

PRESIDENT'S ADVISORY
PANEL
ON FEDERAL TAX REFORM

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March 7, 2005

Dear President's Advisory Panel on Federal Tax Reform,

Enclosed is a tax plan the President could use to:

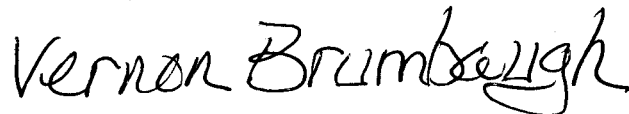
1. Simplify our current tax code while being fair to all taxpayers, and
2. Help reduce the deficit by improving the effectiveness of our international trade.

This tax plan eliminates unfair competition caused by tax free imports. This will allow our manufactures to compete with imports while keeping good jobs at home.

Finally, there is no need for an alternate minimum tax on either income or business since there are only a handful of deductions in the entire code.

I wrote this paper about 7 years ago, but it is just as pertinent today.

Sincerely,



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A FAIR AND SIMPLE TAX CODE

Year after year the American public is subjected to the great tax reform debate: the attempt to devise a system of tax collection which is both fair and simple. New tax codes have been proposed that are simple to explain, but none of them qualify as fair. To assess the fairness of any new proposal, it is necessary to understand how our current tax code works.

We have three major sources of tax revenue. They are: (1) payroll taxes on wages for Medicare and Social Security, (2) income tax, and (3) the business tax.

The Medicare tax is a flat 2.9% on all wages. The 12.4% Social Security tax is regressive because it applies to only the first \$68,000 of wages (the 1997 cutoff value). The income tax is highly progressive with many tax brackets (15, 28, 31, 36, and 39.6%) that take effect as income increases. Note that the payroll taxes are expressed as the total (employee plus employer) value, since the employer's contribution is mainly obtained from a reduction in salaries.

Figure 1 shows the 1997 total Federal tax (income plus Social Security and Medicare taxes) along with its three components. To keep matters simple, no investment income and no deductions for contributions or home mortgage are included. Also, payroll tax refunds for low income taxpayers are ignored.

The taxes are shown for heads of households as a percent of income. The income tax on heads of households falls about half way between the tax on single and married taxpayers, and was chosen to represent a typical result.

The total Federal tax is progressive up to the \$68,000 Social Security cutoff, i.e., as income increases a greater percentage tax is paid. At greater incomes the lack of additional Social Security revenue is initially offset by the 28% income tax bracket. As a result the total Federal tax percentage remains essentially constant for incomes between \$68,000 to about \$140,000. At higher incomes the 36% bracket takes effect and again results in a progressive tax. Thus the progressive income tax code is used to compensate for the regressive Social Security tax, resulting in a total Federal tax that is mostly progressive.

Our business tax is applied to business profits. The calculation of profits starts with sales revenue minus purchases from other firms. Then the cost of investments, wages, benefits, and interest are subtracted before computing the tax.

The business tax on profits and the income tax are loaded with numerous special interest deductions. Both tax codes include an alternate minimum tax (computed while allowing no deductions) in an attempt to reduce tax avoidance through excessive use of deductions.

Every other country in the world taxes business with a value added tax which allows only purchases from other firms and investments to be deducted from sales revenue before computing the tax. Thus the value added tax is simply a tax on net sales minus investment in plant and equipment during the past year.

An important feature of the value added tax is its ability to assure that international trade is taxed fairly. By international agreement, exports are excluded from the value added tax of the exporting country. Instead, the tax is applied by subjecting exports to the value added tax of the importing country. This assures all international trade is taxed exactly once by the same value added tax paid by the domestic manufacturers.

Our business tax on profits does not qualify as a value added tax because wages and benefits are deducted from net sales before computing the tax. Consequently, international law requires our exports to be subjected to our tax on profits plus the value added tax of the importing country. In addition, our business tax cannot be applied to foreign imports which enter our country tax free.

The double taxation of our exports is partially alleviated by approximately 50 bilateral tax treaties designed to recover some of our business tax on exports. Unfortunately, these treaties do not address the problem of unfair competition caused by tax free imports.

The most talked about proposal for a new tax code is the Flat Tax. The original proposal for a Flat Tax would replace the current income tax code with a 19% tax on personal income above a large standard deduction of about \$25,000. The current business tax on profits would be replaced with a 19% tax on earnings, i.e., sales revenues minus purchases from other firms, investments, and wages. The net result of these two 19% taxes is to halve the tax raised from income while tripling the tax on business. The

plan is designed to be revenue neutral since the same total tax is raised from both sources.

The Flat Tax is simple to explain. Whether it is fair depends on how it affects the total Federal tax. It is also important to observe its effect on international trade.

The Flat Tax retains the 2.9% Medicare payroll tax on all wages. It also retains the 12.4% Social Security payroll tax on just the first \$68,000 of wages. Figure 2 shows the effect of combining a flat 19% personal income tax with the regressive Social Security tax, and compares the result with the current Federal tax.

Under the Flat Tax code, the total Federal tax is progressive for incomes less than the Social Security cutoff. But at greater incomes the total Federal tax becomes regressive, since the 19% income tax does not compensate for the lack of additional Social Security revenue. As a result, the affluent benefit most from the Flat Tax at the expense of those who pay the Social Security tax on their entire salary. Taxpayers in the upper 1% of income (incomes greater than \$350,000) would have their Federal taxes reduced by almost 40% relative to the current tax code.

The 19% Flat Tax on earnings does not qualify as a value added tax because wages are deducted before computing the tax. Our domestic manufacturers would have to pay three times as much business tax and then compete with tax free imports. Thus the Flat Tax is unfair to both the average taxpayer and business. It would provide the greatest benefits to the most affluent taxpayers and increase the problem caused by tax free imports.

The following code for a new "Fair and Simple Tax" is designed to improve on both our current tax code and the Flat Tax. This proposed code is based on three principles:

1. The regressive Social Security tax must be replaced with a flat rate to achieve a code that is both fair and simple. An 8.5% Social Security tax on all wages will raise the same revenue as the current 12.4% tax on just the first \$68,000, and solve the dilemma of fairness versus complexity.
2. All income tax deductions (except for home mortgage and charitable contributions) are replaced with a \$25,000 standard deduction. Taxing income above a large standard deduction is a step toward fairness for low and average income taxpayers. When

combined with a Social Security tax on all wages the large standard deduction results in a total Federal tax that is progressive at all income levels, even when using a single tax rate on the remaining taxable income.

3. Business must be taxed on the basis of value added. Trade to and from our country will now be taxed fairly.

To gain the trade benefits associated with the value added tax requires the elimination of all business deductions such as health insurance and the employer contribution to Social Security. However, the value of these deductions is not lost to taxpayers since their elimination from the business tax will allow an equal reduction in the income tax.

Another issue is the proper ratio between the revenues raised by the personal income tax and a value added business tax. Currently we raise four times as much money from the personal income tax as from the business tax. To maintain this ratio requires a value added tax rate of 11%.

The business tax is primarily a tax on consumption. A 15% value added tax on business is recommended as a reasonable compromise between taxing consumption versus a tax on income. It provides approximately a 40% increase in revenue relative to the current business tax on profits and allows an additional reduction in the income tax rate by about two percentage points. It is also the same value added tax agreed to by the European Common Market.

The Fair and Simple Tax is designed to be revenue neutral. This requires the sum of business plus income taxes to remain constant. Starting with a 15% value added tax on business, a revenue neutral tax code requires a single tax rate on personal income above \$25,000 of about 24%.

Three other additions to the tax code are recommended to ensure fairness:

1. The upper five percent of income earners would be required to pay an additional tax of 4 points or 28% on their taxable income above \$150,000. This additional revenue is used to reduce the initial tax rate (on incomes above the \$25,000 standard deduction) from 24 to 22%.
2. Half of all investment income (interest, dividends, and capital gains) would be included as taxable income. Thus all investment income is treated equally with a favorable tax rate.

3. Payroll taxes on wages less than \$15,000 will be returned to the taxpayer by the Social Security Administration. At incomes of \$25,000 and above there would be no refund.

By using two tax rates (22 and 28%) the tax on income is reduced (relative to the current code) by about 25% for all incomes greater than \$50,000. At lesser incomes the percentage reduction is greater thanks to the large standard deduction. In addition, workers with wages less than \$68,000 will also have their payroll taxes reduced from 12.4 to 8.5%, while workers with higher wages will pay an 8.5% payroll tax on wages that were not taxed before. Thus the Fair and Simple Tax code shifts the Federal tax burden toward the higher income levels. However, high income taxpayers are not likely to complain since they will benefit from a maximum tax of 14% on capital gains, dividends, and interest and their heirs will benefit from the elimination of the estate tax.

The flat 8.5% Social Security tax is intended to fairly distribute the cost of the program without changing the monthly checks. This requires limiting the annual earnings used in the Social Security benefit calculations to the original cutoff value, i.e., the average annual wage which was \$68,000 in 1997.

The value added tax encourages growth in business by allowing deductions for capital investments in plant, equipment, and land to be written off immediately following the year in which they occur. Imports would now face the same tax as our domestic manufacturers, eliminating the tax incentive for moving jobs overseas. Corporate welfare would be eliminated since no special benefits, subsidies, or additional deductions are allowed. The corporate choice between debt and equity would no longer be influenced by taxing dividends and not the interest on corporate debt, since the value added tax does not allow the deduction of either one.

Private saving and investment would be stimulated as a result of taxing only half of investment income. 401(k) retirement plans would be maintained and encouraged.

The above discussion has demonstrated that a tax plan can be both fair and simple and eliminate the need for tax advisors and estate planners. The limited number of deductions also eliminates the need for an alternate minimum tax for either the income tax or the value added business tax.

In summary, the tax code for a Fair and Simple Tax becomes:

1. An 8.5% Social Security payroll tax on all wages.
2. A 2.9% Medicare payroll tax on all wages.
3. A 15% value added tax on business.
4. A 22% income tax on taxable income above \$25,000 after deductions for charitable contributions and home mortgage.
5. A 28% income tax on taxable income above \$150,000.
6. Half of all investment income (interest, dividends, and capital gains) are taxed as ordinary income.
7. Payroll taxes on incomes less than \$15,000 are refunded.

Figure 2 compares the total Federal tax raised by the Fair and Simple Tax with that of our current tax code and the Flat Tax. The curve for the Fair and Simple Tax is everywhere progressive. It provides a significant tax reduction for most taxpayers with the greatest percent reduction going to the lower incomes. For example, the reduction is 7% for the upper 1% of income earners making more than \$350,000, while at incomes of \$68,000 or less the reduction is 25% or more.

This reduction in the total Federal tax is paid for by eliminating all deductions except for the large standard deduction, home mortgage, and contributions to charities. Additional revenue is raised by replacing the current business tax on profits with a 15% value added tax.

This revenue neutral plan is offered as a fair, simple, and efficient method for raising the taxes required by our country.

Figure 1. 1997 Taxes as Percent of Income

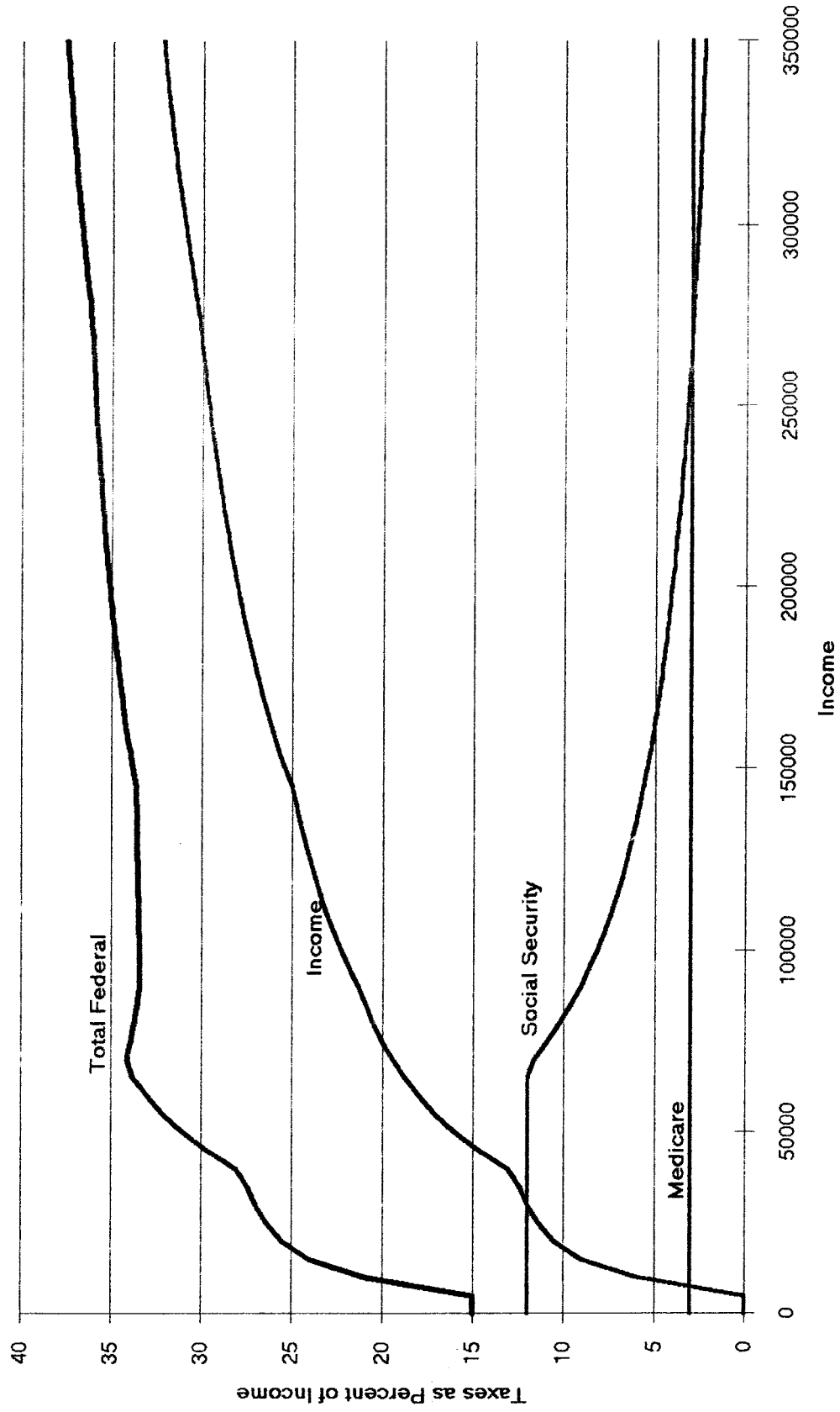


Figure 2. Total Federal Tax as Percent of Income

