# Cato Handbook for Policymakers

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# 41. Federal Tax Reform

**Congress should**

- extend recent tax rate cuts for individual income, dividends, and capital gains;
- simplify the individual income tax by installing rates of 15 and 25 percent and repealing virtually all deductions and credits;
- cut the federal corporate income tax rate from 35 percent to 15 percent;
- turn Roth individual retirement accounts into all-purpose savings accounts by liberalizing rules on contributions and withdrawals;
- replace business depreciation with capital expensing;
- take these reforms further by replacing the income tax with a consumption-based flat tax at 15 percent;
- repeal the individual and corporate alternative minimum taxes; and
- repeal the estate tax.

At the beginning of the 20th century, federal taxes accounted for 3 percent of the nation's gross domestic product, and federal tax rules filled just a few hundred pages. Today, federal taxes account for about 18 percent of GDP, and federal tax laws and regulations span 67,506 pages, according to CCH Inc.

The federal government extracts about $2.8 trillion in federal taxes from families and businesses each year, which imposes a huge economic cost. The most visible cost is people being left with less money to buy food, clothing, and other needed items, while businesses are left with fewer funds for investment.

The federal tax system imposes other costs. The complexity of federal taxation creates compliance and administrative costs, and it makes financial planning more difficult for individuals and businesses. Furthermore, the hidden nature of many federal taxes imposes a cost in transparency. In particular, it is difficult for citizens to figure out the overall burden of taxes they are paying under the current system.

A final cost of the current tax system is that high rates and the unequal treatment of economic activities create distortions that reduce growth. Given all these problems of the current tax system, tax reforms should aim at three goals: simplification, transparency, and increased economic growth.

## Simplification

In 1976, president-to-be Jimmy Carter called for ''a complete overhaul of our income tax system. I feel it's a disgrace to the human race.'' Since that call for reform, the number of pages of federal tax rules has roughly tripled, according to CCH. A recent study by the World Bank found that the United States had the fifth-longest tax code among 20 industrial economies studied. The complexity of the U.S. tax code creates at least five types of costs:

1. **Compliance and enforcement burdens.** Americans spend more than 6 billion hours annually filling out tax forms, keeping records, and learning tax rules, according to the Office of Management and Budget. The paperwork for a tax return of a large corporation can total 10,000 pages. In addition to these costs of tax filing, taxpayers face a burden from audits, notices, liens, levies, seizures, and the millions of penalties assessed each year by the Internal Revenue Service. All in all, a huge public and private tax industry is needed to administer and enforce the complex system, the costs of which are roughly $200 billion annually.
2. **Errors.** Tax complexity causes taxpayers and the IRS to make frequent and costly errors. For example, the IRS has a poor record on answering taxpayer phone inquiries accurately. But don't blame the IRS, blame Congress for larding the tax code with thousands of complex provisions, such as narrow credits and deductions for favored individuals and businesses.
3. **Economic decisionmaking.** Tax complexity impedes efficient decisionmaking by families and businesses. For example, the growing number of saving vehicles under the income tax confuses financial planning. If a family chooses the wrong vehicle for its savings, that

decision could result in higher taxes, lower returns, less liquidity, and payment of withdrawal penalties. For businesses, tax complexity injects uncertainty into capital investment and other important decisions.

4. **Inequity and unfairness.** Although equality under the law is a bedrock principle of justice, individuals pay greatly different tax rates under the income tax. For example, IRS data for 2006 show that income taxes averaged 22 percent of adjusted gross income for those earning more than $200,000, but 9 percent for those earning between $50,000 and $100,000. The tax code can also treat people with similar incomes very unequally as a result of the many special exemptions, deductions, and credits. Tax incentives for education, homeownership, alternative fuels, and other items unfairly favor some Americans over others.
5. **Avoidance and evasion.** Tax complexity leads to greater noncompliance with the tax system. Noncompliance stems both from simple confusion over the tax rules and from the aggressive tax planning that complexity makes possible. Taxpayers take more risks on their tax returns when complexity can hide their strategies from the IRS. If the tax code was radically reformed to create simple and transparent rules, taxpayers would focus on productive endeavors rather than designing elaborate avoidance schemes.

## Transparency

A simple and transparent tax system would present citizens with a clear picture of the burden of government. If the government imposed only one tax at a flat rate, people could easily compare the cost of government with the costs of other items in their budget, such as food and housing.

Unfortunately, policymakers use various techniques to hide the burden of government, which reduces resistance to high taxes. For example, the introduction of federal income tax withholding in 1943 made paying taxes less painful, and thus helped fuel government growth in subsequent decades.

Another problem is that the government conceals the size of the overall tax load by spreading the burden across numerous types of taxes. Each tax may have multiple rates, deductions, and credits, making it difficult for people to fully understand what share of their overall earnings goes to the government.

Perhaps the most important way that politicians reduce resistance to taxation is to collect taxes from businesses, which generally hides the costs from voters. The biggest hidden tax is the ‘‘employer’’ half of the 15 percent payroll tax that funds Social Security and Medicare. This tax is not reported on worker pay stubs, but economists agree that the burden falls on workers in the form of lower wages.

Another hidden tax is the corporate income tax, which is passed through to individuals in the form of higher prices, lower wages, or reduced returns on savings. Other hidden federal taxes include import duties, unemployment insurance taxes, and excise taxes. All in all, 37 percent of federal taxes are hidden, amounting to about $1 trillion in revenue in fiscal year 2009. The result is that voters perceive the ‘‘price’’ of the government to be artificially low, causing them to ‘‘demand’’ too much of it.

Reforms should make tax structures simple, flat, and visible so that the cost of government is more transparent. For the payroll tax, employers should be encouraged to disclose the entire payroll tax on worker pay stubs and on annual tax forms mailed to employees.

For the income tax, the current mess of multiple rates and narrow breaks should be scrapped in favor of a simple flat tax. All taxpayers should pay an equal share of their income or consumption to the government. Under a flat tax, there would be greater ‘‘solidarity’’ among taxpayers because a proposed tax increase would hit everyone equally. The result would be greater opposition to tax increases, unless citizens believed that their government was giving them good value.

## Economic Growth

U.S. output and income levels would be higher if the overall size of the government was reduced. But it is also true that at any particular size of government, the economy would be stronger if the tax system were more efficient. An efficient tax system is one that minimizes distortions that affect working, saving, investing, and entrepreneurship. Unfortunately, the current income tax greatly distorts productive activities and diverts resources into lower-valued uses.

Another way to say this is that the current tax code generates high ‘‘deadweight losses.’’ The magnitude of these losses is directly related to marginal tax rates. Indeed, as marginal rates rise, deadweight losses rise more than proportionally. That is why a flatter tax structure with lower rates would be much more efficient than today’s graduated, or ‘‘progressive,’’ tax structure.

Large reductions in deadweight losses would occur from cutting the highest income tax rates. People with high incomes, such as doctors and executives, often have unique talents. If a skilled surgeon decides to work less because of high tax rates, the biggest losers would be the potential patients who would not benefit from his or her skills.

Another consideration is the high concentration of small businesses in the top income tax brackets. About three-quarters of the top 1 percent of federal taxpayers report some small business income, and these taxpayers have the most flexibility in adjusting their reported taxable income with changes to their working and investing activities.

The bottom line is that every $1 million tax increase costs the economy much more than $1 million because of the losses to efficiency caused by taxpayers' responding to the higher rates. The Congressional Budget Office stated that ''typical estimates of the economic cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised.'' Estimates of deadweight losses by Harvard University's Martin Feldstein and others are even higher.

Aside from reducing tax rates, tax reforms should focus on reducing the income tax code's bias against savings and investment. That bias undermines efforts to expand and modernize the nation's capital stock, which in turn reduces long-run economic growth. Also, the income tax system applies different tax burdens to different forms of savings and investment, which further distorts the economy.

Most major tax reform proposals would switch from an income tax base to a consumption tax base to create a neutral system with respect to savings and investment. For businesses, the tax code can be converted to a consumption base by substituting capital ''expensing'' for depreciation. Under expensing, businesses would immediately deduct the full costs of equipment and structures, rather than deducting the costs over several years.

For individuals, the tax code can be converted to a consumption base by liberalizing Roth individual retirement accounts. Under Roth IRAs, contributions are from after-tax earnings, but account earnings and qualified withdrawals are tax-free. Reforms should liberalize Roth IRA contribution limits, while repealing restrictions on withdrawals. All withdrawals should be made free from taxes and penalties. That would encourage families to build larger nest eggs so that they could enjoy greater economic security free from the government.

Reductions in marginal rates, business capital expensing, and expanded Roth IRAs would move the tax code toward a consumption-based flat tax system built on the design of Hoover Institution senior fellows Robert Hall and Alvin Rabushka. Moving toward a flat tax would make the tax code simpler, more equitable, and more efficient.

## Tax Reform Steps

**Extend income tax rate cuts.** In 2001 and 2003, Congress took some modest tax reform steps, including reducing statutory tax rates on individuals. However, these tax cuts are set to expire at the end of 2010, creating the threat of huge tax increases on taxpayers at all income levels. To avert such a tax hike, Congress should extend the 2001 and 2003 tax cuts permanently.

**Cut the dividend tax rate.** The maximum individual tax rate on dividends is currently 15 percent, but the rate is scheduled to rise to 40 percent in 2011. Even with today's reduced rate, the combined rate on dividends—taking into account both corporate and individual-level taxes—is the eighth highest of the 30 major industrial countries. If the rate rises in 2011, the United States will have the highest dividend tax rate of all major countries. See *Global Tax Revolution* for details.

**Cut the individual capital gains tax rate.** The maximum tax rate on individual capital gains is 15 percent, but the rate is scheduled to rise to 20 percent in 2011. As a first reform step, the rate should be maintained at 15 percent because low capital gains tax rates are important to encouraging entrepreneurship and investment. Note that many other advanced nations and jurisdictions have general capital gains tax rates of zero, including Austria, Belgium, the Czech Republic, Greece, Hong Kong, the Netherlands, New Zealand, and Switzerland.

**Cut the corporate tax rate to 15 percent.** The average statutory corporate tax rate in the European Union was cut from 38 percent in 1996 to 24 percent in 2007. By contrast, the U.S. corporate tax rate is far higher at 40 percent, which includes the 35 percent federal rate plus the average state corporate rate. The federal corporate tax rate should be cut from 35 percent to 15 percent, as discussed further in Chapter 42.

**Extend and expand capital expensing.** To spur economic growth, Congress has enacted a number of temporary tax cuts in recent years that have allowed companies to expense, or immediately deduct, a portion of the costs of qualified capital purchases. But full capital expensing should be made permanent, which would greatly simplify business taxation while boosting investment and economic growth.

**Liberalize Roth IRAs.** Roth IRAs should be turned into all-purpose savings accounts that allow withdrawals for any reason, not just for government-specified purposes. Such accounts would encourage families to build up large pools of savings that could be used for any contingency, including medical expenses, home buying, unemployment, college, or unexpected crises. All personal savings—not just retirement savings—create financial stability and should be encouraged. Such all-purpose Roth accounts would also simplify the tax code because the plethora of current special-purpose accounts could be scrapped.

**Repeal the estate tax.** The tax law of 2001 repealed the federal estate tax, but only through the year 2010. After 2010, the ''death tax'' is revived in full force with a top tax rate of 55 percent. The death tax raises only about 1 percent of federal revenues, but it is very costly to the economy. It has created a large and wasteful estate-planning industry to help people avoid the tax if they hire enough accountants. Indeed, studies indicate that for every $1 raised by the tax, roughly $1 is lost from avoidance, compliance, and enforcement costs.

In addition, the death tax may not actually raise any money, on net, for the government because it tends to suppress income tax collections. The former chairman of the Council of Economic Advisers, Greg Mankiw, concluded that ''estate tax repeal . . . could actually increase total federal revenue,'' and he has noted that ''repeal of the estate tax would stimulate growth and raise incomes for everyone.''

**Repeal the individual and corporate alternative minimum taxes.** The individual alternative minimum tax (AMT) is a parallel income tax system on top of the basic income tax. It has different deductions, exemptions, and tax rates. The AMT is not indexed for inflation, with the result that its burden is expected to grow rapidly in coming years. Without relief from Congress, about 30 million taxpayers will be subject to the AMT by 2010. But there is broad agreement that the AMT should be repealed—America does not need two different income tax systems. The IRS national taxpayer advocate supports repeal, arguing that the AMT is a ''poster child for tax-law complexity.'' The corporate AMT should also be repealed because it distorts business decisionmaking and serves no economic purpose.

**Reform the tax policy process.** When Congress considers changes to the tax code, the Joint Committee on Taxation estimates the effects on federal revenues. Those estimates are important in policy debates, but they are often erroneous and incomplete, and the process is shrouded in secrecy.

One key problem is that estimates do not account for changes that taxes create on the macroeconomy. For example, if marginal tax rates are cut, the economy will grow, generating rising tax revenues to offset government losses from the cut. The tax policy processes at the JCT and the Treasury Department should be reformed so that all analyses of proposed tax policy changes take into account such dynamic effects.

**Enact a consumption-based flat tax.** In recent decades, proposals to replace the federal income tax with a consumption-based tax have gained support because such reforms would simplify the tax code, increase transparency, and spur economic growth. All the reform steps discussed here would move toward a simpler, flatter consumption-based system. As of 2008, 25 nations and jurisdictions have enacted flat tax systems, as discussed in *Global Tax Revolution*. Most of those systems have low tax rates and favorable treatment of savings and investment. America should join this ''flat tax club'' to bring fairness to the tax code, to spur investment, and to revitalize the economy.

### Suggested Readings

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

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Burton, David. ''Reforming the Federal Tax Policy Process.'' Cato Institute Policy Analysis no. 463, December 17, 2002.

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