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A Guide to Tax Reform in the 115th Congress

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Abstract

America needs tax reform. Correctly structured tax reform can make a large contribution to restoring prosperity, increasing job creation, and higher wages. It can make the tax system fairer and less burdensome. Both congressional leaders and President Trump have identified tax reform as a priority, and there is clear public support for major tax reform. Tax reform, however, is a complicated issue that encompasses a wide variety of sub-issues with which Congress will need to contend and properly resolve if tax reform legislation is to achieve its proponents' objectives.

Key Points

- The current tax system is economically destructive, unfair, and, due to its complexity, imposes high compliance costs on society.
- The current system holds the economy back because it has high marginal tax rates, taxes saving and investment heavily, picks winners and losers in the market, and is enormously complex for all taxpayers, especially small businesses.
- Tax reform is essential to restoring economic prosperity for Americans. Properly structured tax reform legislation can dramatically improve the economy, reduce compliance costs, and improve fairness.
- The best way to achieve those goals is to establish a consumption base with low marginal tax rates. There are four kinds of consumption-tax systems.
- If Congress passed, and the President signed into law, a tax reform plan that meets the criteria outlined here, Americans would see significantly enhanced incomes and increased opportunities.

The current tax system is economically destructive, unfair and, due to its complexity, imposes high compliance costs on society. It needs to be substantially reformed. Properly structured tax reform legislation can dramatically improve the economy, reduce compliance costs, and improve fairness. There is clear public support for major tax reform.[1] Congressional leaders as well as President Donald Trump have identified tax reform as a priority.

Principles of Tax Reform

There are five basic principles of effective tax reform:

1. The tax system should raise the revenue necessary to fund a limited government at the lowest level possible for constitutionally appropriate activities. In particular, the tax system should: (a) apply the least economically destructive forms of taxation; (b) have low tax rates, on a broad tax base; (c) minimize interference with the operation of the free market and free enterprise; and

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(d) minimize the cost to taxpayers of compliance with and administration of the tax system.

2. The tax system should minimize its adverse impact on the core institutions of civil society.

3. To help preserve the rights to life, liberty, and property, the tax system should: (a) impose no unreasonable burdens; (b) apply consistently, with special privileges for none; and (c) afford due process to respect taxpayer rights.

4. The entire tax burden imposed (including all forms of taxation) should be transparent and understandable to taxpayers.

5. No aspect of the existing tax system should be immune to change, given the complexity and economic incoherence of the existing tax code.

Why America Needs Fundamental Tax Reform

The country needs tax reform because the tax code has a large negative impact on the economy. The tax system unnecessarily reduces incomes, job creation, wages, savings, investment, entrepreneurship, innovation, and the international competitiveness of U.S. businesses. Fundamental tax reform would alleviate the harm caused by the tax system and substantially increase the size of the economy. This stronger economic growth would substantially improve the incomes of all Americans and enhance economic opportunities.

The current tax system harms the economy for many reasons—tax reform based on sound principles would address each of them.

High Marginal Tax Rates. Tax rates for families, individuals, businesses, and investors are too high. Americans in some states now pay marginal tax rates exceeding 50 percent. That rate includes just a family's federal and state income taxes and not the myriad of other taxes they pay. Such high marginal rates discourage work, savings, investment, and entrepreneurial risk taking—the building blocks of economic growth. By reducing incentives to engage in them, the tax code reduces the size of the economy. The adverse economic impact of marginal tax-rate increases and the positive effect of marginal tax-rate reductions are disproportionate to the magnitude of the marginal tax-rate change.[2]

Improper Tax Base. The current tax base causes double taxation of savings and investment and is therefore biased against savings and investment. This bias reduces the amount of investment in the economy, which reduces productivity growth, real wages, and employment.

Income that is saved or invested is taxed, and the return on that savings or investment is then taxed again. Moreover, income from investments in corporations is double taxed again—first at the corporate level and then when individuals receive dividends or pay capital gains on corporate stock. By double or treble taxing saving and investment at high rates, the tax code deters families from saving for retirement, education, a rainy day, or for any other purpose they desire. This bias against savings and investment results in less capital formation, a less productive economy, and lower real wages.[3]

Picking Winners and Losers. A further problem with the tax base is that Congress has loaded it with too many politically motivated credits, deduc-

1. See for example, Matthew Streit, "Updating the American Tax System: American Attitudes and Support for Tax Reform," The Heritage Foundation, March 2015, http://thf_media.s3.amazonaws.com/2015/pdf/American_Attitudes_and_Support_for_Tax_Reform.pdf.

   This study found that 71 percent of the American public believe that the U.S. tax system "needs major changes and reform" and only 5 percent think the tax system is "working just fine"; 75 percent believe that "taxes should be kept as low as possible to stimulate investment and growth."

2. What economists called the "deadweight loss" or "excess burden" of a marginal tax rate rise increases with the *square* of the tax rate increase. The converse is also true: The excess burden of a marginal tax rate decrease declines with the *square* of the tax rate decrease. See John Creedy, "The Excess Burden of Taxation and Why it (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury *Working Paper* No. 03/29, December 2003, http://www.treasury.govt.nz/publications/research-policy/wp/2003/03-29/twp03-29.pdf (accessed February 6, 2017). Also see, for example, N. Gregory Mankiw, *Principles of Economics*, 4th Edition (2006), Chapter 8 (or many other textbooks on price theory, microeconomics, or principles of economics).

3. More formally, a tax system that taxes labor and capital-factor incomes equally, and only once, results in higher output and higher incomes. Usually in the modern public finance literature, this is called a consumption tax. See N. Gregory Mankiw, Matthew Charles Weinzierl, and Danny Yagan, "Optimal Taxation in Theory and Practice," *Journal of Economic Perspectives*, Vol. 23, No. 4 (2009), pp. 147–174, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.4.147 (accessed February 6, 2017), and Alan J. Auerbach, "The Choice Between Income and Consumption Taxes: A Primer," NBER *Working Paper* No. 12307, June 2006, http://www.nber.org/papers/w12307 (accessed February 6, 2017).

tions, exclusions and exemptions. These provisions inhibit economic growth by eroding the tax base, which necessitates higher tax rates for other activities in order to raise a certain level of revenue. They also alter the decisions of families and businesses. Market forces should determine those decisions, not Washington lawmakers. When government policy picks winners and losers in such a way, it reduces economic efficiency because resources are not put to their highest-valued and most effective use. The economy suffers because of the distortion. The most glaring example of such policies are the myriad of tax breaks for the production and consumption of politically favored types of energy and energy-efficient products.

Anachronistic Business Tax System. The way the tax code treats business is the largest inhibitor of growth in the tax code today. The U.S. has the highest corporate tax rate of any country in the Organization of Economic Co-operation and Development (OECD)—the 35 most industrialized countries in the world.[4] That high rate makes it unattractive for businesses, both foreign and domestic, to locate new investment in the U.S.

Further inhibiting investment is the fact that the U.S. is the only major developed nation that taxes its businesses on the income they earn in foreign countries.[5] This taxation creates another disincentive for U.S. businesses to invest, which further suppresses wage growth and job creation for American workers.[6] The worldwide system also makes it attractive for foreign firms to buy U.S. firms, or for U.S. firms to merge with foreign corporations and move the new company's headquarters abroad—as was the case in the spate of inversions in 2014.[7] In either case, the new business moves its headquarters and legal domicile abroad to avoid the impact of U.S. worldwide taxation.

The U.S. also has one of the worst systems in the industrialized world for businesses to deduct the cost of investments.[8] The U.S. tax code denies businesses the ability to deduct the full cost of investments at the time businesses make them. Instead, the code applies a cumbersome depreciation system that forces businesses to deduct the cost of investment over many years—sometimes as many as 39.[9] It therefore is biased against investment[10] and raises the cost of investing because of the time value of money.[11] Less investment due to those higher costs hurts productivity gains, wage growth, and job creation.

Small businesses face enhanced bias under the current system. After the 2013 tax increases, small business owners now pay a top federal income tax

4. OECD, "Members and Partners," https://www.oecd.org/about/membersandpartners/ (accessed February 6, 2017).
5. Kyle Pomerleau, "Worldwide Taxation is Very Rare," Tax Foundation, February 5, 2015, https://taxfoundation.org/worldwide-taxation-very-rare (accessed February 6, 2017).
6. Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.
7. Curtis S. Dubay, "Business Inversions: Tax Reform Is the Only Way to Curb Them," Heritage Foundation *Issue Brief* No. 2950, September 4, 2014, http://www.heritage.org/research/reports/2014/09/business-inversions-tax-reform-is-the-only-way-to-curb-them.
8. Kyle Pomerleau, "Capital Cost Recovery Across the OECD," Tax Foundation, November 19, 2013, http://taxfoundation.org/article/capital-cost-recovery-across-oecd (accessed February 6, 2017), and William McBride, "How Tax Reform Can Address America's Diminishing Investment and Economic Growth," Tax Foundation, September 23, 2013, http://taxfoundation.org/article/how-tax-reform-can-address-america-s-diminishing-investment-and-economic-growth (accessed February 6, 2017).
9. Internal Revenue Service, "4. Figuring Depreciation Under MACRS," https://www.irs.gov/publications/p946/ch04.html (accessed February 6, 2017).
10. The current tax system is not neutral toward investment. This neutrality criterion is sometimes expressed as ensuring that the private rate of return equals the social rate of return, that the tax system does not raise the user cost of capital, that all factor incomes are taxed once and equally, that the tax system defines income properly, or that the tax is a consumption tax. See, for example, Charles E. Walker and Mark A. Bloomfield, eds., *The Consumption Tax: A Better Alternative?* (Cambridge, MA: Harper and Row, Ballinger, 1987).
11. For the basic user cost of capital analysis with taxes, see Robert E. Hall and Dale W. Jorgenson, "Tax Policy and Investment Behavior," *American Economic Review*, Vol. 57, No. 3 (June, 1967), pp. 391–414, https://web.stanford.edu/~rehall/Tax-Policy-AER-June-1967.pdf (accessed February 6, 2017). See also Kevin A. Hassett and Kathryn Newmark, "Taxation and Business Behavior: A Review of the Recent Literature," in John W. Diamond and George R. Zodrow, eds., *Fundamental Tax Reform: Issues, Choices, and Implications* (Cambridge: MIT Press, 2008), and Alan J. Auerbach, "Taxation and Capital Spending," University of California, Berkeley, September 2005, http://eml.berkeley.edu//~auerbach/capitalspending.pdf (accessed February 6, 2017).

rate of 39.6 percent, and an additional 3.8 percent investment surtax that became law as part of Obamacare. It pushes the top federal tax rate on small business income to 43.4 percent. Large corporations pay a federal tax rate of 35 percent. This disparity is unfair to small businesses and can put them at a disadvantage against their larger competitors. Income from large "C corporations" however is subject to a second level of taxation. Dividends are taxed when received and capital gains on corporate stock due to increased retained earnings are also taxed.[12]

Complexity and Compliance Costs.[13] The tax code is absurdly complicated. The arrival of personal computers and tax software has permitted the creativity of policymakers in Washington to run amok, creating tax complexities far beyond what even tax professionals could manage unaided by electronics. There are a multitude of credits, exemptions, exclusions, and deductions, many of which are subject to special rules and phase-out[14] over different levels of income. As if this was not bad enough, there is a parallel tax called the Alternative Minimum Tax (AMT), as well as the payroll and self-employment taxes that fund Social Security and part of Medicare. All of this complexity imposed on individual taxpayers is relatively minor compared to the torturous rules that businesses must suffer. These compliance costs have a disproportionately adverse impact on small and start-up businesses, which are ill-equipped to spend the resources necessary to deal with this absurd complexity. Among the four largest sources of complexity in the tax law are (1) the capital cost recovery system; (2) inventory accounting; (3) employee benefit taxation, particularly the retirement savings (qualified account) rules; and (4) international taxation. The compliance costs associated with the income tax have been estimated to be in the range of $67 billion to $410 billion.[15] These costs remove productive resources from the economy and must be recovered by businesses in the price of the goods and services they provide. They are effectively a hidden tax on ordinary Americans.

The Elements of Sound Tax Reform: What Reform Should Achieve

Tax reform based on the five principles detailed above would solve the problems laid out above and, therefore, dramatically improve the economy. To fix those problems properly, tax reform would have to meet certain economic objectives, while keeping non-economic objectives in mind as well. Tax reform would substantially enhance economic performance by accomplishing five major economic objectives:

1. **Lower individual and business tax rates.** Tax reform must lower tax rates, in particular the top corporate and individual marginal rates, to strengthen the economy by improving incentives to work, save, and invest.

2. **Establish the right tax base.** Often overlooked in the tax reform debate is the fact that defining the tax base (what the tax code taxes) is as important as lowering the tax rate. Lowering rates is important, but if lower rates apply to an improper base, tax "reform" could potentially have no net benefit for the economy. Worse, if the tax base is structured poorly enough, tax reform would be a net negative for growth. The right tax base is consumption (defined in detail below under "The Four Ways to Achieve Fundamental Tax Reform"), rather than the hybrid income-consumption tax base the current system uses.

3. **Eliminate the bias against savings and investment.** Tax reform must reduce, and ideally eliminate, the bias against saving and investing caused by double taxation. Taxing the right consump-

12. This, of course, is not true for shareholders who are tax-exempt, or who hold their shares in tax-deferred savings vehicles. In addition, most non-resident aliens have a reduced tax rate on dividends because of treaty provisions, and pay no tax on corporate stock capital gains.
13. Compliance costs refer to the accounting, legal, and administrative costs of complying with the tax system. They do not reflect the lost economic output due to disincentive and other effects.
14. A phase-out is a reduction in value of a tax provision as a taxpayer's income increases until it is eliminated or zeroed out. It results in higher effective marginal tax rates during the phase-out period because the tax benefit is reduced with additional income.
15. Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation *Fiscal Fact* No. 512, June 2016, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF512.pdf (accessed February 6, 2017), and Jason J. Fichtner and Jacob M. Feldman, "The Hidden Costs of Tax Compliance," Mercatus Center, May 20, 2013, https://www.mercatus.org/system/files/Fichtner_TaxCompliance_v3.pdf (accessed February 6, 2017).

tion tax base would accomplish this objective since it should eliminate the double taxation of capital gains and dividends, and allow businesses to deduct their capital costs when incurred. Tax reform should lower the corporate tax rate and move to a territorial system, which also mitigates the bias against savings and investment.

4. **Eliminate tax preferences.** More work is necessary to ensure that the base is neutral and does not pick winners and losers. That means that tax reform should eliminate or at least substantially reduce any individual and corporate deductions, credits, exclusions, and exemptions that are not economically justified. Tax reform should eliminate unjustified policies that Congress intended to benefit particular industries, such as those aimed at aiding particular energy sources. The best way to avoid these problems is to start tax reform by defining a proper base and maintaining it.

5. **Simplify the tax system and make it more transparent so that taxpayers understand how much they pay to fund the federal government.** Washington can help reduce the size of government by making the cost of government more apparent to the American people. Because of income and payroll tax withholding, and the hidden costs of corporate, employer payroll, and excise taxes, most Americans have little idea how much they are paying to fund the federal government or how proposed policy changes will affect them. The sheer complexity of the system makes it difficult to understand the true impact of the tax system. Tax reform should strive to make that cost explicit to taxpayers. Once taxpayers know how much of their hard-earned income goes to the federal government, they will be more willing to reduce the size of government since they will better understand its cost to them. A transparent code would be simpler than the current system. Simplicity aids not only the goal of transparency (because taxpayers understand the system), but also the economic goal of lower compliance costs.

If tax reform achieved these objectives, the economy would enjoy sizeable gains. Empirical and modeling work on the economic benefits of tax reform shows the economy could improve significantly from pro-growth tax reform that selects the correct tax base and has a low tax rate. According to Tax Foundation analysis, for example, the economy could grow as much as 15 percent over 10 years because of tax reform.[16] After those 10 years, the average American family's wages would rise by about 10 percent.[17] That would be an extra $5,000 in the pockets of families earning $50,000 per year, roughly the median income in the United States. This is broadly consistent with many earlier estimates of the gains to be had from fundamental tax reform.[18]

A stronger economy also plays a vital role in improving state, local, and federal government finances. It means higher tax revenues and lower spending in connection with those who have suffered economic difficulties. A stronger economy means better wages for all Americans. Better job opportunities are also the most powerful antidote to persistent poverty; and with less poverty comes fewer demands for anti-poverty spending.

Non-Economic Objectives. Tax reform plans should also be designed with non-economic objec-

16. Andrew Lundeen, "Slow Economic Growth Does Not Need to Be the New Normal," Tax Foundation, May 15, 2014, http://taxfoundation.org/blog/slow-economic-growth-does-not-need-be-new-normal (accessed February 6, 2017).

17. Ibid., and Michael Schuyler and William McBride, "The Economic Effects of the Rubio–Lee Tax Reform Plan," Tax Foundation, March 9, 2015, http://taxfoundation.org/article/economic-effects-rubio-lee-tax-reform-plan (accessed February 6, 2017).

18. See, for instance, Hans Fehr, Sabine Jokisch, Ashwin Kambhampati, and Laurence J. Kotlikoff, "Simulating the Elimination of the U.S. Corporate Income Tax," National Bureau of Economic Research *Working Paper* No. 19757, December 2013, http://www.nber.org/papers/w1975 (accessed February 6, 2017); Laurence J. Kotlikoff and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," National Bureau of Economic Research *Working Paper* No. 11858, December 2005; Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the Fair Tax Proposal," Americans for Fair Taxation *Research Monograph*, December 2005; Dale W. Jorgenson and P. J. Wilcoxen, "The Long-Run Dynamics of Fundamental Tax Reform," *American Economic Review*, Vol. 87, No. 2 (May 1997), pp. 126–132; Dale W. Jorgenson, "The Economic Impact of Taxing Consumption," in House Committee on Ways and Means, Replacing the Federal Income Tax, Vol. 2, 104th Cong., Second Sess., 1996, pp. 105–113; Marco Fantini, "Macroeconomic Effects of a Shift from Direct to Indirect Taxation: A Simulation For 15 EU Member States," presented at the 72nd meeting of the OECD, Working Party No. 2 on Tax Policy Analysis and Tax Statistics, Paris, November 14–16, 2006; and Joint Committee on Taxation, "Tax Modeling Project and 1997 Tax Symposium Papers," JCS-21-97, November 20, 1997.

tives in mind. Any reform plan should limit the tax system's adverse impact on the core institutions of civil society, including the family and voluntary civic associations, such as religious and educational institutions, charities, and community organizations.

A just political order protects individuals' natural rights to life, liberty, and property. A just tax system adheres to this principle by imposing an equitable and reasonable burden on taxpayers, with special privileges for none, and respecting taxpayer rights to due process.

The Four Ways to Achieve Fundamental Tax Reform

There are long-standing debates about which type of tax reform plan can best deliver the objectives laid out above. Those plans generally have more in common with each other than is usually understood. In fact, the best and most popular tax reform plans use the correct consumption tax base and have identical economic effects. They vary only in how taxpayers pay them. A useful way to understand their variations is to think of them as distinct software programs used to execute the same function. They all execute that function equally well, but they interact with their users (taxpayers) differently.

For many, a consumption tax means a retail sales tax such as the one that most states levy. However, a consumption tax is any tax on income that is spent on consumption, and which excludes income that is saved or invested until that income is spent on consumption. Consumption taxes do not include the estate and gift tax, also known as the death tax. There are several plans that fit this mold, including:

- The traditional flat tax (often referred to as the Hall–Rabushka flat tax);[19]
- The new flat tax (also known as an expenditure tax, consumed-income tax, cash-flow tax, or inflow-outflow tax);[20]
- A business transfer tax (BTT) (also known as the business flat tax, business-activity tax, or business-consumption tax);[21] and

19. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, CA: Hoover Institution Press, 1995), and Daniel J. Mitchell, "Make Taxes Simple and Fair: Enact the Flat Tax," in Jack Kemp and Ken Blackwell, eds., *The IRS v. The People: Time for Real Tax Reform* (Washington, DC: The Heritage Foundation, 1999), pp. 89–91. For a border-adjusted version of the flat tax, see Report of the President's Advisory Panel on Federal Tax Reform, 2005, http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html (accessed February 6, 2017). The flat tax was first introduced in Congress by Senators Dennis DeConcini (D–AZ) and Steve Symms (R–ID) as the Flat Tax, S. 321, 99th Congress, 1985, and was then sponsored by Representative Dick Armey (R–TX) as H.R. 1040, 105th Congress, 1997, and by Senator Richard Shelby (R–AL) as S. 1040, 105th Congress, 1997. Steve Forbes heavily promoted the proposal during his 1996 and 2000 presidential bids. An optional flat tax was introduced in the 114th Congress by Representative Michael Burgess (R–TX), H.R. 1040, 114th Congress, 2015, and this legislation is too abstract to be enacted in its current form. A graduated rate version of this tax plan has been proposed by economist David Bradford and is called the "X Tax." See David F. Bradford, *Untangling the Income Tax* (Cambridge, MA: Harvard University Press, 1986).
20. J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three. The expenditure tax idea has a long history. It was proposed by John Stuart Mill, *The Principles of Political Economy* (1848); Irving Fisher and Herbert W. Fisher, *Constructive Income Taxation: A Proposal for Reform* (New York and London: Harper, 1942); Nicholas Kaldor, *An Expenditure Tax* (Sydney: Allen & Unwin, 1955); William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," *Harvard Law Review*, Vol. 87, No. 6 (April 1974), pp. 1113–1188; U.S. Department of the Treasury, "Blueprints for Basic Tax Reform," January 17, 1977, https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Blueprints-1977.pdf (accessed February 6, 2017); J. E. Meade, *The Structure and Reform of Direct Taxation* (London: The Institute for Fiscal Studies, 1978); Henry J. Aaron and Harvey Galper, *Assessing Tax Reform* (Washington, DC: Brookings Institution, 1985); and Norman B. Ture, "The Inflow Outflow Tax—a Saving-Deferred Neutral Tax System," Institute for Research on the Economics of Taxation, 1997, http://iret.org/pub/inflow_outflow.pdf (accessed February 6, 2017). This type of plan was first introduced in Congress as the Cash Flow Income Tax Act of 1985 by Representative Cecil Heftel (D–HI), H.R. 1165, 99th Congress, 1985; a version was introduced by Senators Sam Nunn (D–GA) and Pete Domenici (R–NM) as the individual tax in the Unlimited Savings Allowance (USA) Tax Act, S. 722, 104th Congress, 1995. Both of these versions, however, had graduated rates. A concurrent resolution was introduced by Senator Mike Lee (R–UT) based on The Heritage Foundation's "Saving the American Dream" plan, http://savingthedream.org/about-the-plan/plan-details/. Section 504 of S. Con. Res. 44, 112th Congress, 2012, describes the new flat tax plan.
21. A national sales tax–business transfer tax plan (sometimes referred to as the Broad Economic Simplification Tax (BEST) plan) was introduced by Senator Jim DeMint (R–SC) as S. 1921, 109th Congress, 2005. See David R. Burton, "The BEST Tax," testimony before the President's Advisory Panel on Federal Tax Reform, May 11–12, 2005, http://govinfo.library.unt.edu/taxreformpanel/meetings/docs/burton_052005.ppt (accessed February 6, 2017). Representative Paul Ryan (R–WI) introduced a business transfer tax as part of his "Roadmap for America's Future," Budget Committee, U.S. House of Representatives, Title VI of H.R. 6110, 110th Congress, 2008. The business tax in the 1995 USA was a business transfer tax. See Lawrence S. Seidman, The USA Tax: A Progressive Consumption Tax (Cambridge, MA: MIT Press, 1997).

- A national sales tax.[22]

Any sound tax reform plan will either adopt one of these approaches, or a combination of two approaches, or move the current tax system substantially in that direction. A tax reform plan that moves the tax system toward any one of these approaches is constructive.

1. Traditional Flat Tax. To arrive at a consumption base, the traditional flat tax starts on the business side. Businesses take their gross income from the sale of goods or the provision of services and then subtract from that amount the cost of buying goods and services (inputs) to produce their product, including investments in capital—such as machines, equipment, and structures. Businesses also deduct their labor costs. They are taxed at a flat rate on the remainder. Businesses only pay tax on their domestic income.[23]

Families and individuals pay a tax on their labor income, which is mostly the wages that businesses pay them. They, too, pay a flat rate, after a standard deduction that prevents taxation of incomes below a specified amount. Savings and investment are treated like Roth individual retirement accounts (IRAs) under the current system. Individuals accumulate savings after they pay taxes on their earnings, hence later withdrawals from the account are not taxable. Accumulations during intervening periods are not taxed, nor are there taxes on capital gains and dividends. Thus, financial transactions are disregarded when determining taxable income for both individuals and businesses. Interest is neither taxed nor deductible.

The traditional flat tax is a consumption tax because the overall tax base is the value of all goods and services less investment. The value created by capital is taxed at the business level, and the value created by labor is taxed at the individual level. Each factor of production, labor and capital, is taxed once at the same rate.

2. The New Flat Tax. The new flat tax is similar to the traditional flat tax.[24] The new flat tax has one rate for labor income, minus the amounts that families and individuals save. It uses the traditional IRA treatment for savings, which allows families to save with pre-tax dollars. The savings can be invested and grow tax-free. There are no capital gains or dividends taxes. Unlike the traditional flat tax, the new flat tax has deductions for charitable contributions and an optional mortgage interest deduction (where interest is deductible but taxable to the lender). The traditional flat tax could be modified to include these features, or the new flat tax could eliminate interest deductions altogether by exempting all interest income from taxation.

On the business side, the new flat tax allows an immediate deduction for capital expenses, is territorial, provides a border tax adjustment and provides a credit to shareholders for taxes paid at the corporate level. Like the traditional flat tax, the new flat tax is a consumption tax. It taxes only income that people have spent, which equals consumption.

3. Business Transfer Tax. A business transfer tax (BTT) would be imposed on all businesses, not on individuals except those who are sole proprietors (who would be subject to the BTT on their business income). The tax base would be revenue from the sale of goods and services minus purchases of goods and services from other businesses. Wages paid to workers are not deductible. A BTT would expense capital costs. The purchases of capital goods (such as machinery and equipment) would be deductible, as would be all other purchases of goods and services. A BTT is effectively the same as the Hall–Rabushka business tax except wages are taxed at the business level instead of being deducted by the business and then taxed at the individual level.

22. Representatives Dan Schaefer (R–CO) and Billy Tauzin (D–LA) introduced the first national sales tax bill, the National Retail Sales Tax, H.R. 3039, 104th Congress, 1996; Representatives John Linder (R–GA) and Collin Peterson (D–MN) first introduced the Fair Tax, H.R. 2525, 106th Congress, 1999 (H.R. 25 in later Congresses). Representative Rob Woodall (R–GA) became the lead sponsor after Linder's retirement.

    For more details, see David R. Burton and Dan R. Mastromarco, "Emancipating America from the Income Tax: How a National Sales Tax Would Work," Cato Institute *Policy Analysis* No. 272, April 15, 1997, https://www.cato.org/publications/policy-analysis/emancipating-america-income-tax-how-national-sales-tax-would-work (accessed February 6, 2017); David R. Burton, "The National Sales Tax Alternative," in Kemp and Blackwell, eds., *The IRS v. The People*; and Neal Boortz and John Linder, *The Fair Tax Book: Saying Goodbye to the Income Tax and the IRS* (New York: HarperCollins, 2006).

23. In the original Hall–Rabushka flat tax, revenue from exports was included in the tax base, but foreign source income was excluded. The version proposed by the Bush tax panel and the version included in the House "Better Way" plan are border-adjusted. Thus exports are excluded from the tax base and imports are subject to tax.

24. Foster, "The New Flat Tax: Easy as One, Two, Three."

Financial transactions (such as interest, dividends, and capital gains) are not relevant to calculating the taxable base. This is a major simplification. Many of the most problematic issues with an income tax or cash flow tax simply disappear. This is equally true of the traditional flat tax and a sales tax.

All BTTs that have been introduced are territorial and border-adjusted. Thus, income earned outside the U.S. is not taxed. Because of the border-tax adjustment, revenues from exports would be excluded from the taxable base, and imports sold in the U.S. are subject to the same tax as U.S.-produced goods.

4. National Sales Tax. A national sales tax would tax consumption directly by taxing the sale of goods and services to consumers. Intermediate (business-to-business) sales and investment goods would not be taxed. If they were, the tax would cascade (a tax on a tax), which increases prices, hides the amount of tax that people pay, and encourages vertical integration.[25] Both the proposed FairTax and its predecessor[26] have the correct tax base (all consumption goods and services but no intermediate or investment goods or services).

Businesses would collect and remit the sales tax, filing monthly sales tax returns. Both proposals provide a small credit to compensate businesses for this cost. Individuals would file no tax returns. Both sales tax proposals are progressive because they provide each family with a monthly rebate equal to the sales tax rate, times the annual poverty level, divided by 12. Thus, every family is effectively exempt from spending up to the poverty level, and average tax rates increase as consumption expenditures increase.

A sales tax by its nature exempts exports from tax, and taxes goods produced abroad and in the U.S. alike.[27] A sales tax should not treat contributions to charities as the purchase of charitable services, which is analogous to a charitable deduction. The FairTax repeals payroll taxes and therefore has a higher tax rate than its predecessor (which did not repeal payroll taxes).

Revenue Neutrality

When Congress "scores" the revenue impact of a tax proposal, it should take into account the real-world economic impact of that proposal. In other words, the revenue estimate should take into account whether the proposal will increase or decrease the size of the economy and therefore the taxable base. This is sometimes called dynamic scoring.[28] House rules were recently changed to require dynamic scoring.[29] The models maintained by the Joint Committee on Taxation (JCT) staff, however, tend to dramatically understate the economic impact of tax changes.[30] The JCT models should be changed to better reflect economic reality.

A second issue is whether tax reform should be "revenue neutral." In other words, in practice, should a tax reform plan be designed to raise the same amount of revenue as the current tax system, or should it provide a tax cut by reducing revenues? The federal government is expected to raise $43 trillion in tax revenue over the next 10 years (fiscal year (FY) 2018 to FY 2027).[31] This

25. A cascading "gross receipts" tax taxes all transactions. It encourages vertical integration to the detriment of small firms because business-to-business transactions are taxed. Thus, a firm that grows wheat, mills the wheat, bakes bread, and sells it directly to the consumer, would pay such a tax once. If those same economic functions were performed by four smaller firms, the tax would be applied four times. A retail sales tax avoids this problem by only taxing the final consumer sale. A value-added tax (VAT) or goods-and-services tax (GST) avoids this problem by giving a credit for tax paid on inputs. The Hall–Rabushka flat tax, the new flat tax (consumed-income tax), and the business transfer tax avoid this problem by allowing firms to deduct business inputs when calculating their taxable base.

26. Representatives Schaefer and Tauzin introduced the first national sales tax bill, the National Retail Sales Tax, H.R. 3039, 104th Congress, 1996.

27. It is, in public finance parlance, a destination-principle tax rather than an origin-principle tax like the income tax. This is analogous to a border-tax adjustment in some flat tax proposals, a BTT, a VAT, or GST.

28. For a detailed discussion of these issues, see Dan R. Mastromarco, David R. Burton, and William W. Beach, *The Secret Chamber or the Public Square? What Can Be Done to Make Tax Analysis and Revenue Estimation More Transparent and Accurate* (Washington, DC: The Heritage Foundation, 2005).

29. See House Rule XIII 8(b).

30. See, for example, Curtis S. Dubay, "JCT Should Not Predict Federal Reserve Actions in Dynamic Scoring," Heritage Foundation *Issue Brief* No. 4501, December 22, 2015, http://www.heritage.org/taxes/report/jct-should-not-predict-federal-reserve-actions-dynamic-scoring, and Curtis S. Dubay, "JCT Dynamic Score of Bonus Depreciation: Highly Flawed," Heritage Foundation *Issue Brief* No. 4478, November 3, 2015, http://www.heritage.org/taxes/report/jct-dynamic-score-bonus-depreciation-highly-flawed.

31. Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027*, January 2017, Summary Table 1, CBO's Baseline Budget Projections, p. 2, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016outlook.pdf (accessed February 6, 2017).

is approximately 18.2 percent of gross domestic product (GDP),[32] slightly above the post-war average of 17.2 percent.[33] Reducing the federal tax burden to its post-war average would result in a reduction of about $2.3 trillion (5.4 percent).[34] Candidate Trump, in his second campaign tax plan document, proposed a roughly $4.4 trillion tax cut.[35]

Federal spending is substantially above the post-war average of 19 percent of GDP,[36] and is projected to increase to 23 percent of GDP by FY 2026.[37] The federal government is projected to spend $52.5 trillion over the next 10 years.[38]

Until Congress places meaningful constraints on federal spending, there are limits to how large a tax cut is economically prudent. However, Congress should not be wedded to revenue-neutral tax reform. A tax reform plan that reduces taxes will be easier to achieve politically because there will be more "winners" and fewer "losers" than under a revenue-neutral tax plan. The potential gains to the economy from achieving tax reform are very large—a 10 percent increase in GDP over 10 years for an imperfect but well-structured plan. This would mean a cumulative 10-year economic output gain of approximately $13 trillion to the American people.[39] Achieving this enhanced economic growth is important to the prosperity of the American people and will place less pressure on the spending side of the federal budget.

Assuming that Congress will address tax reform as part of the FY 2018 budget reconciliation process, this issue needs to be addressed in the FY 2018 budget resolution. Together with a program of meaningful federal spending restraint, the FY 2018 budget resolution should include instructions to the tax-writing committees that they reform the tax system in accordance with the basic principles set forth at the beginning of this *Backgrounder*, and that they be permitted to adopt a plan that reduces revenues over the 10-year budget window by as much as 1 percent of GDP— about $2.4 trillion over 10 years. GDP over this 10-year period is projected to be $239 trillion.[40] The Heritage Foundation's *Blueprint for Balance: A Federal Budget for 2017*, for example, reduces taxes by $1.3 trillion and achieves a balanced federal budget in its seventh year, FY 2023, with federal revenues at approximately 17.5 percent of GDP in FY 2026.

The House "Better Way" Plan

Under the leadership of House Speaker Paul Ryan (R–WI) and House Ways and Means Committee Chairman Kevin Brady (R–TX), the House Republicans released a blueprint for its tax reform initiative in June 2016.[41] Since that time, the Ways and Means Committee has been drafting legislation and working toward a consensus among Republicans on the committee.

The Ryan–Brady "Better Way" blueprint would provide the lowest marginal tax rates since the 1920s, and expense capital expenses. The top individual tax rate would be 33 percent (compared to

32. Ibid.
33. Office of Management and Budget, *Budget of the U.S. Government, Historical Tables*, "Table 1.2—Summary of Receipts, Outlays, and Surpluses or Deficits (-) as Percentages of GDP: 1930–2021," https://obamawhitehouse.archives.gov/omb/budget/Historicals (accessed February 6, 2017).
34. 17.2 divided by 18.2 minus one (–0.054) times $43 trillion.
35. Alan Cole, "Details and Analysis of the Donald Trump Tax Reform Plan," Tax Foundation *Fiscal Fact* No. 528, September 2016, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF528_FINAL3.pdf (accessed February 6, 2017).
36. Office of Management and Budget, *Budget of the U.S. Government, Historical Tables*, "Table 1.2—Summary of Receipts, Outlays, and Surpluses or Deficits (–) as Percentages of GDP: 1930–2021," https://obamawhitehouse.archives.gov/omb/budget/Historicals (accessed February 6, 2017).
37. Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027*, January 2017, Summary Table 1, CBO's Baseline Budget Projections, p. 2.
38. Ibid.
39. Author calculations, relative to the CBO's GDP projections, and increasing GDP 1 percent in the first year, 2 percent in the second, and so on.
40. Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027*, January 2017, "Table C- 1, CBO's Economic Projections, by Calendar Year," p. 88, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016outlook.pdf (accessed February 6, 2017).
41. "A Better Way: Our Vision for a Confident America, Tax," June 24, 2016, https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf (accessed February 6, 2017).

43.4 percent today); the top tax rate on corporations would be 20 percent (compared to 35 percent today); and the top tax rate on pass-through businesses would be 25 percent (compared to 43.4 percent today). Many other changes would be made. It would have a dramatic positive economic impact. The Tax Foundation estimates it would increase GDP by 9.1 percent over 10 years, and reduce revenues by $191 billion over 10 years.[42]

This plan is most succinctly understood as a graduated rate version of the Hall–Rabushka flat tax.[43] The two primary differences between the Better Way plan and the traditional Hall–Rabushka flat tax are that the Better Way plan has a border-tax adjustment and, instead of taxing only wages at the individual level, it has an additional tax on dividends, interest, and capital gains at half the statutory rate. It is therefore a very large step toward the right tax base with much lower marginal tax rates than those of the current system.

The Trump Administration

During the campaign, Trump spoke often about the need for pro-growth tax reform, and released a plan that evolved over time.[44] He proposed reducing the tax rate on all businesses to 15 percent, and reducing the top individual tax rate to 25 percent. Later plans had a top individual tax rate of 33 percent. He proposed an enhanced child care credit and a larger standard deduction. He also proposed repealing the estate and gift taxes, the alternative minimum tax, and "reducing or eliminating most deductions and loopholes available to the very rich" and "reducing or eliminating corporate loopholes that cater to special interests." The plan would end deferral of tax on overseas income and impose a 10 percent deemed repatriation tax on tax-deferred income overseas. It would limit the deductibility of business-interest expense, and the last version of it had a provision allowing capital expenses to be immediately deducted, provided the business elected to not deduct interest expense.

The dramatically lower tax rates in the Trump campaign plan are very positive. Repealing true tax preferences or loopholes is also positive, although none are specified in the campaign documents. Moving toward a worldwide tax system without deferral is counterproductive and will make it less attractive to headquarter a business in the United States. It is not clear how the expensing and interest deduction limitation would work. If interest is taxable, but not deductible, the plan would overtax interest and have adverse consequences on capital markets. It is also not clear which capital cost recovery system would apply if the taxpayer elects to deduct interest expenses. The Tax Foundation has estimated that the Trump plan would increase GDP by 6.9 percent to 8.2 percent over 10 years and reduce revenues by between $2.6 trillion and $3.9 trillion over 10 years.[45]

Tax Reform in the Senate

The Senate has been less active on tax reform. Senate Finance Committee Chairman Orrin Hatch (R–UT) has discussed integrating the corporate and individual tax system to reduce or eliminate the double taxation of corporate income, and to eliminate the current advantages accorded debt over equity financing by businesses.[46] Senators Mike Lee (R–UT) and Marco Rubio (R–FL),[47] Sena-

42. Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation *Fiscal Fact* No. 516, July 2016, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF516.pdf (accessed February 6, 2017).

43. Graduated rate versions of the Hall–Rabushka flat tax are often called an "X Tax" after David Bradford's proposal. See Bradford, *Untangling the Income Tax*. See also *Report of the President's Advisory Panel on Federal Tax Reform*, 2005, http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html (accessed February 6, 2017).

44. Donald J. Trump, "Tax Reform that Will Make America Great Again," https://assets.donaldjtrump.com/trump-tax-reform.pdf (accessed February 6, 2017), and Trump-Pence, "Tax Plan," September 23, 2016, https://www.donaldjtrump.com/policies/tax-plan (accessed February 6, 2017).

45. Alan Cole, "Details and Analysis of the Donald Trump Tax Reform Plan," Tax Foundation *Fiscal Fact* No. 528, September 2016, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF528_FINAL3.pdf (accessed February 6, 2017).

46. News release, "Hatch Statement at Finance Committee Hearing on Corporate Integration," U.S. Senate Committee on Finance, May 24, 2016, https://www.finance.senate.gov/chairmans-news/hatch-statement-at-finance-committee-hearing-on-corporate-integration (accessed February 6, 2017).

47. Curtis S. Dubay and David R. Burton, "The Lee–Rubio Tax Plan's Business Reforms Are Tremendously Pro-Growth," Heritage Foundation *Backgrounder* No. 3000, March 9, 2015, http://thf_media.s3.amazonaws.com/2015/pdf/BG3000.pdf.

tor Rand Paul (R–KY),[48] and Senator Ted Cruz (R–TX)[49] have offered tax plans. Others are developing them.

Other Considerations Tax Reform Must Address

There are many important issues that any tax reform plan would need to address. Although these issues do not receive as much attention as tax rates, tax reform must get them correct in order to maximize growth. They include:

- **Which taxes to replace.** In addition to the individual and corporate taxes, there are a host of other taxes, including a variety of excise taxes, customs fees, and the estate tax. The biggest additional tax is the payroll tax. Tax reform would need to consider what it would do to these other taxes.

- **Additional tax systems.** There is frequent talk by some that the U.S. needs to levy a credit-invoice value-added tax (VAT). In addition to not raising taxes, tax reform should not add new tax systems on top of the existing ones. Another tax system would increase complexity and likely allow the federal government to extract higher taxes from American taxpayers—a credit-invoice VAT, for instance, would potentially raise taxes by hundreds of billions, or even trillions, of dollars each year.

- **The family.** The tax code should not have a marriage penalty. It should also include allowances for families with children that help eliminate tax on incomes below certain amounts and reflect the contributions parents make to the future prosperity of the country. Their needs must be weighed against how much higher tax rates would rise because of them, and their tendency to remove many taxpayers from the tax rolls entirely.[50]

- **Health care.** Employer-provided health insurance should not be tax preferred. However, the exclusion of employer-provided health insurance has been part of the tax code for approximately 70 years. Thus, changes to it will have tax and health care implications.

- **Charitable contributions.** Allowing money to flow to core charitable and educational institutions on a pre-tax basis is sound policy. A robust civil society is a critical component of a free society. The contours of this deduction depend on the type of tax system implemented. There is a need to rethink the current legal treatment of both the underlying tax exemption and the tax treatment of tax-exempt organizations' business income that is unrelated to the exempt purpose of the organization. There are nearly three dozen categories of tax-exempt organizations in the tax code. Many of these are multibillion-dollar organizations that run large businesses, such as the AARP and Harvard University.

- **Education.** There are a host of deductions and credits in the existing tax code for educational expenses. Tax reform should reduce complexity by consolidating them into a simple policy that reflects the importance of human capital formation.

- **International issues.** Tax reform should create a system that is territorial (only taxes income that businesses earn within the U.S.). The U.S. government should only tax economic activity in the U.S. It should also stop taxing individual Americans on their income earned abroad. Policymakers are also considering a border-adjusted tax system that has the stated objective of equating the tax burden on foreign and U.S.-produced goods both in U.S. markets and in foreign markets. Some economists argue that border tax adjustments would add a significant amount of complexity, be difficult to administer and likely invite retaliatory tariffs from other countries.

48. Andrew Lundeen and Michael Schuyler, "The Economic Effects of Rand Paul's Tax Reform Plan," Tax Foundation, June 18, 2015, https://taxfoundation.org/economic-effects-rand-paul-s-tax-reform-plan/ (accessed February 6, 2017).

49. Kyle Pomerleau and Michael Schuyler, "Details and Analysis of Senator Ted Cruz's Tax Plan," Tax Foundation *Fiscal Fact* No. 489, October 29, 2015, https://taxfoundation.org/details-and-analysis-senator-ted-cruz-s-tax-plan/ (accessed February 6, 2017).

50. Curtis S. Dubay, "Congress Should Be Cautious About Expanding the Child Tax Credit," Heritage Foundation *Issue Brief* No. 4241, June 26, 2014, http://www.heritage.org/research/reports/2014/06/congress-should-be-cautious-about-expanding-the-child-tax-credit.

Other economists argue that replacing the existing origin principle income tax with a destination principle tax would eliminate the current system's bias against production in the U.S. and is consistent with WTO principles allowing other countries to have border-adjusted value added taxes. [51]

- **Interest.** How the tax code handles interest is a frequent topic of misunderstanding. If interest income is taxable to lenders, it should be deductible to borrowers. If interest is not taxable, it should not be deductible. Either treatment keeps taxes from influencing decisions to incur debt.[52] Getting this issue right is important in tax reform because, if done incorrectly, it could have serious negative ramifications for the economy. A consumption tax can employ either treatment. However, it is likely that not taxing interest and denying a deduction can allow a larger rate reduction because of the large number of non-taxable lenders.[53]

- **State and local taxes.** A deduction for state and local taxes makes sense because families cannot spend the money they use to pay those taxes in the private market. However, the deduction has the adverse impact of encouraging larger state and local governments. In addition, the deduction encourages consumption through the medium of state and local government.[54] Therefore, it is probably best for tax reform to repeal the deduction and use the revenue gained to reduce federal marginal tax rates.[55]

- **Income support.** The Earned Income Tax Credit (EITC) encourages work and helps low-income families. It is a welfare program, however, that should be reformed in the context of broader welfare reform. It is also important to be cognizant of the fact that during the phase-out of the EITC, the loss of benefits as income rises is the equivalent of a marginal tax-rate increase on lower-middle-income families. Thus, the phase-out should not be too rapid, and the absolute amount of credit to be phased out must not be too large.

- **Taxation of government benefits.** Current law generally exempts government benefits from taxation (except up to 85 percent of Social Security benefits for higher-income taxpayers and unemployment benefits). This understates the income of benefit recipients and magnifies the value of these benefits compared to income generated from work. Tax reform, in conjunction with reform to assistance programs, should contemplate whether to include those benefits as taxable income, which they rightfully are. If the benefits are excluded, the Treasury Department and the Joint Committee on Taxation should include them on their tax expenditures lists.

- **Government consumption.** Government consumption—federal, state, and local—is about one-third of the economy annually. The tax system should not provide an incentive to consume through government rather than privately. A tax

51. Free-market economists differ about whether replacing the origin principle income tax with a border tax adjusted destination principle consumption tax would have a material economic impact. See, for example, Kyle Pomerleau, "Senator Ted Cruz's Comment About His Border-Adjusted Tax, Explained," Tax Foundation, November 11, 2015, http://taxfoundation.org/blog/senator-ted-cruz-s-comment-about-his-border-adjusted-tax-explained (accessed February 6, 2017); Martin Feldstein and Paul Krugman, "International Trade Effects of Value Added Taxation," in Assaf Razin and Joel Slemrod, eds,, *Taxation in the Global Economy* (Cambridge, MA: National Bureau of Economic Research, 1990), pp. 263–282, http://www.nber.org/chapters/c7211.pdf (accessed February 6, 2017); David G. Raboy, "International Implications of Value Added Taxes," in Murray Weidenbaum, David G. Raboy, and Ernest S. Christian Jr., eds., *Value Added Tax: Orthodoxy and New Thinking* (St. Louis, MO: Center for Study of American Business/Kluwer, 1989), pp. 131–162; and Dan Mitchell, "Shocker: Paul Krugman Makes a Sensible and Accurate Observation about Tax Policy," International Liberty, September 28, 2016, https://danieljmitchell.wordpress.com/2016/09/28/shocker-paul-krugman-makes-a-sensible-and-accurate-observation-about-tax-policy (accessed February 6, 2017) .
52. Curtis S. Dubay, "The Proper Tax Treatment of Interest," Heritage Foundation *Backgrounder* No. 2868, February 19, 2014, http://www.heritage.org/research/reports/2014/02/the-proper-tax-treatment-of-interest.
53. This would include foreign governments, foreign corporations with no operations here, non-resident aliens, tax-exempt organizations, and retirement and pension accounts.
54. For example, trash collection or recreational centers funded with state or local taxes would be deductible, while trash collection or recreational centers purchased from private providers would not be.
55. Curtis S. Dubay, "Tax Reform Should Eliminate the Deduction for State and Local Taxes," Heritage Foundation *Issue Brief* No. 4050, September 19, 2013, http://www.heritage.org/research/reports/2013/09/tax-reform-should-eliminate-the-deduction-for-state-and-local-taxes.

system that taxes government employee wages generally does not create such an incentive. A sales tax or BTT needs to impose a separate tax on government purchases to ensure neutrality.

- **Government enterprises.** Government enterprises, such as Amtrak, commuter rail, mass transit, the U.S. Postal Service, government-owned utilities, and recreation centers, should be taxed just like their private-sector counterparts, and subsidies to these entities should be treated as taxable receipts.

- **Transition issues.** This seemingly technical issue involves trillions of dollars, and addressing it correctly will be a major factor that determines whether the business community and others support tax reform. The biggest single issue is the treatment of costs that businesses have not yet deducted from their income (notably equipment, structures, and inventories). Others include unused foreign tax credits and net operating losses that they have not yet been able to deduct from income (carrybacks). Accounting treatment of deferred tax assets and liabilities in transition is vitally important to public companies. The revenue loss associated with transition rules can necessitate large rate increases over the intermediate term unless countervailing taxes are imposed on windfall gains.

- **Financial intermediation services, financial institutions, and insurance companies (mutual and investor-owned).** Financial intermediation services should be taxed just like other services. Doing this right is complex (but simpler than current law) and needs to be done differently in all four fundamental tax reform plans.

- **Taxation of gambling.** Casinos and lotteries (including state-operated lotteries) should be taxed just as other businesses are taxed. Specific rules may be required to accomplish this result, depending on the plan. Net gambling winnings are income and should be taxed to individuals.

- **Taxation of pass-through entities (including S corporations, cooperatives, REITS,[56] and RICs[57]—such as mutual funds).** Most small businesses and about half of private-sector GDP are taxed as pass-through entities (such as partnerships, LLCs, and LLPs), which means that the business income is taxed on their owners' tax returns. Tax reform should also ensure that these businesses pay the same rate as businesses that pay the corporate rate, and should not double-tax their income.

- **Administration and Taxpayer Rights.** No matter what type of tax reform plan Congress institutes, a revenue-collection agency will remain necessary to enforce the system. Whether that is a reformed IRS, or a new agency created in its place, is up to Congress. Changes to the IRS are essential because of a series of recent inappropriate and illegal actions.[58] Although significant progress has been made over the years, enhanced procedural rights for taxpayers when dealing with the IRS are appropriate. Each of the tax-reform plans described here would aid Congress in reforming the IRS. Since each of them would make enforcing the new tax code simpler than under the current system, they would all allow a considerably smaller revenue agency.

Conclusion

Tax reform is essential to restoring economic prosperity for Americans. The best way to maximize growth is for tax reform to establish a tax system with low marginal tax rates that taxes consumption. There is more than one way to achieve a consumption base. A tax reform plan that moves substantially in this direction is constructive and pro-growth.

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56. REITs: Real Estate Investment Trusts.
57. RICs: Regulated Investment Companies.
58. See, for example, Hans A. von Spakovsky, "The IRS Just Admitted They Could Resume Targeting Conservatives," *Conservative Review*, August 9, 2016, http://www.heritage.org/commentary/the-irs-just-admitted-they-could-resume-targeting-conservatives (accessed February 6, 2017), and David R. Burton, "IRS Politicization Is Inappropriate in a Democratic Republic," The Daily Signal, May 12, 2014, http://dailysignal.com/2014/05/12/irs-politicization-inappropriate-democratic-republic/.