Tax Reform to Enhance the American Economy

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THESIS

The United States Congress needs to reform the tax code so that the American tax system gives as many benefits to the American economy as possible. The tax system needs to be reformed in a way that is horizontally equitable, vertically equitable, less complicated, and easier to enforce. The best change would be from an income tax base to a consumption tax base. Changing the tax base in this direction would not only benefit the economy, it would also be more equitable, and theoretically less complicated and easier to enforce.

THE PROBLEM

The United States government has built up a substantial budget deficit paying for the defense of its citizens, the upholding of its citizens’ rights, and the upholding of justice. Every year this deficit grows. Alan Greenspan, the Chairman of the Federal Reserve Board, has addressed the problem with the government’s deficit on several occasions. In a speech before the US Senate on April 21, 2005 Greenspan declared that the government should take action to eliminate its budget deficit. A growing deficit causes the dollar to weaken against foreign currencies. This in turn causes inflation. To counter inflation the Federal Reserve Board is forced to raise interest rates, slowing economic growth.

1 Alan Greenspan has continually given speeches to various government organizations through his tenure as the Chairman of the Federal Reserve Board. The Board of Governors of the Federal Reserve System provides all of his speeches on their web site. The web site categorizes the speeches by the year in which it was given. 2005’s speeches can be viewed at this URL: http://www.federalreserve.gov/boarddocs/testimony/2005/. From this URL past years speeches can easily be reached as well. Some of his speeches will go into more depth than what this paper may only brush upon.
There are two ways to solve the problem the United States is facing with the rising budget deficit. One solution would be to lower the amount of money that the government spends. With less spending but the same amount of revenue, the budget deficit would naturally lower. Government expenditures can be lowered by reforming current government programs such as welfare or social security.

The revenues of the government could also be altered in an attempt to balance the budget. The obvious way to change the revenues generated by the government is to raise the effective tax rate, although raising the tax rate would be a burden on the American economy and would stunt economic growth. A second possible way to generate more revenues is to reform the current American tax system so that it has a better economic impact than the current tax system. A positive economic impact from a tax system will allow citizens to both spend more and save more creating more tax. Thereby more revenue would be generated.

One method of tax reform would be to change the tax base from an income tax. Some politicians have suggested eliminating the income tax and using only a consumption tax to generate revenue for the federal government. However, this reform would not be the most economically beneficial change for the government to make. A more beneficial tax base for the United States would be the current income tax base supplemented with a nationwide consumption tax.

HISTORY OF THE AMERICAN INCOME TAX

The first income tax in the United States was implemented during the Civil War. In 1862, because of the war, the government did not have the revenue it needed to
support itself. Therefore the government created the Internal Revenue Service as a division of the United States Department of Treasury. Congress voted in and the Internal Revenue Service implemented a new income tax. Like today's income tax the first tax was progressive. Incomes between six hundred and ten thousand dollars were taxed at a three percent rate, and incomes above ten thousand dollars were taxed at a five percent rate. Ten years after the creation of the income tax Congress repealed it because of public opposition. Almost all revenue for the United States government was then generated through the excise taxes placed on alcohol and tobacco, as well as tariffs on imports.

The government attempted to revive the income tax in 1894. A year later the income tax was declared unconstitutional and repealed. It was considered unconstitutional because it was a direct tax, and it was not apportioned among the states on the basis of population. The only way the federal government could levy an income tax would be to create an amendment to the Constitution. In 1913 the United States was close to war and needed to create more revenue. To generate more revenues Congress had to institute more taxes. Congress therefore created the sixteenth amendment. This amendment gave the government power to collect levy taxes on incomes.2

JUDGING THE EFFECTIVENESS OF A TAX BASE

Since the re-creation of the income tax in 1913 it has become extremely vital to the operations of the United States government. By 1996 Income taxes in the United States comprised sixty-two percent of the government's revenue. Fifty percent of its

2 Historical information on the income tax was taken from the Internal Revenue Service's web site, http://www.IRS.gov. A more in depth history of the income taxes and the Internal Revenue Service is presented on this site.
revenue is created from the income taxes of individual citizens alone. The United States has moved from not even having an income tax to generate revenue to completely relying on it for revenue generation. Reforming the current income tax system could strengthen the economy, and therefore generate more revenue for the government. Along with affecting the economy, reforming the tax base will also affect the government agency set to administer the tax as well as individual citizens. In judging whether or not income is the most effective tax base, its economic impact, its enforceability, and its equity need to be addressed. Critics of an income tax base question all of the above.

**ECONOMICS OF AN INCOME TAX**

Economically speaking the current tax system is weak because it taxes savings. The amount of savings in the United States is low compared both historically and internationally. Historically, the United States’ average savings as a percentage of income is close to eight percent. Since 2000 the savings rate has been well below four percent. Compared internationally, the United States amount of savings is also weak. In Europe the current savings rate is almost ten percent. In Japan the current savings rate is almost six percent. The income tax system is one of the reasons for the low amount of savings.

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3 According to information presented by Raymond Batina and Toshihiro Ihori on page four of their book, *Consumption Tax Policy and the Taxation of Capital Income*, the United States government receives most of its revenues from income taxes supplemented by both sales taxes and property taxes. Canada, France, Germany, Italy, Japan, and the United Kingdom do not receive such a large portion of their revenues from income taxes, but instead from consumption taxes. In 1996 France and Germany received forty-eight and forty-seven percent of their total revenues from consumption taxes.

4 David Braford further discusses these three criteria for a good tax base in his book *Taxation, Wealth, and Savings* on page forty-three.

5 Through information taken from several sources, including the Bureau of Economic Analysis, the Federal Reserve Bank of San Francisco researched how to create an increased amount of saving in the United States. Amongst this information is a graph depicting the recent decline in household savings that has been experienced in the United States.

6 These statistics are taken from an article by the Organisation for Economic Co-operation and Development. The article defines the savings rate as “household (net) saving divided by (net) disposable income.”
savings in the United States. Because of the low savings, economic growth in the United States is not at its full potential. If the tax base were changed from an income tax base to perhaps a consumption tax base, the United States could possibly be strengthened economically by the increase in savings\(^7\).

Clearly, the government believes that savings are important to both individuals and the overall economy when they create programs such as Investment Retirement Accounts and Social Security, which both help create savings for Americans when they retire. The income tax base contradicts these attempts to help create savings. "Tax cigarettes and fewer people will smoke; tax savings and fewer people will save."\(^8\) The government uses excise taxes to discourage certain activities, such as drinking and smoking. From a dynamic perspective the income tax discourages people from participating in the activity of saving. Although an income tax does encourage consumption, it discourages savings, which is bad for the future of American citizens\(^9\).

**ENFORCEMENT OF THE INCOME TAX**

There are two problems with the enforcement of the current tax system. The basis of enforcement is that entities can choose to comply or to not comply with tax regulations. Complying with tax regulations is difficult because the government spends

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\(^7\) Joel Slemrod and Jon Bakija discuss the problems with the American income tax system in the beginning of their book *Taxing Ourselves*. On page five the two discuss the low amount of savings in the United States historically in also comparison to the rest of the world.

\(^8\) McCaffery (2002, p. 36)

\(^9\) Edward McCaffery goes much more in depth in his book *Fair Not Flat* in describing the amount that an income tax base affects American's abilities to save. From page thirty-four to page forty-two McCaffery describes the economic theories behind the affects of an income tax. He also uses analogies to give examples, so that the concept can be better understood.

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money on services that not every citizen uses. Nobody wants to spend money and get an unwanted good in return. When a person pays their taxes they get benefits, like the police or road upkeep. Some benefits from paying taxes are not used by every American. For instance, a portion of local property taxes might be used in construction of a high school. A forty-year-old man with no children and no intent of having children will never use this building, although his money is being used to construct it. The citizen that gets no benefits from paying taxes probably will not want to comply with the tax regulations, because they do not use the benefits that taxes provide\(^\text{10}\).

In 2002 the Internal Revenue Service estimated that eighteen percent of all income was not reported. That eighteen percent amounted to 227 billion dollars of uncollected taxes. The United States clearly has a problem with its citizens evading their income tax. The government has to spend more money every year in an effort to enforce the current tax code\(^\text{11}\). If an entity chooses not to comply with tax regulations by hiding its income it will. Clearly, the current tax code is bringing the government further from balancing its budget if every year more money is having to be spent in order to enforce it.

In March of 2005 the United States found the largest tax evasion scam in history. A man hid two hundred million dollars of income in foreign accounts. The foreign banks in which the man had his accounts did not report his income to the Internal Revenue Service, like American banks are required to do. The Internal Revenue Service would not know about his income and therefore he would be able to evade paying his taxes\(^\text{12}\).

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\(^{10}\) Slemrod and Bakija (2004, p. 56)  
\(^{11}\) Slemrod and Bakija (2004, p. 4)  
\(^{12}\) This information is taken from an article found on MSNBC’s web site titled “Entrepreneur accused of biggest-ever tax scam ever.” Although the tax shelter found in this article is a rare example of tax evasion, there are countless numbers of illegal tax shelters in which Americans are participating. By simply searching the internet using Google numerous articles can be found concerning major tax evasion like the one committed by this man.
This man chose not to comply with tax regulations in the United States, but was caught. There still could be more scams just like this man’s stealing potential revenue from the American government.

Usually citizens do not have such an elaborate way to evade taxes. The most usual way to evade them is to be paid wages ‘under the table.’ An individual or company may hire an individual, pay him or her cash, and not report this expense on its tax return. The individual hired will also not report his or her income on their return. Therefore, he or she would evade income taxes. The reason this type of scheme is possible is because entities have to comply with tax regulations. If he, she, or it decides not to comply by paying people ‘under the table’ there is no way to tell the actual incomes or actual expenses of entities.

**COMPLEXITY OF THE INCOME TAX**

The second problem with the enforcement of the income tax system is the complexity that it has developed. Citizens have trouble complying with the tax system because there are too many regulations that the average person does not know. Some citizens in the United States have to calculate their tax liability at two different rates. First he or she calculates how much regular tax is owed to the government, and then how much tax is owed to the government using the Alternative Minimum Tax rate. The citizen then pays the lower of the two taxes calculated\(^\text{13}\).

On top of this complication, there are several different types of income that are taxed at different rates. Dividends, capital gains, interest, wages, self-employment

\(^{13}\) This information was taken from the speech given by Alan Greenspan on the third of March, 2005 to the President’s Advisory Panel on Federal Tax Reform.
income, gambling income, and pension income are all taxed in different ways. These types of income are taxed at different rates to encourage persons to use their money differently. For instance dividends and capital gains are taxed at a lower rate than wages in order to encourage investment. Self-employment income is taxed extra in comparison with wage income because a person making wages pays half the tax and his company pays the other half. A self-employed person has to act as the company and the individual. Pension income is not taxed at all to encourage citizens to save money for when they retire.

There are even exceptions within different types of income. For instance, capital gains on a home lived in for more than two years is not taxed at all. Even the length of time property is held can affect the tax rate. Capital gains from property held less than one year is taxed at a higher rate than property held for more than one year. Interest income can also be taxed in different ways. Interest from government bonds is not taxed at all, while interest from corporate bonds is taxed.

Following the regulations on different types of income, there are also regulations allowing persons to take deductions against their total income and credits against the amount of tax they pay. There are several different types of deductions citizens can take from their total taxable income including mortgage interest, investment expenses, tax preparation fees, IRA contributions, and charitable contributions. Even though most citizens can take these deductions, some cannot. Deductions phase out as citizens have more income. Eventually, if a citizen’s income is high enough, his or her deductions get entirely phased out, and there are very few deductions, which they can take.
Finally, to further complicate matters there are credits United States citizens can take to lower the amount of tax that they pay. There are many different types of credits ranging from foreign tax credits, to credits for educational expenses, to credits for capital expenditures related to government housing. The Earned Income Credit causes much confusion\textsuperscript{14}. The different types of income, the deductions available, and the credits presented complicate taxes to the point where only experts can fully understand the American income tax\textsuperscript{15}.

The average American does not fully understand the income tax system. Therefore, the average American spends twenty-seven hours on his or her tax return. This is over three working days per year an average American citizen spends preparing his or her return. This is a substantial amount of time, which most Americans would like to spend doing just about anything else. Not only do Americans spend a substantial amount of time on their tax returns, they also spend a substantial amount of money. In 1996 nearly two hundred twenty-five billion dollars was paid by Americans to accountants to help prepare tax returns. The complexity of the current tax system frustrates Americans and wastes both their time and money. Those three working days could be used to strengthen the economy instead of being wasted in the preparation of taxes\textsuperscript{16}.

\textsuperscript{14} Also taken from the speech given by Alan Greenspan on the third of March 2005 to the President’s Advisory Panel on Federal Tax Reform. The Earned Income Credit is one of the few refundable credits provided in the tax code. This fact makes it even more complicated than other credits.

\textsuperscript{15} The Internal Revenues Service’s web site provides instructions for most tax forms used when filing taxes with the United States government. The complications in the tax code can be seen directly when looking through these instructions. Almost every instruction has an exception to the rule. The list of forms and their respective instructions can be viewed at http://www.irs.gov/instructions/index.html.

\textsuperscript{16} Information on the amount of time and money spent by Americans on preparing tax returns taken from the Americans for Fair Taxation’s web site. The statistics were taken specifically from an article on the site titled “The Fair Tax and the Federal Income Tax: A Comparative Analysis.” The article is located on the World Wide Web at http://www.fairtax.org/pdfs/currentsystem.pdf.
EQUITY AND THE INCOME TAX

Along with the problems in our tax system's economic impact and in its enforcement, the United States tax system also has problems with the equity of its tax system. There are two types of equity associated with tax systems, vertical equity and horizontal equity. Both of these should be addressed in judging the effectiveness of a tax system. Vertical equity is the principle that people with different levels of income should pay different amounts of tax. In order for citizens to pay fair amounts of taxes the United States has claimed to set up its income tax as a progressive tax, which means wealthier Americans pay more taxes than poorer Americans because they can afford to pay more. The vertical equity of the United States tax system does not work because of the definition of the United States tax system.

The vertical equity of the United States income tax is questionable for two reasons. The government's definition of income favors its citizens that already have a substantial amount of money saved. Under the United States' definition of income, unrealized capital gains are not recognized. Therefore, the more money a citizen has saved the easier for him or her to have more nontaxable gains, because that citizen will have more money to invest. Loans can be taken backed by unrealized gains. This could allow citizens with substantial investments to get cash even though their original cash is still invested. In some situations interest paid on loans can be used to lower aggregate gross income of an individual. Edward McCaffery, a law professor at the University of Southern California and author of the book *Fair Not Flat*, calls using unrealized gains to create more wealth basic tax planning. If used effectively he claims a United States citizens can completely eliminate their taxes, but still have an amount of income
substantially above the average United States citizen. The possibility of McCaffery’s basic tax planning proves that the United States tax system favors Americans who are at an economic advantage over other citizens because of the amount of savings they possess.

The second problem with the vertical equity of the United States tax base is what an income tax taxes. An income tax is a tax on consumption plus savings. With the current tax base there is no incentive for poorer or middle class American citizens to save money and thereby become wealthy. The definition of income and the definition of income tax cause the discrepancy with the vertical equity of the tax base of the United States.

Horizontal equity is the principle that people in similar economic situations should pay the same amount of tax. Like vertical equity, the United States tax system also has problems with its horizontal equity. The horizontal equity in America’s tax system is questionable because people are taxed differently based on different decisions that they make. There are two ways a person can be taxed less because of their decisions.

First, a citizen could decide to spend all of the money that he or she makes instead of saving it. If there are two citizens, each making one thousand dollars in wages, they would initially be taxed the same. If the tax rate were thirty percent on those wages, they would be taxed three hundred dollars. If one of those citizens chose to spend the other seven hundred dollars he or she would pay no more taxes. If the other citizen decided to spend two hundred dollars and invest five hundred at a ten percent rate of return, they

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17 McCaffery discusses his tax planning strategy more in depth on page thirty-two of his book.
18 McCaffery (2002, p. 37)
would have to pay additional taxes on the return on their savings of fifteen dollars. Because of decisions that these citizens make they are taxed differently, which is not horizontally equitable\textsuperscript{20}.

The second way person's taxes could be lowered by his or her decisions is to create opportunities for deductions from their tax base. For instance, a married couple with two children may get tax breaks because they have children. Another couple, because they made a decision to not have children, will not get those tax breaks. Both couples were originally at the same point, but changed their situations because of decisions that they made. The government punishes one couple because they chose not to have children. The extra tax one couple has to pay to the government is a tax on their decisions and therefore unjustified\textsuperscript{21}. The two couples need to be judged as individuals, not families.

**BENEFITS OF A CONSUMPTION TAX BASE**

Clearly, America's current tax system is not as effective as it could be. The system taxes savings, which hurts the American economy. It also is not equitable either vertically or horizontally. On top of those problems, the current revenues generated by the income tax base are not enough to pay for all of our government programs. Having a more effective tax base could raise the total revenues generated by the American tax system. Every year the United States government builds up a larger deficit. Not only can Congress not raise enough revenues for government operations, they also are digging themselves into another hole through the social security system. The social security

\textsuperscript{20} McCaffery (2002, p. 37)

\textsuperscript{21} Slemrod and Bakija (2004, p. 6)
system does not generate enough revenue to support itself. A more effective tax base could possibly bail the United States out of the hole created by the social security. The best change would be from an income tax base to a consumption tax base.

In the 1970s both the United States government and European governments began to research the type of tax base would be most equitable horizontally and vertically and would also have the best economic impact. In 1976 the United States Treasury Department researched what type of tax base would be the most effective. The research was published in the government publication *Blueprints for Basic Tax Reform*. The report takes a strong approach on the economic impacts of different tax bases. The report concludes that in many situations a consumption tax and an income tax will tax the same amount. In all situations both bases tax what money is transferred in the present. In some situations the income tax also taxes what will happen in the future. This is the income tax on savings. Because an income tax base taxes future earnings, it decreases growth in the future. A consumption tax can generate as much revenue as an income tax, while at the same time increasing the economy’s strength.\(^{22}\)

**ECONOMICS OF A CONSUMPTION TAX**

The concept that an income tax taxes savings and a consumption tax does not can be seen mathematically. Taxable income can be defined as an individual or a corporation’s expenditures or consumptions plus their change in savings. \(Y = C + \Delta S\), where \(Y\) is tax base, \(C\) is consumptions, and \(\Delta S\) is the change in savings. With a

\(^{22}\) The United States Treasury Department has a wealth of information on current tax policy, as well as past tax policies. The Treasury Department’s *Blueprint for Basic Tax Reform* is only one of the numerous studies the department has completed. Other studies can be found on the World Wide Web at [http://www.treas.gov/offices/tax-policy/](http://www.treas.gov/offices/tax-policy/). The Blueprints for Basic Tax Reform can be seen at [http://www.treas.gov/offices/tax-policy/library/blueprints/](http://www.treas.gov/offices/tax-policy/library/blueprints/).
consumption tax the tax base is defined as consumptions, so \( Y = C \). The only difference between the two is the change in savings (\( \Delta S \))\(^{23}\). The alternative system using a consumption tax base would be economically superior to an income tax system because it would increase United States citizens' savings and investments, which would stimulate economic growth.

**ADMINISTRATION OF A CONSUMPTION TAX**

A consumption tax would not only have better economic benefits than an income tax, it would also be easier to administer. For individuals a consumption tax system would be less complicated than the current income system. Individuals would not even have to file a tax return. They would not have to pay estimated taxes or have tax withheld from their wages, because citizens would pay taxes as they make retail purchases. Not as much time or effort would be wasted by individuals to produce the amount of tax that they owe. These efforts to simplify the tax system for individuals would obviously make administering the American revenue generation more efficient.

**PROBLEMS WITH A CONSUMPTION TAX**

Even though a consumption tax has many advantages over an income tax, it also has many of the same problems as the income tax and also some problems of its own. In theory administering a consumption tax easy, but in actuality it would be just as difficult as administering an income tax. As stated before the Internal Revenue Service has had trouble with its citizens complying with its regulations. People do not report all of their

\(^{23}\) McCaffery (2002, p. 11)
income to the government. A very similar problem would also be present with the use of a consumption tax base. A national consumption tax would create a black market. People could make 'under the table' sales, thereby not reporting the amount of consumption to the government. There would be no way for the government to keep this black market under control, just as there is no way for the government to record the exact amount of income of each individual.  

A consumption tax would also arguably be simpler than the current income tax base. The problem with this idea is that in theory an income tax is also very simple. It is a tax on income, the bottom line. Consumption tax is simple because it is a tax on the amount of sales a company or individual has. The political nature of taxes is why the current income tax system is complex. Politicians create tax regulations to stimulate parts of the economy or even in some cases they fall into the pressures of lobbyists. With a consumption tax base politicians will still be able to manipulate the regulations, just as they do with the current income tax base. Because of the political nature of taxation, a consumption tax will still have the same question as an income tax – what is taxable? Because a consumption tax will allow evasion like an income tax and will be just as complicated as an income tax, it will be just as difficult to enforce.

Both of the previous problems with a consumption tax base are similar to those of an income tax base. This next problem would only be found in a consumption tax base. The problem is that there is no vertical equity found in a consumption tax. A consumption tax is a flat tax, not progressive like the current tax system. There is no

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24 In an interview with an Ernst and Young tax partner, Nate Lavell, on November 13, 2004 he described how a national consumption tax in the United States would create a black market where entities could trade goods without reporting the transaction for tax purposes. This reason was one of several which led Lavell to believe that a national consumption tax base would not be an effective means of revenue generation for the United States government.
graduated tax rate possible like with an income tax, only a single sales tax rate. Under a consumption tax base a United States citizen making one hundred thousand dollars a year would be paying the same amount of tax for something they buy as a person making one million dollars a year. A person making a million dollars a year could pay the same amount of taxes as a person making one hundred thousand dollars if they choose to consume the same amount. Clearly, if the United States government wants to have a progressive tax system then a consumption tax will not work.

Clearly, there are disadvantages to both the income tax base, and also the consumption tax base. The major economic problem with the income tax system is that it taxes savings. It also has several problems with its equity. Vertically it gives Americans the opportunity to create nontaxable income through the use of unrealized gains. Horizontally it gives citizens who were originally in the same situation tax breaks because of decisions they make. A consumption tax system is vertically inequitable because it is a flat tax, not a progressive tax.

FOREIGN TRENDS IN TAX BASE

While the United States government has decided to keep using an income base, many foreign nations have begun to change to a consumption tax for the economic benefits it offers. The form of consumption tax used in Europe is different than the form of consumption taxation with which citizens of the United States are familiar through state and local taxation. State and local governments in the United States use a retail sales tax, while countries in Europe use a value added tax. The value added tax has begun to replace income taxes in many European nations. France for instance generates
forty-eight percent of its revenues from a consumption tax\textsuperscript{25}. By having a large consumption tax France encourages its citizens to save, thereby helping the overall economy of the nation.

The difference between Europe’s value added tax and the America’s state and local retail sales taxes is that a value added tax is spread throughout the entire production process, while a retail sales tax is paid completely at the final point of purchase, at the retail sale. In both situations the cost of the tax is paid entirely by the consumer. With a retail sales tax only retailers have to pay consumption taxes because they are the only party making a retail sale. With a value added tax the producers and the retailers have to pay taxes\textsuperscript{26}. There are more collection points with a value added tax because tax is collected from both producers and retailers. Therefore, a value added tax would be more difficult to enforce than a sales tax\textsuperscript{27}. The cost of the taxes incurred by the producers is eventually pushed onto the consumer, just as the costs of a retail sales tax are pushed onto the consumer.

**CURRENT ATTEMPTS AT REFORM**

Congress needs to reform the tax code so that the American tax system gives as many economic benefits as possible. The tax system also needs to be reformed in a way that is horizontally equitable, vertically equitable, less complicated, and easier to enforce.

\textsuperscript{25} Batina and Ihori (2000, p. 4)
\textsuperscript{26} Definition of value added tax taken from an online financial dictionary called InvestorWords. The dictionary is excellent at defining financial terms, because it goes into more depth than most regular dictionaries. Also, because it is online, it is easily navigable and words can therefore be easily found. The URL for the dictionary is http://www.InvestorWords.com
\textsuperscript{27} James Fellows, a CPA and professor of taxation at the University of South Florida, wrote in an article titled “Consumption Taxes: a view of future tax reform in America” the effects that a change from an income tax base to a consumption tax base would have on the American economy. In that article he described why a retail sales tax would be a more effective method of implementing a consumption tax than a value added tax.
Recently, Congress made an attempt at reform through the American Job Creations Act of 2004. The act made several major changes to the tax law in an attempt to make the tax system easier to administrate, economically stimulating, and more equitable. It created provisions that prevent certain types of tax shelters simplifying the enforcement of the tax code. It made changes for methods of depreciation by allowing qualified leasehold improvements to be depreciated over a shorter time stimulating economic growth through encouraging investments in fixed assets. It also now allows citizens living in states with sales taxes to deduct the amount of sales tax paid, just as citizens living in states with income taxes can deduct their state income taxes paid improving horizontal equity.

Although the American Job Creations Act of 2004 strived to improve the administration, the economic benefits, and the equity of the current tax system, it also had affects that hurt the current tax system. The law makes the tax system more complicated. Citizens have to relearn the tax code. The new law has to be interpreted so that Americans know whether or not their actions comply with the law. Clearly, even though the American Job Creations Act of 2004 made moves to improve the current tax system, the improvements were not enough, and in fact made the tax law even more complicated than before\(^28\). The federal tax system clearly still needs much more reform.

\(^{28}\) The information regarding the American Job Creations Act of 2004 is taken from a summary written by BNA Tax Management. BNA Tax Management is a subsidiary of the Bureau of National Affairs, Inc. (BNA), which is a publisher that provides “intensive coverage of legal and regulatory developments for decision makers in business and government.” Authors for BNA Tax Management include former IRS Commissioners, leading educators, practitioners with the foremost accounting firms, and partners from the world’s most prestigious law firms. The summary presented by BNA Tax Management provides much more information regarding the changes the law made. These changes all demonstrate the new complications created by the law. The summary can be found on BNA Tax Management’s web site at http://www.bnatax.com/tm/eti tm_summary.htm. The actual American Job Creations Act of 2004 can be viewed online at this location http://thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.04520:.
THE FAIR TAX AND OTHER PROPOSED REFORMS

The idea to shift the federal government's tax base from an income to a consumption base has been steadily looming over Washington since the creation of *Blueprints for Basic Tax Reform* was created in the 1970s. Several recent bills concerning a massive reform have not survived. The reason the proposed tax reforms have not survived is because many of the tax proposals are shot down as being a flat tax. Though clearly, a consumption tax is not a flat tax. In 2003 Congressman John Linder proposed a bill called the Fair Tax Act of 2003\(^29\).

The Fair Tax Act is supposed to benefit every entity affected by taxes. Americans for Fair Taxation is an organization that supports the Fair Tax Act. This organization has done extensive research on the effects of the Fair Tax on American citizens and the American economy. Americans for Fair Taxation claim the Fair Tax Act of 2003 will lower the tax rate for all Americans while generating more revenue for the government. At the same time the new tax law will also stimulate the overall economy of the United States.

According to Americans for Fair Taxation individual citizens will greatly benefit from a Fair Tax Act passing. One of the largest benefits of the Fair Tax for individuals is the elimination of having to file a tax return saving them time and money. Compliance costs for taxpayers in 1996 were nearly two hundred twenty-five billion dollars. The Americans for Fair Taxation claim, "The Fair Tax will reduce compliance costs of most

\(^{29}\) According to John Linder's web site located at http://linder.house.gov/, he is the primary sponsor of the Fair Tax. Linder is a Republican Congressman for the Seventh Congressional District of Georgia. The text of the actual act can be found at http://thomas.loc.gov/cgi-bin/query/z?c108:H.R.25:. 
TAX REFORM TO ENHANCE THE AMERICAN ECONOMY

people to zero.” As far as saving time, one of slogans of the Americans for Fair Taxation organization is “April 15. Make It Just Another Day30.”

The Fair Tax will not only save Americans money on compliance costs, but also continue the American tax system as a progressive tax system. Thereby the tax will be able to keep vertical equity unlike most consumption tax proposals. The Fair Tax will eliminate taxes for people below the poverty line by creating a universal tax rebate. All Americans will receive a rebate on the amount of consumption taxes paid by people below the poverty line. The rebate will be based on family size. The more income people have, the more consuming they tend to do. Therefore, a wealthy family will pay a larger amount of tax than a family living below the poverty line. The rebate creates a progressive consumption tax, making the rich have a larger tax burden than the poor.

Because Americans will save on taxes by spending less money, the Fair Tax encourages Americans to save. This encouragement of saving and investing will stimulate the overall economy because of the creation of more capital. Looking at several different nations we can see evidence that lowering the capital gains tax rate stimulates the economy. In Europe capital gains are taxed at different rates than in the United States. In 1998 France taxed capital gains at a twenty-six percent rate with no difference between long-term and short-term gains. The same year in the United Kingdom the tax rate is forty percent for both short-term and long-term capital gains. These are compared to the United States tax rates that year of almost forty percent for short-term gains and twenty percent for long-term gains. Generally, the lower the tax on

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30 Americans for Fair Taxation is a conservative political organization favoring Linder’s Fair Tax Act. Its web site is located at http://www.fairtax.org/. The statistics presented in this paragraph are found in an article prepared by the Americans for Fair Taxation located at http://www.fairtax.org/pdfs/currentsystem.pdf.
capital gains, the higher a country’s savings. Of these three nations France has the lowest amount of tax on capital gains. France also has the highest amount of savings of the three nations\(^\text{31}\).

A second way the Fair Tax will encourage economic growth is by lowering interest rates. Interest rates of regular bonds will lower to the same level as tax-exempt bonds, because the bondholders will not be paying taxes on their interest income. A reduction in interest rates stimulates economic growth. Economic growth will generate more jobs in America and increase the American standard of living\(^\text{32}\).

The Fair Tax Act of 2003 has not been the only recent massive tax reform bill. In 2004 Congressman Billy Tauzin proposed another bill for a national sales tax. This bill was called the Individual Tax Freedom Act of 2004. Like the Fair Tax Act of 2003 the Individual Freedom Act would eliminate the income tax and generate revenue through a national sales tax. Unlike the Fair Tax this newer proposal would not eliminate payroll taxes like the Social Security Tax\(^\text{33}\).

**CONCLUSION**

A stronger American economy would help reduce the government’s budget deficit. Tax reform is one way to strengthen it. Changing the tax system from an income

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\(^{31}\) The information on saving and capital gains tax rates is from an article by the American Council for Capital Formation (ACCF). According to its website the ACCF is a “nonpartisan organization dedicated to the advocacy of tax and environmental policies that encourage saving and investment.” The specific article the statistics were taken from is titled “An International Comparison of Capital Gains Tax Rates” and is located at the URL http://www.accf.org/publications/reports/sr-intcomparisoncap1998.html.

\(^{32}\) The information concerning the effects of the current tax system being changed to the Fair Tax is taken from another website created by Americans for Fair Taxation: http://www.fairtaxvolunteer.org/main.html. It concentrates on recruiting assistance in achieving the organization’s goals. The information presented is found at this URL http://www.fairtaxvolunteer.org/main.html.

tax to a consumption tax would build up the overall economy in the United States because of the increase in savings the change would cause. The economic benefits of a consumption tax would eventually cause the government to generate more revenue than if it were to continue using an income tax base. Of course, now the issue of implementing a major tax reform and what economic effects such a change would bring should be addressed. According to Alan Greenspan the problem with changing the tax system overnight is that the economy would not be able to handle a change that large. The change needs to be gradual because of transition issues presented by such a change. Clearly, a consumption tax is economically superior to an income tax and therefore the United States should gradually reform its tax system to implement these economic benefits.

34 Greenspan (3 March, 2005)
REFERENCES


