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THE NEXT STEP FOR TAX RELIEF AND REFORM

DANIEL J. MITCHELL, PH.D.

President George W. Bush's tax relief package, by reducing tax rates on work, saving, and investment, will boost economic growth and reduce the burden of government for all taxpayers; but it should also be viewed as only a first step. The White House and congressional leaders should put further tax relief and reform on the agenda because:

- **The tax burden is still too high, inhibiting economic growth.** Because many tax rates remain too high, federal tax revenues are expected to climb from $2 trillion to $3.5 trillion over the next decade.
- **Additional tax cuts can bring us closer to a flat tax.** Pro-growth tax cuts, such as repeal of the capital gains tax, expensing of business investment, and universal IRAs, are important reforms that move the Internal Revenue Code closer to a flat tax.
- **A lower tax burden will help control federal spending.** Budget surpluses between 1998 and 2001 undermined fiscal discipline. Indeed, federal spending grew twice as fast when the budget was in surplus as it did when the budget was in deficit.
- **Pro-growth tax reforms enhance international competitiveness.** America's overall tax burden is low compared to Europe's, which helps explain why our economy is stronger. But some changes, such as eliminating worldwide taxation of corporate income, would help ensure that the United States remains the world's strongest economy.

Lawmakers should remember that simply handing money to people—for example, through rebates and credits—does not stimulate additional economic activity. Tax cuts will improve the economy's performance only if they increase incentives to work, save, and invest. To generate economic benefits, tax reform should focus on three goals:

1. **Lower rates.** A tax cut that reduces marginal tax rates will boost incentives to create jobs, increase income, and generate wealth.
2. **Less double taxation of savings and investment.** Income from savings and investment often is taxed more than once. This anti-capital bias in the tax code reduces productivity growth and makes America less productive.

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3. **Simplicity.** Eliminating some of the most counterproductive and confusing sections of the tax code would substantially reduce the tax system's huge $200 billion compliance burden.

Fortunately, there are many tax cuts that satisfy these criteria. With regard to both the personal income tax and the corporate income tax, the options include:

- **Accelerated tax rate reduction.** Much of the Bush tax cut, including rate reductions and death tax repeal, does not take effect until 2004, 2006, and 2010. Deferring rate reductions inevitably means that their economic benefits also will be delayed. All scheduled tax rate reductions should take effect immediately.
- **Permanent tax cuts.** Almost all of the tax cuts approved last year will disappear in 2011. Even the pro-growth provision of the 2002 stimulus bill—easing the depreciation tax on business investment—vanishes after just three years. To ensure that rate reductions have a significant effect on growth, all supply-side tax cuts should be made permanent.
- **Capital gains relief.** Like the death tax, the capital gains tax is a form of double taxation that should be abolished. It penalizes investment, hinders capital mobility, suppresses job growth, and undermines U.S. competitiveness. At the very least, reducing this tax would boost financial markets and be a big step toward a simple and fair tax code.
- **IRA expansion.** People should not be double taxed on income that they save and invest. To eliminate this bias in the tax code, all savings should receive IRA treatment. For simplicity and privacy, the back-ended (Roth) IRA is preferable, but any shift toward a system that taxes income only once would be an improvement.
- **Repealing the alternative minimum tax (AMT).** The alternative minimum tax is a parallel tax system for individual and corporate taxpayers deemed to benefit from "too many" deductions, credits, and other preferences. Many tax code preferences should not exist, but the AMT is an extremely costly and inefficient way of addressing the problem.
- **Ending double taxation of dividends.** The income earned by shareholders is taxed twice—by the corporate income tax and then by the personal income tax. As a result, the actual tax rate imposed on corporate earnings can be well over 50 percent. This anti-investment feature should be abolished, preferably at the individual level for reasons of simplicity and privacy.
- **Corporate rate reduction.** Corporations do not pay tax; they simply collect taxes that are borne by shareholders, workers, and consumers. Reducing the corporate tax rate will improve incentives to invest and make U.S.-based companies more competitive in the global economy.
- **Territorial instead of worldwide taxation.** The United States taxes income earned in other countries. This policy results in heavy compliance costs, interferes with the sovereignty of other nations, and puts U.S. companies at a competitive disadvantage. A territorial system, by contrast, only taxes income earned in the United States and will make American companies more competitive.
- **Expensing instead of depreciation.** When a business makes an investment, it often is not allowed to subtract that cost immediately when determining taxable income. This punishes companies for boosting worker productivity. Allowing those costs to be deducted when they are incurred would greatly simplify the tax system and increase incentives to invest.

Lower tax rates on productive behavior lead to a stronger economy because workers, investors, and entrepreneurs are not penalized for creating wealth. Good tax policy also helps control the size of government by reducing tax revenues and keeping resources in the productive sector of the economy. The tax reforms listed above are a good first step toward overdue reform.

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NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

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The Internal Revenue Code needs reform, and taxpayers need relief. The tax code is a nightmare of complexity, entailing nearly 1,100 separate forms and publications. Federal tax revenues consume more than 19 percent of national economic output, a burden that is high by historical standards, and tax rates on productive activity are still far higher then they were when President Ronald Reagan left office.

President George W. Bush's tax relief package from last year is a step in the right direction. By reducing marginal tax rates on work, saving, and investment, the President's tax cut will boost economic growth and reduce the burden for all taxpayers. If repeal of the death tax is achieved, it will eliminate a long-standing injustice in the tax code and significantly reduce inefficient and costly tax planning.

But the Administration's tax package should be viewed as only a first step in a series of long-overdue reforms. The White House and congressional leaders should put further tax relief and reform on the agenda because:

- **The long-term budget surplus is larger than anticipated.** The most recent figures from the Congressional Budget Office indicate that surplus revenues will total $1.6 trillion over the next 10 fiscal years,[1] and that includes the revenue effect of last year's modest $1.28 trillion tax cut.
- **Additional tax relief will boost the economy's performance.** Tax rates remain far too high. To energize a soft economy, lawmakers should seek far larger reductions in the tax penalties that are imposed on productive behavior. If Russia can have a 13 percent flat tax, U.S. lawmakers should be able to reduce America's top tax rate to 28 percent.
- **Additional tax cuts will help pave the way for institution of a flat tax.** Lowering tax rates and repealing the death tax are important steps toward fundamental tax reform, but large projected surpluses now create a golden opportunity to address other inequities in the

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1. Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2003–2012*, January 2002, at *http://www.cbo.gov/showdoc.cfm?index=3277&sequence=0&from=7*.

tax code and eliminate many of the 1,100-plus forms required by the Internal Revenue Code.[2]

- **Lowering taxes will help control federal spending.** The tax "cut" of 2001 only reduced the growth rate of tax collections. Federal tax revenues are still expected to climb from $2 trillion to $3.5 trillion throughout the next decade.[3] More money in Washington will mean more spending. Budget surpluses between 1998 and 2001, for instance, undermined fiscal discipline, and spending grew twice as fast with budget surpluses as it did when the budget was in deficit.[4]
- **Pro-growth tax reforms enhance international competitiveness.** America's economy has outperformed the economies of its major trading partners, in large part because our overall tax burden is low by industrial-world standards. The United States also is viewed by foreign investors as a safe haven. Additional pro-growth tax cuts will attract even more investment and further establish the United States as the world's strongest economy.

NOT ALL TAX CUTS HELP THE ECONOMY AND SIMPLIFY THE TAX CODE

The benefits discussed above will occur only if lawmakers choose the right *kind* of tax cuts. Tax cuts that simply hand money to people—such as rebates and credits—do not stimulate additional economic activity because there is no incentive to work more, save more, or invest more. These "Keynesian" tax cuts merely give individual taxpayers money that otherwise would have gone to individuals in private credit markets. Even from the discredited Keynesian approach, this type of tax cut is ineffective since it does not yield added purchasing power in the economy.

Economic growth, by definition, means an increase in national income. Tax cuts will improve the economy's performance only if they increase incentives to work, save, and invest. To generate economic benefits, tax cuts should focus on three goals:

1. **Lower rates to stimulate productive activity.** Taxes are, essentially, penalties on productive behavior; the higher the rate, the steeper the penalty. A tax cut that reduces marginal tax rates will boost incentives to create jobs, increase income, and generate wealth. Simply stated, people are more likely to work, save, and invest when they can keep more of the money they earn.
2. **Reduce double taxation on savings and investment.** Income from savings and investment often is taxed more than once, compounding the damage caused by high marginal tax rates. Indeed, one dollar of income could be subject to four different kinds of taxation—personal income tax, corporate income tax, capital gains tax, and death tax. The anti-capital bias in the tax code reduces America's productivity growth. Although it would be best to eliminate all incidents of double taxation (as a flat tax would), any tax cut that moves in that direction will improve the economy's performance.
3. **Simplify the tax system.** With more than 1,100 forms and publications, our tax code has become a nightmare of complexity that imposes a hidden compliance tax of at least $194 billion each year.[5] Many tax cuts, particularly those that reform the Internal Revenue Code, can substantially reduce the compliance tax by eliminating some of the most counterproductive and confusing sections of the tax code.

A variety of tax cuts satisfy the goals listed above. Indeed, the two main components of the President's 2001 tax cut—reductions in marginal tax rates and repeal of the death tax—make progress in this direction. However, additional reform is needed to reduce the tax burden and reform the tax code.

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2. Forms and Publications, IRS Web site, at *http://www.irs.gov/forms_pubs/formpub2.html*.
3. CBO, *The Budget and Economic Outlook: Fiscal Years 2003–2012*.
4. Historical Budget Data, CBO website, at *http://www.cbo.gov/showdoc.cfm?index=1821&sequence=0&from=7*.
5. Scott Moody, "The Cost of Tax Compliance," Tax Foundation, February 2002, at *http://www.taxfoundation.org/compliance2002.html*.

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THE NEXT STEPS FOR TAX REFORM

The Bush tax cuts—particularly the marginal tax rate reductions and putative repeal of the death tax—will boost economic performance and make the tax code fairer. However, these tax cuts are just a small step toward the reform that is needed. Large budget surpluses and a soft economy indicate that further tax relief is both desirable and possible.

But not all tax cuts are created equal. Some proposals further complicate the tax code and create preferences for the well-connected and politically powerful. Pro-growth tax cuts, by contrast, result in a system that is fairer and less complicated. The tax cuts described below should be implemented as part of a comprehensive effort to move the tax code toward a single-rate, consumption-based system.

Implement the Bush tax cuts immediately.

Problem: Delayed implementation of tax cuts dampens the economy's short-term performance. The majority of personal income tax rate reductions in the Bush tax cut do not take effect until 2004 and 2006, and repeal of the death tax does not take effect until 2010. If lower rates are phased in over an extended period of time, taxpayers may choose to defer economic activity until the cuts take effect. This creates a perverse incentive that could dampen the economy's short-term performance.

Solution: Make tax cuts effective immediately. Lower tax rates improve incentives to work, save, and invest. However, these beneficial results will not occur until rate reductions actually take effect. Tax rate reductions, therefore, should take effect immediately.

Incremental Changes. Lawmakers can choose to accelerate reductions in some tax rates but not in others. They also can choose to have tax rate reductions take effect sooner—for example, in 2003 and 2005 instead of 2004 and 2006. These incremental steps for accelerating reductions are inferior to full and immediate implementation of rate cuts. If lawmakers opt to take only incremental steps, they should begin with reductions in the highest tax rates to generate the greatest economic benefits.

Make the Bush tax cuts permanent.

Problem: Sunsetting tax cuts blunts pro-growth impact. All of the significant provisions of the Bush tax cut will sunset in 2011. At that time, personal income tax rates will climb back to Clinton-era levels and the death tax will reappear. This situation is the perverse result of budget rules that required a 60-vote supermajority in the U.S. Senate to make the Bush tax cut permanent.

Solution: Make tax cuts permanent. Tax rate reductions increase incentives to work, save, and invest; but if taxpayers know that tax rates will increase in the future, they will adjust their plans accordingly. Long-range choices—particularly investment decisions—are the most likely to be affected by the existence of a future tax increase. To protect the economy from the adverse effects of a substantial tax increase in 2011, this sunset clause should be removed.

Incremental Changes. If they are reluctant to make the President's tax cuts permanent, lawmakers could at least choose to extend them. Although this would protect the economy from a tax increase in 2011, it is not a long-run solution. Unless the extension was for a sufficiently long period (for example, until 2050), some investors would still choose to curtail their activities.

Implement capital gains tax relief.

Problem: Taxing the increase in the value of assets is double taxation. Under current law, investors are subject to a tax when they sell an asset for more than its original purchase price. The tax imposed on a "capital gain" depends on the asset and how long it has been owned, but the general rate is 20 percent. Since assets are purchased with after-tax income, however, any tax on an increase in the value of that asset is a form of double taxation. This creates a bias against capital formation since there is no comparable second layer of tax on after-tax income that is consumed. Looking at the issue from another perspective, assets rise in value because of a market expectation of higher future returns, yet that future income, should it actually material-

ize, will be taxed. To tax the mere expectation of the income is a form of double taxation.

Solution: End double taxation to encourage capital formation. The simple maxim that no income should be double taxed dictates that the capital gains tax should be abolished.[6] Many of our major trading partners, in fact, have no capital gains tax.

Incremental changes. The most straightforward change would be to lower the capital gains tax rate. If the tax rate is constantly lowered, it could eventually reach the proper level—zero. Another potential incremental reform is to index the capital gains tax adjusting for inflation, thus protecting investors from having to pay a double tax on gains that represent nothing more than a general rise in overall price levels.

Implement IRA expansion.

Problem: Double taxation discourages savings. Taxpayers must pay tax on their income when it is earned, and then they must pay a second layer of tax if they save some money and earn a return. Yet there is no equivalent second tax burden if they consume their income. This tax bias against savings and investment penalizes thrift and reduces capital formation.

Solution: Apply the IRA system to all savings. A neutral, fair tax system would not impose a higher tax burden on income that is saved and invested than on income that is consumed.[7] Individual retirement accounts protect taxpayers from having to pay two layers of tax on income that is saved. IRAs can be "front-ended," meaning that the income that is saved is deductible but will be subject to tax when interest and principal is withdrawn. Alternatively, they can be "back-ended," meaning that the income is taxed the year it is earned but no additional tax is levied on interest if that after-tax income is saved. Regrettably, there are very restrictive rules regarding who can benefit from IRAs and how much income can be protected; the limit is between $2,000 and $5,000 annually. Ideally, all savings should receive IRA treatment. To achieve this goal, all restrictions on the size of IRAs should be eliminated. In addition, there should be no limitations regarding when money can be withdrawn or how that money can be used.

Incremental changes. If it is not possible to expand the IRA system to include all savings, incremental changes could be made with regard to taxation of savings. One simple way to reduce the double taxation of savings would be to increase IRA contribution limits. In addition, lawmakers could eliminate current restrictions that prevent upper-income taxpayers from using IRAs.

Repeal the personal alternative minimum tax.

Problem: The AMT seeks to reduce the value of deductions, credits, and other preferences within the system. Individual taxpayers who have deductions that are considered too high for their income are required to recalculate their taxable income using the AMT and then pay as much as a 28 percent tax on that amount. The AMT is an extremely costly and inefficient way of addressing the problem of excessive deductions.

Solution: The AMT should be repealed. A far better approach is to finance across-the-board tax rate reductions by repealing needless tax preferences.

Incremental changes. Lawmakers could mitigate the effect of the AMT by determining that certain deductions are not "AMT preferences." Alternatively, they could lower the AMT tax rate so that the re-calculation of taxable income would not be as likely to result in a significantly higher tax burden.

6. Stephen Moore and Phil Kerpen, "A Capital Gains Tax Cut: The Key to Economic Recovery," Institute for Policy Innovation *Policy Report* No. 164, October 11, 2001, at *http://www.ipi.org/ipi/IPIPublications.nsf/4e3087e6ce3d8be6862567d8006fd628/78e185b636384d4d86256ae2002b4f65?OpenDocument*.

7. Stephen Entin, "Fixing the Saving Problem: How the Tax System Depresses Saving, and What to Do About It," Institute for Research on the Economics of Taxation, August 6, 2001, at *ftp://ftp.iret.org/pub/BLTN-85.PDF.*

Eliminate the double taxation of dividends.

Problem: Double taxing dividends discourages investment. Income earned by shareholders is taxed twice. After the 35 percent corporate income tax is applied at the company level, the personal income tax takes as much as 38.6 percent of any after-tax profits that are distributed to shareholders. The combination of these two levies can result in an effective tax rate of more than 60 percent on corporate earnings.

Solution: Integrate personal and corporate income tax codes. A 60 percent tax rate surely discourages investment. The personal and corporate income tax codes should be integrated, thereby eliminating this explicit form of double taxation. The easiest way to eliminate the double tax is to stop requiring individuals to pay the second layer of tax. This approach has numerous advantages, particularly the reduction in paperwork and the enhancement of privacy.

Incremental changes. Reducing the individual income tax rate on dividends would be one way to lower the level of double taxation. Lawmakers, for instance, could tax dividends at the capital gains rate. This policy would reduce the burden of double taxation on corporate earnings and also eliminate any tax-driven reason for investors to prefer retained earnings instead of distributed earnings. Alternatively, lawmakers could create an exclusion by applying the individual income tax to, for example, 50 percent of dividend income.

Reduce corporate tax rates.

Problem: An excessive corporate tax rate penalizes productive activity. The corporate income tax rate in the United States is 35 percent—higher even than the corporate tax rates in such nations as France and Sweden. By taking more than one-third of business profits, this tax imposes a substantial penalty on business activity. Corporate taxes are borne by shareholders, workers, and consumers. As owners of the corporation, shareholders pay the initial tax, but workers and consumers suffer as well because of higher prices and lower wages.

Solution: Reduce the corporate tax rate. Reducing the corporate tax rate will improve incentives to invest and make U.S.-based companies more competitive in the global economy. Ultimately, the corporate tax should be as low as possible.

Incremental changes. Even a modest reduction in the corporate tax rate (just one or two percentage points, for example) would have an impact on investment and U.S. competitiveness.

Institute territorial rather than worldwide taxation.

Problem: Worldwide taxation imposes high compliance costs and collects little revenue. The Internal Revenue Code seeks to tax income that is earned by U.S. taxpayers in other countries. This hurts all taxpayers, but it has a particularly adverse impact on American-based companies and has even led some firms to re-domicile in low-tax jurisdictions like Bermuda.

Solution: Adopt territorial taxation. Countries should not tax income that is earned in other nations. A territorial tax system respects the sovereign prerogative of each nation to tax the income earned within its borders and is much simpler to administer since it does not require complicated tax treaties or intrusive tax information exchange agreements.[8] Perhaps most important, a territorial system facilitates tax competition among nations since politicians are aware that excessive taxation will lead investors and entrepreneurs to shift activity to more market-friendly jurisdictions.

Incremental changes. If a complete switch to territorial taxation is not immediately possible, lawmakers should shift in that direction by implementing territorial taxation for corporate income. This step would help U.S. companies compete and—unlike existing provisions of U.S. tax law for overseas income—is fully compliant with international treaty obligations.

8. See, for instance, *http://www.freedomandprosperity.org/ltr/ctc2/Territorial.pdf*.

Adopt a system of expensing rather than depreciation.

Problem: Depreciation penalizes investment and discourages capital formation. When businesses invest in new plants or equipment, they are not allowed to deduct those costs in the year that they are incurred. Instead, they can only deduct a portion of the costs in the first year and then write off the rest over a period of years through a process known as depreciation. Depending on the asset, it may take as long as four decades for a business to depreciate the full cost of an investment. The 2002 stimulus legislation temporarily reduces this tax on certain investments by increasing the amount of depreciation that is available for the next three years. Depreciation is both an administrative headache and a tax penalty on investment.

Solution: Allow expensing to deduct costs when they are incurred. A neutral tax code would allow all costs to be recognized and deducted when they are incurred. This commonsense practice is known as expensing. Taxable business income should be calculated by subtracting total costs from total revenue, not by forcing companies to act as if certain costs occur in the future. Shifting from depreciation to expensing will reduce the bias against capital formation and therefore lead to more investment and higher wages.[9]

Incremental changes. The ideal reform would be to shift immediately to a system of expensing capital expenditures. Short of that, any change that allows businesses to deduct costs more quickly is a step in the right direction. In the tax policy community, this policy is known as "shortening asset lives" or "compressing depreciation schedules." Another reform would be to make the provisions of the 2002 stimulus legislation permanent.

Repeal the corporate alternative minimum tax.

Problem: The AMT entails large compliance costs and brings in little revenue. Like individuals, businesses are forced to pay an alternative minimum tax if their deductions are deemed to be too high compared to their income. The AMT rate is 20 percent.

Solution: Repeal the corporate AMT. Although the corporate AMT rate is lower than the personal AMT rate, it may do more damage. It imposes a large compliance burden on companies and is most likely to take effect during periods of economic downturn. This feature of the tax code should be repealed.[10]

Incremental changes. Given that the alternative minimum tax is an inefficient mechanism and not a major revenue-raiser, there is no reason why it cannot be eliminated immediately. If lawmakers prefer to act slowly, however, it is possible to lower the rate and change the law to reduce the likelihood that companies would be forced to pay the AMT.

CONCLUSION

Opponents of tax reform often rely on historical inaccuracies when arguing against tax cuts. They frequently claim, for example, that the 1993 tax increase was responsible for budget surpluses and that tax cuts will make it more difficult to balance the budget again.

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9. James R. Kee, "Introductory Discussion of the Basic Concepts of Depreciation and Expensing," Institute for Research on the Economics of Taxation, March 10, 1999, at *ftp://ftp.iret.org/pub/BLTN-75.PDF.*

10. John Barry, Terence Chorvat, and Michael Knoll, "The Corporate Alternative Minimum Tax," Tax Foundation *Fiscal Policy Memo*, November 5, 2001, at *http://www.taxfoundation.org/camt.html*.

This historical revisionism is contradicted by the Clinton Administration's own budget documents. In early 1995, nearly 18 months after the 1993 tax increase was enacted, the Office of Management and Budget projected $200 billion-plus budget *deficits* for the next 10 years.[11] Events after that date—including the 1997 capital gains tax cut and a reduction in the growth of federal spending—caused the economy to expand and the budget deficit to vanish.

Opponents also argue that tax cuts will boost interest rates, but this assertion also is belied by factual evidence. Interest rates are influenced by monetary policy and global capital markets, where trillions of dollars change hands every day. It is silly to think that a shift in the government's fiscal balance (even a large one) could be enough to increase the price of credit substantially. On the contrary, it is far more likely that tax rate reductions would *reduce* interest rates, since they reduce the "tax premium" that investors must demand when providing capital.

Just as tax increases did not cause the deficit to disappear, tax cuts will not cause it to expand. Lower tax rates and other long-overdue tax reforms will help to promote a vibrant economy. This, in turn, will help to generate at least some additional revenue and thereby create a virtuous cycle that will allow for further tax reductions.

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11. Office of Management and Budget, *Budget of the United States Government, FY 1996, Economic and Accounting Analyses*, January 1995, at *http://w3.access.gpo.gov/usbudget/fy1996/bud96p.pdf*.