Cato Handbook *for* Policymakers

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5. Federal Tax Reform

Congress should

- replace current individual income tax rates with rates of 15 and 25 percent;
- cut the top dividend and capital gains tax rates to 15 percent;
- repeal virtually all deductions and credits;
- cut the corporate income tax rate to 15 percent;
- create universal savings accounts so that all families can build wealth without double taxation;
- replace business depreciation with capital expensing;
- take reforms further by replacing the income tax with a consumption-based flat tax;
- repeal the individual and corporate alternative minimum taxes; and
- repeal the estate tax.

At the beginning of the 20th century, federal taxes accounted for 3 percent of the nation's gross domestic product (GDP), and federal tax rules filled just a few hundred pages. Today, federal taxes account for more than 18 percent of GDP, and federal tax rules span 75,000 pages, according to tax analysis firm CCH Inc. The federal government will extract $3.5 trillion in taxes from families and businesses in 2017. Individuals will be left with less income to buy food, clothing, and other needed items, while businesses will be left with less income to hire workers and build factories.

Federal taxation is costly in other ways as well. The tax code's complexity creates a large paperwork burden and makes financial planning more difficult. Tax complexity also breeds confusion and distrust about the cost of government and who bears the burden. Another cost of the tax system

is the damage to economic growth. High tax rates reduce productive activities, such as working and investing, and the unequal tax treatment of different industries and activities steers resources into low-value uses.

Congress should cut spending to reduce the overall burden of taxes, and it should reform the tax code with three goals in mind: simplification, transparency, and increased economic growth. Fundamentally, taxes should be lower, flatter, and simpler, and reforms should move in that direction.

Simplification

In 1976, president-to-be Jimmy Carter called for "a complete overhaul of our income tax system. I feel it's a disgrace to the human race." Since that call for reform, the number of pages of federal tax rules has tripled, according to CCH. Congress continues to create new deductions, credits, and penalties, while the Treasury Department churns out an endless stream of regulations. Tax complexity creates at least five costs:

1. Compliance burdens. Americans spend more than 6 billion hours annually filling out tax forms, keeping records, and learning tax rules, according to the Office of Management and Budget. The paperwork for a corporate tax return can be 10,000 pages in length. In addition to the costs of filing, taxpayers face a burden from audits, notices, liens, levies, seizures, and the millions of penalties assessed each year by the Internal Revenue Service (IRS). Complying with the federal tax code costs the economy hundreds of billions of dollars annually.

2. Errors. Tax complexity causes taxpayers and the IRS to make frequent and costly errors. The IRS does an awful job in accurately answering phone queries from taxpayers. But that is mainly the fault of Congress for larding up the tax code with hundreds of special breaks and penalties for individuals and businesses, including the complicated tax-filing rules under the Affordable Care Act.

3. Economic decisionmaking. Tax complexity impedes efficient decisionmaking. For example, if a family chooses the wrong vehicle for its savings, that decision could result in higher taxes, lower returns, less liquidity, or penalties on withdrawals. For businesses, tax complexity injects uncertainty into hiring, capital investment, and other important decisions.

4. Inequity and unfairness. Although equality under the law is a bedrock principle of justice, individuals pay greatly different tax rates under the income tax. For example, IRS data for 2013 show that income taxes averaged 27 percent of adjusted gross income for the top 1 percent

of households compared with 14 percent for taxpayers overall. At the same time, people with similar incomes are treated unequally as a result of exemptions, deductions, and credits in the tax code related to education, home ownership, and other items.

5. Avoidance and evasion. Tax complexity leads to greater noncompliance with the tax system. Noncompliance stems from confusion over the tax rules and aggressive tax planning. People take more risks on their tax returns when rates are high, and complexity hides their strategies from the IRS. If the tax code had low rates and a simple base, individuals and businesses would focus on productive activities rather than tax avoidance.

Transparency

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

Unfortunately, policymakers use numerous techniques to hide the burden of government. They run deficits, which defers taxes until the future and makes a share of today's spending seem free. They collect income and payroll taxes through employer withholding to make paying taxes less painful. And they conceal the size of the overall tax load by spreading the burden across multiple tax bases.

Policymakers also hide the tax burden from citizens by collecting taxes from businesses. The largest hidden tax is the "employer" half of the 15 percent payroll tax that funds Social Security and Medicare. That tax is not reported on worker paystubs, but economists agree that the burden falls on workers in the form of lower wages. Another hidden tax is the corporate income tax, which is passed through to individuals in the form of higher prices, lower wages, and reduced returns on savings. Together, deficits, the corporate income tax, and the employer half of the payroll tax hide from individuals more than one-third of the cost of federal spending. The result is that people perceive the "price" of federal spending to be artificially low, and they "demand" too much of it.

Reforms should make the federal tax structure simpler, flatter, and more transparent so people can understand the cost of government. For example, the entire payroll tax should be shown on worker paystubs and W-2 tax forms so that people can more readily see the costs of Social Security and Medicare. For the income tax, the current mess of multiple rates and

narrow breaks should ultimately be scrapped in favor of a simple flat tax. All taxpayers should pay an equal share of their earnings to the government above a basic exemption amount. That would create greater "solidarity" among taxpayers because a proposed rate increase would hit everyone equally. With equal treatment, there would be greater opposition to tax increases, especially if people believed that they were not getting good value from their government.

Economic Growth

American incomes would be higher and growth more robust if the overall size of the federal government was reduced. But it is also true that for any particular size of government, the economy would be stronger if marginal tax rates were lower and the tax base was simpler and more neutral. Such reforms would minimize tax distortions that undermine working, saving, investing, and entrepreneurship.

The income tax distorts productive activities, thereby creating "deadweight losses." The size of such losses rises rapidly as marginal tax rates rise. Harvard University's Gregory Mankiw explains, "It is a standard proposition in economics that the deadweight loss of a tax rises approximately with the square of the tax rate. . . . If we double the size of a tax, the deadweight loss increases four-fold." Thus, a low-rate tax structure is much less damaging than a high-rate structure, and cutting the highest rates would create the largest benefits. People with high incomes often have unique talents, and they may respond strongly to tax rate changes. Tax increases on high-earning doctors, for example, may cause them to reduce their work hours or retire earlier, which would hurt patients and the overall economy.

Policymakers should also keep in mind that there is a high concentration of small businesses in the top income tax brackets. About three-quarters of the top 1 percent of federal taxpayers report some small business income, and these taxpayers often have flexibility in adjusting their reported income with changes to their working and investing activities.

The upshot is that for every $1 billion tax increase, the harm to the private economy is more than $1 billion because of the losses caused as taxpayers reduce their productive efforts. The Congressional Budget Office found that "typical estimates of the economic [or deadweight] cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised." Harvard University's Martin Feldstein estimates that the

deadweight cost of tax rate increases may exceed "one dollar per dollar of revenue raised."

Aside from reducing tax rates, tax reforms should reduce the tax code's bias against savings and investment. That bias reduces the size and quality of the nation's capital stock, which in turn reduces worker incomes. Tax reforms should transition from an income tax base to a consumption base—a base that is neutral with respect to savings and investment. For businesses, the tax code can be moved toward a consumption base by substituting capital "expensing" for depreciation. Under expensing, businesses would immediately deduct the costs of equipment and structures they purchased, rather than deducting the costs over a period of years. For individuals, the tax code can be moved toward a consumption base by enacting universal savings accounts (USAs) like those introduced by Sen. Jeff Flake (R-AZ) and Rep. David Brat (R-VA) in 2015. Contributions to USAs would come from after tax income, and all account earnings would be tax free. Individuals could withdraw funds tax free at any time for any reason, which would increase liquidity and encourage saving. Both Great Britain and Canada have enacted such accounts, and they have been hugely popular. USAs would encourage people to build larger nest eggs and increase their personal financial security.

Tax Reform Steps

To reform the complex and burdensome U.S. tax code, Congress should take the following steps:

- **Simplify the tax-rate structure**. The current income tax structure of seven rates should be collapsed to two rates of 15 and 25 percent.
- **Cut dividend and capital gains rates**. Corporate equity is currently taxed at both the corporate and individual levels, which biases the tax code in favor of debt. To alleviate this distortion and encourage investment, Congress should cut the top individual tax rates on dividends and capital gains to 15 percent.
- **End most deductions and credits**. Special-interest tax breaks—including the mortgage interest deduction, the state and local tax deduction, the exclusion for interest on state and local government bonds, and virtually all tax credits—should be repealed.
- **Cut the corporate tax rate to 15 percent**. According to the international auditing firm KPMG, the global average corporate tax rate is 24 percent, which is far lower than the combined U.S. federal-state

rate of 40 percent. Congress should slash the federal rate of 35 percent to 15 percent, which would match the federal rate in Canada. Interestingly, Canada collects about the same amount of corporate taxes as a share of GDP as we do, partly because the low Canadian rate reduces tax avoidance and increases investment.

- **Expand capital expensing**. Congress has enacted a number of temporary measures in recent years allowing companies to expense a portion of their capital purchases. Congress should enact full and permanent capital expensing, which would boost investment and productivity, and in turn raise worker wages.
- **Enact universal savings accounts**. Congress should enact all-purpose savings accounts, USAs, which would combine tax-free accumulation with tax-free withdrawals at any time for any reason. USAs would encourage families to build up nest eggs that could be used for any purpose, such as medical and college expenses, buying a home, covering spells of unemployment, or starting a business. All personal savings—not just retirement savings—should be encouraged.
- **Repeal the estate tax**. The federal estate or "death tax" has a top rate of 40 percent. It raises less than 1 percent of federal revenues but creates substantial economic damage. It reduces savings and has created a wasteful estate planning industry to help people avoid it. The death tax may not actually raise any money for the government, on net, because it suppresses income tax collections. Mankiw concluded that "estate tax repeal . . . could actually increase total federal revenue," noting that "repeal of the estate tax would stimulate growth and raise incomes for everyone."
- **Enact a consumption-based flat tax**. In recent decades, proposals to replace the federal income tax with a consumption-based flat tax have gained support. Such reforms would simplify taxation, increase savings and investment, and spur growth. The reform steps discussed here would move the United States toward a low-rate consumption-based system. About two dozen nations have enacted flat tax systems, as discussed in *Global Tax Revolution*. America should join this "flat tax club" to increase fairness and revitalize the economy.

Suggested Readings

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