A Few Things the Tax Reform Panel Needs to Remember

“Drop Kick Me Jesus Through The Goalposts Of Life”

This title of a country and western song describes succinctly, if not explicitly, the objective of an ideal tax reform. To achieve this objective, the Tax Reform Panel needs to keep many things in mind. I have chosen to emphasize ten in my remarks, ranging from several platitudes to a suggestion made largely in jest.

1. Taxes should be used to raise money, not to spend it.
2. Democracy is improved if everyone pays taxes, at least at the margin.

This poses technical issues in the design of low-income relief.

3. The perception of fairness—as well as fairness itself—is important.
4. It is unconscionable that so many taxpayers use the services of professional preparers.

The UK has long had a system under which most taxpayers do not file returns.

- Our system is so complicated that this may be impossible.
- So perhaps we should eliminate some of the bells and whistles.

Many taxpayers use the services of professional preparers to get tax refund anticipation loans.

- The government should never have had the money.
- If we want to retain the EITC, it should be possible to create a system in which recipients do not need the services of tax preparers and refundable credits are refunded currently.

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1 I added this song title and the words at the end of the paper in response to Jane Gravelle’s inclusion of “The Good, the Bad, and the Ugly” in her description of the provisions of the 2004 corporate tax bill (Gravelle, 2005).
5. Turbotax is a mixed blessing.

It simplifies the preparation of tax returns, but:

- It converts return preparation into a “black box” operation.
- No one knows—or needs to know—the tax law.
- It makes taxpayers codependent with a dysfunctional Congress that continually enacts legislation, much of which has little redeeming social value.

6. Something like the scheme Mike Graetz has proposed seems like a good idea, if it can be made to “add up.”

With a personal exemption of $100,000 or more, some 80 percent of taxpayers could be eliminated from the tax rolls.

- Below that level, taxpayers would pay only a (credit–method) VAT and payroll taxes.
- The payroll tax system could be used to provide low–income relief.

7. Don’t forget that state and local governments exist and are important.

They rely on the federal income tax base and the IRS.

- Conformity with federal law and the IRS simplifies life for taxpayers.
- Eliminating the federal income tax would not eliminate state income taxes.
  - It would undermine uniformity of state law.
  - Without the IRS there would still be 46 state tax administrations.

State (and in some states local) governments rely heavily on retail sales taxes—and will continue to do so.

It is important to coordinate any new federal sales tax with existing RSTs.

- Aggregate federal and state and local tax rates would be higher than an RST could sustain.
- A VAT is the only form of sales tax that could sustain aggregate rates much above 10 percent.
- A federal VAT could probably be coordinated with state and local RSTs.
- This might be the catalyst needed to improve badly defective state and local RSTs.

8. Don’t forget international implications of tax reform; we exist in an interdependent world.

We ignored international implications in 1981—and did lots of harm.

Using a sales tax to reduce income tax rates might be a good idea.

- It would reduce the marginal effective tax rate on capital and thus the cost of capital in the United States
  - There would be an incentive to shift income into the U.S., instead of out, increasing our tax base.
  - There would be pressure to reduce income tax rates around the world.
  - It should probably be done gradually, by phasing in sales tax rates and income tax rate reductions.
- Replacing the entire income tax with a sales tax would create massive disruptions.
  - It should be done, if at all, only after international consultations.

9. Things to remember about the Flat Tax:

The Flat Tax has five independent characteristics:
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- The flat rate
- A “clean” base (lack of exemptions, deductions, and credits)
- Expensing of all business purchases
- Exemption of capital income
- Lack of interest deductions

The first two features (the flat rate and clean tax base) are not unique to the Flat Tax.

- Even if the ideal clean Flat Tax base could be adopted, which I doubt, it is unlikely to remain clean long.

The treatment of interest expense is crucial.

- It would be improper to exempt capital income without making interest non-deductible.
- Expensing without disallowance of interest deductions would create negative METRs and tax shelters and undermine the perception of fairness.

Transition to the flat tax would involve wrenching adjustments.

Remember that the flat tax also has international implications.

- Disallowance of interest deductions on debt to foreigners would raise the cost of capital to American borrowers.
- The U.S. probably would not allow foreign tax credits for the Flat Tax if another country adopted it. What would they do if we adopted it?

10. A way must be found to discourage the Congress from enacting complicated and distortionary provisions. Having wracked my brain, I have come up with the following modest proposal, which I am sure can be improved:

- For sins committed in needlessly complicating the U.S. income tax, all Members of the House and all Senators should be required to do community service – while in office and for ten years thereafter.
- Each year, with only a calculator (no computer and no tax preparation software), they should be required to complete tax returns for several taxpayers with these types of complicated issues:
  - The AMT
  - The EITC
  - Small business tax returns

As accessories to these crimes, all members of the staffs of the three tax-writing committees and all those on the staffs of Members who have proposed tax legislation that, on balance, would add to the length of the Internal Revenue Code should be required to do the same penance, though perhaps for a shorter period after leaving congressional service.

Unless we are careful—and lucky—the words of this old Roy Acuff song may, unfortunately, describe the results of the present tax reform effort:

When whiskey and blood run together,  
Did you hear anyone pray?  
I heard the crash on the highway,  
But I didn’t hear nobody pray.

REFERENCES

Gravelle, Jane.  

Graetz, Michael J.  