The Basis for Tax Reform November 16, 2004

A lot of sincere effort has gone into developing a scheme for tax reform. Think tanks, policy groups, congressional subcommittees, and individual lawmakers have put forth number of ideas. We have a number of creative alternatives, but none have had the traction to survive a legislative process. It's time to pick a basic framework; address any basic flaws; and organize the new tax law in a way to assure passage. A further goal is to organize the law so that it is not as subject to endless tinkering and manipulation.

Tax simplification has been promoted in three basic ways: Various forms of a national sales tax; a new VAT tax; and single or two rate income taxes. Sticking to some form of income tax has major advantages if it can be made to work in a permanent and fair way. We already have a fully formed IRS to enable collections and most accounting is organized to accommodate the paying of income taxes. The use of individual exemptions could maintain a progressive tax structure. Both a sales tax and VAT tax have major barriers to implementation and tax collection. Both are relatively regressive taxes, so a lot of continuous tinkering would be required to meet perceived needs of "fairness." The tinkering will result in a lot of exemptions and preferences, and the end tax rates will be a lot higher than initially projected. Rates higher than 10% are likely to meet a lot of resistance, tax evasion and tax fraud. The end game could be a continuing complex income tax and the addition of a new tax that is complex and subject to endless tinkering manipulation.

Steve Forbes, Richard Gephart and Richard Armey have put forth alternatives of single or double rate income tax rates. All three of these alternatives are supported by strong analysis and as well as academic support. None of them have a chance of passage without modification. We will select the Armey proposal and modify it to mollify objections to the proposal as originally written.

The major objection to these proposals is that they are less progressive than the existing system, and therefore they are perceived as being unfair. A second objection in the case of the Armey and Forbes proposals is that they are unlikely to raise the required revenues at the proposed low rates. Our objection to these schemes is that they do not discourage manipulation and complexity in the tax code in a number of important ways. A single rate alone will not address mal-distribution of wealth, and none of the proposals address the preferences and exemptions in a way that avoid future manipulation.

All of these shortcomings can be fixed in a way that promotes broad support and passage. But first we should look at who pays taxes and who doesn't. Who gets preferences and exemptions and who doesn't?

The biblical adage that "money is the root of all evil" was never truer when applied to the tax code. The ultimate failing of our tax code is that it fails to create and encourage a constituency that minimizes spending. This failure is promoted by permitting selective taxation and spending so that various groups have the real or imagined belief that they are getting something for free. The single tax rate plus rules for the control of deficit spending could provide control of overall spending. If we adopted a single tax rate (that includes current Social Security and Medicare taxes) with a deductible that relieves the bottom 20% of payers (they don't pay any net taxes now), 80% of the voters would resist increases in spending. For this scheme to work all other incremental taxes, except for user fees and custom duties, would be prohibited. All tax preferences would be prohibited.

Another major failing of our tax code is that it fails its progressive mandate. True, the rich suffer high tax rates on income and an onerous death tax. Unfortunately, these high tax rates are based on income, and the very rich escape many if not most of these taxes through various avoidance schemes. Perhaps the biggest tax avoidance scheme is to not create current income.

This tax scheme suggested above would cause a firestorm of controversy. Every favored group would be hit. Tax preferences would be eliminated and spending would be cut. The current tax code is devised with a lot of cunning so that everybody belongs to some favored group. The only possible way to legislate such a tax reform would be to lower everybody's tax rate. As we will see, this could be accomplished.

The elimination of preferences would be offset to a large degree by the elimination of various separate taxes and lower tax rates. The elephants in the room are the coming crises in Social Security and Medicare/Medicaid. Large tax increases and benefit cuts are coming just to support these two programs as they are currently devised. Clearly, tax reform is an empty promise unless those two programs are also reformed.

Obviously, new taxation is needed. But we now have a lot of experience that suggests that higher tax rates damage the economy and lower overall revenues. Incremental Social Security and Medicare tax increases are unlikely to solve the problem unless we also control overall spending. The Congress of the 1970's used the then Social Security surplus to raise benefits and support the general budget. They continue to follow this formula.

When he was asked why he robbed banks, Willie Sutton said "Because that is where the money is." To find new tax revenue, we must go where the money is, and we must do it in such a way that we maintain work incentives and economic growth. The United States has vast wealth, but much of it is held by a relatively small group of people. Much of this wealth is also held by corporations and tax favored institutions. A wealth tax could generate a lot of revenue.

A few countries and states use wealth taxes to generate revenue. They are somewhat effective, but they have some drawbacks. Intangible wealth votes with its feet…it will move to a lower tax or non-tax jurisdiction. Wealth taxes are expensive and controversial to apply, so they should only apply to the top 5-10% of wealth holders. Definitions and rule making could be as complex as the current tax code. It is a tax that could be used to destroy the capital holding class. In addition to revenue generation, a wealth tax has a major advantage. All of the powerful voices in the country would favor spending limits.

The very wealthy in this country pay very low tax rates on very little declared income. That would end with a wealth tax on the top 5-10% of payers.

Since simultaneous reform of Social Security and Medicare is required, we will set some goals for that reform. The financial requirements of Social Security reform and Medicare reform are overwhelming…more than $12 trillion in unfunded liabilities. We have to start by cutting spending.

First, we make individuals in the top 5% of income and wealth holders ineligible for Social Security benefits. Second, we add an additional 1% of the top wealth/income holders to the ineligibility list each year for 5 years. This should stabilize the system for about 10 years. Third, immigrants that come to this country who are older than 45 years are ineligible for Social Security and Medicare benefits. We raise the retirement age 3 months every year for the next 20 years.

Controlling medical expenses is extremely difficult. New, but expensive procedures extend life and greatly increase overall medical costs. We start by mandating transparency and uniform pricing. Many individuals would favor personal management of their health care finances, but they have almost no way to do cost comparisons or receive competitive price offerings. Moreover, providers have widely varying price structures for same service or product depending on the status of the payer. They offer preferential pricing to insurance companies, some major institutions, some corporations and Medicare. Insurance companies offer preferential pricing to some buyers.

All medical providers are required to publish their lowest detailed price for service along with key metrics that describe the quality of their service. No customer, including government entities, may legally receive a lower price including incentives and discounts. All providers must sell to all customers at a price no more than 25% greater than their lowest price.

The federal, state, or local government is the payer of last resort for the bottom 30% of wealth/income holders. Governments provide private insurance assistance to the bottom 30% of wealth/income holders.

The federal government supports private savings accounts for retirement and health care by adding 50% of the savings to the deductible for federal taxes for the bottom 80% of payers. Earnings on these savings (if any) are free of federal income taxes, but the assets are subject to the applicable wealth taxes. These tax advantaged savings are limited to 10% of income.

Whether these reforms will substantially reduce government medical cost burdens and broaden the private health insurance market remains to be seen. Shortfalls will be funded by increasing the flat rate, so the incentives are in the right place to control costs. If the changes are successful, the next step is to gradually eliminate government sponsored health care for all but the indigent which we would define as the bottom 20% of wealth/income holders.

The following is a set of specific parameters for new legislation which needs to be in the form of an amendment to the US Constitution.

1. All federal income and gains taxes are limited to a single rate.
2. The deductible for this rate is an amount equal to the amount of net income earned by the highest of the bottom 20% of the taxpayers of the previous year.
3. A wealth tax may be imposed on all assets of all wealth holders including all entities (individuals, corporations, and institutions of all types including non-profits, churches, endowments etc.). The deductible for this tax is the holding of the highest entity in the bottom 90% of wealth holders based on the previous year. The maximum annual tax rate allowed is 1% of assets. Assets are not adjusted for liabilities except for certain financial institutions such as banks and savings banks or other financial institutions whose primary function is to be a repository of funds.
4. All tax preferences are eliminated including deductibility of interest, tax free bond income, and charitable contributions.
5. Deductibles apply to each individual man woman and child, but may be combined on a single return for living groups. Tax preferences or penalties for families are eliminated.
6. Users taxes are encouraged where technically feasible, but use of the fees collected are limited to maintenance of the service or sinking funds for further capital improvements. Greater amounts are returned to payers in the form of reduced fees.
7. Tariffs may continue via separate legislation.
8. All other taxes including the death tax, Social Security taxes and Medical taxes are abolished.
9. A 3% deduction on all wages is collected and remitted by employers, but these funds may be recovered by low income payers by filing a tax return. Higher income payers may recover the funds or use them to fund income tax liabilities.
10. Detailed wealth (asset) statements must be filed by the top 20% of asset holders each year. The bottom 80% must file a statement with their return that confirms that they are in the bottom 80% of wealth holders.
11. Individual wealth of citizens is taxed on a worldwide basis. The wealth of foreigners is taxed on assets held in the United States. The wealth of foreign and multinational corporations is taxed based on the assets used to support US income generation and all US based assets.
12. Deficit spending is another form of taxation, so a set of automatic adjustment to the flat tax rate will close the previous year's deficits. A flat tax rate change affects 80% of the voters, so incentives to control spending are also automatic.

It is anticipated that the resulting flat tax rate will be in the low 20's with a wealth tax of 1% on the top 10% of wealth holders.

Winners and Losers

More than 70% of the population are net winners with this series of changes, but virtually everybody will lose something. The big losers are those that pay little or no taxes now…certain corporations, churches, charities, non profits, endowments, etc. Keep in mind that the deductibles are high, so the overwhelming percentage of these institutions is unaffected. Those that cannot take care of themselves will continue to be aided by various forms of welfare.

The biggest losers with be the wealthiest Americans. Some of these changes will be very big. For example, Bill Gates and Warren Buffet will pay more than $500,000,000 in wealth taxes each year. And they will have to sell assets or earn additional income to pay those taxes. Theresa Heinz Kerry will pay about $10,000,000 in addition to the $1,000,000 in federal taxes she pays now. These are vast sums…but they can afford it.

The biggest winners are the most productive and hard working of our society…entrepreneurs, entertainers, scientists, new businesses, doctors, etc. The great thing is that they will all soon become rich enough…to pay wealth taxes.