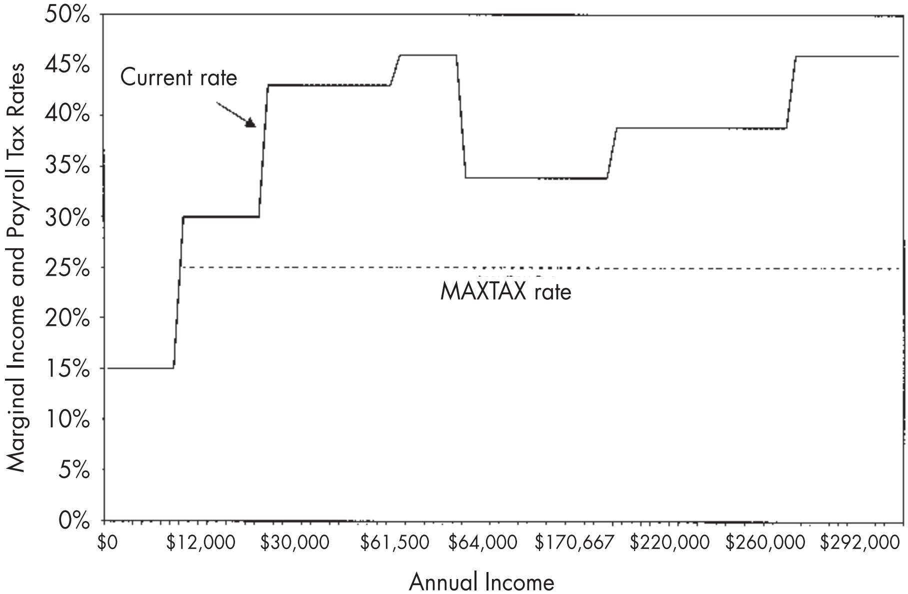
| | | |
|---|---|---|
| 1) | Gross income | |
| | a) Wages and salaries | $ _____ . __ |
| | b) Pensions | $ _____ . __ |
| | c) Net indexed capital gains | $ _____ . __ |
| | d) Dividends and interest | $ _____ . __ |
| | e) Gifts and bequests | $ _____ . __ |
| | f) Government benefits | $ _____ . __ |
| | g) Total gross income (Add lines 1a through 1f) | $ _____ . __ |
| 2) | Total federal tax (Multiply line 1g by 25%) | $ _____ . __ |
| 3) | Payroll tax paid during the year (Employer and employee share) | $ _____ . __ |
| 4) | Total income tax (Line 2 minus line 3) | $ _____ . __ |

four lines. All deductions, credits, and write-offs would be eliminated. The new system would be optional, meaning that workers would have the right to remain under the old income and payroll tax regime. But once a worker freely chose the 25 percent MAXTAX, he or she could not go back into the old system.

Former senator Spencer Abraham of Michigan introduced a tax choice plan in Congress. The major virtue of the plan is that it completely disarms the political enemies of tax overhaul. First, it does not take away deductions from Americans unless they freely choose to give them up. So it reduces the special-interest-group opposition.

Second, because the plan combines the regressive payroll tax with a slightly progressive income tax, it ensures that every American—regardless of income—pays the same flat 25 percent tax rate on every dollar earned. The plan is particularly beneficial to low- and middle-income working families. As Figure 5.4 shows, the marginal rate now paid by many middle-income workers is 43 percent (15 percent payroll plus 28 percent income tax). Under current law, the payroll tax rate is 15 percent on income up to $68,000 a year. Under the MAXTAX, workers with incomes below the $68,000 threshold would pay an effective 10 percent income tax rate. That would be a very attractive alternative for millions of Americans.

**Figure 5.4**
**Toward Tax Fairness: Current Tax Rates versus MAXTAX Proposal (individual filer)**




Finally, there is no costly transition from the current code to the 25 percent MAXTAX. The free-to-choose feature means that workers and companies migrate into the flat tax when it's advantageous for them to do so.

This concept is not new or untested. In fact, the idea of making the flat tax optional originated in Hong Kong. As the Hudson Institute's Alan Reynolds explains in a forthcoming Cato Institute study, Hong Kong's 15 percent flat tax, which is the envy of the world, is *optional*. Hong Kong also has a convoluted system resembling our own, but the flat-tax option has rendered it obsolete.

In the United States this approach to tax reform could steamroll the political juggernaut in Washington that is opposed to change. The goal should be to enact the 25 percent MAXTAX by April 15, 2001.

### *The National Sales Tax Replacement of the Income Tax*

The ultimate goal for all advocates of limited government and economic freedom should be to abolish the income tax altogether. A 25 percent maximum tax could be an intermediate step to complete repeal of the Internal Revenue Code.

The best replacement for the income tax would be a national retail sales tax imposed on all final-use goods and services. The retail sales tax is far preferable to the value-added tax (VAT), which is supported by many business groups in Washington and is the centerpiece of a bipartisan tax reform proposal by Sen. Pete Domenici of New Mexico and former senator Sam Nunn. European-style VATs, in their various incarnations, have been disasters in virtually every nation in which they have been enacted. They have not increased savings rates. The tax rates have been continually raised. And most important, VATs have served as engines of growth of government. That is because the VAT is a tax that is hidden from the consumer—embedded in the costs of goods and services consumers purchase.

A 1997 Cato study by tax experts David Burton and Dan Mastromarco outlines the features of a national sales tax plan. Rep. Billy Tauzin has borrowed many of these features in his national sales tax bill in the House. The four components of the plan are as follows:

- **A 15 percent sales tax falling eventually to 10 percent on the final purchase of goods and services at the retail level.** The sales tax would be similar to the familiar state sales tax collected at the cash register in 45 states and the District of Columbia. Intermediate purchases would be exempt. The individual and corporate income tax, the estate and gift tax, and most non-trust-fund excise taxes would be repealed. The rate should decline in future years to 10 to 12 percent as economic growth allows more revenues to be raised at a lower rate and as government spending is reduced.
- **A universal rebate for every household exempting all consumption up to the poverty level.** A national sales tax need not be regressive. By allowing the first $18,588 of consumption each year for a family of four to be tax-free, the system protects low-income families from the tax. The rebate could be provided as a credit against the payroll tax, allowing all workers to be reimbursed for any sales tax paid on consumption up to the poverty level.
- **Reimbursement to states and retailers for the cost of collecting the national sales tax**. The national sales tax should provide an administrative credit to retailers to compensate them for the cost of collecting and remitting the tax. A one-half of 1 percent credit would reimburse retailers about $4 billion for their compliance and collection

costs. In a national system administered by the states, states should be compensated for their costs.

- **Abolition of the Internal Revenue Service.** The states should be primarily responsible for administering the national sales tax since they have the most expertise in sales tax administration. The IRS would be abolished, and a much smaller, less intrusive federal excise tax bureau would collect trust fund excise taxes such as the gasoline tax. The Social Security Administration would enforce and collect payroll taxes.

Boston University economist Laurence Kotlikoff has estimated the impact of a revenue-neutral replacement of the income tax with a retail sales tax. He calculates that, after just five years, the national savings rate would rise to two and a half times its current anemic level; the capital stock would grow by 8 percent above the level attained under the current tax system; and output would be 5 percent, or $500 billion, higher than otherwise.

## Conclusion

Congress must recognize that 2001 will be the ideal moment to harness prosperity and make bold use of the new multi-trillion-dollar revenue surplus. Our recommended tax cut measures would represent significant down payments on even greater future tax simplification and ultimate repeal of the tax code.

The tax strategy described here would maximize opportunity, enhance individual responsibility, and restrain government. Congress should act immediately to roll back taxes for two reasons. First, today's record taxes are now the greatest single threat to the current economic expansion. And second, tax cuts are an essential preemptive measure against the advocates of bigger government, who wish to claim the surplus funds for new federal programs.

### Suggested Readings

Adams, Charles. *Those Dirty Rotten Taxes: The Tax Revolts That Built America.* New York: Free Press, 1998.

Burton, David, and Dan R. Mastromarco, "Emancipating America from the Income Tax: How a National Sales Tax Would Work." Cato Institute Policy Analysis no. 272, April 15, 1997.

Friedman, Milton. "Let's Revamp the Tax Code—But How?" *Wall Street Journal,* April 15, 1998.

Kotlikoff, Laurence. "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax." Cato Institute Policy Analysis no. 193, April 15, 1993.

Kudlow, Lawrence, and Stephen Moore. "Congress's $1 Trillion Opportunity." Institute for Policy Innovation, Lewisville, Texas, May 1998.

Lindsey, Lawrence. *The Growth Experiment: How the New Tax Policy Is Transforming the U.S. Economy*. New, York: Basic Books, 1990.

Lukas. Aaron. "Tax Bytes: A Primer on the Taxation of Electronic Commerce." Cato Institute Trade Policy Analysis no. 9, December 17, 1999.

McCaffery, Edward. "Grave Robbers: The Case against the Death Tax." Cato Institute Policy Analysis no. 353, October 4, 1999.

*—Prepared by Stephen Moore, Aaron Lukas, and Stephen Slivinski*