What Tax Reform Should Look Like Under the Next President

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American families and businesses are overtaxed and Washington spends too much money. Progress has already been made curtailing spending when the Republican-controlled Congress implemented discretionary spending caps through passage of the 2011 Budget Control Act. Because of these caps, overall spending has since declined from 24 to 20 percent of GDP and discretionary spending has decreased from over nine percent of GDP to less than seven percent of GDP.

The next step must be enacting comprehensive, pro-growth reforms to the tax code to help get the economy back on track and increase economic growth. The next president must start by reducing income tax rates across the board so American families are able to spend, save, and invest more of their hard-earned income.

Any changes to the tax code should move toward a consumption base, simplify the system, and ensure that revenue is kept at the historical average of 18 percent of GDP. In addition, any changes must be considered using dynamic scoring, which will provide greater accuracy over macroeconomic effects. Finally, tax reform should be a net tax cut, not a backdoor for increasing the tax burden on Americans.

These principles provide an outline of how to reform the countless problem areas in the tax code to reform.

First, US business tax rates are some of the highest in the world, not to mention inconsistent. Rates should be lowered and simplified.

Second, tax extenders, the temporary provisions within the code, must be made permanent, or redundant under tax reform to encourage efficiency and clarity.

Third, the tax code must stop discouraging business investment by allowing full expensing.

Fourth, the US must move from a worldwide system of taxation to a territoriality system.

Fifth, it should become easier for taxpayers to use tax advantaged savings accounts.

Sixth, the Death Tax and the AMT should be repealed. Ideally the capital gains tax should be repealed too, or reduced.

Seventh, entitlements should be reformed and Social Security and Medicare payroll taxes should be phased out.

While there are many flawed areas within the tax code that require reform, there are also many proposals that would push the code in the wrong direction by increasing complexity and inefficiency. For one, tax reform must ensure that the IRS is reined in and is kept out of tax preparation business. New taxes, for example those on the internet and online commerce should

not be considered. And there is no need to implement a "Buffett Rule," requiring upper income earners to pay a certain minimum percentage of their income. Taxpayers can already pay more if they feel so inclined.

The ideas outlined in this paper should serve as a guide toward improving the tax code to better serve the American people and promote economic growth and prosperity. In general, metrics outlining specific reductions have not been included, as this can vary plan to plan. But by implementing these ideas, the next president has an opportunity to simplify the tax code for families and businesses, remove inconsistencies and inefficiencies, provide certainty, promote stronger growth and create more jobs.

Move Toward a Consumption Tax Base

Any changes to the tax code should be based around moving toward a consumption base: curtailing or eliminating most tax exclusions, adjustments, deductions, and credits and taxing labor at the point of consumption while leaving savings alone.

Moving toward this type of tax base is not only the least demanding on the free market, but also on supply and demand because it leaves the maximum amount of productive income untouched from taxation so that it can increase productivity, grow wages, create jobs, augment nest eggs, etc. Eventually, even this income is consumed and subject to taxation, so there are no loopholes.

As a result, it is the most economically efficient base and promotes stronger economic growth.

Utilize Dynamic Scoring to Analyze Macroeconomic Effects of Tax Cuts

The merits of any change to the tax code should be analyzed through the perspective of dynamic scoring. Currently, all tax legislation is analyzed and "scored" by the Joint Committee on Taxation (JCT), a bureaucracy that does not divulge their full methodology, or make their work available for peer review. For decades, JCT analysis did not incorporate the Laffer Curve in their methodology, which simply states that moving from very high to very low marginal income tax rates increase the incentive of taxpayers to work, save, and invest. Doing the opposite – moving from a very low to a very high marginal income tax rate – has the opposite effect.

Under their outdated methodology, JCT does not take into account "macroeconomic" changes. In other words, they didn't think that large tax changes impact the economy.

Fortunately, the Republican controlled Congress has taken steps to rectify this oversight. Now, JCT scoring of legislation takes into account changes in behavior. This does not mean, as some on the left try to argue, that tax cuts somehow pay for themselves. It simply means that commonsense economic effects are taken into account.

The Congressional Budget Office (CBO) estimates that every 0.1 percentage points in higher GDP growth equates to roughly $59 billion in revenue over ten years. Extrapolating, tax reform that can achieve four percent growth – as opposed to the current anemic two percent – equates to roughly $1.12 trillion more in revenue over ten years. Dynamic scoring allows this kind of growth to be factored into any proposed changes to the tax code.

Maintain Revenues of 18 percent of GDP or less

The historical average of tax revenues is 18 percent of GDP, which should serve as a guide for future fiscal policy assumptions and decision-making. Under the current tax system, revenue as a percentage of GDP will continually rise because of real bracket creep (incomes rising faster than inflation-adjusted tax brackets). As a result, Americans will be taxed more and more if lawmakers do nothing.

CBO projects that because of bracket creep, federal tax revenues will rise from $3.2 trillion in 2015 to $5 trillion in 2025. As a percentage of GDP, tax revenues also rise in this period, from 17.7 percent to 18.3 percent of economic output (note that the historical average is just under 18 percent of GDP). Revenues will reach 20 percent of GDP in 2045, 21 percent in 2056, 22 percent in 2068, 23 percent in 2079, and fully 24 percent of GDP by the end of the century.

When politicians seek to increase taxes, they conveniently ignore these numbers. After all, it naturally leads to the conclusion that there is no reason to increase taxes on the American people. And it makes keeping the Taxpayer Protection Pledge, a promise made by a politician to their constituents, a reasonable, common-sense commitment.

Reduce Business Rates so America Can Compete With the Rest of the World

There are two main problems with business taxes under the code today. First, the code treats businesses differently depending on whether they register as corporations or flow-through firms. This means that the choices a business owner makes will result in drastically different and confusing tax, legal, and employment consequences. Removing this discrepancy and treating all businesses equally will level the playing field and help simplify the tax code.

Secondly, American business tax rates are uncompetitive with the rest of the world. This is problematic because corporations have greater choice over which country to be based in, and where to take their jobs. Including state income taxes, the business tax rate stands at 39 percent for corporations and approaching 50 percent for flow-through firms. By comparison, the UK's rate is 20 percent, and Germany and Canada's rate is just 15 percent. In fact, the average rate among developed countries is just under 25 percent. With such high rates, the US simply cannot compete.

Corporate Tax Rates Across the World

Country	Corporate Tax Rate
United States	35%
Italy	30.6%
Germany	30%
Mexico	30%
China	25%
Finland	20%

Singapore	17%
Hong Kong	16.5%
Canada	15%
Ireland	12.5%

For businesses, the equation is simple. If they are going to make an extra billion dollars, they would rather do it in a country where that billion dollars will lose 25 percent in taxes than in a country where it will lose 40 percent in taxes.

Luckily, fixing this problem is relatively simple – lower the rate to a level that competes with other developed nations. This means the federal rate needs to be lower than 25 percent, as states impose their own business tax.

Reduce Uncertainty in Tax Planning

Every year or two, Congress reauthorizes a set of around 55 tax provisions that are about to expire, or have just expired. These "tax-extenders" include many important provisions including 50-percent business expensing, a research-and-development tax credit, and provisions to prevent double taxation.

The most important extenders, like the three above, should be made permanent. Others can be made permanent, be removed entirely, or made redundant by ironing out inconsistencies in the code. Doing so would reduce uncertainty for taxpayers and small businesses. For policy makers, it would ensure a more stable, fixed understanding of the tax revenue baseline, and will make pro-growth reform easier.

Move from the Current System of Depreciation to Full Business Expensing

Ideally, the tax code should allow full business expensing. When a business invests in new equipment such as computers, automobiles, machines, and furniture they should be able to reduce their taxable income dollar-for-dollar by the amount purchased. This encourages owners to put more of their hard-earned income back into their business, which will help create jobs and stronger economic growth.

Under the current tax code, there is a bias toward that discourages business owners from making investments. Some business investments are given immediate expensing under the tax code while others are subject to a slow multi-year deduction process known as depreciation.

There is no rhyme or reason to how each item is categorized, or over how many years a certain purchase can be deducted. However, the complex formula under which costs are deducted creates burdens on business owners that ends up discouraging business investment.

Congress currently has a temporary tax extender or that allows businesses to deduct a percentage of business purchases (currently 50 percent). The remainder is subject to depreciation.

Ideally, any tax plan should move toward full-cost recovery for business purchases. 100 percent, full business expensing would increase economic growth, create new jobs, and raise wages.

Promoting investment through business expensing has been an issue that has drawn widespread support. President Obama has included bonus depreciation in past proposals, and Democrats proposed full business expensing back in 1981.

Business owners should not be discouraged from investing in new equipment.

Move From Worldwide to Territorial System of Taxation

Most of the world has a territorial tax system. They tax money earned in their country but welcome the return of money earned abroad tax-free. This makes sense because this money is already taxed in the country where it was earned.

The US is different. It is one of only seven OECD countries (with Chile, Greece, Ireland, Israel, South Korea, and Mexico) in the world that has a worldwide tax system, which means that if you are an American, the IRS tries to tax everything you earn regardless of where you earn it. Incidentally, every other country that has a worldwide tax system has lower rates than the US.

Changing to a territorial system will help simplify the tax code, stop the IRS from harassing businesses and taxpayers, and make it easier for the US to compete globally.

Moving forward, one option toward this change is to have optional repatriation of business income stored overseas. Currently, American businesses are sitting on over $2 trillion in after tax earnings overseas and so bringing this money back through repatriation would provide a boost to the economy, create jobs, and increase income.

In fact, there is already a model to follow, when repatriation last occurred in 2005. That year, businesses could bring back income at a rate of 5.25 percent – far below the normal rate the IRS double taxes income.

Switching from the current worldwide tax system, to a territorial system should be a no-brainer. Not only will it make the country more competitive and reduce complexity, but it will also be a massive economic stimulus.

Encourage and Simplify the Use of Tax Preferred Savings Accounts

Currently, there are about 15 tax-advantaged savings accounts that taxpayers can use to save for retirement, health care, and education. When used correctly these saving accounts drastically reduce the tax burden on families. There is just one problem – the current system is so complex it is enough to make your head spin, and it causes most Americans to under-save. Taxpayers have too many options, which encourages them to make the wrong choice – do nothing and instead consume what could have been saved.

One solution is to roll these fifteen choices into a streamlined system with a few flexible, but defined savings accounts. Back in the mid-2000s, the Treasury Department came up with a proposed three-account system to replace the existing system. Here’s how it would work:

Employer Retirement Savings Accounts (ERSAs). This would replace all the employer options that exist. The accounts would work much like Safe-Harbor 401(k) plans do today, where employers make sure that all employees benefit in exchange for a waiver of onerous non-discrimination testing. The current 401(k) elective deferral limit ($18,000 in 2015, plus a $6000 catch-up for older workers) would apply. Deferrals could be either pre-tax or after-tax, depending on participant wishes.

Retirement Savings Accounts (RSAs). These would replace all the personal IRA-type products that exist today. Anyone could save up to $10,000 per year into an RSA. The money would be deposited after tax, but would grow tax-free if used for retirement after age 55. There would be no income limits on contributions, so they would be very easy to understand.

Lifetime Savings Accounts (LSAs). These would work just like RSAs, but there would be no requirement that the funds be used for retirement. In addition to retirement, they could be used for healthcare, education, a first home, to start a small business, etc. Importantly, there would be no earned income requirement, so even the parents of children could make annual LSA contributions on their behalf. LSAs would replace HSAs, FSAs, HRAs, 529s, and Coverdells.

Another option is to create an additional account (not displacing what's already there), but which allows saving in the simplest possible way. These types of accounts already exist in Canada and the United Kingdom, and they are doing very well.

In Canada, the government created "Tax Free Savings Accounts" (TFSAs) in 2009. Any adult can contribute up to $10,000 per year (with rollover of contribution eligibility if you skip or partially skip a year). The money grows tax-free, and can be used for any purpose, including but not limited to retirement. The accounts can be opened at any bank or brokerage firm, online or in person. This is as simple as it gets. The British version is called an "Individual Savings Account" (ISA), and there you can sock away an amazing $23,000 per year with tax-free growth.

Clearly, tax preferred accounts need to be simplified. While these accounts already exist, the reality is they are far too confusing and complex for most American families. By simplifying these saving accounts, Americans would almost certainly save more than they currently do (and be taxed less).

Repeal the Alternative Minimum Tax

First imposed in 1969, the Alternative Minimum Tax (AMT) was established to prevent certain Americans and corporations from using otherwise available deductions to reduce (and in some cases eliminate) their income tax liability. The AMT sets a certain income threshold and requires individuals whose income exceeds this threshold to calculate both regular tax burden and AMT and pay the higher amount. The AMT was thus intended to act as a failsafe mechanism to ensure that a small number of upper income individuals could not abuse deductions.

But as with just about every other tax, the AMT has expanded to hit a far larger percentage of Americans than was ever intended. In 1970, the tax hit just 20,000 taxpayers but by 2011, it had grown to hit 4.3 million including many upper-middle class taxpayers.

Because wages are continuously increasing, the AMT will only continue to hit more and more taxpayers over time.

This tax is an unnecessary complication within the code and no longer meets its intended purpose. It should be repealed.

Reduce Capital Gains Tax Rates

A capital gain is a profit derived from the sale of a stock, bond or other asset and together with dividends are taxed at a lower rate. Currently, the top rate today is 23.8 percent for assets held longer than a year, an unusual number due to the sum of the 20 percent statutory capital gains rate plus the 3.8 percentage point surtax from Obamacare.

In the ideal consumption base model, income derived from investments (as well as income saved) would be not be taxed at all. The capital gains tax hits income that has already been subjected to income taxes and has been reinvested to help create jobs, grow wages, and increase economic growth. This double taxation makes no sense from the perspective of encouraging investment and stronger growth.

Recently, presidential candidates from both parties have proposed taxing "carried interest" capital gains – the portion of investment that the expert investor receives from the transaction – as ordinary income. Essentially, these proposals would hike taxes on expert investors from 23.8 percent to 39.6 percent (assuming no change in the top rate.)

Taxing carried interest capital gains as ordinary income is a proposal that goes in the wrong direction. In fact, every time this has been proposed, it has been quickly shot down by those who realize it is a back door proposal to taxing all capital gains as ordinary income. Lawmakers should be encouraging, not discouraging investment.

As it stands now, Uncle Sam takes a bite every time a transaction is made. A key policy goal should be incremental progress toward a consumption base of taxation and therefore cutting the tax rate on capital gains (and dividends, distributed after-tax corporate earnings) to zero.

Repeal the Death Tax

One of the most intrusive and unfair taxes is the Death Tax, which requires you to tell the IRS about everything you own at the moment of death – your bank accounts, investments, home, value of your business, and more. Perhaps worse, the Death Tax is a tax you pay on savings you have already paid taxes on at least once, and probably more than once. Right now, the tax sits at 35 percent with an exemption threshold of $5.43 million, so grieving families will have to pay millions when hit with this tax.

Not only is the Death Tax unfair, it is easily avoided by the truly rich, who are able to avoid paying the tax with an army of accountants, attorneys, and charitable planners. Because the tax can be avoided by the very wealthy, those who are hit by the Death Tax tend to be those who didn't plan ahead. First and second generation families, with a small business are those hit hardest.

There are clear benefits to repealing this tax. For one, repeal of the Death Tax would cost almost nothing. Right now, the tax makes up less than one percent of federal revenue and that number is dropping. The tax is also unpopular -- it has been opposed by 60 to 70 percent of adults, registered voters, and likely voters in poll after poll after poll.

Lastly, repealing the Death Tax is good for the economy. It is estimated that repeal will create 139,000 jobs, increase private business hours by 0.1 percent, and increase wages by 0.7 percent.

Make Social Security and Medicare Payroll Taxes Redundant Through Reform

Even though the Republican controlled Congress has reined in spending, it remains high. In 2015, spending as a percentage of GDP reached at 20.5 percent. The culprit is not day-to-day spending, but entitlement spending on Medicaid, Medicare, food stamps, and Social Security. Social Security and Medicare taxes account for about one-third of all federal taxes collected, so reforming these programs could both rein in spending and reduce taxes.

When Social Security was first enacted in 1935, there were 42 Americans in the workforce for every retiree of age to get Social Security. That ratio has since dropped to 5.04 workers per retiree in 1980 and 4.65 workers per retiree in 2000. By 2050 there will be 2.65 workers per retiree.

The numbers are similarly bleak for the long-term sustainability of Medicare. These programs clearly need reform. Fortunately, the direction to go in is obvious.

Privatizing Social Security and reforming Medicare to make it a defined-contribution 401(k) – style savings program would take these programs off budget and dramatically drop the cost of total government spending while also reducing the tax rates needed to fund the these programs.

Of course, this would have to be a gradual process – allowing those who have paid into the existing system to continue using it, while slowly phasing it out and allowing younger workers to use a more efficient private system.

Reforming these programs in this direction will not only strengthen and protect entitlements for future generations, it will also drastically lessen the tax burden on American families and business.

Stop Internet Taxes and Taxation Without Representation

While the most obvious check on taxation without representation is our republican form of government, a critical check has also been established in states through the concept of "physical nexus." This means that a person or business has to have some kind of physical presence –

employees, own or lease property – within a state in order to be subject to the taxation authority of a state.

As the digital and physical world meld together, the physical nexus is being threatened. In many cases, states are using the expansion of digital commerce to expand their tax base by assessing business, income, franchise, and sales taxes across borders on businesses that have customers, but no property or employees in the taxing state.

Appropriate boundaries need to be set on taxation authority to withstand regulatory overreach. But rather than restrain this behavior, some in Washington want to encourage it. Misleadingly named legislation like the "Marketplace Fairness Act" and "Remote Transactions Parity Act" give states cross-border tax authority over businesses located outside their jurisdiction.

These bills are a perfect example of what not to do. In reality, they have nothing to do with "fairness" or "parity," but instead open to door to taxation without representation and inhibit the innovation that the internet provides.

Shifting the cost of government to non-residents poses a direct threat to the principle of republican governance by the people. It also violates the "benefits principle" by pushing the tax burden onto those that receive no direct benefit from the state.

Physical presence must be maintained not only in order to prevent state tax base expansion, but also to prevent states from exporting their lawsuits, tax liens, and other policing to non-residents.

People Who Feel They Are Undertaxed Can Already Do Something About It

Taxpayers so inclined can already pay more taxes through a "tax me more account." Any American may make a donation today simply by writing a check to the Treasury, to a fund known as "Gifts to the United States." In addition, at least eight states have a "tax me more fund" that allows those who feel they are not paying enough in taxes to contribute to their state's treasury.

Warren Buffett has famously complained that his average effective tax rate was too low compared to his secretary. Over the years, the "Buffett Rule" – the idea that the wealthy should pay a higher tax rate than middle class families – has been brought up by time and time again by some on the left. These same people continue to ignore the fact that they can already pay more in taxes if they so wish.

While extreme examples undoubtedly exist, the tax code is already steeply progressive. The top one percent of households pay an average income tax rate of over 20 percent, and a total tax rate of 29 percent. By comparison, the middle quintile of households pays an average income tax rate of 2.4 percent and a total tax rate of over 11 percent.

A Buffett Rule is clearly nothing more than a talking point of the left. If anything, implementing it would result in AMT style bracket creep, and this new tax would soon expand beyond its initial intent to hit millions of taxpayers.

Keep the IRS Reined in and out of the Tax Preparation Business

Some argue that the IRS needs more resources to better do its job and expand its reach. In reality, the opposite is true. Even after adjusting for inflation, the IRS has far more funding than it had 30 years ago.

One annual suggestion is that the agency should expand to tax preparation. After all, the IRS has all this information on you anyway, so wouldn't it just be easier and better if they simply prepared your taxes for you?

For one, it's a giant conflict of interest for the IRS to determine your tax liability, and then to be able to seize your wages and assets in order to collect that tax liability. And even without this conflict of interest, this idea makes no sense. There already exists “free file” tax preparation software that can be easily used by taxpayers across the country.

The IRS has completely failed to serve taxpayers in recent years, from its targeting of political non-profits, to its bumbling implementation of Obamacare, to its recent failure to protect the personal information of hundreds of thousands of taxpayers. The agency clearly needs reform and greater efficiency, not to be made bigger. Through simplifying and removing inconsistencies in the tax code, the ability of the agency to abuse its power will be curtailed.