



## FIXING THE TAX CODE

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The U.S. tax code is broken. It is too complex, too unfair, and too burdensome. Most importantly, the current tax code stifles economic growth, which hurts families, communities, and individuals.

As House Ways and Means Committee Chairman Kevin Brady stated last November, “America needs a simpler, fairer, flatter tax code that’s built for growth – the growth of our family’s paychecks, the growth of our local businesses, and the economic growth of our nation.”<sup>1</sup>

Real, comprehensive tax reform will be good for the economy and good for the federal budget. Taxes have “significant negative effects... on economic growth,” according to a review of the academic literature on the subject conducted by the Tax Foundation. Slow growth can, in turn, have profound effects on the federal budget outlook. According to the CBO, if the actual annual growth rate of real GDP is just 0.1 percentage point lower than its recent projections, budget deficits would increase \$327 billion over the next decade.<sup>2</sup> At a time when GDP growth is about equal to inflation, we know we can and must do better and create an economic environment that unleashes a new generation of prosperity and self-sufficiency. In his 1982 State of the Union Address, President Reagan perfectly articulated this economic reality: “Raising taxes won’t balance the budget; it will encourage more government spending and less private investment. Raising taxes will slow economic growth, reduce production, and destroy future jobs, making it more difficult for those without jobs to find them and more likely that those who now have jobs could lose them.”<sup>3</sup>

While some attack tax reform proposals as “costing” the government money, this erroneously assumes the government is more entitled to your paycheck than you are. This is utter nonsense. Ensuring that people keep more of their hard-earned money is not wrong. Those who believe government should take more out of each paycheck seek only to advance their own interests at the expense of the taxpayer, without regard or concern for the good of the country. A reformed tax code should only extract money from Americans to

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<sup>1</sup> Representative Kevin Brady, “Chairman Brady Lays out Vision for Ways and Means Committee”, November 18, 2015. <http://waysandmeans.house.gov/chairman-brady-lays-out-vision-for-ways-and-means-committee/>

<sup>2</sup> Congressional Budget Office, The Budget and Economic Outlook: 2016 to 2026, January 25, 2016. <https://www.cbo.gov/publication/51129>

<sup>3</sup> President Ronald Reagan, Address Before a Joint Session of the Congress Reporting on the State of the Union, January 26, 1982. <http://www.presidency.ucsb.edu/ws/?pid=42687>

fund legitimate, constitutional, and essential programs. It should do so without the wasteful inefficiency created by the current code's infinite special-interest carve outs.

The RSC proposal lays out principles for comprehensive tax reform that would start from scratch and write a new tax code for individuals and families that broadens the economic tax base and significantly lowers marginal rates. The new tax code should not punish saving and investment. The new tax code should recognize the importance of families, children, and marriage. The new code should accommodate healthcare costs and incentivize charitable giving, while doing away with the Death Tax. Most importantly, the new code should be simple, pro-growth, and fair for all Americans.

## **PERMANENCY AND A PATH FOR REFORM**

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In recent years, Congress and the president have repeatedly scrambled at the last minute to pass so-called "tax extenders:" bills that keep "temporary" parts of the tax code alive. Occasionally, lawmakers have even strained to pass tax extenders *retroactively*. Encouraging Americans to budget through tax incentives one year at a time is ineffective and imprudent. Only in Washington could this lack of stability pass for sound economic policy.

Fortunately, Congress recently took a step to stop this erratic cycle of tax extenders by enacting the Protecting Americans from Tax Hikes (PATH) Act of 2015. This law made positive tax extenders provisions – such as those benefiting charitable giving – permanent law. At the same time, the bill only provided short term extensions of many of the previously perpetually renewed provisions that benefit wasteful special interests. No longer will good policies be held hostage by demands to also extend the bad. Unwarranted tax breaks, like special treatment for Hollywood film and television production costs, will finally expire. This proposal assumes they stay that way.

The PATH Act set us on a better path for completely overhauling the tax code. However, we still have much work ahead of us.

## **FAIRNESS**

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The tax code is not fair for most taxpayers. There are still more than 150 so-called tax expenditures that provide more than \$1 trillion worth of credits, deductions, exclusions, and exemptions for government-chosen tax-winners each year. These loopholes and carve-outs favor special interests and those with the means to curry political favor in Washington. Special exemptions and social engineering create economic distortions and cause people to make choices that would not make economic sense otherwise.

Only about 30 percent of individuals use itemized deductions, meaning many targeted tax breaks do not help most individuals. If you do not have a high-priced accountant digging

through the tax code's 70,000 pages to find you the best deals — or a high-priced lobbyist to get you a carve out in the tax code itself — you are at a disadvantage.

At the same time, tax code compliance drains an astounding amount of resources from businesses, families, and individuals. A recent IRS study reported that American families spent more than three billion hours a year computing and complying with individual deductions. Add to that the three billion hours businesses spend complying with the code and it takes a full-time equivalent work force of 3.4 million people just for the nation to file its taxes.<sup>4</sup> This is an economic inefficiency and needs to be addressed during tax reform.

In a 1979 speech, Representative Jack Kemp said that “in a stagnant or contracting economy, politics becomes the art of pitting class against class, rich against poor, white against black, capital against labor...”<sup>5</sup> This indictment of the wanton political sophistry of the years of President Carter's stagnant economy rings true for today's liberal politics under President Obama's stagnant economy. Those who practice the politics of division will attack this and other tax proposals in attempts to set one group of Americans against another. We reject the idea that tax policy is a zero sum exercise and that for some to benefit, others must suffer.

Tax policy should make sense for all individuals and the health of the economy on the whole, not just those who run special interests. At a more basic level, it is imperative that government policies treat all of us equally.

The business tax code should be agnostic as to the type of business activity being taxed, not playing favorites, whether the company is involved in energy, agriculture, health care, technology, manufacturing, is a small business, or a retail firm. Further, the code should treat businesses equally by taxing corporations and pass-through businesses at the same rates, instead of the unequal treatment provided by the current system. The individual tax code should not be used for social engineering, as a weapon of class warfare, or as an instrument to dole out taxpayer-funded favors to the well-connected.

## **PRO-FAMILY**

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Tax reform should eliminate disincentives to form families found in the current tax code. The tax code has brackets that are not twice as large for married couples than for individual filers, creating a marriage penalty. Certain tax credits, such as the Earned Income Tax Credit (EITC), can also contribute to a marriage penalty. These penalties can be up to 12 percent

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<sup>4</sup> Jason J. Fichtner, Jacob Feldman, Mercatus Center, “The Hidden Costs of Tax Compliance”, May 20, 2013. <http://mercatus.org/publication/hidden-costs-tax-compliance>

<sup>5</sup> Morton Kondracke and Fred Barnes, Jack Kemp: The Bleeding-Heart Conservative Who Changed America, page 8.

of the family's income.<sup>6</sup> The marriage penalty is another case where Democrats have successfully obtained a distortion in the tax code in order to extract more revenue from the American people. It is unfair, and the marriage penalty needs to be fully eliminated. The RSC proposal calls for eliminating these penalties as a part of comprehensive tax reform.

## COMPETITIVENESS

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Our outdated tax code puts U.S. businesses at a disadvantage relative to our foreign competitors. Not only is the U.S. corporate tax rate the highest in the industrialized world at 35 percent, but the tax code also punishes U.S.-based multi-national corporations by forcing them to pay double taxes if they invest global profits back home. This so-called “worldwide system” of corporate taxation has been abandoned by an overwhelming majority of Organization for Economic Co-operation and Development (OECD) countries. Only six of 34 OECD countries (including the U.S.) still employ a worldwide system, down from 17 in 2000.<sup>7</sup> Because it can be economically advantageous to keep those profits out of the U.S., it is estimated that U.S.-based companies currently hold more than \$2.1 trillion overseas, locked away instead of being used to put more Americans back to work or to reinvest in our economy.<sup>8</sup>

The damage inflicted by our uncompetitive tax code is readily evident in the increasing trend of inversions, in which U.S. companies are acquired by foreign companies and lower their tax burden by choosing a new national home. The need to reform the international tax system has been further underscored by the OCED's Base Erosion and Profits Shifting (BEPS) project, which could have adverse impacts on U.S.-based multinational corporations. Moving to a true territorial system where income is only taxed in the country where it is earned is an important piece of business tax reform. However, this change should take place in the context of comprehensive tax reform, not as part of dangerous proposals that would use international tax reform to “pay” for higher spending.

Businesses should also be permitted to fully expense all capital expenditures before calculating any tax liability. This pro-growth reform will allow businesses to take on more risk-taking by investing in a business or expanding a current business. It will increase productivity, which will increase wages and the number of jobs available to the American people. Full-expensing will also increase international competitiveness.

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<sup>6</sup> Kyle Pomerleau, Tax Foundation, “Understanding the Marriage Penalty and Marriage Bonus”, April 23, 2015. <http://taxfoundation.org/article/understanding-marriage-penalty-and-marriage-bonus>

<sup>7</sup> Price Waterhouse Coopers for the Technology CEO Council, “Evolution of Territorial Tax Systems in the OECD,” April 2, 2013.

[http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems\\_20130402b.pdf](http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf)

<sup>8</sup> Richard Rubin, Bloomberg Business, “U.S. Companies Are Stashing \$2.1 Trillion Overseas to Avoid Taxes”, March 4, 2015. <http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes>

Fixing the corporate tax code would be a boon for families. Distortions created by special interest provisions reduce investments in industries that could be more profitable or productive, while supporting those that have less chances of success. Increased tax compliance costs are passed on to individuals and families in the form of higher prices, lower wages, and fewer job opportunities. Ultimately, American families and workers suffer the brunt of our tax code failures as they struggle to comply with its confusing intricacies and as U.S. corporations hire fewer workers at lower wages.

## **REAL-WORLD SCORING**

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For too long, tax reform proposals have been evaluated by CBO and JCT by a method that fails to account for the way people change their behaviors in response to changes in the tax code.

For several years, RSC budgets have proposed that real-world dynamic scoring be the measure by which tax reform proposals are measured. At the beginning of the 114th Congress, the House adopted a new rule that requires CBO and JCT to incorporate the macroeconomic effects of major legislation into the budgetary analysis of that legislation. Several bills have been subject to dynamic analysis in the past year, showing the positive effects on the budget of pro-growth policies, such as repealing Obamacare, lowering taxes, and lowering spending. The models used could be improved. Specifically models should take into account the fact that before the federal government can spend any money it must first take that money out of the economy.<sup>9</sup> Adopting dynamic scoring is an important step that ensures policymakers understand the true impact of tax reform on the economy, businesses, families, and individuals.

As Washington moves to scrap the outdated tax code, policymakers should factor in what economists have known for decades: the right tax reforms will trigger a positive chain reaction of investment, economic growth, and job creation. Dynamically-scored, revenue-neutral tax reform—as called for by this proposal—ensures the dollars freed by pro-growth tax reform stay in the pockets of American families and generate economic prosperity, not federal spending boondoggles.

## **ABOLISH THE IRS**

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In its current form, the Internal Revenue Service (IRS) is at best an inefficient behemoth weighing down our economy. At its worst, the IRS has shown a capacity for outright corruption and political targeting. Under the Obama Administration, the IRS has illegally

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<sup>9</sup> Curtis Dubay, Heritage Foundation, “CBO Should Update Its Methodology Before Dynamically Scoring Spending Bills”, March 5, 2015. <http://www.heritage.org/research/reports/2015/03/cbo-should-update-its-methodology-before-dynamically-scoring-spending-bills>

targeted conservatives.<sup>10</sup> It has channeled millions of taxpayer dollars away from taxpayer assistance for employee bonuses.<sup>11</sup> It has allowed taxpayer information to be compromised in a data breach.<sup>12</sup> The IRS has even intentionally leaked confidential taxpayer information.<sup>13</sup> Despite these facts, the president's budget actually calls for increasing spending on the IRS by \$1 billion.

This proposal takes the bold step of calling for the complete elimination of the IRS. Tax collection and enforcement activities would be moved to a new, smaller, and more accountable department at the Treasury. Applicants to the new department would need to undergo a rigorous evaluation of their work performance before being hired to positions of trust, and would be subject to discipline and termination if they failed to honor that trust. This fresh start is necessary to reassure Americans that the agency with access to every paycheck is trustworthy and honest.

## **PRO-GROWTH, PRO-TAXPAYER REFORM**

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This proposal calls on the House Ways and Means Committee to produce a tax reform plan consistent with the following principles:

- Targets revenue neutrality (relative to CBO's baseline revenue projection) based on a dynamic score that takes into account the macroeconomic effects of reform.
- Collapses the current seven brackets for individuals into just two, with a top rate of 25 percent.
- Simplifies the tax code to ensure that fewer Americans will be required to itemize deductions.
- Gives equal tax treatment to individual and employer healthcare expenditures modeled on the American Health Care Reform Act.
- Encourages charitable giving.
- Repeals the Death Tax.

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<sup>10</sup> Zachary A. Goldfarb and Karen Tumulty, Washington Post, "IRS admits targeting conservatives for tax scrutiny in 2012 election", May 10, 2013. [https://www.washingtonpost.com/business/economy/irs-admits-targeting-conservatives-for-tax-scrutiny-in-2012-election/2013/05/10/3b6a0ada-b987-11e2-92f3-f291801936b8\\_story.html](https://www.washingtonpost.com/business/economy/irs-admits-targeting-conservatives-for-tax-scrutiny-in-2012-election/2013/05/10/3b6a0ada-b987-11e2-92f3-f291801936b8_story.html)

<sup>11</sup> Sarah Westwood, Washington Examiner, "IRS diverted millions from taxpayer assistance to pay for employee bonuses", April 22, 2015. <http://www.washingtonexaminer.com/irs-diverted-millions-from-taxpayer-assistance-to-pay-for-employee-bonuses/article/2563430>

<sup>12</sup> Bernie Becker, The Hill, "IRS: Taxpayer breach larger than first reported", August 17, 2015. <http://thehill.com/policy/finance/251292-irs-taxpayer-breach-larger-than-first-reported>

<sup>13</sup> Jonathan H. Adler, Washington Post, "IRS agrees to pay non-profit group \$50,000 for unauthorized release of tax return", June 24, 2014. <https://www.washingtonpost.com/news/volokh-conspiracy/wp/2014/06/24/irs-agrees-to-pay-non-profit-group-50000-for-unauthorized-release-of-tax-return/>

- Eliminates marriage penalties.
- Provides tax-free universal savings accounts to reward saving.
- Exempts workers above the normal retirement age from the employee side payroll taxes.
- Eliminates marriage penalties and encourages families.
- Repeals the alternative minimum tax.
- Reduces double taxation by lowering the top corporate rate to 25 percent.
- Sets a maximum rate for capital gains and dividends at 15 percent.
- Encourages net investment, savings, and entrepreneurial activity, including full expensing.
- Moves to a competitive territorial system of international taxation.
- Ends distortionary special interest giveaways, such as the Wind Production Tax Credit.

To force Congress to finally act on comprehensive tax reform, this proposal recommends enacting H.R. 27, Representative Bob Goodlatte's Tax Code Termination Act. This legislation would sunset the current tax code at the end of 2019, setting a firm deadline for a simpler, fairer tax code to be enacted.

We must craft a tax code that ensures American competitiveness and success for the 21st century. Fundamental reform is never easy. Each of the exceptions and exemptions in the current tax code has a defender, but economists tell us that having fewer exceptions and exemptions will create a broader base. Paired with lower rates, it creates faster economic growth than the convoluted system we have today.

Growth-oriented tax plans would strengthen the economy and support the nation's funding needs. There are several good ideas on how to best accomplish that.

The FairTax is a fundamental tax-reform plan that would eliminate taxes on wages, self-employment, capital gains, gifts, and estate transfers in favor of a consumption tax that would provide the economic certainty American families, businesses, and entrepreneurs desire.

The Flat Tax, proposed in many different forms by members of Congress, Nobel Prize-winning economist Milton Friedman, and think tanks such as the Heritage Foundation, also seeks to end the current income tax in favor of one that encourages more economic growth.

Leading conservative reformers have put forth tax reform plans that pair strong pro-growth corporate tax reform with individual tax reform that emphasizes families, marriage, and the cost of raising children.

Congress should consider the full myriad of pro-growth plans put forward by conservatives and move aggressively toward fundamental tax reform.