



Restoring the American Dream
TAX REFORM 2010

Guiding Principle: *Taxation is the means by which government derives the revenue to carry on its essential functions. Limited government by definition means limited taxation. Essential functions are ones which benefit the entire body politic, not just a portion of it, and which carry out constitutionally limited purposes stated in Article I, Section 8 of the U.S. Constitution.*

Secondary Principles: Meaningful tax reform requires meaningful spending reform. Every dollar of spending comes from the taxpayer (either now or, in the case of deficit spending, in the future).

Long Term Reform:

Value Added Tax: Backers of a national sales tax known as a value-added tax (“VAT”) see this system as an easy fix for the government’s budget deficits. The VAT is widely used in the European Union (the “EU”) as a major source of revenue. However, data show that VAT avoidance and fraud is widespread in the EU and would lead to systemic problems in the United States, such as a receipts gap, increasing rates of taxation and continuing deficits.¹ Enactment of a VAT would only add an additional revenue source, increasing the cost of all goods and products, but will not address the principal issue of the purpose of taxation or the grave matter of federal over-spending. The solution to federal deficits is reduced spending, not increased taxation.

The FairTax: According to its proponents, “The FairTax plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax -- administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we

¹ *Value-Added Tax: No Easy Fix for the Deficit*, Curtis S. Dubay, WebMemo, The Heritage Foundation, No. 2772, January 21, 2010.

choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.”² , However, the FairTax’s prebate concept contradicts a basic tenet that all citizens have a responsibility to fund the essential services of government. While I can and will support The FairTax, a simple flat tax can be constructed to accomplish essentially the same goals of The FairTax but with a simpler transition and implementation.

Fundamental Change: The federal tax system will only be fundamentally changed when the guiding principle of the system is affirmed. Stopping and reversing the use of the tax system as a means of social policy, to reward certain economic activities while punishing others, as a means of redistribution of wealth and other goals which are inconsistent with the country’s founding principles will require a multi-generational commitment and the strict scrutiny of each taxing proposal for its compliance with the guiding principle stated above. Each tax benefit constituency clamors for its continuing benefit but all must share in the burden as the economic ship is righted.

Immediate Issues and Short Term Reforms

Individual Income Taxation: Income taxes should be simple, understandable and straight-forward.³ Limitation of deductions, credits and other complications should be coupled with rate reduction, leading to greater equality, fairness and transparency. Broadening the income tax base and decreasing income tax rates has a proven track record of increasing government revenues by increasing economic growth.⁴ A simple flat tax would include all segments of society in ensuring that tax increases generate adequate value.⁵ Systems of “refundable credits” constitute wealth transfer payments and create huge negative conditions for taxpayers to rise above the level of receipt of these payments.⁶

Dividend Tax Rate: The maximum individual income tax rate on qualifying dividends is currently 15%. However, that rate is scheduled to increase to 40% in 2011. At the 40% level, the United States will have the highest dividend tax rate of all major countries.⁷ At a minimum the rate should remain at the current level.

Capital Gains: The scheduled increase in the capital gains rate from 15% to 20% in 2011 should be eliminated. Ultimately the capital gains rate should be reduced or eliminated to

² http://www.fairtax.org/site/PageServer?pagename=about_basics_tagline.

³ The cost of income tax compliance is roughly \$200 billion annually. Chapter 41, *Cato Handbook for Policymakers*, 7th Edition (hereinafter “*Cato Handbook*”), page 422.

⁴ Both Democratic (John F. Kennedy) and Republican (Ronald Reagan) administrations provide proof.

⁵ The percentage of tax filers who pay no taxes has increased from 21.3 percent in 1980 to 34 percent in 2008, resulting in 48 million taxpayers paying nothing. *The Heritage Center for Data Analysis. The 2009 Index of Dependence on Government*, William W. Beach, March 4, 2010 (hereinafter “*Dependence Index*”), page 2.

⁶ Internal Revenue Code of 1986 (hereinafter “IRC”) Section 32. The effect can be illustrated by a simple example: Assume a single filing taxpayer has 3 or more qualifying children and earned income of \$16,420. That person is entitled to a “refundable credit” of \$5,657, for total income of \$22,077. Assume that person makes \$17,000, an additional \$580. The combination of the phase out of the earned income credit and the imposition of employment taxes put that individual into a marginal rate of 29.66%. Total net income from the \$580 additional earned income is only \$408.

⁷ *Cato Handbook*, page 426.

encourage entrepreneurship and investment. Many advanced nations have a zero capital gains rate including, Austria, Belgium, the Czech Republic, Greece, Hong Kong, the Netherlands, New Zealand and Switzerland.⁸

Corporate Income Taxes: Federal marginal income tax rates on corporate income over \$100,000 range from 34% to 39%.⁹ Meanwhile other countries since 1985 have steadily reduced the average corporate rate to 26.6%.¹⁰ Interim reductions in the corporate income tax with a goal of eliminating them entirely could transition the effect of reduced government revenues from this source of taxation while allowing greater resources to remain with corporations for investment in personnel, equipment and economic growth. An in depth simulation demonstrates that repealing the corporate income tax would cost approximately \$300 billion in annual tax revenue from that source but result in two years in an additional 2 million jobs, \$280 billion in inflation-adjusted GDP, \$4,000 more in real disposable income for a family of four and \$707 billion more in household net wealth.¹¹

Alternative Minimum Tax: Alternative Minimum Tax (“AMT”) is a questionably good idea gone bad. Originally enacted in response to “zero taxpayer millionaires,” its breadth has steadily increased until it is expected to reach about 30 million taxpayers in 2010.¹² It constitutes a mind-numbing complex parallel taxing system requiring duplication of books and records thereby increasing compliance costs. Both the individual and corporate AMT should be repealed, resulting in simplification of the taxing system and elimination of tax-driven distorted business decisions.

Transfer Taxes; Estate, Gift and Generation Skipping Transfer Taxes: For 2010 only, the estate tax and generation skipping tax are repealed and the maximum gift tax rate is 35%. In 2011, both taxes return and the maximum gift and estate tax go to 55%, which is also the flat rate on generation skipping transfers.¹³ Death taxes raise only about 1% of federal revenues but this is offset by roughly the same amount lost from avoidance, compliance and enforcement costs.¹⁴ Aside from the questionable economics of these taxes, they punish hard work and success. These transfer taxes are instruments of social change, not fiscal need.

Americans of all economic strata realize the inherent unfairness of making death a taxing event.¹⁵ Although this tax may be the most blatant example of the federal government’s intrusive efforts to redistribute the hard-earned wealth of its citizens, repeal of this tax is not about protecting the wealthy. This is about creating jobs and protecting working families. With our unemployment the highest it’s been in 26 years, former Congressional Budget Office Director Doug Holtz-Eakin found that Congress could create more than a million new jobs just by acting now to permanently repeal the federal death tax.¹⁶ The permanent repeal of this

⁸ *Cato Handbook*, page 426.

⁹ IRC Section 11(b).

¹⁰ *Time for a Real Change: Repeal the Corporate Income Tax*, Karen A. Campbell, Backgrounder, The Heritage Foundation, No. 2248, March 13, 2009 (hereinafter “*Time for a Real Change*”), page 2.

¹¹ *Time for a Real Change*, pages 1, 2, Appendix C.

¹² *Cato Handbook*, page 427.

¹³ IRC Sections 2001 and 2641.

¹⁴ *Cato Handbook*, page 427.

¹⁵ *Seven Reasons Why Congress Should Repeal, Not Fix, the Death Tax*, William W. Beach, Backgrounder, The Heritage Foundation, No 2688, November 9, 2009.

¹⁶ Holtz-Eakin, Doug; “Changing Views of the Estate Tax: Implications for Legislative Options”; February 2009.

counterproductive and destructive tax would create thousands of new jobs in Arkansas and help Arkansas' working families. And *the federal government's tax revenues would actually increase, because the taxes generated by the new jobs created will actually exceed the amounts that would have been collected from death taxes.*¹⁷

Employment Taxes: Employment taxes (Social Security, aka FICA and OASDI, and Medicare Tax) take 15.3% of all wages from the first dollar to \$106,800 in 2010. Every dollar above that amount is subject to the 2.9% Medicare Tax. The imposition of a 3.8% tax on investment income under the guise of Medicare which is part of the recent health care legislation signals a policy break from the inception of these taxes.¹⁸ Heretofore these taxes were paid only on "earned income" and not "passive income" such as dividends, rents, capital gain, interest and the like. Once this connection is broken, there is no theoretical limit on the sources of income or wealth to which these taxes can be applied. To restore the integrity of employment taxes, the imposition of employment taxes on unearned income should be repealed. Reform of employment taxes will only be possible with reform of this single largest entitlement of the federal government, Social Security.¹⁹

¹⁷ Entin, Stephen, "Economic Impact of the Estate Tax: Effects of Various Possible Reform Options," American Family Business Foundation, June 2009, page 3, www.nodeathtax.org/files/AFBF_Entin_2009.pdf.

¹⁸ Health Care and Education Reconciliation Act of 2010, Section 1402.

¹⁹ Good background reading on these issues are, *Hiring Tax Credit Will Not Create Long-Term Jobs*, Curtis S. Dubai, Backgrounder, The Heritage Foundation, No. 2791, February 3, 2010 and *Payroll Tax Holiday: Adding to Growing Social Security Deficits*, John L. Ligon, Backgrounder, The Heritage Foundation, No. 2374, February 22, 2010.