Research

Principles of Tax Reform

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The U.S. personal and corporation income taxes are overly complicated, outdated, inefficient, burdensome, anti-growth, and hinder U.S. competitiveness. There is a clear need for reforms. What principles should govern reform of the U.S. income taxes?

1. The Tax System Should Be Based on Core Values

The tax code raises revenue. But it should be more than a haphazard collection of provisions that add up to a revenue target. Instead, it should be built to support core values and the pursuit of overall economic objectives.

The overriding economic imperative of this age is more rapid long-term economic growth. To support that objective, the tax code should reward saving and investment in physical capital, technological capital, and human capital. The mirror image of supporting saving and investment is taxing consumption. Since consumption represents what each individual or family takes *out* of the economy, this is consistent with an ethical foundation of taxing on the basis of what one takes out of society. An income tax, on the other hand, puts the burden on labor and capital income. In contrast to a tax on consumption, this taxes more heavily those that contribute the most labor effort or capital to the economy.

2. The Tax Code Should Be a Simple, Transparent Reflection of those Values

The U.S. income tax has been built on a principle of voluntary compliance. Unfortunately, a convoluted, opaque tax code makes it difficult for taxpayers to easily discern the link between their tax liabilities and the overall objectives of the code. This feeds the perception that the code can be manipulated and is unfair, which undercuts the incentives for voluntary compliance.

3. Spending Does Not Belong Hidden in the Tax Code

The tax code should be designed to *raise* revenue. Unfortunately, over time key spending programs to support work and incentivize research have been embedded in the tax code, such as the Earned Income Tax Credit (EITC) and the Research & Experimentation Tax Credit. The policy objectives of these programs are sound, but they should be classified for what they are: spending programs.

4. Growth and International Competitiveness are the Key Imperatives

A tax code focused on growth and international competitiveness will have three key features: (1) strong incentives for saving and investment, (2) non-interference in the allocation of capital among its competing uses, and (3) a move toward taxing firms on the basis of their activity in the United States – not worldwide – consistent with the approach of our competitors.

Too much attention has been focused on using the tax code for redistribution. A second lesson of reclassifying the EITC is that it makes it clear that the bulk of redistribution is done on the spending side of the federal budget. The need to support growth furthers the case that the tax code should not be a vehicle for redistribution.

A Model Tax Reform

Among the plans presented to the Tax Foundation is a progressive consumption tax in the style of David Bradford's X-tax. The plan would eliminate the current individual and corporate tax code. On the business side, the tax base would be cash flow of all businesses, corporate and non-corporate. Firms would be able to deduct, among other items, purchases from other businesses and employee compensation. Notice that this provides non-taxation of capital investment (purchases of capital goods from other businesses), human capital investment (purchases of training or schooling) and technological investment (investment in labs, purchases of lab services, and lab workers). The rate applied to the remaining revenue is flat and set at the top rate for the household portion of the tax.

On the individual side, tax rates for joint filers would be 15 percent on first $50,000; 25 percent on next $100,000; and 35 percent over $150,000. Brackets for all unmarried taxpayers are half these amounts. All brackets indexed for inflation after 2015 by the chained Consumer Price Index. There would be an exemption from taxation of income equal to 100 percent of the federal poverty limit up to a family size of 2. This limit would also be indexed at the rate of inflation.

The plan contains few tax credits: a new credit of 15 percent of charitable contributions in excess of $500 and a new refundable credit for first-time homebuyers (as defined for the American Recovery and Reinvestment Act credit) equal to 15 percent of the value of the purchased home, claimed in five equal installments (i.e., 3 percent of the value) in each of the first 5 years of ownership. The existing mortgage interest deduction would be phased out for existing mortgages over 10 years.