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Routing

Options for Tax Reform

by Chris Edwards

Executive Summary

President Bush has established an advisory panel to study federal tax reform options. The panel is headed by former senators Connie Mack of Florida and John Breaux of Louisiana. Congressional leaders, including House Speaker Dennis Hastert and Majority Leader Tom Delay, have also pledged their support for reform.

Enacting a major tax reform bill will be a challenge, but the president has been remarkably successful with his tax agenda so far. Income tax rates have been reduced, dividend and capital gains taxes have been cut, and the tax rules on retirement savings vehicles have been liberalized.

However, the tax system remains terribly complex and inefficient. The number of pages of federal tax rules has increased 48 percent in the past decade. The complex alternative minimum tax will hit about 35 million households by the end of the decade if not repealed. The high-rate U.S. corporate income tax is under growing pressure as global investment capital has become more mobile.

This study looks at possible changes to address those problems. It identifies three goals for tax reform: simplification, efficiency, and limited government. The latter goal focuses on tax code features such as visibility and equal treatment that cultivate an understanding of the high cost of government.

This study examines reform options including a flat tax, a national retail sales tax, and a savings-exempt tax in reference to those goals. It also proposes a new option: a "dual-rate income tax." This revenue-neutral option would convert the individual income tax to a two-rate system that eliminates most deductions and credits and allows nearly all families to pay tax at a low 15 percent rate. A 27 percent rate would kick in for earnings above $90,000 (single) and $180,000 (married).

To promote growth, the maximum individual rate on dividends, interest, and capital gains would be 15 percent. The corporate tax rate would be dropped to 15 percent and interest made nondeductible. These changes would equalize and cut the combined top income and payroll tax rates on wages, dividends, interest, and small business income to just under 30 percent, compared with between 35 and 45 percent under current law.

The dual-rate tax plan would retain the standard deduction, an expanded personal exemption, and the earned income tax credit. The plan would create a simpler and more efficient tax code within the structure of today's system and may be just the type of tax plan that the president's advisory panel is looking for.

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Introduction

The Bush administration and the Republican Congress have been remarkably successful at passing tax cut legislation. In the past four years, they have enacted four substantial tax bills.[1] Table 1 summarizes the progress those bills have made toward the three tax reform goals examined in this study: simplification, efficiency, and limited government. There has been progress toward making the tax code more efficient with cuts to individual tax rates, reduced taxes on dividends and capital gains, and liberalization of savings instruments such as individual retirement accounts (IRAs). However, there has been no progress toward making the tax code simpler or making the burden more equal and visible to help limit the government's growth.

Another problem with recent tax cuts is that they have not been matched by federal spending cuts. Federal outlays jumped 31 percent between fiscal 2001 and 2005 as the administration and Congress went on a spending spree.[2] High spending has created large and persistent deficits. The deficits may impede the ability of Congress to move ahead with further tax reforms because reforms are easier to enact when accompanied by tax cuts. Congress needs to make spending cuts a high priority in order to create room in the budget for tax reform. In another report, I have proposed more than 100 budget cuts to bring the deficit down to zero over five years.[3]

That said, the president has indicated that he wants to pursue tax reform on a revenue-neutral basis—neither increasing nor reducing overall federal revenues. The Tax Reform Act of 1986 illustrated that it is possible to make major changes to the tax code on a revenue-neutral basis, although numerous of the revenue raisers in that bill were economically damaging.[4] Note that the use of "dynamic scoring" of tax changes could help grease the skids of reform. Dynamic scoring would take into account the real-world economic benefits of adopting a more efficient tax system. Congress could enact a pro-efficiency tax reform that might reduce federal revenue on a static basis but would be revenue-neutral on a dynamic basis as the positive effects of reform boosted the economy.

The following sections discuss the three main goals of tax reform, as illustrated in

Table 1
Recent Progress toward Tax Reform Goals

Tax Reform Goal	Progress?	Notes
1. Simplification	No	The number of pages of federal tax rules is up 48 percent in the past decade. Congress continues to add special interest tax breaks to the code. Simplification has been studied by the Treasury and the Joint Committee on Taxation, but no action has been taken.
2. Efficiency	Yes	Individual tax rates have been cut. Top dividend and capital gains rates have been reduced to 15 percent. Savings vehicles such as IRAs have been liberalized. Business capital expensing was enacted temporarily. However, all reforms will expire unless Congress acts to make them permanent.
3. Limited government	No	The corporate income tax and half of the 15.3 percent payroll tax create large hidden burdens on individuals. The tax code is as intrusive as ever and treats Americans very unequally.

Figure 1
Goals of Tax Reform

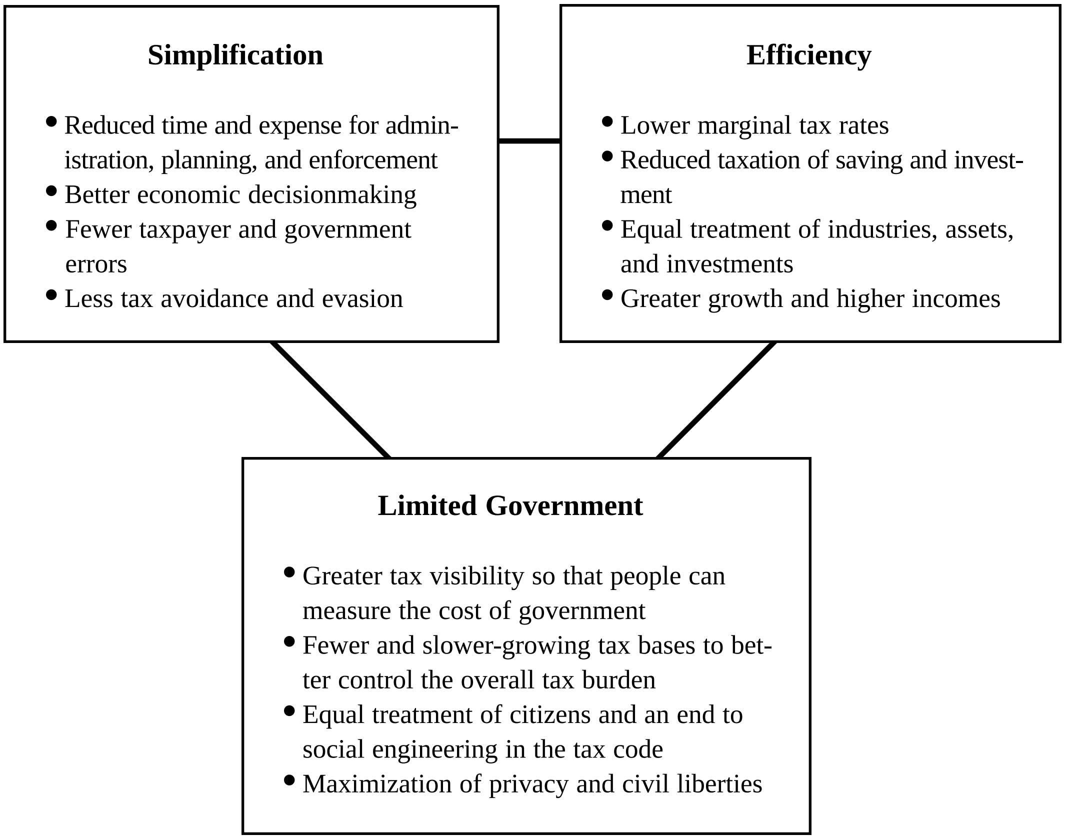

Figure 1. I then discuss some preliminary reforms to clear the decks for broader changes. Last, the paper examines four alternate tax proposals: a flat tax, a sales tax, a savings-exempt tax, and a "dual-rate income tax." The latter proposal would create a simpler and more efficient income tax—a good model for the type of reform that the administration and its tax advisory panel may be considering.

Simplification

According to CCH, a tax law publisher, federal tax rules spanned 60,044 pages in 2004—48 percent more pages than a decade ago.[5] Taxpayers have to contend with a rising number of tax forms, longer tax instructions, and returns that are more cluttered with special credits and deductions.

The complexity of today's tax system creates five main problems. First, it imposes high administrative and compliance costs. Americans spend 6.5 billion hours annually filling out tax forms, keeping records, and learning tax rules.[6] Many of the best and brightest are drawn into the nation's "tax industry," which helps individuals and businesses reduce their taxes and comply with the complicated law. The cost of complying with federal income taxes is roughly $200 billion annually.[7]

Second, tax complexity impedes efficient decisionmaking by individuals and businesses. For example, the growing number of tax rules on pensions, savings vehicles, and investment earnings confuses family finan-

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The IRS has suffered a string of losses in court cases that charged corporations with creating illegal tax shelters.

cial planning. For businesses, the complex and ever-changing income tax injects uncertainty into decisions such as investment spending.

Third, tax complexity causes taxpayers and the Internal Revenue Service to make frequent and costly errors. Special tax provisions that are enacted for social policy reasons, such as the earned income tax credit (EITC) and the alternative minimum tax (AMT), often become nightmares of complexity. Consider that almost one-third of EITC payments—about $9 billion annually—are erroneous.[8] Or consider what the IRS National Taxpayer Advocate recently said about the AMT:

> [M]ost taxpayers subject to the AMT don't know it before they prepare their taxes. As a result, many taxpayers discover too late that they underpaid their tax and are therefore subject to a penalty for failure to pay sufficient estimated tax. Indeed, taxpayers often must complete a 12-line worksheet, read eight pages of instructions, and complete a 55-line form simply to determine whether AMT applies.[9]

Fourth, tax complexity promotes invasion of personal privacy by the government. The government must hunt for volumes of data to enforce the current system because Congress has larded the code with breaks that need special documentation. The IRS needs your mortgage records for the mortgage interest deduction, your education records for education tax breaks, and so on. Because the base of the current tax system is income defined broadly, savings and capital gains are taxed. That results in the IRS gaining access to bank account and investment data, property transaction records, and myriad other financial data.[10]

Privacy would be greatly increased under a simpler consumption-based tax system that had no special breaks. For example, the Hall-Rabushka flat tax would generally tax just wages at the individual level, not dividends, interest, or capital gains.[11] As a consequence, half a billion IRS Form 1099s that track financial income would no longer be needed, and information about Americans' personal saving would become none of the government's business.

A fifth problem caused by tax complexity is that it leads to greater noncompliance with the tax system. Today, many taxpayers end up paying the wrong tax amount because they are confused about what income is taxable and what tax breaks are allowed. Complexity also fosters aggressive tax planning. Since complex tax rules are subject to multiple interpretations, they spur taxpayers to take risks in the hope that their tax-cutting strategies are not caught by the IRS. The connection between income tax complexity and aggressive tax planning was driven home by the Enron scandal.[12] The congressional report that untangled Enron's tax shelters was 2,700 pages long.[13] It makes no sense that the code is so complicated that such a huge effort is needed just to evaluate one company's tax situation.

Despite the impression left by Enron, it is a popular misconception that the problem with the corporate income tax is simply wrongdoing on the part of business executives. Instead, the complexity of the income tax makes it very ambiguous whether or not any particular corporate tax reduction strategy is illegal.[14] David Weisbach of the University of Chicago Law School notes that the government's "attacks on shelters often rely on vague standards" based on incoherent doctrines.[15]

Indeed, the *Washington Post* recently reported that the IRS has suffered a string of losses in court cases that charged corporations with creating illegal tax shelters.[16] In one recent case, a U.S. District Court ruled in favor of Black and Decker, which saved $57 million in taxes by creating a fancy transaction to offset a capital gain that it had in 1998.[17] Black and Decker won the case, but its shareholders, workers, and the U.S. economy are losers because of the wasteful efforts that are put into the cat-and-mouse struggle with the

IRS. Ultimately, the corporate tax should be repealed or radically reformed so that companies and the government do not have to expend their energies on efforts that add nothing to the nation's output.[18]

Another misconception is that any replacement tax system would become just as complicated as the current one because politicians enjoy enacting special breaks. However, excessive complexity is intrinsic to the income tax, which attempts to measure unavoidably complicated items such as capital gains and depreciation.[19] By contrast, consumption taxes and wage taxes have more transparent and coherent tax bases and do not require all the ad hoc rules that the income tax does. The federal payroll tax that funds Social Security has remained a simple, flat-rate system for decades.

It is true that politicians will always be tempted to carve out narrow tax breaks for favored groups, but the bigger source of complexity is the income base of the current system. A goal of tax reform is to find a cleaner and more consistent base that would be more resistant to political tampering over the long run.

Efficiency

Although U.S. economic output would be higher if federal spending and revenues were reduced, it is also true that, at any particular level of revenue, output would be higher if the tax system were more efficient. An efficient tax system is one that minimizes distortions that affect working, saving, investing, and entrepreneurship. The current income tax system is very inefficient because it alters wage, price, and profit signals and diverts resources into low productivity uses. This section looks at some of the distortionary features of the current tax system that should be high-priority targets for reform.

Marginal Tax Rates

A key goal of tax reform is to cut marginal tax rates because high rates exacerbate distortions in the tax code. Those distortions create economic costs, or "deadweight losses." For example, the income tax puts corporate equity at a disadvantage compared with debt. As a result, the tax code induces corporations to carry excessive debt, which may cause added bankruptcies and reduced output.

The magnitude of deadweight losses is directly related to marginal tax rates. In fact, as marginal rates rise, deadweight losses rise more than proportionally.[20] That is why a flatter tax structure with lower rates would be much more efficient than today's graduated, or "progressive," tax structure. Some people favor graduated tax structures in order to redistribute income, but that policy comes at a high economic cost.[21]

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Looking at the individual income tax, the largest reductions in deadweight losses would come from cutting the highest rates. People with high incomes often have unique talents as entrepreneurs, executives, or surgeons, for example. If a skilled surgeon decides to work less because tax rates are increased, the real losers are the potential patients who suffer from the withdrawal of her skills from the market.

Also, there is a high concentration of small businesses in the top income tax brackets.[22] About three-quarters of the top 1 percent of federal taxpayers report some small business income.[23] A series of studies by economists Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen found that marginal tax rate changes have a substantial effect on small business hiring, investment, and growth.[24] For example, the authors found that a five percentage point reduction in marginal tax rates would cause a 10 percent increase in capital expenditures. A recent study by economists William Gentry and Glenn Hubbard found that higher marginal tax rates and greater tax progressivity discourage entrepreneurship.[25]

Another factor to consider is that the largest behavioral effects of tax changes come in the highest tax brackets.[26] If tax rates are increased, the tax base will shrink as people increase their tax avoidance and reduce their earnings, perhaps by working less overtime or retiring early. Those in the top brackets have the most flexibility in adjusting their taxable income, and their actions create substantial impacts on the economy.[27] Larger behavioral changes create larger deadweight losses.

How large are deadweight losses from high taxes? The Congressional Budget Office says 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."[28] One estimate by economists Dale Jorgenson and Kun-Young Yun found that the marginal deadweight loss of the individual income tax is 35 cents on the dollar.[29] That means that a new $100 million government program financed by income taxes would cost the private sector $135 million. Jorgenson and Yun conclude that "there appear to be large potential welfare gains that could be exploited through tax reform aimed at lowering marginal tax rates."[30]

The existence of deadweight losses means that the government essentially uses a "leaky bucket" whenever it takes action. Michael Boskin, former chairman of the Council of Economic Advisers, explains: "The cost to the economy of each additional tax dollar is about $1.40 to $1.50. Now that tax dollar . . . is put into a bucket. Some of it leaks out in overhead, waste, and so on. In a well-managed program, the government may spend 80 or 90 cents of that dollar on achieving its goals. Inefficient programs would be much lower, $.30 or $.40 on the dollar."[31]

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Boskin's leaky bucket should be fixed in two ways. First, the government should be downsized and inefficient programs repealed in order to stop the leaks on the spending side of the budget. Second, marginal tax rates should be reduced to make sure that needed government revenue is raised with the least damage to the economy.

Saving and Investment

Saving is one of the root sources of economic growth because it provides businesses with the investment funds they need to expand and modernize their factories, machinery, and other assets. When businesses increase their capital investment, U.S. productivity rises. Rising productivity in turn translates into higher wages for American workers.

Unfortunately, the current tax code stands in the way of the growth process by discouraging saving and investment. Under the income tax, current consumption is not taxed, but the returns to saving are. That encourages people to spend their earnings now rather than to save for their long-term financial security. Similarly, businesses are discouraged from making long-term investments because they are not allowed to immediately deduct, or expense, the cost of their capital purchases.

Those distortions would be eliminated under a consumption-based tax, which would remove a layer of tax from saving and investment. Jorgenson and Yun have found that "the potential welfare gain from replacing the current income taxes with consumption-based individual taxes is potentially very large."[32] Their economic modeling indicates that the gain would be in the range of $2.6 trillion to $4.3 trillion. For comparison, total U.S. output is about $12 trillion.

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 purchase price of equipment, structures, and other investments.[33] The effect would be to reduce the cost of capital and spur greater capital accumulation. (The cost of capital is the required rate of return that businesses need in order to go ahead with new investments.) The tax laws of 2002 and 2003 provided partial expensing on a temporary basis.[34] An alternative way to remove the tax bias against investment would be to eliminate taxes imposed on businesses altogether, as proposed under some tax reform options.

For individuals, the tax code can be converted to a consumption base by either exempting all new saving from taxation or exempting the returns to saving from tax. The tax code already contains many pro-savings elements, but the rules are far too complex. The code has different rules for dividends, interest, capital gains, 401(k)s, Keoghs, SIMPLEs, SEPs, IRAs, pension plans, annuities, and tax-exempt bonds. Saving options involve different rules for tax rates, eligibility, contributions, distributions, withdrawals, penalties, and rollovers.[35]

The rules on traditional employer pensions are so complex that many firms have dropped pensions altogether.[36] Also, many companies have large shortfalls in their pension plans, and the federal agency that is supposed to insure pensions, the Pension Benefit Guaranty Corporation, is in severe financial distress.[37] Tax reform would end this mess by eliminating the need for traditional pensions and the PBGC. Under a consumption-based system, retirement saving would become individually based, freeing Americans from risky employer schemes. Under the Hall-Rabushka flat tax, individuals would save as much as they wanted from their after-tax earnings, and all accumulations and withdrawals would be free from taxes and government rules.[38]

Short of a full consumption-based plan such as Hall-Rabushka, Congress could simplify and encourage saving substantially. One promising route is the Bush administration's proposed "lifetime savings accounts," which are like supercharged Roth IRAs. LSAs would allow all individuals to make large after-tax contributions to savings. All withdrawals from saving would be free from taxes and penalties. The flexibility of withdrawals would make LSAs very liquid, encouraging families to build large nest eggs. With larger pools of savings, Americans could better pay for their own retirement and enjoy greater economic security free from the government.

Ending Central Planning

A leader on tax policy in the 1980s, former congressman Richard Gephardt (D-MO), said that he favored closing special interest tax breaks in order to improve economic efficiency. In a 1985 *Cato Journal* article he wrote:

> The main argument for tax reform, I believe, is to achieve greater efficiency in the way the tax code works. When Congress gets into the business of figuring out $370 billion of tax breaks a year, the House Ways and Means Committee and the Senate Finance Committee really are put in the business of trying, at least partially, to plan the American economy. . . . I confess that I am not qualified to act as a central planner and I do not know anybody on either committee who is.[39]

Unfortunately, central planning in the income tax code continues unabated 20 years later. Special breaks in the tax code have risen in value from Gephardt's $370 billion to more than $700 billion.[40] The tax code is riddled with incentives and disincentives that have disparate impacts on individuals, investments, and industries. The tax code alters market price and profit signals, redirecting resources into less productive uses. Examples include the tax preference for owner-occupied homes and the ad hoc tax rules for depreciation, which favor some industries over others.

Another example of "central planning" is the income tax exclusion for interest on state and local government bonds. That break gives a financing advantage to government-sponsored projects over private projects. The *Washington Post* recently reported that at least 38 major league sports venues have been built since 1990 using tax-exempt bond financing.[41] The tax break favors sexy projects favored by politicians over unglamorous private projects that are the real backbone of the economy, such as oil refineries and machine tool factories. A related subsidy for state and local governments is Qualified Zone Academy Bonds, which fund state and local school buildings through complex tax credits.[42]

While many tax distortions stem from such deliberate central planning, others arise

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from fundamental structural problems with the income tax. A good example is how the tax code applies a single layer of tax to noncorporate business profits and two layers to corporate profits. Economist Jane Gravelle estimates that the marginal effective tax rate on corporate investments is about 32 percent, compared to the rate on noncorporate investment of about 18 percent.[43] The consequence is that many firms that could operate more efficiently in corporate form are induced by the tax law to operate as partnerships and other forms.

Another fundamental distortion in the income tax is the depreciation system, which creates different effective tax rates on different types of investment. Depreciation is distorted by inflation and the ad hoc rules that govern the time period over which investment costs are deducted. The result is that some assets and industries are favored over others. For example, investment in equipment is generally favored over investment in structures. That works in favor of the mining industry, which invests heavily in equipment, but works against the petroleum industry, which invests more in structures.[44] Economists think that such distortions cause large economic losses.[45]

The Tax Reform Act of 1986 moved toward equalizing marginal tax rates on investments, but it pushed up effective rates on many types of assets, particularly equipment. For example, before TRA86 the marginal tax rate on corporate investment in electric transmission equipment was 21 percent and the rate on communications equipment was 4 percent.[46] After TRA86, those tax rates jumped to 36 percent and 22 percent, respectively. A 2002 study by Treasury economist James Mackie found that there are still substantial differences in effective tax rates across industries and types of assets.[47]

Although an income tax could, in theory, get rid of some of the distortions, it would be much easier to do so by adopting a consumption-based tax. With the income tax, creating more neutrality often requires more complex rules. By contrast, consumption-based taxes create neutrality with simple rules. The flat tax would substitute business expensing for depreciation, which would equalize marginal effective tax rates on investment across industries and assets. Such a system would both simplify business tax accounting and remove distortions that affect investment decisions.

Finally, if tax rates were cut under tax reform, the damage of any remaining "central planning" provisions in the code would be reduced. For example, the tax preference for owner-occupied homes would be less distortive under a 15 percent tax rate than under the current top tax rate of 35 percent.[48] As a side benefit, the Washington game of lobbying for tax loopholes would be starved as rates fell and the value of narrow breaks was reduced.

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More Efficiency Means Higher Incomes

The replacement of the income tax with a simple consumption-based system would cause resources to flow from lower-valued to higher-valued uses and the capital intensity of the economy to increase. In the short term there would be some economic dislocations, but in the long term the American economy would be larger and incomes higher.

Numerous economic models have simulated consumption-based tax reform, each based on various assumptions and parameters. The results have varied quite widely, but it appears that under a revenue-neutral reform, switching to a flat consumption-based system might increase U.S. incomes by up to 10 percent in the long run:[49]

- Boston University's Laurence Kotlikoff found that replacing the income tax with a retail sales tax would increase per capita income by about 7 percent in the long run. Even higher gains would be possible if the progressivity of the tax system were reduced.[50]
- Alan Auerbach of the University of California at Berkeley found that long-run gross domestic product per capita would be 9.7 percent higher under a

national sales tax and 8.4 percent higher under the Hall-Rabushka flat tax.[51]

- In an *American Economic Review* study, David Altig and others (including Kotlikoff and Auerbach) found that replacing the income tax with a flat consumption-based tax would raise long-run incomes by 9 percent and that replacing the income tax with a progressive consumption tax would raise incomes by 5 percent.[52]
- Former chairman of the Council of Economic Advisers Michael Boskin thinks that the long-term gain to GDP from a consumption-based tax reform would be about 10 percent.[53]
- A 1997 Joint Committee on Taxation report summarized results from nine different models that simulated a flat rate consumption-based tax. The results ranged widely, with different models finding that long-run GDP would be from 1.7 to 16.9 percent greater. The model average was 5.8 percent.[54]
- Dale Jorgenson and Kun-Young Yun found that a Hall-Rabushka flat tax would create welfare gains of $2.1 trillion and a sales tax that included low-income relief would create gains of $3.3 trillion.[55]

Those would be large gains, but such models do not account for all the benefits of tax reform. For one thing, tax reform would reduce the roughly $200 billion in annual compliance costs of the tax system. With a simpler system, corporate executives and small business people would waste less time on tax planning and spend more time focusing on creating growth in the economy.

Also, economic models usually do not include the full benefits of technology advances that occur from rising capital investment. Tax cuts can generate rising investment in business machinery. But new machines do not just replace similar old machines; they embody new technologies that increase productivity and spur growth. When economic models do not include that benefit of investment tax cuts, they understate the economic benefits and overstate the government revenue loss.[56]

Tax reform would also create nonmonetary benefits for Americans. For example, eliminating today's complex tax rules on personal savings would make financial planning much easier and more flexible. Also, a simpler tax code would give Americans satisfaction in having a government that treated everyone more equally. Those sorts of benefits of reform are tough to put dollar values on but would be substantial nevertheless.

Limited Government

Scholars of the public choice school argue that "democracy contains an inherent bias toward inefficiently large government."[57] That bias stems from public officials acting in self-interested ways that are contrary to the broad public interest. For example, logrolling between members of Congress results in the passage of expensive provisions that do not have wide support among the public. Large omnibus spending bills typically include many items that would not gain legislative support under a more visible stand-alone vote. Legislators have a bias toward dishing out government largesse to visible and important constituencies, while hiding the resulting costs from current taxpayers in the form of deficits.

To steer democracy toward a more efficiently sized government, legislators need to be restrained by rules to deter shortsighted and self-interested policy actions. For example, 49 of the 50 states have statutory or constitutional requirements for balanced budgets to ensure that legislators do not evade the tough fiscal tradeoffs that they are elected to make. Also, most state governors have line-item veto power with which to eliminate narrow special interest spending.

The federal government is notably lacking in such fiscal constraints, as the current spectacle of high spending and big deficits makes clear. A Congressional Research Service report

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noted: "State constitutions are much more detailed about the budget process than the U.S. Constitution. It is not unusual for state constitutions to . . . prohibit legislation in appropriations bills, specify the style and format of appropriations bills, direct that appropriations bills shall embrace nothing but appropriations, and require a single subject for each bill."[58] A number of states impose controls on the overall annual growth rate of revenues or spending.

To fix the undisciplined federal budget process, new controls are needed, akin to the tougher controls that many states have.[59] To control spending, a cap that tightly limits annual growth in overall outlays is a good option.[60] To control taxes, a constitutional amendment to require a supermajority vote to enact tax increases should be considered.

Aside from such formal budget rules, the structure of the tax system can play an important role in controlling the size of government. Different tax structures lead to different fiscal outcomes. For example, the introduction of withholding for the federal income tax in 1943 made paying taxes less painful, thus helping fuel government growth in subsequent decades.[61] Another feature that fuels government growth is "bracket creep" under the graduated income tax, which bestows ever higher revenues on the government without the need for unpopular votes in Congress.[62]

Economists James Buchanan and Geoffrey Brennan explored the importance of tax structures to the size of the government in their 1980 book *The Power to Tax: Analytical Foundations of a Fiscal Constitution*.[63] The authors challenged the "benevolent despot model of public finance," which assumes that the level of taxes is already decided and that the role of experts and policymakers is simply to find the most efficient way to raise it. If, instead, government is viewed as a revenue-maximizing Leviathan, finding the most efficient tax system becomes more complicated. A certain tax structure may promote economic efficiency in the short run, but it may affect the economy negatively in the long term if it promotes excessive government growth.

Consider the broadness of tax bases. Orthodox public finance theory concludes that broad tax bases are more efficient than narrow ones because under a broad base resources would flow to their most efficient uses, not to tax-favored uses. That is correct as far as it goes, but Buchanan and Brennan point out the benefit of narrow bases: "To the extent that activities which yield value to taxpayers remain outside the allowable reaches of the fiscal authority, the appetites of Leviathan are checked. People may resort to nontaxable options, and in the knowledge that they will do so, government necessarily curbs its revenue extraction."[64] Thus, a narrower tax base will limit the government's total tax take, which increases economic efficiency.

Other tax system attributes that can check the appetite of Leviathan include visibility and equal treatment. The following sections discuss tax code design and limited government.

Visibility

Consumers in the marketplace like to see prices clearly displayed before making a purchase. People weigh the benefits of buying products against the costs to their pocketbook. There is no reason why the federal government should not be as open and transparent about its costs as grocery stores or gas stations are. It is important that citizens in a democracy understand the costs of government. Indeed, public understanding is more important than ever because most of the constitutional constraints that used to restrict government growth have been discarded.

Unfortunately, the federal tax system does not allow an easy way for citizens to gauge and control the cost of government. The income tax has many different rates, deductions, and credits, making it difficult for people to perceive what share of their earnings is being taxed. Also, citizens face unlegislated tax increases as a result of economic growth under a graduated income tax system.

Another way that the federal government conceals the size of the tax load is by spreading the burden across numerous tax bases. A century ago, the federal government had just two main tax sources, alcohol excises and customs duties, and the government remained small.[65] In the 20th century, three powerful revenue engines were added—the individual income tax, the corporate income tax, and the payroll tax—and federal spending expanded dramatically.

The federal revenue engine is made more powerful by the fact that a big share of the tax burden is hidden from the general public's view. The biggest hidden tax is the employer half of the 15.3 percent payroll tax that funds Social Security and Medicare. That $372 billion tax is not reported on worker paystubs, yet economists agree that the burden ultimately falls on workers in the form of reduced wages.

The second largest hidden tax is the $230 billion corporate income tax. That tax is ultimately passed through to individuals in the form of higher prices, lower wages, or reduced investment returns. Like the payroll tax, businesses collect it, but individuals bear the burden. Other federal taxes that are hidden from the public's view include import duties; unemployment insurance taxes; and excise taxes on gasoline, alcohol, and tobacco.

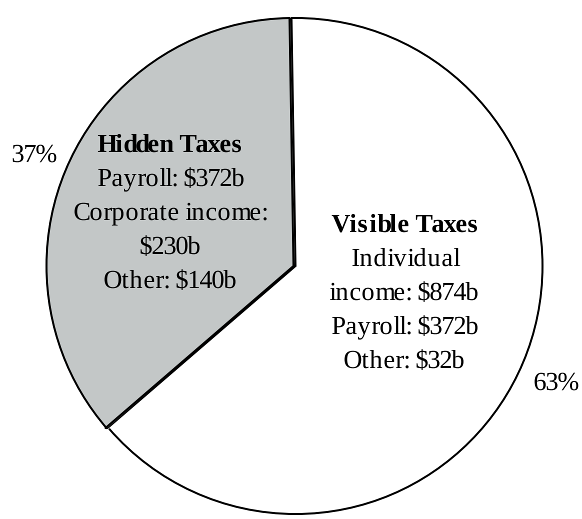
All in all, 37 percent of federal taxes are hidden, as shown in Figure 2.[66] As a consequence, voters perceive the "price" of government to be artificially low, causing the "demand" for government services to be too high. Public choice economists call this problem "fiscal illusion," a strategy used by legislators to make the government appear to be less of a burden than it actually is.

A goal of tax reform should be to end fiscal illusion and make the tax burden transparent. A good first step would be for Congress to reconsider the Right-to-Know National Payroll Act, which was passed by the House in 2000 but not signed into law.[67] The proposal would require employers to disclose the entire payroll tax paid for each worker on annual income tax W-2 forms mailed to employees. Another idea is to encourage employers to voluntarily provide fuller information about payroll taxes on worker paystubs.[68]

H. L. Mencken said, "Democracy is the theory that the common people know what they

The federal revenue engine is made more powerful by the fact that a big share of the tax burden is hidden from the general public's view.

Figure 2
Hidden and Visible Federal Taxes, FY05 ($ billions)



Source: Author's calculations based on *Budget of the U.S. Government, FY2005*. "Other" hidden taxes include customs duties; unemployment insurance taxes; and excise taxes on alcohol, fuel, and tobacco. "Other" visible taxes include estate and gift taxes and various smaller levies.

Excluding some activities from the tax base distorts resource allocation. But from a limited-government perspective, narrower and slower-growing tax bases are advantageous.

want, and deserve to get it good and hard."[69] The people do not hesitate to demand government spending when they want it, but that needs to be balanced with a tax system under which the people feel the full cost of the spending "good and hard."

Tax Bases

Choosing the right tax base for federal tax reform has important implications for limited government. For one thing, revenues from some types of taxes tend to grow more slowly than revenues from others. For example, sales tax revenues tend to grown more slowly than income tax revenues over time. From 1973 to 2003, state sales tax revenue grew at an annual average rate of 7.1 percent while state income revenue grew at 8.3 percent.[70] That occurred partly because income tax rates tend to be more graduated that sales tax rates, but it is also a tax base issue. Sales taxes tend to exclude newer, fast-growing industries, such as service industries, from the tax base. Services have increased from 45 percent of personal consumption expenditures in 1970 to 59 percent today, thus effectively narrowing the sales tax base.[71]

Economists note that excluding some activities from the tax base distorts resource allocation. But from a limited-government perspective, narrower and slower-growing tax bases are advantageous. Consider the federal corporate income tax. The government's "yield" from the tax—measured as a share of GDP—has been falling over time as the tax base has narrowed. The corporate tax is grossly inefficient and should be reformed or repealed, but at least it has not provided fuel for expanded government.[72]

Under any major tax reform, the tradeoff between tax base broadness and limited government needs to be considered. Some consumption tax proposals have very broad tax bases. Although that would be economically neutral, it would not be "neutral" from a political economy perspective if it resulted in larger government. Under tax reform, some portion of a consumption base should be exempted—if there are reasonable economic or administrative reasons for it—in order to limit the government's revenue-raising power.

Brennan and Buchanan say that taxpayers should "deliberately . . . build certain 'loopholes' or 'escape routes' in the tax structure. These provide the protection or guarantee against undue fiscal exploitation."[73] Thus, a 20 percent tax on half of consumption may be preferable to a 10 percent tax on all consumption because the latter system may morph over time into a 20 percent tax on all consumption.

Nobel laureate Gary Becker and fellow economist Casey Mulligan built on Buchanan and Brennan's observations in a 1998 paper.[74] After examining a sample of countries over time, they conclude that those with "'more efficient' tax systems—systems which rely on broad-based taxes with fairly flat rate structures—are associated with larger governments."[75] The authors also conclude that "an efficient tax system may not minimize the total deadweight costs of government activities" if increased tax collection efficiency is outweighed by the inefficiency of the government consuming more resources.[76]

Consider the single largest exclusion from the current income tax base, employer contributions for health insurance, which are deductible to employers and exempt from tax for employees. This exemption has increasingly narrowed the income tax base over time. In 1983 the exclusion created a federal revenue loss equal to about 6 percent of individual income tax receipts.[77] But because health care costs have grown quickly, the exclusion now creates a federal revenue loss equal to 12 percent of income tax receipts. If health costs continue to rise faster than U.S. incomes, the exclusion will act to further reduce growth in federal tax receipts.

That is good news from a limited-government perspective, but it is also true that the current tax treatment of health care creates serious distortions. In particular, the exclusion itself is an important reason why health care spending has risen so rapidly in recent decades. (Another reason is that employer health contributions are exempt from the payroll tax).[78] The exclusion has also caused the U.S. health care system to gravitate toward employer-based insurance coverage and away from individual coverage and control.

Tax reform should address those distortions. Individual health care coverage should receive tax treatment similar to that afforded employer-based coverage. Recently enacted health savings accounts have helped to move the health care system modestly toward more individual control. A further reform step was suggested by former White House economist Glenn Hubbard and coauthors writing in the *Wall Street Journal*.[79] They argued that anyone with at least catastrophic insurance coverage should be allowed to deduct personal health care expenses under the income tax. That would increase health industry efficiency by promoting individual insurance coverage and out-of-pocket spending. Other analysts have proposed an individual tax credit for personal health care expenses.[80]

Another reform option would be to limit the current exclusion for employer-provided coverage to a fixed dollar amount, while providing limited tax benefits for individual coverage.[81] Some tax reform proposals, such as the Hall-Rabushka flat tax, would simply eliminate the preferential treatment of health care in the tax code.

Interestingly, a number of consumption-based tax reform plans would exempt education spending from taxation on the basis that education is an "investment."[82] Although most education spending probably does have a long-term payoff, much health care spending does as well. If medical treatment increases a worker's long-term productivity, perhaps it should be considered investment spending as well. When a construction worker undergoes back surgery, his medical costs are an investment in his productivity. Both health care and education spending contain elements of both consumption and investment; thus, it seems that the proper tax treatment is a judgment call.[83]

Another sector that requires a careful look under consumption-based tax reform is financial services. Excluding financial services from the tax base might make economic sense under a consumption-based system. In a 2000 study, Treasury economists Harry Grubert and James Mackie make a good argument that the main purpose of investment businesses, insurance, and related industries is to help Americans save.[84] The value added by those industries represents the transactions costs of saving, not consumption spending. Thus, they argue that excluding financial services from taxation would be consistent with the goal of creating a pro-saving or consumption-based tax system.

Another advantage of exempting financial services is that it would be a tricky industry to tax under any consumption-based system. State retail sales taxes and European value-added taxes (VATs) typically exclude financial services. To tax the industry, special rules would be needed, which would increase the tax system's complexity.[85] That is also true for other services industries, and it is one reason why state sales taxes apply to only about half of the full personal consumption base.[86] In sum, narrowing the tax base may make sense under consumption-based tax reform if it confers a simplification advantage and there is a good economic justification for it.

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A final consideration regarding the tax base and tax reform is how many different tax bases federal revenue should be raised from. From an efficiency standpoint, economists might favor a greater number of bases. Two 10 percent taxes on different bases might be less distortionary than one 20 percent tax because deadweight losses rise more than proportionally as tax rates rise. On the other hand, more tax bases would create larger compliance costs than fewer bases.

More important, a greater number of tax bases would make it more difficult for citizens to control the government's total tax take. After European countries imposed VATs in addition to existing income taxes during the 1960s and 1970s, their government budgets ballooned. In 1970 tax revenue as a share of GDP averaged 30 percent in Europe and 28 percent in the United States.[87] By 2000, the European average had soared to 42 percent as

VAT rates rose, while the U.S. tax share had risen only modestly to 30 percent.

To summarize, tax reforms should create a simpler and more efficient system, but the public should be on guard that reform does not make it easier for the government to raise money. New sources of revenue should not be added unless other sources of revenue are eliminated. The tax system should be made more transparent so that citizens are more aware of the government's full costs. A focus on those limited-government aspects of tax reform is especially important because the coming entitlement crisis will create a tempting excuse for some policymakers to call for higher federal revenues.[88]

Vertical "equity" is often used to imply the exact opposite of equal treatment.

Equal Treatment of Individuals

Equality under the law is a core American principle that should help guide federal tax reforms. Public finance experts refer to "horizontal equity" as the idea that individuals with similar income or consumption levels should pay similar amounts of tax. Unfortunately, individuals are treated very unequally under the income tax as a result of the code's many exemptions, deductions, and credits. For example, homeowners and renters with similar incomes can pay substantially different amounts of tax because of the mortgage interest deduction. Another disparity is between the many workers who receive tax-free health insurance through their employers and workers who do not have employer coverage and have to pay for health care with after-tax dollars.[89] Similarly, there is unequal access to savings vehicles in the tax code. Some workers have access to 401(k) plans through their employers, but many do not. Reforms should create a tax system that provides equal opportunities to all.

In addition to horizontal equity, some public finance specialists call for "vertical equity" in the tax code. However, this concept has no clear meaning. Indeed, vertical "equity" is often used to imply the exact opposite of equal treatment—that people with higher incomes should pay a larger share of their income in taxes. Under the federal income tax, the average tax rate (tax paid divided by adjusted gross income) for those earning over $200,000 was 26 percent in 2002.[90] By comparison, the average tax rate on households earning between $50,000 and $100,000 was 11 percent. Those figures indicate that the income tax is overly graduated and creates a high degree of inequality.

A goal of tax reform should be to move the system toward proportional tax burdens. With proportional burdens, all taxpayers would pay an equal share of their income (or consumption) to the government. Greater equality in the tax burden would have two key benefits. First, it would improve economic efficiency because, as noted, the deadweight losses of the tax system rise more than proportionally as tax rates rise. Raising taxes on someone in the 35 percent rate bracket creates more economic damage than raising taxes on someone in the 15 percent bracket.

A second benefit of a more proportional tax system would be to reduce the demand for government. Under today's highly graduated system, many people are not aware of the burden created by the federal government. Indeed, 64 million of 151 million U.S. households (42 percent) did not pay a dime in federal income taxes in 2004.[91] The "price" of government is zero for those folks, so they likely demand too much of it. As Michael Boskin lamented: "We now have a much higher ratio of people who are net income recipients to people who are taxpayers than in any previous time in history."[92]

Since the 1980s, Congress has taken millions of Americans off the income tax rolls. Expansion of the standard deduction, the personal exemption, the EITC, the child tax credit, and the creation of the 10 percent tax bracket helped zero out tax liability for many families. No one wants to increase taxes on lower-income families, so the best way to create more tax equality would be to cut federal spending and ratchet down taxes on the 58 percent of households who do pay income taxes. That way, the nonpayers could retain their tax freedom, but other Americans would be treated more fairly.

Greater equality under a more uniform and proportional tax system would create "solidarity" among taxpayers.[93] Under the current tax system, with its multiple rates, deductions, and credits, politicians can use a "divide-and-conquer" strategy to confuse the public about who is affected by proposed cuts or increases. By contrast, if the tax system had a single statutory rate (above a basic exempt amount), a proposed increase would generate widespread opposition, unless people thought that politicians would spend the added funding wisely.

Clearing the Decks for Reform

Repeal the Alternative Minimum Tax

The individual alternative minimum tax (AMT) is a complex income tax that operates alongside the ordinary income tax and requires many taxpayers to calculate their taxes two different ways. The corporate AMT is also burdensome and adds uncertainty to business decisionmaking. There is broad agreement that the ill-conceived alternative taxes should be repealed because they serve no economic purpose.

AMT repeal has been recommended by the Joint Committee on Taxation.[94] The IRS National Taxpayer Advocate has also supported repeal, noting that the AMT is "so complicated that many taxpayers are not aware that they may be subject to it" and that it is "too complicated for most taxpayers to calculate without paid professional help."[95]

There are many problems with the AMT. For one thing, it is not indexed for inflation. That is one reason why current projections show that 35 million taxpayers will be subject to the AMT by 2010 under current law.[96]

The broader issue with the AMT is that the government does not need two separate income tax systems. The AMT was installed to prevent individuals from taking too many special tax breaks under the regular income tax. Who put those special breaks into the tax code? Congress did, of course. Thus, the AMT is a complex Band-Aid to make up for the failure of Congress to impose an equal and neutral regular income tax.

The solution is to repeal the AMT and end narrow tax breaks in the regular tax code. Replacing the income tax with a simple and neutral consumption-based system would achieve consistent tax treatment for families and businesses, and there would be no need for a special add-on tax.

Repeal the Estate Tax

The 2001 tax law repealed the federal estate tax, but only for the single year of 2010. After 2010, the "death tax" returns in full force with a top tax rate of 55 percent. The estate tax raises only about 1 percent of federal revenues but imposes a substantial cost on the economy. The chairman of the Council on Economic Advisers, Greg Mankiw, noted at a November 2003 Treasury conference that as a tax on savings, the death tax suppresses growth and reduces the wages of average workers. He concluded that "the repeal of the estate tax would stimulate growth and raise incomes for everyone."[97]

The estate tax is probably the most inefficient tax in America. It has created a huge and wasteful estate planning industry to help wealthy Americans avoid the tax if they hire enough lawyers and accountants. Studies indicate that for every dollar raised by the tax, roughly one dollar is lost to avoidance, compliance, and enforcement costs. In addition, the tax may not actually raise any money for the government, on net, as noted by Mankiw at the Treasury conference. The reason is that the impact of the estate tax suppresses other federal tax collections, thus offsetting estate tax receipts. Mankiw concluded that "estate tax repeal . . . could actually increase total federal revenue."[98] Congress should complete the job it started in the 2001 tax law and permanently repeal the death tax.

Modernize the Tax Policy Process

When Congress considers raising or cutting taxes, the Joint Committee on Taxation is charged with estimating the expected

Greater equality under a more uniform and proportional tax system would create "solidarity" among taxpayers.

A recent study by Gregory Mankiw and Matthew Weinzierl showed that the dynamic effects of capital income tax cuts can be large.

changes to federal tax revenues. Those estimates are very important to policy debates, but they can be flawed or incomplete. One problem is that JCT estimates have traditionally been "static," meaning that they do not take into account the effects of tax changes on the macroeconomy. If marginal tax rates are cut, for example, the economy will grow faster and generate a partly offsetting increase in federal revenues.

Such macroeconomic feedbacks can be captured in "dynamic" estimates of tax policy changes. A recent study by Gregory Mankiw and Matthew Weinzierl showed that the dynamic effects of capital income tax cuts can be large.[99] In a neoclassical growth model, using what the authors say are empirically plausible assumptions, they find that the government would recoup 50 percent of the revenues lost from a cut to capital income taxes over the long term. The authors find that such dynamic feedback effects of cuts to capital income taxes are stronger than the effects of cuts to labor taxes.

In recent years, the JCT and the Congressional Budget Office have begun to modernize their tax-estimating apparatus, and some recent analyses have included macroeconomic modeling results.[100] Those efforts should continue, and economic modeling should be made a routine part of the tax policy process. One benefit would be to help members of Congress understand that tax changes are not just about gaining or losing revenues for the government, that tax changes can create substantial impacts on the economy.

Other aspects of the tax policy process should also be modernized. One problem area has been an overreliance on "distributional" tables, which show tax liability for people at different income levels. Traditional distribution tables capture taxpayers at a single point in time and do not reveal the dynamism in most individuals' tax situations. Using a new data set, Treasury economists recently looked at the effect of the Bush income tax cuts over a long time frame and found that there is substantial movement of people between tax brackets.[101] For example, they found that a traditional one-year analysis showed that just 35 percent of taxpayers benefit from the new 25, 28, 33, and 35 percent tax rates. But over 10 years, 61 percent of taxpayers benefit from the lower rates. In sum, new analysis tools can provide useful information regarding the effects of proposed tax changes. Congress and the administration should incorporate those new tools into their regular policy processes.

Four Options for Tax Reform

Most of the tax reform proposals of recent years have had similar economic structures.[102] The flat tax, sales tax, and other proposals would all replace the income tax with a low-rate consumption-based system that would exempt savings, or the return from savings, from taxation. But reform plans have differed on key design features, such as the point of collection and the visibility of taxation.

Table 2 shows the basic structure of four tax reform options: a Hall-Rabushka flat tax, a national retail sales tax, a savings-exempt tax, and a dual-rate income tax. The first three options would repeal the individual and corporate income taxes, and the fourth would reform the income tax system. The tax rates given for the first three options are the proposed rates. There has been debate about whether or not the tax rates for these proposals are revenue neutral, as discussed below. For the dual-rate tax, I have designed the structure to be roughly revenue neutral on a static basis. From a dynamic perspective, all four plans would increase the economy's efficiency and likely create positive revenue feedbacks for the government. Thus we could reduce tax rates over time and still retain revenue neutrality.

Tables 3 to 5 summarize the simplification, efficiency, and limited-government implications of each tax option. Those implications are discussed in the following sections for each reform option.

Table 2
Structure of Tax Reform Plans
Options 1 to 3 would replace the individual and corporate income taxes. Tax rates are as proposed. Option 4 would reform the income tax. Tax rates are roughly revenue neutral.

Tax Plan	Individuals	Businesses
1. Hall-Rabushka Flat Tax	• 19% tax on wages and salaries • Dividends, interest, and capital gains not taxed • Large personal allowances: $9,500 singles, $16,500 married, $4,500 per dependent • All other deductions and credits eliminated	• 19% cash-flow tax on all businesses • Capital expensing • Wages are deductible, but interest and dividends are not • Territorial treatment of foreign investment • Cash-flow accounting that excludes financial flows from tax base
2. Retail Sales Tax	• Tax not collected from individuals • Most sales tax plans would mail rebate checks to all U.S. households	• Sales tax collected from 10 million retailers. Alternatively, a VAT would be collected from 25 million businesses. • To replace income taxes, a 17% (tax-exclusive) rate would be needed on 55% of GDP • The FairTax would have a 30% rate on a broader tax base to replace income and payroll taxes
3. Savings-Exempt Tax	• Flat rate tax of about 22% on individual income that is not saved, per IRET plan • Large basic family allowances • All saving is deducted, but all saving withdrawals are taxed • Nearly all other deductions and credits are ended	• No business tax
4. Dual-Rate Income Tax	• Income tax rates of 15% and 27%. Higher rate begins at $90,000 (single) and $180,000 (married) • Dividends, interest, and capital gains taxed at 15% maximum • Standard deduction per current law. Personal exemption increased from $3,200 to $4,500 • Earned income tax credit retained • Savings vehicles, such as IRAs, retained • All other deductions and credits eliminated	• 15% tax on corporations • Wages are deductible, but interest and dividends are not • Further optional reforms include capital expensing and territorial treatment for international investments

Table 3
Simplification Comparison

Tax Plan	Benefits	Concerns
1. Hall-Rabushka Flat Tax	• Ends personal taxes on dividends, interest, and capital gains and ends need for special savings vehicles such as IRAs • Ends complex business rules for depreciation, inventory, capital gains, and mergers and acquisitions • Simplifies tax rules on foreign investment	• Some business tax items, such as transfer pricing, would continue to create complexity • Taxation of financial institutions would need special rules
2. Retail Sales Tax	• Ends all personal taxation • Individuals could save and invest tax-free without any complex rules • Businesses could invest, hire, and reorganize without complex and distortionary rules	• Rebate mechanism would add complexity • Compliance costs on 10 million retail businesses may be large • Taxing some industries, such as financial services, would require special rules • Susceptible to creation of multiple rates and exemptions
3. Savings-Exempt Tax	• All business taxes are repealed • Neutral individual tax that ends narrow breaks • No capital gains taxation	• Calculations related to personal financial income and net saving might be complex • Individual tax would be susceptible to reintroduction of special tax breaks
4. Dual-Rate Income Tax	• Individual income tax is simplified by repealing most deductions and credits and taxing nearly all income at 15% • For corporations, the lower tax rate and neutral debt/equity treatment would reduce tax sheltering	• Tax system is simplified, but it would retain a broad income base making it susceptible to the reintroduction of special tax breaks

The flat tax adopts essentially Roth IRA treatment for personal saving.

1. Hall-Rabushka Flat Tax

Benefits

In 1981 Robert Hall and Alvin Rabushka of the Hoover Institution introduced their "flat tax" proposal.[103] Since then, numerous versions of the Hall-Rabushka plan have been proposed, including the flat tax proposals of former house majority leader Dick Armey and 1996 presidential candidate Steve Forbes. More recently, Rep. Michael Burgess (R-TX) and Sen. Arlen Specter (R-PA) have introduced Hall-Rabushka-style plans in Congress. Princeton University economist David Bradford has proposed an "X-Tax," which has a structure similar to that of the Hall-Rabushka plan but would have two tax rates instead of one.

Under the Hall-Rabushka plan, wages in excess of a large personal exemption would be taxed at a flat 19 percent. Individuals would not be taxed on interest, dividends, or capital gains because capital income would be taxed at the business level. The flat tax adopts essentially Roth IRA treatment for personal saving—wages would be taxed when earned, but after-tax earnings that were saved would accumulate tax-free. The exception is pension benefits, which would be subject to the individual tax because contributions were from pretax income.

Large and small businesses would file the same simple tax return and pay a flat 19 percent on a net cash-flow base.[104] Taxable cash flow would equal revenues from the sale of goods and services, less deductions for wages, materials, equipment, buildings, and other purchases.[105]

The flat tax is not just a simple version of the current income tax. It is a consumption-based tax system because it uniformly removes a layer of taxation from saving and investment. For individuals, it does not tax the return to savings. For businesses, it allows an immediate deduction, or expensing, of the full value of new capital investment.

The flat tax uniformly removes a layer of taxation from saving and investment.

Table 4
Economic Efficiency Comparison

Tax Plan	Benefits	Concerns
1. Hall-Rabushka Flat Tax	• Ends tax bias against saving and investment and cuts top marginal tax rates • Equalizes marginal tax rates across different industries, assets, and investments • All businesses taxed under the same system	• Retains a tax on businesses, although one that is much less distortionary • Not "border adjustable" as are some other tax options, which might affect U.S. business competitiveness
2. Retail Sales Tax	• Ends tax bias against saving and investment and cuts top marginal tax rates • Ends most business tax distortions, although retail businesses would have to collect the sales tax	• Susceptible to the creation of exemptions and multiple tax rates • Rebate mechanism would reduce efficiency • Evasion may be a serious problem with a high rate
3. Savings-Exempt Tax	• Ends tax bias against saving and investment and cuts top marginal tax rates • Ends all business tax distortions	• Individual tax susceptible to reintroduction of special tax breaks
4. Dual-Rate Income Tax	• Cuts the top marginal tax rate on wages, dividends, interest, and small business profits • Equalizes treatment of debt and equity • Eliminates many income tax distortions by reducing rates and ending most deductions and credits	• Does not reduce taxes on saving and investment as much as a consumption-based system • Retains an income tax on businesses • Susceptible to reintroduction of special tax breaks

Table 5
Limited Government Comparison

Tax Plan	Benefits	Concerns
1. Hall-Rabushka Flat Tax	• No need for government to probe family finances because taxation of financial income is ended • All individuals and businesses treated neutrally and equally	• A large business tax remains hidden from the general public • Individual wage tax could be expanded into an income tax • The three major federal tax bases are retained
2. Retail Sales Tax	• Individual tax filing eliminated • Tax burden fully visible to individuals • If the sales tax had a high rate of 15% or more, it would be difficult to raise it any further • The number of major federal tax bases reduced from three to one under the FairTax	• Politicians could manipulate the system to create multiple rates and exemptions • Rebate checks would create dependence on government for a monthly handout • Americans may end up with both an income tax and a sales tax unless Sixteenth Amendment repealed
3. Savings-Exempt Tax	• Full tax burden visible to individuals because businesses do not collect taxes • The number of major federal tax bases reduced from three to two	• Taxation of personal savings and withdrawals requires giving additional financial data to the government • Substantial individual tax compliance burden
4. Dual-Rate Income Tax	• Income tax would be more neutral and horizontally equitable than the current system • Simple structure of individual tax would increase tax code transparency	• Basic income tax structure remains in place. Rates and complexity might increase over time • Retains a hidden tax on corporations • All three major federal tax bases are retained

For multinational businesses, the flat tax is "territorial," thus taxing only business activities within the United States.

A flat tax would be much simpler and more efficient than the income tax, as I have discussed in detail elsewhere.[106] Ending personal taxes on dividends, interest, and capital gains would remove large paperwork and financial-planning difficulties that families face under the current tax code. The flat tax would eliminate half a billion IRS Form 1099s, which are used to report personal financial income.[107]

For businesses, the flat tax would simplify the most complex parts of the tax code, including accounting for inventories and capital investment. The flat tax would use simple cash accounting in place of accrual accounting, which is used under the income tax. Accrual accounting requires that firms match revenues and expenses each year to measure net income and to "capitalize" expenses that create future benefits. Under the flat tax, businesses would include receipts when cash is received and deduct the full costs of materials and equipment when purchased. Aside from simplification, such capital "expensing" would eliminate distortions on marginal investment decisions.[108]

For multinational businesses, the flat tax is "territorial," thus taxing only business activities within the United States. That would eliminate most U.S. tax rules on international investment and make the United States an excellent place to locate the headquarters of global corporations. All in all, the flat tax's combination of capital expensing, territoriality, and a low tax rate would give the United States a superior business tax system and give U.S. firms a competitive edge in world markets.

Concerns

A first point of contention regarding the flat tax has been whether the proposed tax rate of 19 percent (17 percent under the Armey version) would be revenue neutral or not.[109] A 1996 Treasury study argued that the revenue-neutral Armey tax rate would be 21 percent.[110] But federal income tax revenues have been cut in recent years—from 10.7 percent of GDP in FY96 to 9.1 percent in FY05.[111] Thus, a somewhat lower flat tax rate of about 18 percent would be revenue neutral today.

The tax rate under the flat tax could be lower if the system did not include such large basic exemptions. Under the version of Armey's plan introduced in the 107th Congress, a married couple with two children would not pay any tax on earnings of less than $35,200. That would create a problem from a limited-government perspective because it would take millions of families off the tax rolls. In particular, Armey figured that his plan would reduce the number of taxpayers by 10 million; thus 10 million more people would view government spending as "free," and they would demand more of it.[112]

Some concerns about the flat tax regard the business part of the system. The Hall-Rabushka business tax would be much simpler than the corporate income tax, but there are administrative issues that would need to be ironed out. For example, experts have pointed to areas where the flat tax would be vulnerable to business tax sheltering, such as transfer pricing, that would require extra policing.[113] Nonetheless, the low rate of the flat tax would be a large cut from today's corporate rate of 35 percent. That would reduce incentives for companies to engage in all sorts of tax-sheltering activities.

Another concern is that the flat tax system would retain a business-level tax, thus perpetuating a hidden tax burden on individuals. Hall and Rabushka were well aware that "people pay taxes, not businesses," but they decided that taxing capital income at the business level would be simpler than at the individual level.[114] They called their business tax "a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages but to tax it only once."[115] That design is efficient, but it is a weakness from a limited-government perspective.

The flat tax system would retain a business-level tax, thus perpetuating a hidden tax burden on individuals.

A final concern raised by some tax reformers is that the flat tax is not "border adjustable." Border adjustable taxes would exempt exports from U.S. taxes, while imposing taxes on imports. Some analysts argue that border adjustability would make U.S. businesses more competitive in global markets. Retail sales taxes and European VATs are examples of border adjustable taxes.[116] By contrast, the flat tax and the current corporate income tax are not border adjustable.

Some supporters of tax reform are determined that any major reform plan be border adjustable.[117] Former Ways and Means Committee chairman Bill Archer supported a sales tax reform instead of the flat tax partly because of this issue.[118] The Simplified USA Tax of Ways and Means member Phil English (R-PA) would replace the corporate income tax with a 12 percent border adjustable tax.[119] Under the plan, businesses would be taxed on domestic sales less purchases. Capital investment would be expensed. Wages and interest would be nondeductible.

Border adjustable plans have appeal, given recent concerns about the U.S. manufacturing industry and the outsourcing of jobs. However, economists generally argue that border adjustability would not make much difference to U.S. business competitiveness. They argue that foreign exchange markets would eventually push up the value of the dollar after a border adjustable tax was imposed, offsetting any initial exporting advantage. The CBO said that border adjustability might seem "to favor the location of production domestically and encourage exports while discouraging imports, but that argument is without merit."[120] Public finance economist Gilbert Metcalf said that it is a "fallacy" that a border adjustable tax would improve the trade balance.[121]

Still, the extent to which an exchange rate offset would occur is subject to uncertainty. Current market exchange rates reflect numerous factors, and it might take years to reach any new equilibrium after the federal tax system is changed.[122] Note also that tax reform would affect other factors that influence trade flows, such as the level of domestic saving and investment decisions by multinational corporations.

There is general agreement that the United States needs a tax code that is less burdensome on businesses in the increasingly competitive global economy.

Former chairman of the National Economic Council, Larry Lindsey, summarized his view regarding the lack of border adjustability of the current tax system:

> Economists believe that this disadvantages American production less than it might seem because the differential taxation will be reflected in the exchange rate. But in a world in which many of our trading partners in Asia and Latin America fix their exchange rates with the dollar, this adjustment is much slower, and less transparent, than it should be. Moreover, if exchange rates are determined by capital flows over the intermediate term, rather than by trade, it might take a long time for the burden of taxes on domestic producers to be offset in the foreign exchange market.[123]

Other economists have pointed out that, even as the exchange rate adjusted under a new border adjustable tax, there would still be differential industry impacts of tax reform. For example, it is likely that net exports of capital-intensive goods would increase under a consumption-based tax even if the long-run trade balance were unchanged.[124] One definite advantage of a border adjustable tax would be elimination of today's complex transfer pricing rules on multinational corporations.

There is general agreement that the United States needs a tax code that is less burdensome on businesses in the increasingly competitive global economy. The U.S. corporate tax rate is substantially higher than that of nearly all of our trading partners.[125] Replacing the income tax with a consumption-based system with lower tax rates—whether or not border adjustable—would increase the capital intensity of U.S. production and make the United States an excellent location for international investment.

Ultimately, border adjustability may need to be part of any major business tax reform package to garner enough legislative support. Political time frames are short, and stimulating net exports in the short run with a border adjustable tax is attractive to many legislators, even if it wouldn't make a difference to the trade balance in the long run.

2. Retail Sales Tax

Benefits

In the 1990s Reps. Dan Schaefer (R-CO) and Billy Tauzin (R-LA) gained support for their plan to replace the individual and corporate income taxes with a 15 percent national retail sales tax.[126] More recently, the "FairTax" proposal championed by Rep. John Linder (R-GA) has garnered more than 50 cosponsors in the House. The FairTax would replace the individual and corporate income taxes and the federal payroll tax with a 23 percent retail sales tax.[127] House Speaker Dennis Hastert has said that he favors replacing the income tax with a sales tax or a value-added tax, and Majority Leader Tom Delay has said that he favors a sales tax but is open to other tax reform options.

The proposed tax rates of these plans are calculated on a "tax inclusive" basis. That allows for an apples-to-apples comparison with income tax rates, which are also expressed on a tax inclusive basis. By contrast, state sales tax rates are usually expressed on a "tax exclusive" basis, which is simply the percentage mark-up on a product. For example, a 5 percent (tax exclusive) sales tax on a $100 item yields a tax of $5. This rate is the same as a 4.8 percent rate measured on a tax inclusive basis, calculated as 5/(100 + 5). The Schaefer-Tauzin plan has a tax exclusive rate of 18 percent, and the FairTax plan has a tax exclusive rate of 30 percent. Thus, a consumer purchasing a $1,000 computer after the FairTax was enacted would pay $300 in tax.

Replacing income taxes with a national sales tax has potentially large benefits. There is no doubt that a workable flat retail sales tax would strongly promote economic growth by ending the income tax bias against saving, eliminating distortions on business investment, and reducing top marginal tax rates.

A national sales tax would also be much simpler than the income tax. It is true that Congress would likely manipulate a sales tax over time to include numerous different rates and exemptions.[128] However, that would be a minor problem compared with the complexities of the current system, which has hundreds of deductions, exemptions, and credits and different effective tax rates on every industry. Even with numerous exemptions, real-world state sales taxes have compliance costs that are perhaps only one-fifth as high as income tax compliance costs, when measured as a share of revenue collected.[129]

Finally, a big advantage of replacing income taxes with a retail sales tax would be that the full federal tax burden would be visible to individuals. The FairTax plan would repeal the two largest hidden taxes, the corporate income tax and the employer payroll tax. Citizens would see the full cost of government every time they were at a retail checkout counter.

Some analysts argue that people would have a hard time figuring out their total taxes paid under a sales tax. Economist Steve Entin, for example, says that "taxes should not be hidden by being collected in bits and pieces over the course of a year as the taxpayer goes shopping, as either sales or value-added taxes."[130] Although taxes reported on paystubs, such as the income tax, allow people to see the share of their earnings being taxed, sales taxes have the advantage of providing more frequent reminders of the government's burden if they are noticed at the checkout counter.

A frequently discussed alternative to a sales tax is a "credit-invoice" value-added tax. Sales taxes and this form of VAT are similar in many ways. Both taxes treat savings and investment favorably, both would end distortions on business investment, and both would have lower compliance costs than the income tax.

The difference between VATs and sales taxes is administrative: VATs are collected at each stage of production, while sales taxes are collected only at final purchase. Under a credit-invoice VAT, businesses receive a credit for taxes paid on their purchases so that by the time a product is sold at retail its full value added has been taxed once, but not more than once. That is the same result as a retail sales tax.

If a VAT is considered as a replacement for the income tax, it would be crucial that the implementing legislation require that the VAT be explicitly listed on sales receipts, as are retail sales taxes. That would make the burden of the VAT fully visible to the general public. In Europe, VATs are hidden in the price of goods and services, making those taxes "money machines" for governments. European politicians have been able to steadily increase VAT rates to an average rate of about 20 percent today.[131]

However, Canada has had a different VAT experience.[132] It adopted a "goods and services tax" in 1991, which has a structure similar to that of European VATs. The difference is that the Canadian GST is legally required to be listed on retail sales receipts. That requirement has been crucial in averting any increase in the GST's 7 percent rate. I am told that Canadian taxpayers hate the GST

There is no doubt that a workable flat retail sales tax would strongly promote economic growth by ending the income tax bias against saving.

Adding a major new federal revenue source would be a disaster for limited government in the United States, akin to adding the income tax in 1913 and creating income tax withholding in 1943.

because they see it every time they go shopping, and they have shot down occasional proposals by the government to raise the rate. Since the introduction of the GST, total federal tax revenues in Canada have actually fallen modestly as a share of GDP.[133] In 2000 Australia adopted a 10 percent GST that is legally required to be listed on all retail sales receipts.[134]

The Canadian experience suggests that a visible, or explicitly listed, VAT is a reform option to consider if income taxes are completely repealed. However, as with the national sales tax, the Sixteenth Amendment would have to be repealed first to ensure that Americans did not end up with both the income tax and a VAT, as did the Canadians and Australians.

With that proviso, and if made visible, a VAT would have some advantages over a sales tax. First, VATs are thought to be more easily enforceable than sales taxes for two reasons: the collection burden is spread across more businesses, and the tax creates a ready audit trail for administrators. Easy enforceability would be an important advantage if the rate of a proposed consumption tax were high (as under the FairTax).

Second, VATs avoid "cascading," a form of double taxation that occurs under sales taxes when intermediate goods and services are taxed. Mechanisms can be put in place to avoid that problem, but about 40 percent of current state sales tax revenue comes from double-taxed intermediate products.[135] Although recent national sales tax proposals are designed to eliminate cascading, politicians tend not to mind cascading because it is a form of hidden taxation. VATs more easily avoid cascading by giving businesses credits against taxes paid on inputs.

Concerns

For supporters of limited government, a key concern regarding sales taxes and VATs is that they are often supported as add-ons rather than replacements for existing federal taxes. For example, one option examined by a 2002 Bush administration study would retain versions of the corporate and individual income taxes and impose a new 15 percent VAT on top.[136] Although the plan, designed by Prof. Michael Graetz, is supposed to be revenue neutral, it would give the government a new tax base while retaining the most inefficient parts of the current tax code, namely the corporate income tax and the individual income tax on people with high incomes. This plan deserves a quick burial because it has few advantages and opens the door to rapidly rising taxes in the future.

A number of fiscal experts support creating a new federal consumption tax in order to pay for the rising costs of entitlement programs. Boston University's Laurence Kotlikoff has a plan that would create a 10 percent national retail sales tax to help finance Social Security reform.[137] University of Michigan tax law professor Reuven Avi-Yonah also wants to create a new federal revenue source. He recently argued in *Tax Notes* that the "revenue-raising potential [of the income tax] is inherently limited . . . to fund the social safety net, the government needs another tax instrument that can produce high levels of revenue."[138] He concludes:

> To finance the retirement and health needs of the baby boom generation, not to speak about other urgent needs like extending health insurance to all Americans, we face a budgetary gap of $70 trillion. There is simply no way to raise that kind of revenue with the existing income tax . . . we need to adopt a VAT in addition to the existing income tax.[139]

The dilemma for tax reformers who believe in limited government is that advocates who believe in big government, such as Avi-Yonah, might steer Congress toward adopting a new consumption tax as an add-on rather than a replacement system. Adding a major new federal revenue source would be a disaster for limited government in the United States, akin to adding the income tax in 1913 and creating income tax withholding in 1943. European governments have swelled in size since they began adopting their hidden VATs in the 1960s on top of their income tax systems. Imposing a federal sales tax or VAT without complete and permanent repeal of the income tax should be avoided at all costs. If Congress moves to replace the income tax with a national retail sales tax or VAT, it should be paired with repeal of the Sixteenth Amendment to the Constitution to ensure that the income tax does not reappear in the future.[140]

Aside from concerns about limited government, there are concerns about the administrative feasibility of a sales tax that has a high enough rate and broad enough base to replace current federal revenues. The FairTax would tax an extremely broad base covering all consumption in the United States. The base would account for 84 percent of GDP according to the designers of the FairTax.[141] By contrast, the average state sales tax base covers about 36 percent of GDP, with a range from about 26 percent in New Jersey to 71 percent in New Mexico.[142] In Europe, VATs typically tax only about 41 percent of GDP.[143]

The FairTax would tax many items that currently bear no state sales taxes, including many services, and other items that face little sales or income tax.[144] For example, the FairTax would impose taxation on health care goods and services. (The Hall-Rabushka flat tax would also tax some items that are not currently taxed, such as employer contributions for health insurance.) Although that would be a step toward creating a more neutral tax system, it would be difficult politically to impose sales taxes on such items as hospital bills and prescription drugs. A leading sales tax champion of the 1990s, former Ways and Means Committee chairman Bill Archer, would have exempted the health care sector from the sales tax base.[145]

It is true that many state sales taxes have bases that are too narrow as a result of unjustified exemptions. Economists generally support broader sales tax bases than currently exist in the states. However, the narrowness of real-world sales tax and VAT bases indicates that there are both political and technical limitations on how broad a base could be under a national sales tax.

Because the FairTax plan would eliminate both the income tax and the federal payroll tax, it needs a very broad base and high rate in order to be revenue neutral. I have argued that narrower tax bases have the advantage of making revenue harder for the government to raise. But if the FairTax base were narrower, its rate would be higher than 30 percent, which some analysts argue already understates the required revenue-neutral rate.[146] Note that a federal sales tax would be layered on top of existing state and local sales taxes, which have combined rates up to 11 percent.[147]

Some economists have argued that noncompliance would be a serious problem with a high-rate sales tax and that a rate above about 10 percent "cannot be effectively administered."[148] Economist Robert Hall recently testified to Congress that "sales taxes are notoriously leaky and cannot sustain tax rates much above 10 percent."[149] The problem arises because sales taxes would be collected from about 10 million businesses selling at retail, whereas the current federal tax burden is spread across about 130 million households and 25 million businesses. Collecting $1.8 trillion per year in federal revenue under the FairTax from that smaller number of taxpayers creates a concentrated pressure point for evasion.

Nonetheless, it is far too pessimistic to say that a sales tax above 10 percent could not work. There appears to be little proof of that claim—critics who take that view seem to simply cite similar opinions from other critics.[150] It is simply unknown how high a feasible sales tax rate could be. I suspect that a 15 to 20 percent sales tax could be made to work, but no doubt with tougher enforcement than today's low-rate state sales taxes.[151] Supporters of a sales tax point out that, with fewer taxpayers under a sales tax system, the government would be able to focus more intense enforcement pressure on them to reduce evasion.[152]

Of course, tax evasion is a substantial problem under the current tax system. Govern-

Imposing a federal sales tax or VAT without complete and permanent repeal of the income tax should be avoided at all costs.

ment studies have found that the "tax gap" of tax owed but not paid under the individual income tax is about 20 percent of tax receipts.[153] That estimate includes only unpaid taxes on legal income, not unpaid taxes on income from illegal activities, such as drug dealing. Some economists argue that a national sales tax would be able to get at some types of economic activity that the current system misses. Thus, a sales tax might create some new tax evasion problems but might solve others.[154]

Note that the current tax system imposes high marginal rates on many people who have good opportunities to evade taxes.[155] For example, self-employed contractors, nannies, exotic dancers, taxi drivers, and others who receive cash for services have a strong incentive to evade, given that they face a 15 percent payroll tax plus an income tax with rates of 10 to 35 percent. The latest in a long parade of high-profile nanny tax evaders was former New York police commissioner Bernard Kerik.

The point is that there is substantial evasion under the current high-rate tax system, but no one says that it "cannot be administered." When the federal income tax was introduced in 1913 with a top rate of 7 percent, people would have thought that rates above, perhaps, 30 percent would be impossible to enforce. Yet the government did enforce top marginal income tax rates of 70 percent and above from 1936 through 1981.[156] It was a very inefficient tax system, but it did operate.

A sales tax with a 17 percent tax exclusive rate and a base of 55 percent of GDP would raise enough to replace revenues from the individual and corporate income taxes.

If feasible, the replacement of the income tax with a sales tax would generally be favorable from a limited-government perspective. But one concern regards proposed rebate systems under the various sales tax plans, which are designed to relieve taxes on low-income families. Under the FairTax, the government would mail checks to all U.S. households each month to offset the burden of sales taxes on consumption up to the poverty line. In 2003 the official poverty level for a family of four was $18,660; thus FairTax rebates per family would have been about $467 per month, or $5,600 annually.[157]

Such rebates may create a fraud problem. The current EITC program, which mails checks to 22 million households, faces a large fraud and error problem on the order of 25 percent.[158] The FairTax would mail larger checks to six times as many households. However, the FairTax rebate would be much simpler than the EITC, which varies on the basis of income and other factors.

Another concern with rebates is that they would get Americans hooked on receiving money from Washington each month, akin to a welfare check. Politicians would be tempted to dish out ever larger rebates to favored groups—conservatives would push to give larger rebates to married couples, liberals would push to give larger rebates to single mothers, and so on.

Finally, a design problem with the FairTax is repeal of the federal payroll tax. The payroll tax is the simplest and most pro-saving federal tax.[159] It is true that the payroll tax is a partly hidden tax, but that problem can be fixed as discussed above. By including payroll tax repeal, the FairTax needs to raise 67 percent more revenue than a sales tax that just replaces the income tax. The needed high rate and very broad base open the FairTax up to the concerns discussed.

An alternative to the FairTax would be to replace the individual and corporate income taxes with a lower-rate and narrower-base sales tax. A narrower base would limit a sales tax's revenue-raising potential, and it would anticipate that policymakers would want to exempt some activities from the tax base. A sales tax with a 17 percent tax exclusive rate and a base of 55 percent of GDP would raise $1.15 trillion in FY05.[160] That would be enough to replace revenues from the individual and corporate income taxes and leave room for a narrowly tailored low-income credit like the EITC, but delivered through the payroll tax system.[161]

3. Savings-Exempt Tax

Benefits

A savings-exempt tax would replace the individual and corporate income taxes with a comprehensive tax on individuals that allowed a full deduction for net saving during a year. Under such a system, there would be no need for a business-level tax because capital income would be handled at the individual level. The tax base of a savings-exempt tax would be economically similar to the base of a sales tax and the Hall-Rabushka flat tax, and it would have the same pro-growth advantages. A savings-exempt tax has also been called a "saving-deferred tax," a "consumed-income tax," and a "personal consumption tax."

A tax of this type is the Inflow-Outflow tax designed by the Institute for Research on the Economics of Taxation.[162] The IRET plan would have a flat rate above a basic personal allowance, and it would get rid of virtually all of today's deductions, credits, and other narrow breaks.[163] Another prominent savings-exempt tax plan was the individual part of the "USA" tax proposed by former senator Sam Nunn (D-GA) and Sen. Pete Domenici (R-NM).[164] However, that plan would have retained a business-level tax, unlike the IRET plan.

Under a savings-exempt tax, individual tax returns would be similar to today's income tax returns. Income from various sources would be tallied and deductions taken. But a savings-exempt tax return would include an extra schedule that detailed an individual's additions to savings and withdrawals from savings, such as assets held in bank accounts and mutual funds. If savings during a year exceeded withdrawals, the taxpayer would receive a deduction. If withdrawals exceeded savings, the net withdrawal would be added to taxable income. Complex capital gains calculations would be eliminated.

The key advantage of the IRET design is that there would be no need for a tax on businesses. Business payouts of dividends and interest would be taxed at the individual level if not saved. The IRET plan would eliminate the direct taxation of both corporations and small businesses. That would massively simplify the tax code and remove all tax distortions from capital investment and other business decisions.

Another key advantage of a savings-exempt tax that eliminated business taxation would be to make the federal tax burden highly visible. IRET argues that the two purposes of the tax system are to raise revenue with minimal economic damage and to allow citizens to accurately "price" the government.[165] The IRET plan does that by creating a highly visible and pro-savings flat tax collected from individuals.

Concerns

The key disadvantage of a savings-exempt tax system would be reduced personal financial privacy and increased individual tax complexity related to personal saving and withdrawals. The creation of a deduction for net saving would require that the government track Americans' personal finances in detail.[166]

Aside from the new savings deduction, the IRET plan is a fairly simple tax structure with a flat rate and few deductions. Some aspects of personal finances would be simplified; for example, capital gains taxation would be eliminated. The elimination of all business taxation would be a massive simplification. However, a savings-exempt tax system would retain the general form of the individual income tax and thus would be an inviting target for politicians to reintroduce social engineering tax breaks into the code.

4. Dual-Rate Income Tax

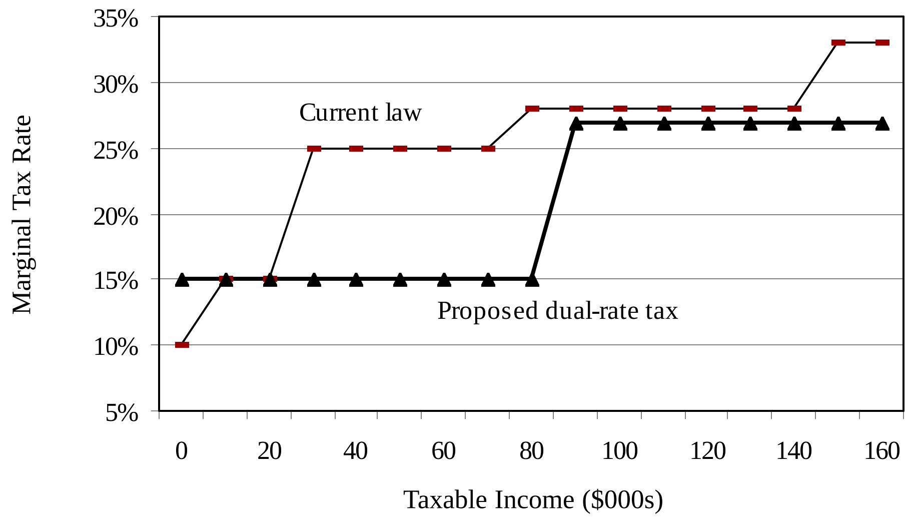
Benefits

This option would reform individual and corporate income taxes by cutting marginal tax rates, creating neutrality between different income sources, and ending narrow tax breaks. The dual-rate tax would provide an incremental step toward a flat consumption-based system.[167] The dual-rate tax is a good model for the president's advisory panel if it wants to propose reforms within the general bounds of the current tax structure.

Under this plan, the individual income tax would be turned into a two-rate tax that eliminated most deductions and credits. Individuals would be taxed at a low 15 per-

The dual-rate tax would provide an incremental step toward a flat consumption-based system.

Figure 3
Marginal Income Tax Rate, Single Taxpayer



Source: Author's calculations.
Note: Figure excludes the EITC. Taxpayer assumed to take the standard deduction.

Under the dual-rate tax, the vast majority of families—roughly 95 percent—would face a low 15 percent marginal income tax rate.

cent rate on income up to about $90,000 (singles) and $180,000 (married) and 27 percent on earnings above those thresholds.[168] Currently, there are six income tax rates ranging from 10 to 35 percent.

Under the dual-rate tax, the vast majority of families—roughly 95 percent—would face a low 15 percent marginal income tax rate. Under current law for 2005, singles with taxable income above $29,700 and couples with taxable income above $59,400 are in the 25 percent and higher tax brackets. The dual-rate tax would cut the marginal rate for most of those taxpayers to 15 percent (see Figure 3).

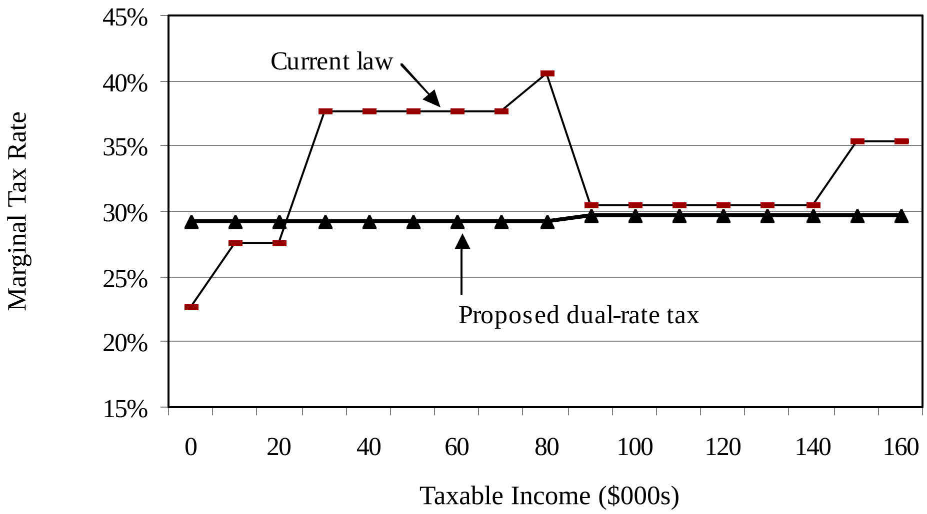
The 27 percent rate would kick in at the wage threshold at which the 12.4 percent payroll tax that funds Social Security cuts out. The effect would be to create a consistent marginal tax rate of about 29 percent on earnings of all middle- and higher-income households, taking into account both the payroll and the income tax. That would be a big cut in the marginal rate for many middle-income families, who currently face a marginal rate of about 38 to 41 percent (see Figure 4).[169] For example, single earners with wages between about $38,000 and $90,000 face a payroll tax rate of 15.3 percent and marginal income tax rates of 25 or 28 percent under current law.

While marginal tax rates would fall under the dual-rate system, nearly all credits and deductions would be eliminated, such as the mortgage interest deduction.[170] By dropping marginal rates and ending special breaks, the dual-rate tax would create a high degree of horizontal equity.

The dual-rate tax plan would retain the current law standard deduction, which is $5,000 for singles and $10,000 for married couples in 2005. The plan would also include an increased personal exemption, which would partly offset the elimination of the child tax credit. The exemption would be increased from $3,200 under current law in 2005 to $4,500. The plan would also retain the EITC, which reduces taxes for low-income workers.

The dual-rate tax would also retain pro-savings features of the current tax code, including 401(k)s, IRAs, and Health Savings Accounts. Indeed, further steps to simplify

Figure 4
Marginal Tax Rate on Wages, Single Taxpayer, Combined Income and Payroll Tax Rate



Source: Author's calculations.
Note: Figure excludes the EITC. Taxpayer assumed to take the standard deduction. Calculations include the effect of half of the payroll tax being deductible against the corporate tax.

and liberalize personal savings could be incorporated into the plan.[171]

A key goal of the dual-rate system is to reduce and equalize tax rates on income from savings. The maximum tax rate on dividends, interest, and capital gains would be set at the lower personal rate of 15 percent. (Interest is currently taxed up to the maximum individual rate of 35 percent.) To match that change, the corporate tax rate would be cut to 15 percent and net interest deductions (interest receipts less interest deductions) excluded from the tax base.[172] The result would be that interest and dividends would be taxed at both the corporate level and the individual level at 15 percent, for a net combined rate of 28 percent.[173]

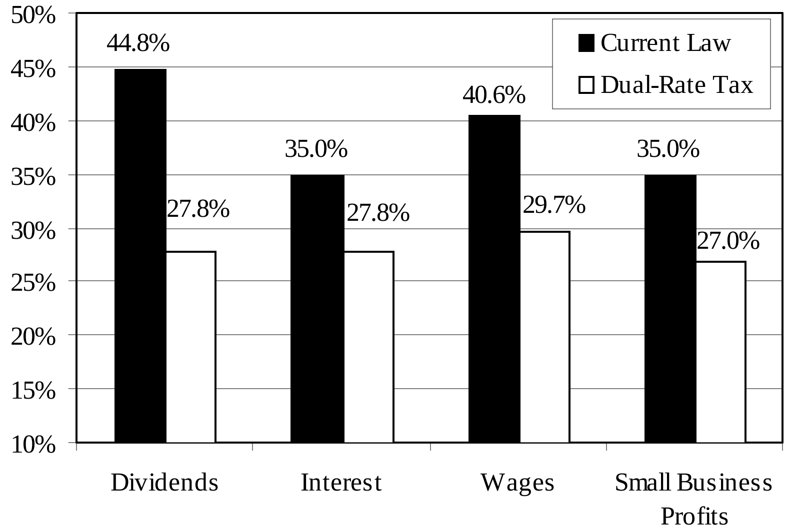
Table 6 and Figure 5 show that the top combined marginal rates on wages, dividends, interest, and small business profits would be just under 30 percent in the dual-rate plan, compared to 35 to 45 percent under the current tax system.[174] Wages would be taxed under the individual income tax and the existing payroll tax. Interest and dividends would be taxed under the individual and corporate income taxes.

The dual-rate tax plan borrows from the "dual income tax" systems that have been implemented in a number of Nordic countries. Those systems feature a low flat rate on individual capital income (such as interest, dividends, and capital gains) and higher, graduated rates on labor income. Denmark, Finland, Norway, and Sweden implemented dual income taxes a decade ago, and the Netherlands and Austria have more recently enacted similar reforms.[175] Capital income is taxed at a lower flat rate in order to reduce economic distortions and to respond to rising global capital mobility. If countries do not cut tax rates on capital income, tax competition will cause capital to flow abroad. For example, the Netherlands dropped its tax rate on dividends and capital gains to 25 percent from 52 percent in 2001 in order to reduce tax evasion. Many citizens had opened bank accounts in Switzerland and elsewhere to avoid the Dutch tax.[176]

Ending special breaks under the current tax system in favor of lower rates would create a simpler and more efficient tax system.

The top combined marginal rates on wages, dividends, interest, and small business profits would be just under 30 percent in the dual-rate plan, compared to 35 to 45 percent under the current tax system.

Figure 5
Top Marginal Tax Rates



Source: Author's calculations.
Note: Includes individual income tax, corporate income tax, and the payroll tax. See Table 6 for details.

Table 6
Top Marginal Tax Rates

	Current Law	Dual-Rate Tax
1. Corporate income tax		
Dividends	35%	15%
Interest	0%	15%
Wages	0%	0%
2. Individual income tax		
Dividends	15%	15%
Interest	35%	15%
Capital gains	15%	15%
Wages	35%	27%
Small business profits	35%	27%
3. Federal payroll tax		
Wages below $90,000	15.3%	15.3%
Wages above $90,000	2.9%	2.9%
Combined tax rates		
Dividends	44.8%	27.8%
Interest	35.0%	27.8%
Wages	40.6%	29.7%
Small business profits	35.0%	27.0%

Source: Author's calculations.
Note: Combined tax rates for wages include the effect of the employer half of the payroll tax being deductible against the corporate tax.

Consider the advantage of eliminating the itemized deduction for state and local income and property taxes. The deduction encourages state and local governments to raise taxes because higher taxes are offset by the federal deduction. The deduction mutes beneficial tax competition between jurisdictions. Also, before the recent change that allows a federal deduction for state sales taxes, states were encouraged to favor income taxes over more pro-saving sales taxes.

Eliminating the deductibility of state and local taxes was discussed before the Tax Reform Act of 1986. President Ronald Reagan noted in June 1985: "Perhaps if the high-tax states didn't have this federal crutch to prop up their big spending, they might have to cut taxes to stay competitive."[177] Indeed, a study at the time by Harvard's Martin Feldstein and Gilbert Metcalf found that federal deductibility led to modestly higher state spending.[178] The dual-rate tax system would eliminate this pro-spending distortion.

The changes to the individual income tax under the proposed dual-rate system are estimated to be roughly revenue neutral on a static basis. Calculations were based on my analysis of IRS tax return data for 2002 and a preliminary estimate by the Tax Foundation for 2004 using their individual tax microsimulation model.[179]

The proposed changes to the corporate income tax under the dual-rate plan are suggested incremental reforms, rather than a detailed proposal. To get the corporate rate down to 15 percent, a variety of tax base broadeners and federal spending cuts would be needed. The first step would be to end the deduction for net interest in order to create neutrality between corporate debt and equity.

The second step would be to end or limit the deduction for employer-paid health insurance benefits. As discussed above, employer-paid benefits for health insurance are currently tax-free, creating distortions in the delivery of health care in the United States. An alternative to limiting the employer deduction would be to limit the individual exclusion for employer-provided benefits.[180] If the tax benefits for employer-provided coverage were limited or ended, tax reform could instead provide individuals with a tax deduction or tax credit for individual insurance purchased. As noted, Glenn Hubbard and others have argued that individuals should be able to deduct insurance premiums and out-of-pocket expenses in order to move the health system back toward individual control.[181]

Another corporate base broadener would be to eliminate the deduction for state and local income, sales, and property taxes. That would create the benefit of increasing tax competition between the states. Without the federal deduction, businesses would be more sensitive to state taxes in their location decisions, thus providing a useful constraint on state and local fiscal policy.

The combination of these corporate tax changes (net interest, the health care deduction, and state and local taxes) would expand the corporate tax base by about 70 percent and offset more than half of the revenue loss from the rate cut.[182] To get the corporate rate all the way down to 15 percent and retain revenue neutrality, corporate subsidies on the spending side of the federal budget could be cut. Also note that cutting the corporate tax rate would create macroeconomic feedback effects that would offset a large share of the revenue loss.[183]

The proposed corporate tax changes borrow from both the Hall-Rabushka flat tax and the "comprehensive business income tax" proposed in a 1992 Treasury study.[184] Both proposals would equalize the treatment of interest and dividends by excluding interest from the business tax base. Also, the flat tax would broaden the tax base by ending the deduction for employer-paid health benefits. The flat tax would also end the business deduction for federal payroll taxes. The dual-rate tax retains deductibility of federal payroll taxes but ends the deduction of state and local taxes to encourage interstate tax competition.

Like the dual-rate tax, the flat tax base for corporations would be larger than the corporate income tax base, allowing the tax rate to

The itemized deduction for state and local income and property taxes encourages state and local governments to raise taxes.

A 15 percent corporate tax that was territorial and included expensing would spur growth and give the United States one of the best business tax climates in world.

be cut substantially.[185] Analyses have found that the Hall-Rabushka flat tax would be revenue neutral for corporations at about 19 percent.[186]

Under the dual-rate system, the corporate tax could be moved all the way to a Hall-Rabushka cash-flow business tax with four further steps. First, depreciation would be replaced by capital expensing. Second, accrual accounting would be replaced by cash accounting. Third, the "worldwide" tax system would be replaced by a "territorial" system that taxes firms on their domestic profits only. Territorial taxes are used by most industrial countries today because they are simpler and they allow firms to better compete in foreign markets.[187] Fourth, the tax would be extended from corporations to all types of businesses.

To summarize, the dual-rate tax plan would move incrementally toward a lower-rate pro-saving system. The plan would cut top marginal tax rates on working, saving, and small businesses. It would create greater tax equality between families, while also providing low-income tax relief. For corporations, various base broadeners and subsidy cuts would be used to reduce the tax rate sharply. A 15 percent corporate tax that was territorial and included expensing would spur growth and give the United States one of the best business tax climates in world.

Concerns

The dual-rate tax system would retain the basic structure of the income tax, thus forfeiting some of the efficiency benefits of a consumption-based system. Also, complex income tax features such as capital gains taxation would be retained. Nonetheless, the reduced tax rates, the equal treatment of interest and dividends, and the elimination of deductions and credits would create gains in simplicity and growth.

From a limited-government perspective, the main concern regarding this option is that the individual and corporate tax bases would be broader. A broader tax base would tend to raise increased revenue over time if tax rates were moved upward again. The Tax Reform Act of 1986, which broadened the base and lowered rates, offers a mixed lesson on this point. On the one hand, the low tax rates of 1986 did not last long. (Rates went up in 1990 and 1993.) On the other hand, recent tax bills have reversed the 1986 act by narrowing the tax base, often in beneficial ways such as liberalizing IRAs.

On visibility, the dual-rate system would retain a large hidden tax in the form of the 15 percent corporate tax. On the other hand, the individual tax would have a simple structure, which would allow individuals to more clearly understand what share of income they paid in taxes. Although this option is the least radical of the four presented in this paper, it would be a bold reform stoke, giving the United States a far simpler and more efficient tax code.

Conclusion

This report has provided four models of tax reform for policymakers to consider. The most dramatic reform would be to rip out the income tax and replace it with a retail sales tax. A 17 percent sales tax with a base that covered 55 percent of GDP could replace the individual and corporate income taxes on a revenue-neutral basis in 2005. If feasible, a sales tax would be much simpler and more efficient than the income tax. A national sales tax would also make the tax burden visible—people would feel the burden of government "good and hard" every time they went shopping.

Another leading alternative to the income tax is the Hall-Rabushka flat tax. The flat tax has been studied for 20 years, and while not yet adopted it has provided an excellent paradigm to guide incremental reforms. Recent tax rate cuts, reductions to dividend and capital gains taxes, creation of Roth IRAs, and partial expensing of business investment have all moved toward the flat tax ideal.

The proposed dual-rate income tax would represent a further jump toward the flat tax. Marginal tax rates would be cut and most deductions and credits eliminated to simplify the code and increase horizontal equity. The vast majority of families would pay a simple, flat 15 percent tax. The combined top federal tax rates on wages, dividends, interest, and small business income would be cut and equalized. For corporations, the low 15 percent rate would spur investment and make U.S. businesses more competitive in the global economy. This option provides a good model for the president's advisory panel if it does not want to move all the way to a consumption-based system.

The president's call for tax reform creates both risks and opportunities for taxpayers and the economy. The risk stems from commentators who view major tax changes as an opportunity to increase revenues in order to fund entitlement programs and reduce the budget deficit. Recently, there have been calls to raise income and payroll taxes, and calls to create an add-on sales tax or VAT. Those calls should be rejected—under no circumstances should a tax reform bill be considered if it raises taxes. There is no need for higher taxes when there are hundreds of inefficient federal programs that could be eliminated to save money.[188]

The fact that the economy needs pro-saving and pro-growth policies more than ever provides the opportunity for tax reform. The financial strains that will be caused by the retirement of the baby-boom generation will be easier to handle if U.S. economic performance is maximized. Tax reforms can help to increase personal saving, allowing people to be better prepared for their future health care and retirement needs. And tax reforms can increase investment and productivity, enabling U.S. businesses to better tackle rising competition in global markets. Tax reform involves some risks, but if it is tailored to maximize savings, investment, and growth, all families will enjoy greater financial security and rising incomes.

Notes

Stephen Entin, David Burton, Dan Mastromarco, and Ryan Ellis provided helpful comments. Of course, all errors are those of the author.

1. The Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Jobs Creation Act of 2004.

2. Congressional Budget Office (CBO), "The Budget and Economic Outlook," September 2004, www.cbo.gov.

3. Chris Edwards, "Downsizing the Federal Government," Cato Institute Policy Analysis no. 515, June 2, 2004.

4. In particular, the 1986 tax act increased taxes on savings and investment in a number of ways, such as by scaling back individual retirement accounts.

5. This is the page count for the CCH "Standard Federal Tax Reporter," which includes the tax code, tax regulations, and related IRS rulings. See www.cch.com/wbot2004.

6. Office of Management and Budget, "Information Collection Budget of the U.S. Government," FY2004, p. 17, www.whitehouse.gov/omb/inforeg/infocoll.html.

7. Income tax compliance costs have been variously estimated at between 10 and 20 percent of revenues collected. Such estimates typically apply a per hour wage rate to the estimated number of hours that Americans spend on tax compliance activities. See discussion in Chris Edwards, "Tax Complexity Factbook," Joint Economic Committee, April 2000.

8. General Accounting Office (GAO), "Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds," GAO-03-922T, June 18, 2003, p. 13.

9. Internal Revenue Service (IRS), National Taxpayer Advocate, "Annual Report to Congress," December 31, 2004, p. 3, www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

10. For example, the IRS recently gained access to data on Visa cards issued by foreign banks. See "Washington in Brief," *Washington Post*, March 29, 2002, p. A11.

11. However, pension benefits would be taxed under the flat tax because pension contributions are from pre-tax income. This form of saving would decline in importance under a flat tax.

12. For a detailed discussion, see Chris Edwards, "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax," Cato Institute

Policy Analysis no. 484, August 14, 2003.

13. Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," vol. 1, Report, JCS-3-03, February 2003.

14. David Weisbach of the University of Chicago Law School notes: "The typical corporate tax shelter case is more difficult. It will almost always be ambiguous whether the transaction should be treated as a permissible tax reduction or not." David Weisbach, "Corporate Tax Avoidance," *National Tax Association Proceedings of the 69th Annual Conference 2003* (Washington: National Tax Association, 2004), p. 9.

15. Ibid., p. 13.

16. Albert B. Crenshaw, "All Tax Shelters Are Not Illegal, Another Court Tells IRS," *Washington Post*, November 4, 2004.

17. Albert B. Crenshaw, "Black & Decker Wins IRS Tax Shelter Case," *Washington Post*, October 22, 2004.

18. For a discussion, see Edwards, "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax."

19. For a discussion about why consumption-based taxes are simpler than income taxes, see Chris Edwards, "Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation," Cato Institute Policy Analysis no. 416, October 17, 2001.

20. Michael Boskin, "A Framework for the Tax Reform Debate," in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution, 1996), p. 14.

21. After modeling various tax reforms, economists Dale Jorgenson and Kun-Young Yun conclude that "one of our most important findings is that redistribution through tax policy is very costly in terms of efficiency." Dale Jorgenson and Kun-Young Yun, *Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, MA: MIT Press, 2001), p. 321.

22. For a summary of the literature, see Chris Edwards, "Economic Benefits of Personal Income Tax Rate Reductions," Joint Economic Committee, April 2001.

23. Scott Hodge and Scott Moody, "Wealthy Americans and Business Activity," Special Report no. 131, Tax Foundation, August 2004. Small business income includes income from sole proprietorships, partnerships, farms, and S corporations.

24. See the following National Bureau of Economic Research (NBER) papers by Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen: "Entrepreneurs, Income Taxes, and Investment," NBER Working Paper 6374, January 1998; "Income Taxes and Entrepreneurs' Use of Labor," NBER Working Paper 6578, May 2000; and "Personal Income Taxes and the Growth of Small Firms," NBER Working Paper 7980, October 2000. All papers available at www.nber.org.

25. William M. Gentry and R. Glenn Hubbard, "Success Taxes, Entrepreneurial Entry, and Innovation," NBER Working Paper no. 10551, June 2004.

26. For some empirical estimates, see Emmanuel Saez and Jonathan Gruber, "The Elasticity of Taxable Income: Evidence and Implications," NBER Working Paper no. 7512, January 2000. Saez and Gruber found that the elasticity of taxable income for those earning less than $100,000 was only as third as large as for those earning more than $100,000. For a comprehensive survey of the literature, see Seth Giertz, "Recent Literature on Taxable-Income Elasticities," Technical Paper Series 2004–16, CBO, December 2004.

27. The magnitude of economic benefits from tax rate cuts can be estimated by looking at the increase in the size of the tax base. In particular, the change in compensated taxable income determines the magnitude of the change in deadweight losses. See Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," NBER Working Paper 5055, March 1995.

28. CBO, "Budget Options," February 2001, p. 381.

29. Jorgenson and Yun, pp. 289, 302.

30. Ibid., p. 304.

31. Boskin, "A Framework for the Tax Reform Debate," p. 14.

32. Jorgenson and Yun, p. 280.

33. Expensing exempts the "normal" risk-free rate of return from taxation. But "above-normal" returns would continue to be taxed under a system with expensing, such as the flat tax. Above-normal returns stem from monopoly power, unexpected windfalls, and other factors. Because it is thought that above-normal returns account for most of business profits, a tax system with expensing would continue to tax most business profits. See Glenn Hubbard, Testimony before the House Ways and Means Committee, Hearing on "The Impact on Individuals and Families of

Replacing the Federal Income Tax," April 15, 1997. See also Daniel Shaviro, "Replacing the Income Tax with a Progressive Consumption Tax," *Tax Notes*, April 5, 2004, p. 91.

34. The Job Creation and Worker Assistance Act of 2002 allowed businesses to expense 30 percent of qualified capital equipment. The Jobs and Growth Tax Relief Reconciliation Act of 2003 expanded expensing to 50 percent, but this reform expired at the end of 2004.

35. Eugene Steuerle of the Urban Institute has a useful summary table showing the complexity of the current retirement and pension rules. See Eugene Steuerle, Testimony before the House Ways and Means Committee, Subcommittee on Oversight, Hearing on "Impact of Complexity of the Tax Code on Individual Taxpayers and Small Businesses," May, 25, 1999.

36. On pension complexity, the Joint Committee on Taxation notes that "the federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex sets of rules applicable to any area of the tax law." See Joint Committee on Taxation, *Study on the Overall State of the Federal Tax System*, vol. 2, JCS-3-01 (Washington: Government Printing Office, April 2001), p. 149.

37 Albert Crenshaw, "Pension Providers May Pay More for Insurance," *Washington Post*, January 11, 2005, p. A1.

38. Note that under the flat tax businesses would still deduct pension plan contributions, and benefits would be taxable to individuals. But in the long run employer-based pensions would be deemphasized because the tax hurdles to other savings would be eliminated.

39. Richard Gephardt, "The Economics and Politics of Tax Reform," *Cato Journal* 5, no. 2 (Fall 1985): 458.

40. As measured by official "tax expenditures." See *Budget of the U.S. Government, FY2005, Analytical Perspectives*, p. 294. Official measures of tax expenditures have numerous shortcomings, as discussed in the budget.

41. Peter Whoriskey, "Stadiums Are Built on Federal Tax Break," *Washington Post*, July 29, 2003, p. A1.

42. Dennis Zimmerman and Elizabeth Pinkston, "Tax-Credit Bonds: Are There Advantages to This New Financial Instrument that Compensate for Introducing Additional Complexity?" in *National Tax Association Proceedings of the 96th Annual Conference*, p. 426.

43. Jane Gravelle, "Historical Effective Marginal Tax Rates on Capital Income," Congressional Research Service, Report no. RS21706, January 12, 2004. These rates are for 2003 and include the effects of temporary capital expensing and the tax rate cuts that are set to expire later in the decade.

44. CBO, "The Economic Effects of Comprehensive Tax Reform," July 1997, p. 39.

45. Jorgenson and Yun, p. 317.

46. Jane Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge, MA: MIT Press, 1994), p. 55.

47. James B. Mackie, "Unfinished Business of the 1986 Tax Reform Act: An Effective Tax Rate Analysis of Current Issues in the Taxation of Capital Income," *National Tax Journal* 60, no. 2 (June 2002): 293.

48. Regarding owner-occupied housing, the tax preference results from the combination of the mortgage interest deduction and the exemption from taxable income of imputed rent on homes.

49. Note that these simulations are mainly from the mid-1990s, thus before the recent federal tax cuts.

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

51. Alan Auerbach, "Tax Reform, Capital Allocation, Efficiency, and Growth," in *Economic Effects of Fundamental Tax Reform*, ed. Henry Aaron and William Gale (Washington: Brookings Institution Press, 1996), p. 58. These are the closed economy, no adjustment cost, simulations.

52. David Altig et al., "Simulating Fundamental Tax Reform in the United States," *American Economic Review* 91, no. 3 (June 2001): 574.

53. Boskin, "A Framework for the Tax Reform Debate," p. 24.

54. Joint Committee on Taxation, "Tax Modeling Project and 1997 Symposium Papers," JCS-21-97, November 20, 1997, p. 21. Two of the models did not produce long-run results. Also, both the "low" and "high" of the Fullerton-Rogers model runs are including in my average.

55. Jorgenson and Yun, p. 334.

56. For a discussion of capital taxation and dynamic revenue scoring, see Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A

Back-of-the-Envelope Guide," NBER Working Paper no. w11000, December 2004. Mankiw and Weinzierl figure that if the technology benefits from capital investment are indeed large, a cut to capital taxes would only cost the government about 26 percent of the traditionally estimated revenue loss.

57. Randall Holcombe, "Tax Policy from a Public Choice Perspective," *National Tax Journal* 51, no. 2 (June 1998): p. 366.

58. Louis Fisher, "Line Item Veto Act of 1996: Lessons from the States," Congressional Research Service, December 26, 1996.

59. The House Republican Study Committee has proposed changes to the budget process in the "Family Budget Protection Act" that would reduce the current bias toward overspending.

60. For state experiences with budget limitations, see Michael New, "Proposition 13 and State Budget Limitations: Past Successes and Future Options," Cato Institute Briefing Paper no. 83, June 19, 2003.

61. For a discussion, see Amity Shlaes, *The Greedy Hand* (New York: Harcourt, 1999), pp. 3–8.

62. The income tax is partly indexed for inflation today, but real growth continues to push taxpayers into higher tax brackets over time.

63. Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980). Also available online at www.econlib.org/library/buchanan/buchCv9c12.html.

64. Ibid., chap. 3, p. 48.

65. In 1900 alcohol excises accounted for 35 percent of federal revenues and customs duties accounted for 45 percent. See Chris Edwards, "The U.S. Economy at the Beginning and End of the 20th Century," Joint Economic Committee, December 1999, p. 26.

66. For a detailed discussion of this issue, see Bryan Riley, Eric Schlecht, and John Berthoud, "Hidden Taxes: How Much Do You Really Pay?" Institute for Policy Innovation, July 2001.

67. The legislation was H. R. 1264 sponsored by Rep. Pete Hoekstra (R-MI).

68. See the Mackinac Center for Public Policy project on the Right-to-Know Payroll Form at www.mackinac.org.

69. H. L. Mencken, *A Little Book in C Major*, 1916, www.bartleby.com/73/423.html.

70. U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 3.3, www.bea.doc.gov/bea/dn/nipaweb/index.asp. This is only a rough comparison because it does not adjust for the effect of legislated tax changes during the period.

71. Council of Economic Advisers, *Economic Report of the President 2004* (Washington: Government Printing Office, February 2003), p. 284.

72. Federal corporate tax revenues have fallen from an average of 3.8 percent of GDP in the 1960s to 1.5 percent in 2004.

73. Brennan and Buchanan, p. 199.

74. Gary Becker and Casey Mulligan, "Deadweight Costs and the Size of Government," NBER Working Paper no. 6789, November 1998.

75. Ibid., Abstract.

76. Ibid., p. 1.

77. *Budget of the U.S. Government, FY1984, Special Analyses* (Washington: Government Printing Office, 1983), p. G-32

78. For background, see Jonathan Gruber and James Poterba, "Reform and Employer-Provided Health Insurance," in *Economic Effects of Fundamental Tax Reform*, p. 125.

79. John Cogan, Glenn Hubbard, and Daniel Kessler, "Brilliant Deduction," *Wall Street Journal*, December 8, 2004.

80. Grace-Marie Turner, "Health Care: Avoiding the Achilles Heel of Tax Reform," Institute for Policy Innovation, Policy Report no. 167, February 2002.

81. For a discussion, see Robert B. Helms, "Tax Reform and Health Insurance," American Enterprise Institute, February 2005. See also the joint statement of a group of conservative and libertarian scholars at www.galen.org/vision.asp.

82. For example, the FairTax would tax health care but exempt spending on education and training.

83. A share of higher education spending and numerous health care products and procedures probably do not affect long-term productivity and may be considered consumption.

84. Harry Grubert and James Mackie, "Must Financial Services Be Taxed under a Consumption Tax," *National Tax Journal* 53, no. 1 (March 2000): 23.

85. See Peter Merrill and Chris Edwards, "Cash-Flow Taxation of Financial Services," *National Tax Journal* 49, no. 3 (September 1996).

86. William Fox, "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?" Report prepared for the State of Hawaii Tax Review Commission, October 15, 2002, p. 12. Fox calculates tax bases as share of personal income. I have converted his figures to a share of personal consumption expenditures.

87. Organization for Economic Cooperation and Development, *Revenue Statistics* 1965–2001 (Paris: OECD, 2002).

88. For background on the entitlement spending crisis, see Chris Edwards and Tad DeHaven, "War between the Generations: Federal Spending on the Elderly Expected to Explode," Cato Institute Policy Analysis no. 488, September 16, 2003.

89. See discussion in Cogan, Hubbard, and Kessler.

90. IRS, "Individual Income Tax Returns: Preliminary Data, 2002," *SOI Bulletin*, Winter 2003–2004, p. 6.

91. Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2005–2009," JCS-1-05, January 12, 2005, p. 41.

92. Boskin, "A Framework for the Tax Reform Debate," p. 13.

93. For a discussion on this issue, see Edward Crane et al., "Rewriting the Code: A Roundtable on Tax Reform," *Reason Online*, July 1995, www.reason.com/9507/tax.html.

94. Joint Committee on Taxation, *Study on the Overall State of the Federal Tax System*, vol. 1, JCS-3-01 (Washington: Government Printing Office, April 2001), p. 10.

95. IRS, National Taxpayer Advocate, "Annual Report to Congress," December 31, 2004, p. 3, www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

96. Joint Committee on Taxation, "Budget Effects of The Conference Agreement for H. R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003," JCT-55-03, May 22, 2003.

97. Gregory Mankiw, comments at "Roundtable on Jobs, Growth, and Abolition of the Death Tax," U.S. Treasury, November 6, 2003.

98. Ibid.

99. Mankiw and Weinzierl.

100. For background, see David Burton, "Reforming the Federal Tax Policy Process," Cato Institute Policy Analysis no. 463, December 17, 2002.

101. Julie-Anne Cronin et al. Office of Tax Analysis, U.S. Treasury, "Treasury's New Panel Model for Tax Analysis," *National Tax Association Proceedings of the 69th Annual Conference*, p. 379.

102. For a good survey, see Martin Sullivan, "Flat Taxes and Consumption Taxes: A Guide to the Debate," American Institute of Certified Public Accountants, December 1995.

103. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2d ed. (Palo Alto: Hoover Institution Press, 1995).

104. The Hall-Rabushka tax is an "R-based" (R for real) cash-flow tax under which financial flows such as interest, dividends, and capital gains are disregarded. By contrast, an R+F cash-flow tax would include real and financial flows in measuring the tax base.

105. Business expenses that would *not* be deductible under the flat tax include interest, dividends, nonpension fringe benefits, the employer's share of payroll taxes, and bad debts.

106. Edwards, "Simplifying Federal Taxes."

107. This includes 1099INT, 1099DIV, 1099B, and 1098 forms. See GAO, "Potential Impact of Alternative Taxes on Taxpayers and Administrators," GAO/GGD-98-37, January 1998, p. 37.

108. Mervyn King, "The Cash Flow Corporate Income Tax," NBER Working Paper no. 1993, August 1986, pp. 14–21.

109. Dick Armey designed his 17 percent flat tax to create an overall tax cut, while Hall and Rabushka designed their 19 percent plan to be revenue neutral.

110. U.S. Treasury, "New Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds," *Tax Notes*, January 22, 1996, p. 451.

111. CBO, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015," January 2005, p. 3.

112. Dick Armey, "The Impact on Individuals and Families of Replacing the Federal Income Tax," Testimony before the House Ways and Means Committee, April 17, 1997.

113. Transfer pricing is the shifting of profits from high-tax to low-tax countries using the prices of products and intangibles that are traded

between corporations and their subsidiaries. Another point of trouble for the flat tax would be separating financial and nonfinancial transactions.

114. Robert Hall and Alvin Rabuska, "The Flat Tax: A Simple, Progressive Consumption Tax," in *Frontiers of Tax Reform*, p. 33.

115. Ibid., p. 33.

116. Current international trade rules allow exports to be exempt and imports to be taxed under "indirect" taxes, such as sales taxes and credit-invoice VATs, but not "direct" taxes, such as the corporate income tax.

117. For example, see Ernest Christian, "The International Components of Tax Reform," Institute for Policy Innovation, Policy Report no. 166, February 2002.

118. Bill Archer, "Goals of Fundamental Tax Reform," in *Frontiers of Tax Reform* p. 8.

119. The bill was H. R. 269 in the 108th Congress. See Rep. Phil English webpage, www.house.gov/english/pdf/SUSATbrfg.pdf.

120. CBO, "The Economic Effects of Comprehensive Tax Reform," July 1997, p. 28.

121. Gilbert Metcalf, "The Role of a Value-Added Tax in Fundamental Tax Reform," in *Frontiers of Tax Reform*, p. 97.

122. See discussion in James Hines, "Fundamental Tax Reform in an International Setting," in *Economic Effects of Fundamental Tax Reform*, p. 479. Hines notes that exchange rates can differ from purchasing power parities for years, but not differ in the long term; thus export benefits of border adjustments are eventually nullified.

123. Lawrence Lindsey, "Simplify, Simplify, Simplify," *Wall Street Journal*, September 16, 2004.

124. U.S. International Trade Commission, "Implications for U.S. Trade and Competitiveness of a Broad-Based Consumption Tax," Publication 3110, June 1998, p. 33.

125. Chris Edwards, "Corporate Tax Reform: Bush, Kerry, and Congress Fall Short," Cato Institute Tax & Budget Bulletin no. 21, September 2004, www.cato.org/pubs/tbb/index.html.

126. For background on this plan, see Arthur Hall, "Analysis and Summary of the National Retail Sales Act of 1996," Tax Foundation, March 1996. The plan would also have eliminated the estate tax and most federal excise taxes.

127. The FairTax (H. R. 25 in the 108th Congress) would also replace the estate tax. For background, see www.fairtax.org.

128. European VATs, for example, typically have multiple rates and exemptions. See Alexandre Mathis, "VAT Indicators," European Commission, Working Paper no. 2, April 2004.

129. See Joel Slemrod, "Which Is the Simplest Tax System of Them All?" in *Economic Effects of Fundamental Tax Reform*, p. 369. Slemrod notes that studies of state income tax compliance put the cost at between 2.4 and 4.8 percent of revenues. Income tax cost estimates range from Slemrod's 10 percent of revenues to about 20 percent of revenues. Slemrod, however, notes that low-rate state sales taxes are not directly comparable to federal taxes.

130. Steve Entin, "The Inflow Outflow Tax: A Saving-Deferred Neutral Tax System," Institute for Research on the Economics of Taxation, www.iret.org, undated, p. 4.

131. This is the average of the "standard rate" of VAT. See Mathis.

132. Based on discussions with Jason Clemens, Fraser Institute; David Perry, Canadian Tax Foundation; and others.

133. Revenues fell from 36.4 percent in 1991 to 35.2 percent in 2001, according to Organization for Economic Cooperation and Development, *Revenue Statistics* 1965–2001.

134. E-mail communications with Chris Evans, director, Atax, University of New South Wales, and Peter Saunders, social research director, Centre for Independent Studies, New South Wales. Retail prices in Australia are normally quoted on a tax-inclusive basis, but sales receipts separately list the amount of GST in the price.

135. Raymond Ring, "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal* 52, no. 1 (March 1999): 79. On cascading, see also John Mikesell, "The American Retail Sales Tax: Considerations on Their [*sic*] Structure, Operations, and Potential as a Foundation for a Federal Sales Tax," *National Tax Journal* 50, no. 1 (March 1997): 149.

136. The study took the form of a memo to Treasury Secretary Paul O'Neill from Assistant Secretary (Tax Policy) Pam Olson, "Tax Reform Materials," November 7, 2002. Available at http://thepriceofloyalty.ronsuskind.com/the-

bushfiles/archives/000093.html.

137. Laurence Kotlikoff, "How to Fix Taxes and Social Security," *Washington Post*, November 7, 2004, p. B7. Kotlikoff says that the sales tax rate could be reduced over time as a new Social Security system based on private accounts was phased in.

138. Reuven Avi-Yonah, "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT," *Tax Notes*, December 20, 2004, p. 1653.

139. Ibid., p. 1666.

140. The FairTax designers support repeal of the Sixteenth Amendment.

141. David Burton and Dan Mastromarco, "Response to William Gale," March 16, 1998, p. 3, www.fairtax.org. This figure can be roughly calculated by adding personal consumption expenditures to government consumption and dividing by GDP. This share of GDP is prior to rebates for low-income households.

142. Fox, p. 12. Fox calculates tax bases as share of personal income. I have roughly converted his figures into shares of GDP.

143. Cited in William Gale, "The Required Tax Rate in a National Retail Sales Tax," Brookings Institution, May 1999, p. 15.

144. For the coverage of state sales tax bases, see Paul Menchik, "Consumption Patterns, Demographic Change and Sales Tax Revenue: Is Yet Another Fiscal Shock on the Horizon?" *National Tax Association Proceedings of the 96th Annual Conference*, p. 367.

145. Archer, p. 8.

146. Some studies have calculated that the revenue-neutral rate for a FairTax would be higher than 30 percent. See Gale, "The Required Tax Rate in a National Retail Sales Tax." And see Joint Committee on Taxation, "Budget Neutral Rate for H.R. 2525," Memorandum to John Buckley, April 2000. Memo replicated in Martin Sullivan, "The Rise and Fall of the National Sales Tax," *Tax Notes*, November 15, 2004. However, the designers of the FairTax have challenged these estimates. See David Burton and Dan Mastromarco, response to Ken Kies's letter to Chairman Archer, February 4, 1998, which critiques an earlier JCT estimate. Joint Committee on Taxation, "The Impact on Individuals and Families of Replacing the Federal Income Tax," JCT-8-97, April 14, 1997. See also Burton and Mastromarco, "Response to William Gale."

147. Federation of Tax Administrators, "Comparison of State and Local Retail Sales Taxes," January 2004, www.taxadmin.org/fta/rate/.

148. Sullivan, "The Rise and Fall of the National Sales Tax," p. 919. For an alternative view, see Dan Mastromarco, "The FairTax and Tax Compliance: An Analytical Perspective," *Tax Notes*, April 20, 1998

149. Robert Hall, "Guidelines for Tax Reform," Testimony to the House Budget Committee, October 6, 2004, www.house.gov/budget/hearings.htm.

150. For example, Bruce Bartlett cites the OECD saying: "Governments have gone on record as saying a [sales tax] of more than 10 percent to 12 percent is too fragile to tax evasive possibilities." Economist Bill Gale recently argued: "Governments have gone on record noting that at rates of more than 12 percent, sales taxes are too easy to evade." Bruce Bartlett, "Consequences of Replacing Federal Taxes with a Sales Tax," Joint Economic Committee, August 1995, p. 8. William Gale, "Federal Revenue Options," Testimony to the House Budget Committee, October 6, 2004, p. 4.

151. One scholarly analysis of possible evasion under a national sales tax concluded that it is hard to say whether it would be better or worse than under the income tax. See Matthew Murray, "Would Tax Evasion and Tax Avoidance Undermine a National Retail Sales Tax?" *National Tax Journal* 50, no. 1 (March 1997): 167.

152. Burton and Mastromarco, "Response to William Gale," p. 24.

153. GAO, "Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap,"GAO/T-GGD-97-35, January 9, 1997, p. 8. The figure is based on the $95 billion tax gap for individuals in 1992 divided by individual income taxes of $476 billion that year.

154. For a discussion of these issues, see David Burton and Dan Mastromarco, "Response to Ken Kies' Letter to Chairman Archer," Americans for Fair Taxation, February 4, 1998, www.fairtax.org.

155. Burton and Mastromarco, "Response to William Gale," p. 7.

156. Tax Foundation, *Facts and Figures on Government Finance*, 36th ed. (Washington: Tax Foundation, 2003), Table C29.

157. U.S. Bureau of the Census, "Poverty Thresholds 2003," www.census.gov/hhes/poverty/threshld/thresh03.html.

158. GAO, "Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds," p. 13.

159. Taxes on wages are economically similar to taxes on consumption. See discussion in Joint Committee on Taxation, "Impact on Individuals and Families of Replacing the Federal Income Tax," p. 93.

160. Author's calculations based on CBO, "The Budget and Economic Outlook: An Update," September 2004, p. 4. Various analyses have found that a VAT base of about 55 percent of GDP is a fairly realistic base. For example, see CBO, "Effects of Adopting a Value-Added Tax," February 1992, Table 8, p. 22. The "broad" base calculated by CBO at 55 percent of GDP would exclude parts of food, housing, health care, religious, and financial services consumption from the tax base.

161. A payroll credit combined with a sales tax is discussed in Gilbert Metcalf, "The National Sales Tax: Who Bears the Burden?" Cato Institute Policy Analysis no. 289, December 8, 1997. I am assuming a credit as costly as the refundable portion of the EITC at about $34 billion.

162. Entin. An original model of this design was a proposal by economist David Bradford. See David Bradford, *Blueprints for Basic Tax Reform*, 2d ed. (Arlington, VA: Tax Analysts, 1984).

163. The IRET plan would retain a deduction for education expenses, with the justification that education is an investment not consumption.

164. Under the "Unlimited Savings Allowance" (USA) tax plan of Nunn and Domenici, the corporate income tax would be replaced by an 11 percent broad-based business tax. See Ernest Christian, "De-Radicalizing Tax Reform," *Tax Notes*, April 13, 1998, p. 243.

165. Entin.

166. For a discussion of administrative issues under such a tax, see GAO, "Potential Impact of Alternative Taxes on Taxpayers and Administrators," GAO/GGD-98-37, January 1998, p. 174. For another view, see Slemrod, p. 377. Slemrod thinks that such a tax would be unenforceable at the standard of privacy that Americans would expect from the government. See also Charles McClure and George Zodrow, "A Hybrid Approach to Direct Consumption Taxation," in *Frontiers of Tax Reform*, p. 78.

167. Tax expert Ernest Christian's incremental steps toward reform are called the "five easy pieces," which include reduced marginal tax rates, equalized treatment of debt and equity, business capital expensing, expanded personal savings opportunities, and creation of a more internationally competitive U.S. corporate tax. See Christian, "De-Radicalizing Tax Reform."

168. More precisely, the plan's tax rates would be applied to taxable income, which would be adjusted gross income (as under current law) less the standard deduction and an expanded personal exemption. In 2005 the standard deduction is $5,000 for single and $10,000 for married filers, and the expanded personal exemption would be $4,500. Thus, the 27 percent bracket would begin at about $80,000 of taxable income for singles and about $160,000 of taxable income for married couples. (Dividends, interest, and capital gains would taxed at a maximum of 15 percent.)

169. Calculations include the effect of the employer-paid payroll tax being deductible against the corporate income tax.

170. For a full list of "tax expenditures" in the code, see *Budget of the U.S. Government FY2005, Analytic Perspectives*, p. 285. Note, however, that official lists of tax expenditures have certain technical shortcomings.

171. The administration has proposed adding lifetime savings accounts and simplifying the rules on current retirement plans. For a description, see U.S. Treasury, "General Explanation of the Administration's FY2005 Revenue Proposals," February 2004, www.treas.gov/offices/tax-policy/library/bluebk04.pdf.

172. Looking at IRS data for all nonfinancial C corporations for 2000 and 2001, the interest deduction is typically about $60 billion larger than interest income. Special rules would be required for the financial services industry. For corporate data, see IRS, Statistics of Income Division, *Corporate Income Tax Returns 2001* (Washington: Government Printing Office, undated), Table 12.

173. Calculated as 15 + (1 – 0.15)*15.

174. For this proposal, I have assumed that the corporate income tax would be paid by C corporations, as under current law. Small businesses would continue to pay tax under the individual system. However, in the long run the tax code should be reformed to equalize the tax treatment of all businesses.

175. Alessandro Bavila, "Moving Away from Global Taxation: Dual Income Tax and Other Forms of Taxation," *European Taxation* (Amsterdam: International Bureau of Fiscal Documentation, June 2001). See also Paul van den Noord and

Christopher Heady, "Surveillance of Tax Policies: A Synthesis of Findings in Economic Surveys," OECD Working Paper 303, July 17, 2001.

176. Hubert Hamaekers, "Taxation Trends in Europe," *Asia-Pacific Tax Bulletin* (International Bureau of Fiscal Documentation), February 2003, p. 48.

177. Ronald Reagan, Remarks during a White House Briefing on Tax Reform, June 7, 1985, www.reagan.utexas.edu/resource/speeches/1985/60785b.htm.

178. Martin Feldstein and Gilbert Metcalf, "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," NBER Working Paper no. 1791, January 1986.

179. The Tax Foundation's Individual Tax Simulation Model is based on the IRS, Statistics of Income, public use data file.

180. See Helms.

181. Cogan, Hubbard, and Kessler.

182. Based on my calculations of aggregate IRS data for all nonfinancial C corporations in 2000 and 2001. The exclusion of interest income and deductions would expand the corporate tax base by about 10 percent; ending the health insurance deduction would expand the base by about 30 percent; and ending deductions for state and local taxes would expand the base by about 30 percent. Special rules would be needed for the financial services industry under such a tax plan. For corporate data, see IRS, Statistics of Income Division, Table 12.

183. Business subsidies, or "corporate welfare," on the spending side of the federal budget total about $90 billion annually. See Chris Edwards and Tad DeHaven, "Corporate Welfare Update," Cato Institute Tax & Budget Bulletin no. 7, May 2002.

184. U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems* (Washington: Government Printing Office, January 1992).

185. An analysis by Price Waterhouse (now PricewaterhouseCoopers) for nonfinancial C corporations for 1992 shows that the flat tax base would have been 62 percent larger than the income tax base. Price Waterhouse, "Tax Liability of Nonfinancial Corporations under the USA and Flat Taxes: An Industry Analysis," June 29, 1992.

186. For example, a PricewaterhouseCoopers analysis looking at the years 1998 through 1992 found that a flat tax with a rate of about 19 percent would be revenue neutral for all U.S. nonfinancial corporations. See Peter Merrill et al., "Corporate Tax Liability under the USA and Flat Taxes," *Tax Notes*, August 7, 1995.

187. For a discussion of international tax systems used in other countries, see Peter Merrill, PricewaterhouseCoopers, Testimony before the House Budget Committee on the "Competitiveness of the U.S. Tax Code," July 22, 2004.

188. Edwards, "Downsizing the Federal Government."

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