

## 9. Taxes

THE goal of tax policy should be to raise the amount of money needed to fund legitimate functions of government while doing the least amount of damage to the economy and respecting the principle of treating taxpayers equally. This is why a low-rate, consumption-based system like the flat tax is the ideal approach. A flat tax has a low tax rate and eliminates the current tax code's pervasive bias against saving and investment. It also eliminates special preferences and penalties that lead individuals and businesses to make choices based on tax considerations rather than on economic benefits. This is why a flat tax will boost growth. Since a flat tax also is based on the principle that all taxpayers are treated equally regardless of how they earn their income, how they spend their income, or the level of their income, the system is both morally and economically superior to the current Internal Revenue Code.

by *Daniel J. Mitchell, Ph.D.*

### Notes

#### Recommendations

**1. Make the Bush tax cuts permanent.** While far from perfect, the Bush tax cuts have moved tax policy in the right direction. Income tax rates have been slightly reduced, with the top tax rate falling from 39.6 percent to 35 percent; the double taxation of dividends on capital gains has dropped to 15 percent; and the death tax will disappear in 2010.

**2. Fundamentally reform the tax code.** Tax cuts are just one step toward the ideal of scrapping the colossal federal tax code. Either a flat tax or a single-rate national sales tax would be fairer, would lower compliance costs, and would spur economic growth. One of the current system's blights is the alternative minimum tax (AMT), a "Catch-22" system that forces an ever-larger number of taxpayers to recalculate their tax burdens and, if it results in a higher tax liability, pay more tax.

**3. Eliminate the death tax.** The estate tax is one of the most inefficient and immoral features of the current tax system. Its sheer complexity results in high compliance costs—by some estimates, as much money as is raised by estate taxes. Many small businesses and family farms are destroyed by its penalty, which distorts incentives and hurts families. Although the 2001 tax cut kills the death tax in 2011, the penalty is resurrected the following year.

**4. Institute dynamic scoring of tax proposals.** Congress routinely debates changes in tax policy largely without considering their economic or dynamic effects. Absent an understanding of how tax and fiscal policy influences economic behavior, the static “cost” estimates produced by official revenue estimators (the staff of the Joint Committee on Taxation, the Congressional Budget Office, and the Treasury Department’s Office of Tax Analysis) are often shockingly wrong and nearly always misleading. The current static approach creates an artificial and incorrect bias in favor of tax rate increases and against pro-growth tax rate reductions.

**5. Lower the corporate income tax rate.** The United States now has the world’s second highest corporate tax rate, second only to Japan’s. America’s corporate tax rate is higher than the rate in every European nation—even socialist welfare states like France and Sweden. This creates a significant competitive disadvantage for U.S.-based companies. But even if the United States were the world’s only nation, the corporate tax rate should be reduced.

**6. Abolish “worldwide” taxation.** The greedy hand of the Internal Revenue Service reaches out to tax labor income, capital income, and corporate income earned in other nations—even though this income already is subject to foreign tax. This “worldwide” taxation places U.S. companies at a competitive disadvantage, reducing their share of the global market. Some argue that worldwide taxation is a good idea because it discourages U.S. companies from operating abroad, but this policy neither limits competition from factories in low-tax countries nor restricts imports. Instead, it impedes U.S. companies’ ability to capture a bigger share of foreign markets, thereby leading to fewer exports from the United States and fewer jobs here. Territorial taxation—the common-sense notion of taxing only income earned inside national borders—is good tax policy, and reducing the tax burden on foreign-source income is a simple step in this direction that would help the economy by resulting in more jobs, better jobs, and improved competitiveness for U.S. companies.

## Facts and Figures

■ America’s top personal income tax rate is 25 percent higher than it was when Ronald Reagan left office. If the tax cuts are allowed to expire, the top tax rate will climb to 39.6 percent—more than 41 percent higher than the top rate when Reagan was President.

■ Failure to make the Bush tax cuts permanent will push the overall tax burden to above 20 percent of gross domestic product (GDP)—higher than it was in every year of the Carter Administration and higher than it was in seven of the eight years when Bill Clinton was President.

## Notes

■ By reducing the double tax on dividends and capital gains and accelerating income tax rate reductions (enacted in 2001 but originally not scheduled to take effect until 2004 and 2006), the 2003 legislation embodied sound economic principles.

■ GDP growth in the third quarter of 2003 was the largest since Reagan's first term (7.2 percent), and the average growth rate (after inflation is subtracted) over the last seven quarters since then has been a solid 3.7 percent. Pro-growth tax changes have helped to pull the economy out of recession and trigger a strong recovery.

■ After passage of the 2001 and 2003 tax cuts, unemployment declined steadily; business investment responded positively, reversing three straight quarters of decline; GDP growth skyrocketed in the third quarter of 2003, achieving the best quarterly increase in 20 years; and the economy grew by an average growth rate of 3.7 percent (after inflation) over the seven quarters that followed the third quarter of 2003.

■ The current tax code is 17,000 pages long and includes more than 1,100 forms and publications. Taxpayers are forced to spend almost \$200 billion each year just to comply with it, and even IRS employees do not understand the laws they are supposed to enforce. Several years ago, a General Accounting Office survey found that IRS employees gave incorrect tax advice half the time.

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*This chapter can be read online at [issues2006.org/taxes](http://issues2006.org/taxes).*

## Notes

### Additional Reading

William W. Beach, "The Bush Budget's Hidden Gold: Dynamic Scoring Comes to the Treasury," Heritage Foundation *WebMemo* No. 994, February 9, 2006, at [www.heritage.org/Research/Taxes/wm994.cfm](http://www.heritage.org/Research/Taxes/wm994.cfm).

William W. Beach and Rea S. Hederman, Jr., "Make the Bush Tax Cuts Permanent," Heritage Foundation *WebMemo* No. 956, January 5, 2006, at [www.heritage.org/Research/Taxes/wm956.cfm](http://www.heritage.org/Research/Taxes/wm956.cfm).

Daniel J. Mitchell, Ph.D., "A Brief Guide to the Flat Tax," Heritage Foundation *Background* No. 1866, July 7, 2005, at [www.heritage.org/Research/Taxes/bg1866.cfm](http://www.heritage.org/Research/Taxes/bg1866.cfm).

Daniel J. Mitchell, Ph.D., "A 'Supply-Side' Success Story," Heritage Foundation *WebMemo* No. 755, July 7, 2005, at [www.heritage.org/Research/Taxes/wm755.cfm](http://www.heritage.org/Research/Taxes/wm755.cfm).

William W. Beach, "Now Is (Still) the Time to Permanently Repeal Federal Death Taxes," Heritage Foundation *WebMemo* No. 720, April 12, 2005, at [www.heritage.org/Research/Taxes/wm720.cfm](http://www.heritage.org/Research/Taxes/wm720.cfm).

Daniel J. Mitchell, Ph.D., "Making American Companies More Competitive," Heritage Foundation *Background* No. 1691, September 25, 2003, at [www.heritage.org/Research/Taxes/BG1691.cfm](http://www.heritage.org/Research/Taxes/BG1691.cfm).