

The Princeton Economic Institute Proposal for Economic Growth & Tax Reform

A Basic Fundamental Approach To Real Reform:

"Consequently, the battle for tax reform is NOT merely a battle to provide tax breaks for the rich or any class - it is a battle for the very survival of our society."

Basic Fundamental Approach To Reform:

Most government programs are well intended. However, the practical implementation of such programs has always proven to be far from efficient and at times a total disaster. One key factor that insures private sector viability is none other than self-interest. As Adam Smith explained back in 1776 (Wealth of Nations), each of us contributes to society through our own self-interest. The drive to economically survive insures that the economy works well in a competitive manner. This key issue of self-interest, when viewed from the government's perspective, becomes equally as dangerous as the ruling rich of the feudal system. The socialists of Marx's day viewed the world through the eyes of a monarchy. But things have changed drastically over the past 100 year or more. The individual who earns an income greater than the national average does not prey upon the misfortunes of others nor does he suppress the lower classes in our modern day circumstances. Such oppression was only possible in the past when both wealth and power coexisted within the same hands. Therefore, the mere fact that someone might be rich today does not pose a danger to society provided that same individual lacks the necessary power to dictate the fate of society as a whole. In other words, class warfare today is no longer a valid social issue but rather an issue of pure and senseless material jealousy.

However, we have replaced the lords of the land as well as kings with politicians. Such dangerous combinations of power and wealth do exist in the hands of government despite the fact that the government might be an elected body presiding over the people. This is clearly demonstrated by the very existence of the income tax code and the fact that an individual remains guilty until he himself proves his own innocence when it comes to paying government its tax revenue. Government always, and without exception, seeks to expand its own power base and its revenue stream from its population regardless of the type of government system be it a democracy, dictatorship or communistic state.

Government programs are intended to solidify its power base by purchasing the votes of the people it will most benefit. Therefore, if we look at the welfare system, we have spent over \$4 trillion dollars since 1970 with the purported purpose of lifting people out of poverty. The sad fact of this matter is that the number of people in this poverty group have only increased since welfare payments and benefits are higher than starting salaries in the private sector. This has merely encouraged people to remain dependent upon government - perhaps to some extent intentional at that when jurymandering is consider. Adding this dependent segment of society to the sheer number of public sector employees, we find that we are dangerously approaching levels equal to nearly 45% of the entire civil work force. In reality, this is the base from which government draws its power and a vital link in this power struggle to control the revenue garnished from the private sector.

The problem that we face is the fact that government has, up to now, been free from Adam Smith's invisible hand insofar as having to efficiently manage its resources. Possessing supreme tax authority, government need only increase the tax rate and enact punitive tax codes to insure compliance.

The challenge that we now face is how to restructure government to make it more tolerable for the population at large and to prevent government from expanding its power base even further. If this effort fails, history clearly warns that government, regardless of its constitutional rules, always dies by its own hand. In other words, if we do **NOT** succeed in restructuring government, government will self-destruct under its own regulation in true Byzantine style leaving a vacuum of political and social uncertainty ahead. **Consequently, the battle for tax reform is NOT merely a battle to provide tax breaks for the rich or any class - it is a battle for the very survival of our society.**

IMPROVING MANAGEMENT SKILLS IN GOVERNMENT

What we must realize is that while fraud may often be a small percentage of any program in terms of participants, the actual percentage of fraud in terms of dollars may far exceed 20% of the total program in monetary terms. This was one lesson we learned the hard way with the S&L Crisis. Fraud is a natural tendency of any operation. Retail stores must take into account shoplifters. Warehouses must take into account employee theft, and government must realize that fraud is a major part of any program it seeks to institute.

Government must **FIRST** improve its own work force and implement rules and benefits that are equal to that of the private sector. For example, statistics prove that government workers call in sick nearly twice as often as anyone in the private sector. Pension benefits are often far in excess of standards present within the private sector. Unless these imbalances are corrected, the long-term efficient performance of government cannot be improved costing society far too high a price, which unnecessarily reduces national productivity and ultimately the standard of living for all.

We must accept the fact that fraud is rampant in all government programs from welfare and food stamps to medicare and student loans. Since government is incapable of performing audits of every participant within a program and government workers may not actually provide an efficient audit, **the solution is to reduce the number of potential recipients that deal directly with the government in order to reduce fraud. In other words, we need some sort of intervening body that is responsible for providing services or collecting revenues who can then be audited in a more efficient manner to insure compliance.** This approach can be used in terms of welfare and other programs where an intermediary stands between the actual recipient and government itself. But when it comes to taxes, we must look at the benefits of an **INDIRECT** system compared to a **DIRECT** accountability system of an income tax. Since government is incapable of auditing every tax payer to insure compliance, we need to reduce the number of people who directly report to the government. Therefore, a retail sales tax will significantly reduce the number of people that need to be audited to insure compliance. **Instead of auditing 120 million citizens, following them around to conduct "life style" audits, or requiring 1099s to be filed for every transaction in excess of \$600 nationwide, a retail sales tax will require audits of only business - less than 20 million. The savings alone at the IRS in collection costs will amount to over \$45 billion during a 5 to 7 year period.**

NEW APPROACH TO TAX REFORM: The Principle and The Benefit

If we keep in mind that the efficient approach to any government program should be to reduce the number of people in the private sector that are directly capable of circumventing government efforts, then this basic reform is also applicable to tax reform. Therefore, we must seek to restructure government as if it were an inefficient company on the brink of disaster - for this is the reality of our circumstance. It is highly doubtful that anyone under the age of 50 will be able to receive the same social security benefits that the system currently provides today. In other words, a lifetime of paying into the SS fund will result in little security for retirement with nothing much to show for it - not even a tax deduction.

The following are key points that must be accomplished in order to reverse our current economic decline and the silent encroachment of government. If these reforms are NOT enacted, the United States of the 21st century will stand in stark contrast to that of the late 20th century. We simply will not have the resources to cope with the promises that government has already made. This will result in government becoming more aggressive in trying to raise revenue and further changes to the tax code even beyond any tax reform of 1996/1997.

I. REPLACE PERSONAL INCOME TAXES WITH A 10% NATIONAL RETAIL SALES TAX

- **A)** Repeal the 16th Amendment to the Constitution that provides the Federal government the authority to tax individuals on their personal income. The repeal of the 16th Amendment will **NOT** preclude states from imposing an income tax nor will it prevent the federal government from imposing an income tax on business. It will merely free the individual from his personal accountability with respect to the federal government.
- **B)** Replace the personal income tax with a 10% national retail sales tax. Such a system will provide a much more stable base of revenue for the government that is automatically indexed to inflation without need for government intervention (*see Appendix A*).
- **C)** All sales of goods and services will be subject to the national sales tax. The **ONLY** exemptions will be as follows:
 - 1) Unprepared foods. (Prepared foods at a restaurant will be taxable).
 - 2) Health-care and medicine (including hospitals and over-the-counter drugs)
 - 3) Basic rent and mortgage payments and any associated interest costs.

II STIPULATE A 15% RAISE IN TAKE-HOME PAY.

It is unfortunate, but necessary, that we insure that all taxes currently withheld from the gross salary of workers be returned to the worker in his take-home pay check. Therefore, we are mandating that all employers must pass on such deductions currently associated with the income tax.

III INCREASE ALL EXCISE TAXES BY 10%.

All excise taxes will be increased by 10% including cigarettes and alcohol.

IV READJUST ALL IMPORT TAXES TO A FLAT 10% TAX

Any direct imports by a consumer will be subject to the 10% national sales tax. Travelers will be required to itemize their purchases overseas as they currently do today. They should simply write a check for 10% of their purchases and present it at the time of arrival. The government will still retain the right to verify any purchases by inspection if they feel necessary to insure compliance. The only exemptions will be as follows:

- a) Visitors, holding a non-US passport will be exempt up to \$1,000.
- b) Gifts under \$200 sent through the mail or carrier service by relatives or friends living overseas.
- c) Imports of goods by distributors or retailers for resale to the general public.
- d) This tax will not replace any tariffs imposed by government due to trade negotiations.

V. IMPOSE A 2% NATIONAL REAL ESTATE SALES TAX:

The treatment of real estate must be considered in a different manner since this represents the majority of savings for the individual. In our proposal, we see real estate being subject to a 2% sales (transfer) tax. This may be split between the buyer and the seller and will be applicable to both commercial as well as residential housing. What is important is the fact that such a tax is minimal and represents a substantial savings from the current system of capital gains. In reality, any income derived through long-term capital appreciation will be totally tax free to the average middle class citizen who by far owns more than 70% of all the real estate nationwide.

VI ELIMINATE ALL CAPITAL GAINS & INHERITANCE TAXATION

In order to refocus our economy in the direction of job creation for the long-term, we need to eliminate all taxation involving capital gains and inheritance taxes. This reform will thereby provide a benefit for taking risks long-term vs short-term profits. The elimination of inheritance taxes will enable American companies to once again grow over the course of several generations thus providing long-term job security and leaving the door open for the creation of the next GM for the 21st century.

VII MANDATE THE AUTOMATIC EXPIRATION OF ANY FUTURE TAX INCREASE

We cannot simply outlaw any and all possible future tax increases. In time of national crisis due to war or some huge natural disaster, it may become necessary to provide government with the means to increase the current level of taxation. However, it is too dangerous to stipulate the preconditions for imposing such a tax increase. If we were to limit any tax increase to a condition of war, future politicians might find it advantageous to declare war in some remote corner of the world in order to justify raising taxes. On the other hand, we must respect the fact that government has **NEVER** kept any promise it has made when it comes to eliminating taxes. The income tax itself was imposed with the promise of repeal once the cost of the war had been paid. Obviously, this promise has never been kept. Even Alexander Hamilton swore that the US government would redeem all the debts of the old Continental Congress. To this day, hundreds of millions of dollars of outstanding Continental Currency remains outstanding despite the fact that even the Constitution contained a clause guaranteeing its redemption. **For these reasons, we must be realistic about government in the future. Any tax increase must be allowed in times of a national crisis, but such increases must automatically expire after 4 years. They may not be immediately replaced within a 2 year period nor should they be allowed to be extended. If such a need exists, then the tax reform must also provide for a national referendum on this issue. If the need is valid, then the people must sanction any extension whatsoever and such extensions may not be for a period of more than 2 years.**

VIII PROVIDE FOR A TRANSITIONAL TAX AMNESTY

A key point in all current tax proposals is what to do about income that has not been reported previously. Will the IRS retain the right to audit individuals for past sins? The simplest way to deal with this problem is to extend a national tax amnesty program. Any income that has gone unreported, and is currently not in dispute with the IRS, should be allowed to come forward. The tax rate should be a flat 15% without penalty or interest. Such programs have been used by many states with great success including New York, Pennsylvania and others. While some would argue that this benefits the rich, we must not allow this type of Marxist slogans to prevent a potentially huge windfall in revenue. What we are talking about here is revenue that the IRS is not aware of and lacks the ability to track in any event. The benefit to the citizen or company involved, is that such an amnesty will allow them to declare income that has not been shown thereby increasing their on the record balance sheets that will then help them in the real world of credit. The IRS argues that up to 60% of some self-employed individuals under-report their income. If this is even remotely true, then the potential revenue waiting to be collected could easily amount to hundreds of billions of dollars. Therefore, the amnesty can be summarized as follows:

- a) A flat tax of 15% without penalty or interest.
- b) Relief from any prosecution by federal or state authorities.
- c) All states must accept the amnesty and allow the same terms and conditions relative to any possible state income taxes that might be outstanding.
- d) All revenue should be used as seed capital for SS trust fund and/or reducing the national debt.

IX. REFORM BUSINESS INCOME TAXES

Business taxes must be reformed by refocusing the bracket system to profits relative to the costs involved to generate those profits (*see defining the problem*). If gross profits are no more than twice the gross cost to produce such a profit, then the tax rate should be 15%. If the gross profits exceed twice gross cost levels, then the tax rate should be 25%. Of course to keep this system honest, all dividends, director bonuses and salaries should be **DEDUCTED** from the gross cost calculations.

X. BUSINESS DEDUCTIONS & INTERSTATE REGULATION

It is not reasonable to expect business to operate without deductions as is the case under the flat tax. If the interest costs of a business were 25% of its total cost while its net profits were only 10%, the flat tax would actually require business to pay more in taxes than it earned on a net basis. The mere threat of such a predicament is simply intolerable from a business perspective. Therefore, business must be allowed to deduct interest expenditures as a normal cost of operations. Business must also be allowed to deduct any and all taxation costs incurred at the state and local levels. We cannot allow business to be subjected to three levels of government all denying the impact of the other. In order for business to be competitive on a global scale, taxation of business must be considered in its totality. However, we must also realize that states, in their greed, could raise taxes to such an extent that they crowd out the ability of the federal government to raise revenue from the business community. Therefore, we need some sort of balance by setting a limit on the amount of taxation paid to the local government that will be deductible on federal taxes. Such a limitation should be 5% of total net profits. This will encourage state competition and help to bring business taxation in line on a national basis in order to enhance global competition. These states that seek to raise taxes on business well in excess of 5% of total net profits, will find themselves net losers as business will quickly begin to migrate to the most tax-effective states. Small differentials of less than 3% are **NOT** typically a stimulus for corporate migration within the United States. However, when differentials between states exceed 7%, companies do begin to consider relocation. We must also prohibit the states from taxing companies on worldwide income generated by manufacturing bases in other nations or in other states. In addition, we must sponsor an international agreement on the taxation of multinationals prohibiting the taxation of worldwide income and restricting such taxation exclusively to domestic generated business in each nation. At least domestically, this trend must be stopped or else we will become a nation of tax collectors traveling around in search of victims.

- a) Limit deductions for business to 5% on net profits for local income taxes.
- b) Prohibit the taxation of worldwide income by any level of government.
- c) Prohibit states from imposing taxes on non-resident companies.
- d) Prohibit all forms of government from taxing wages of non-residents.
- e) Business and individuals should be subject to taxation only at the point of residence and may not be taxed on the same income in more than one state.
- f) Sponsor an international agreement that prohibits taxation of worldwide income.

BENEFITS OF THE PEI PROPOSAL:

I. BROADEN THE TAX BASE TO PROVIDE TAX RELIEF:

If the goal is to "**broaden**" the tax base, then **ONLY** a consumption tax will accomplish that goal by tapping into the underground economy. A Flat Tax will merely shift the burden of tax payers from one group to another. Under a retail sales tax, revenue can be captured from the underground economy in addition to solving the problem of illegal aliens gaining access to our services without having to contribute to the well being of the nation.

- **A. \$100 BILLION IN POTENTIAL NEW REVENUE**

According to the IRS, 17% of the economy is underground. While this figure is most likely a gross **UNDER-ESTIMATE**, it does show that if we collect revenue on a consumption basis rather than on a direct income basis, then it will be possible to see a dramatic increase in revenue.

- **B) ILLEGAL ALIENS COULD REACH 20% OF THE POPULATION BY 2003**

Currently, the growth rate of illegal aliens is very alarming. We cannot totally prevent this trend, which may exceed 20% of the population in some states by the year 2003. These same individuals are entitled to all sorts of benefits including education for their children. However, the cost of providing benefits without requiring tax contributions is unjust and an issue of rising discontent as illustrated by California's Proposition 187. **If it is unfair to withhold benefits from those in need, then it is equally unjust to exempt such persons from taxation while imposing tax regulations exclusively to natural born Americans.** The only solution to this problem is not greater enforcement by the INS but to end the discrimination created by the tax code.

II. REDUCING COST OF TAX COLLECTION:

The IRS currently employs more people than most departments in Washington combined. This is a huge waste of resources and an impossible task to manage. Currently, the lag time between filing and an actual audit review of your return can be as much as 3 years. Even if a citizen makes an honest mistake, the interest and penalties that will be incurred can at times equal or exceed the actual amount of the error. A 10% retail sales tax will **ELIMINATE** the necessity for individuals to file an income tax return at all. This will allow for nearly an 80% reduction in the cost to run the IRS or reorient this agency to audit recipients in an effort to eliminate fraud. The remaining work force can provide a more efficient auditing system of business who will be responsible for collecting the revenue on behalf of government.

III ATTRACTING OFFSHORE CAPITAL TO INCREASE INVESTMENT AND REDUCE INTEREST RATES:

If we attract offshore capital from around the world into the US domestic economy and create a confident and contented capital environment, *we will see economic growth that will also increase revenues thereby reducing the burden upon the middle-class.*

- **A) INTEREST RATES DECLINE AS CAPITAL CONCENTRATES**

By eliminating the personal income tax and replacing it with a national retail sales, we will end the benefit of maintaining capital in an offshore environment. Since the offshore capital reserves are estimated to be between \$2 trillion and \$4 trillion, attracting that capital, or a portion thereof, back into our domestic markets will significantly reduce domestic interest rates. As capital concentrated in Japan, interest rates fell to their lowest level. As capital concentrated within the United States during World War II, interest rates also declined to their lowest point during the 20th century despite the huge increase in government deficit spending. During the Swedish financial crisis, as capital suddenly took flight, overnight rates soared to 500%. Interest rates are merely the price of capital. The more capital available, the lower the price. If the supply declines, the price of that commodity rises. In this case - interest rates.

- **B) A 30% DECLINE IN INTEREST RATES WILL SAVE 10 YEARS IN MORTGAGE PAYMENTS, INCREASE NATIONAL SAVINGS & CREATE JOBS**

A decline in interest rates of only 30% will help to save nearly 10 years of purchasing power for the average middle class citizen. Currently, the price of a home is actually more than **DOUBLED** by the fact that interest rates are more than twice that of the 1960s. This excessively high cost of owning a home drains the national wealth and reduces productivity. Achieving a reduction in interest rates of this magnitude will stimulate economic growth and significantly improve long-term employment within the nation.

- **C) A DECLINE IN INTEREST RATES COULD SAVE \$2 TRILLION**

Interest currently accounts for more than 15% of total government spending. A 30% decline in interest rates **COULD** result in an annual savings of more than \$100 billion in the current fiscal year and nearly \$2 trillion dollars over a 10 year period. Such savings can be massive thereby reducing the threat to key social programs.

III. CONCERN ABOUT TAX AVOIDANCE

While there is a concern that the retail sales tax will be more easily avoided than an income tax, such concerns are **NOT** well founded. Some even argue that a black market could develop much like the GST created in Canada. There are two key points that reject this notion. **First:** A black market is possible in Canada only because goods can be purchased cheaper in the US thereby providing a source. **Second:** Avoidance of the GST in Canada has become almost patriotic due to the fact that it raised the overall tax burden rather than replacing it with a fairer system.

- **A) FEWER TAX RETURNS PRODUCE MORE EFFICIENT COMPLIANCE**

Being freed from the burden of potentially auditing every individual return in the nation means that we can redirect our collection efforts to a more cost effective approach when it comes to business. For example, a retail sales tax will be collected by all merchants. To insure compliance, all tax collectors (merchants & service providers) will need to provide a gross purchase of goods and submit this with their monthly return of gross sales. If the gross sales do not match gross services within a predetermined limit (minus inventory), then an audit will follow. The burden of collection will be entirely that of the retail community since this is in effect their position

as a "trustee" agent for the government. Therefore, regardless of whether or not the taxes were collected, they will be payable by the retail merchant. This legal distinction will help insure that the tax is in fact collected. As long as merchants and service providers are aware of the fact that **wholesale purchases, minus inventory equals taxable transactions**, and that such information is being supplied, then avoidance will be minimal and at the merchant's risk. This will **NOT** create an altogether new burden for the retail trade since the majority are already collecting sales taxes on a state level. In addition, if remittance of collected taxes are to be paid on a monthly basis, then the merchant will reap some interest benefit which will also help to defer collection costs.

IV. RESTORING BUSINESS CONFIDENCE:

Since business requires a stable and well defined infrastructure, it is in the best interests of commerce itself to contribute to the overall functions of the state. We must remain conscious about the fact that business provides the economic growth and expansion that is vital to maintain our general living standards and job creation not to mention technological advancements. To attract business and retain it within our domestic borders, it is important to keep in mind that business owes no loyalty to any flag and in turn should not be forced to do so. What is necessary is to provide an environment that will attract business from around the world and retain it domestically. The benefits to business under the PEI proposal are as follows:

- A). Well maintained infrastructure
- B). Clearly defined regulations that are held to a realistic minimum
- C) Competitive international tax rate of 15%
- D) Guarantee against future tax increases
- E) Stable business environment to promote long-term growth
- F) Elimination of capital gains tax to promote long-term investment
- G) End US taxation of worldwide income
- H) End of inheritance taxes to allow small business to grow between generations

V IMPOSE SELF-RESTRAINT UPON GOVERNMENT

- History warns that most nations have run into trouble due to rising expenditures and shrinking revenues. Spain borrowed so heavily against future finds of gold in the New World, that when their revenues fell below expenditures, they first turned against their own people and then finally defaulted on their Italian bankers. The fiscal irresponsibility of Spain destroyed their economy and that of Italy. The once great banking industry of Venice was replaced by the Dutch and Germans who in turn lost it to Britain. It was the fiscal irresponsibility of Britain that led to punitive tax increases in her colonies and eventually the American Revolution. Today, the average American is now paying more than twice the rates of taxation compared to what was expected of him under Britain. More than 200 years later, we have merely replaced a king with politicians that have proved to be equally as greedy if not more so. Above all, the PEI Proposal seeks to restore sense to government and prevent its inevitable desire to expand its revenues to the point of economic collapse.

Scoring the PEI Tax Reform Proposal

Data based upon BEA 3rd Quarter 1994 in billions

The following results are a crude calculation of what would be generated from a 10% national sales tax combined with a 15% corporate/business income tax, 2% sales tax on real estate (commercial & residential) and a 10% increase in excise taxes.

Under Dynamic section assumptions, there would be a net savings from a reduction in interest rates due to the tax free status of government bonds. In addition, by placing social security off-budget and actually accruing capital contributions that would be invested in a combination of bonds and private sector shares, a 5% annual return would be possible if the fund were truly segregated as required by law in the private sector. Also elimination of personal income tax will reduce IRS collection costs.

Personal Consumption Expenditure 4657.5	
10% sales tax.....	465.75
Property Transactions including Commercial & Residential	
2% sales tax (1177.1).....	23.54
State & Local Government Purchases Goods & Services	
10% sales tax (89.2).....	8.90
Total Revenue generated by sales taxes.....	498.19

Proprietor's Income w/IVA & CCAAd (467.0)	
15% Flat Tax.....	70.05
Corporate Profits w/IVA & CCAAd (556.0)	
15% Flat Tax.....	83.40
Total Flat Tax Revenue.....	153.45
Food Exemption (Gross 683.7) non-prepared food.....	-34.18
10% Increase in Excise Taxes (91.9).....	9.19
Net Revenue Based Upon Static Assumptions....	626.65

Dynamic Model Adjustments

1/3 reduction in interest expenditures (bonds tax free)...	73.65
10% increase in corporate/business profits....	15.34
Increase in consumption (17% Underground IRS est)....	79.17
Privatization Social Security 5% return.....	27.88
Savings on interest for current year	
reduction in deficit spending.....	8.25
Reduction in IRS collection costs.....	10.00

Net Total Revenue.....	830.94
Social Security Revenue (unchanged).....	557.60
Total Gross Revenue.....	1,388.54
Actual Gross Revenue Received 3rd quar '94..	1,388.80
Net reduction in Deficit.....	.26