FEDERAL TAX REFORM

As noted previously, the Federal tax code is needlessly complex and burdensome, and it discourages economic growth and U.S. competitiveness in the international marketplace. Further, taxpayers and their families face, in the next few years, sharply higher tax rates on income and investment, the reinstitution of the marriage penalty, and higher taxes per child, among numerous other tax increases as a result of the schedule expiration of the 2001 and 2003 tax laws. There is also the Alternative Minimum Tax [AMT], which becomes a more intractable problem every year.

For the longer term, the overall Federal tax burden is projected to reach unprecedented levels as a share of economic resources. The current tax code also puts American businesses and American-made products at a competitive disadvantage against foreign competitors, making it harder to keep jobs in the U.S. and to grow the economy.

As is true with the structure of major Federal entitlement programs, the problems in the Federal tax law cannot be corrected by merely tinkering with an excessively complex and burdensome tax code. What is needed is a restructuring of the tax laws – one that is broad and yet achievable. It is the kind of tax reform called for in this proposal.

This proposal eliminates the AMT and allows individuals to choose how they will pay their Federal income taxes. It eliminates the tax on savings and shifts toward a consumption tax for businesses, making it easier for U.S. businesses to invest in their own businesses and create more jobs in the U.S. Most important, this plan is designed to hold overall Federal tax revenue at roughly 18.5 percent of GDP for the foreseeable future – consistent with the historical average of the past 40 years – rather than allowing the tax burden to rise to unprecedented levels, as is assumed under current tax law.

Individual Income Taxes

A world-class tax system should be simple, fair, and efficient. The U.S. tax code fails on all three counts. The system is notoriously complex, as families must spend significant time and money navigating a labyrinth of deductions and credits, a host of different rules for characterizing income, and a variety of schedules for taxing that income. The code is also patently unfair, as many of the tax deductions and preferences in the system – which serve to narrow the tax base – are mainly used by a relatively small share of mostly higher-income individuals. It is also highly inefficient, as tax considerations (rather than economic fundamentals) often distort individual decisions to work, save, and invest, leading to a misallocation of resources and lower economic growth.

Individuals react negatively toward the tax code partly because it steers them toward certain activities and away from others. In addition, there are always a few “surprises” – such as the AMT – that end up raising their tax bills. They lack a certain control over their own financial lives.

This reform proposal attempts to solve these problem in a fundamentally American way: by offering individuals a choice. Individuals can choose to pay their Federal taxes under the existing tax code, with all the familiar deductions and schedules, or they could move to a highly simplified income tax system. The simplified plan broadens the tax base by clearing out nearly all of the existing tax deductions and credits, compresses the tax schedule down to two low rates and retains a generous standard deduction and exemption level. The tax form for this system could fit on a postcard. The goal is a more simple, fair and efficient tax code, the components of which are described below.

Full Repeal of the AMT. The Alternative Minimum Tax originally was intended to apply to a small fraction of wealthy taxpayers. But because it was never indexed for inflation, it has in recent years threatened to ensnare millions of middle-income filers. To date, Congress has only extended protection from this AMT expansion on a year-by-year basis. This proposal eliminates the AMT entirely and permanently.

Eliminates Double Taxation of Savings. The current system essentially taxes savings twice – individuals pay tax on their earnings and, if they choose to invest those after-tax funds, they must pay another tax on the return from their savings (i.e. interest, capital gains, or dividends). The plan eliminates this second layer of taxation. Not only is this fair to individual taxpayers, it also is good for the economy. Greater savings leads to more investment and higher rates of productivity. Higher productivity ultimately drives increased living standards. The plan also eliminates the Death Tax, another form of double taxation that is particularly harmful to small businesses.

Offers Taxpayers a Choice. The proposal allows individual income taxpayers to make their own choice about how best to pay their taxes. Within 10 years of enactment of this legislation, individuals would choose one of the two tax systems. But individuals are allowed *one* additional changeover between the two tax systems over the course of their lifetimes. Individuals are also allowed to change tax systems when a major life event (death, divorce, or marriage) alters their tax filing status.

Simplified Income Tax Rates. In contrast to the six tax rates in the current code, the simplified tax has just two rates: 10 percent on adjusted gross income [AGI] (as defined below) up to $100,000 for joint filers, and $50,000 for single filers; and 25 percent on taxable income above these amounts. These tax brackets are adjusted each year by a cost-of-living adjustment as measured by increases in the consumer price index [CPI]. (See Table 7 on the next page for a comparison with current tax brackets.) Taxable income equals earnings minus a standard deduction and personal exemption.

Broader Tax Base. The new, simplified code eliminates nearly all existing tax deductions, exclusions, and other special provisions, but retains the health care tax credit described above.

Generous Standard Deductions, and Personal Exemptions. The standard deduction is $25,000 for joint tax filers, $12,500 for single filers. The personal exemption is $3,500. The combination is equivalent to a $39,000 exemption for a family of four.

The tables below compare the tax rates in the Simplified Tax with those in the current code.

Table 7: Tax Rate Comparison - Single Filers

Current Tax Code		Simplified Tax	
Marginal Rate	Taxable Income	Marginal Rate	Taxable Income
10 percent	$0-$7,825	10 percent	$0-$50,000
15 percent	$7,825-$31,850		
25 percent	$31,850-$77,100	25 percent	$50,000 and over
28 percent	$77,100-$160,850		
33 percent	$160,850-$349,700		
35 percent	$349,700 and over		

Table 8: Tax Rate Comparison - Joint Filers

Current Tax Code		Simplified Tax	
Marginal Rate	Taxable Income	Marginal Rate	Taxable Income
10 percent	$0-$15,650	10 percent	$0-$100,000
15 percent	$15,650-$63,700		
25 percent	$63,700-$128,500	25 percent	$100,000 and over
28 percent	$128,500-$195,850		
33 percent	$195,850-$349,700		
35 percent	$349,700 and over		

Prevents Future Increase in Tax Burdens. This individual tax system – in combination with the business tax described below – is designed to keep Federal revenues at approximately 18.5 percent of GDP for the foreseeable future, roughly equivalent to the historical average.

Gives Taxpayers Greater Certainty. Under current law, the scheduled expiration of the 2001 and 2003 tax relief measures along with a growing expansion of the AMT would push overall tax burdens to an unprecedented level in the coming years. By reforming the entire tax code and removing these upward pressures on taxes, this plan gives Americans peace of mind so that they can adequately plan for their financial future.

Business Taxation

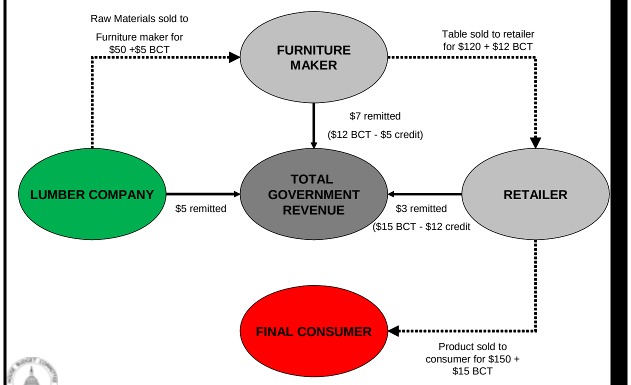
In addition to creating a simpler and fairer income tax system for individuals and families, this plan does away with the corporate income tax, which discourages investment and job creation, distorts business activity and puts American businesses at a competitive disadvantage against foreign competitors. In its place, this proposal establishes a simple and efficient Business Consumption Tax [BCT] that will enhance the international competitiveness of U.S. businesses and put the economy on solid footing to meet the challenges of the 21st century.

Business Consumption Tax. The proposal creates an 8.5-percent BCT on goods and services. It operates under what is known as the "credit invoice method," in which businesses apply the BCT to the sales of their products or services and then claim a credit for the BCT paid on purchases of material costs from other businesses shown on purchase invoices. The difference between the BCT collected on sales and credit for the BCT paid on input purchases is then paid to the Federal Government. The system provides a clear audit trail of the business tax because the amount is clearly stated on sales and purchase receipts.

The flow chart alongside shows how the BCT would operate for businesses involved in the production of a wood table. Revenues are remitted to the government at each stage of the production process and the BCT is incorporated in the final sale price to the end consumer.

Transition to the BCT. The plan incorporates temporary "transition relief" to facilitate the switch from the current income tax system to the BCT. The plan also addresses complications in the treatment of the financial services industry under a tax system such as the BCT.

Figure 13
How the Business Consumption Tax Works



Source: Government Accountability Office Note: Illustration based on 10-percent BCT rate.

Leveling the Playing Field. To level the playing field and eliminate the competitive disadvantage on American businesses and American-made products, the BCT is not imposed on U.S. exports when it leaves the U.S. It is instead imposed on foreign imports when it enters the U.S. As a result, the BCT is "border adjustable."

Currently, the U.S. corporate income tax is not border adjustable (i.e., the tax cannot be removed from exports or imposed on imports). In contrast, foreign competitors in Europe have the advantage of removing their own taxes on their exports. The World Trade Organization [WTO] established the requirements for a border adjustable tax system. Direct taxes, such as the corporate income tax, are not border adjustable, but indirect taxes, such as the BCT, are border adjustable. (It is important to note that the WTO has ruled that the credit invoice method business tax is border adjustable.)

Encouraging Investment. Under the current corporate income tax, investments are typically depreciated gradually over the life of an asset. A portion of the cost of the investment is deducted from revenues each year until the full price is recaptured over time (depending on the length of the depreciation schedule).

Under the BCT, the cost of an investment is fully deducted immediately – in other words, investments are expensed. That becomes important from a tax perspective because a dollar's worth of tax benefit today is worth more than a tax benefit in the future for any business. Expensing becomes the key element in shifting from a system that taxes income to a system that taxes consumption (i.e. income less investment). This would boost overall investment in the economy, which would in turn spur job creation, productivity and rising living standards.

Elimination of the Corporate Income Tax. Like the individual income tax, the corporate income tax contains a host of tax preferences that end up narrowing the corporate tax base by up to 25 percent, according to the Treasury Department. That narrow tax base requires higher tax rates to raise a given amount of revenue. The current statutory U.S. corporate tax rate (including State corporate taxes) is 39 percent, the second highest tax rate in the Organisation for Economic Cooperation and Development [OECD] and 8 percentage points higher than the OECD average. This adds to the disadvantage already placed on American businesses and, in turn, American jobs. In addition, a country's corporate income tax rate can become one of the key determinants of where businesses choose to locate and invest.

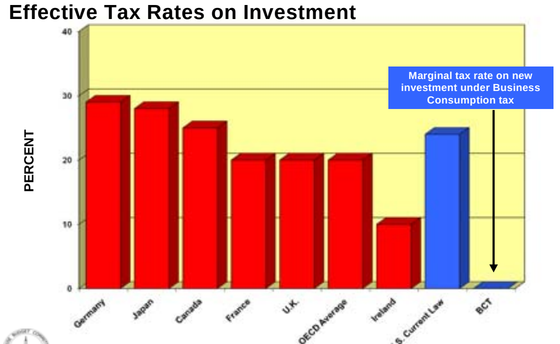
The plan eliminates the corporate income tax entirely, replacing it with the Business Consumption Tax on a broad tax base. The tax base is broadened by eliminating various business tax preferences in today's system, which allows for a significantly lower tax rate under the BCT.

Boost to Competitiveness. By eliminating the corporate income tax and instituting a single-digit business consumption tax with immediate expensing, the U.S. would dramatically enhance its investment climate.

The figure alongside gives a sense of how much. It shows a cross-country comparison of the marginal effective tax rates on new business investment. Effective tax rates are a useful way to distill all of the elements of the tax code that influence the burden on new investment (e.g. statutory business tax rates and depreciation treatment). Currently, the marginal effective tax rate on new business investment in the U.S. is roughly 25 percent, above the OECD average of 20 percent. By implementing the BCT, the U.S. would essentially drive down the marginal effective rate to *zero*. In other words, the BCT would essentially eliminate the tax distortion on new business investment in the U.S. The result would be a quantum leap in terms of establishing a competitive business tax for the 21st century.

Figure 14

Effective Tax Rates on Investment



Note: Equity Financed Equipment

Source: U.S. Treasury, Committee on the Budget, U.S. House of Representatives

The move would also help to level the playing field so American businesses and American-made products are no longer at a competitive disadvantage against foreign competitors. In fact, this plan gives the U.S. a leg up on its foreign competitors by only taxing investment *once* – at the business level. Foreign competitors will continue to tax investment twice – at the business level and at the individual level via a tax on capital gains or dividends – which has the effect of raising their cost of capital.

One further metric of the enhanced competitiveness of U.S. businesses under this plan is the level of the consumption tax itself. A U.S. Business Consumption Tax of 8.5 percent is roughly *half* that of the OECD average. (Other countries typically employ a consumption tax along with a corporate income tax and their businesses taxes as a whole typically raise more revenues as a share of their overall economy than the U.S.)

Key Benefits

To summarize some of the principal benefits of the tax policy described above:

- An uncompetitive business tax climate has forced many U.S. companies to relocate and send job abroad, often through mergers and acquisitions with foreign companies. This tax plan would reverse this trend.

- With an enhanced investment climate, international businesses, particularly capital-intensive industries such as manufacturing, would have a greater incentive to invest in the U.S. and expand production here, which creates jobs.

- The United States' relatively high statutory corporate income tax has led to multinational corporations shifting their profits to lower-tax countries, essentially shifting the tax base overseas. Many U.S. businesses also delay the repatriation of earnings from their foreign affiliates. This plan would bring these earnings and profits back to the U.S.

- Greater investment in the U.S. would also help to speed the pace of technological innovation in the U.S. economy, a key factor in raising productivity.

- There is a clear link between investment and capital formation and productivity and rising living standards. Between 1973 and 1995, for instance, productivity grew at just under 1.5 percent, implying that living standards in the U.S. would double every 50 years. Since 1995, productivity, spurred by technological innovation and investment, has increased at a 3.0-percent rate. This rate implies it will take only 25 years for living standards to double, half as long as under a slower rate of productivity. A business climate that fosters investment, therefore, is one of the keys to future U.S. prosperity.

- The way the U.S. taxes international business operations is important because roughly two-thirds of U.S. export trade (a growing share of the U.S. economy) is facilitated by U.S. multinational companies and their foreign affiliates.