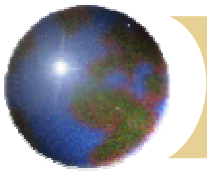


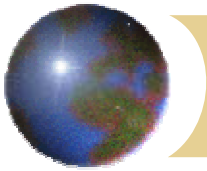
# *Principles of Tax Reform*

Presentation to International Conference on  
Economic Reforms for Europe – Sponsored  
by INEKO, March 18, 2004



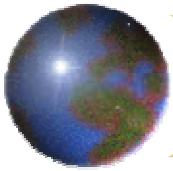
## *Two Major Issues*

- ❖ What is the appropriate role of government?
- ❖ The classical liberal vision of small government.
- ❖ Or the welfare state vision of large government.
- ❖ How should government be financed?
- ❖ Broad-base and low-rate system designed to minimize distortions.
- ❖ Or a tax code as a tool of social policy.



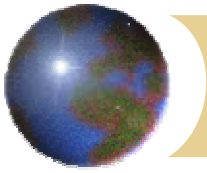
## *What Should Government Do?*

- ✦ There are certain core functions of government - including national defense, legal system, and public safety.
- ✦ The more governments stray from these core functions, the less likely they are to be competent in any area.
- ✦ The more governments stray from these core functions, the higher the tax burden.
- ✦ This means less growth.



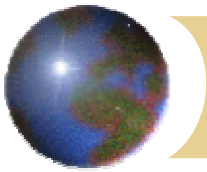
## *Effectiveness versus Size*

- ✦ There is an inverse relationship between effectiveness and size when comparing governments.
- ✦ Governments that try to do too much often do nothing well.
- ✦ Governments that concentrate on core functions tend to perform more competently.
- ✦ Smaller governments are more capable.



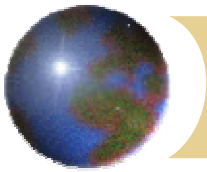
# *What is the Goal of Economic Policy?*

- ✦ To create conditions that encourage people to create wealth and improve their living standards.
- ✦ To create a large tax base so that the legitimate functions of government can be financed at low tax rates.
- ✦ To preserve and enhance liberty so people can enjoy freedom.



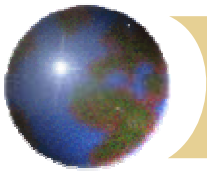
## *What is Good Tax Policy?*

- ✚ Tax Income at a low rate, ideally no more than 20 percent.
- ✚ Define the tax base correctly, taxing Income only one time.
- ✚ Tax all income alike, since neutrality ensures economic criteria rather than tax provisions determine resource allocation.
- ✚ Tax only income earned inside national borders, the common-sense notion of territorial taxation.



## *Why Have a Low Tax Rate?*

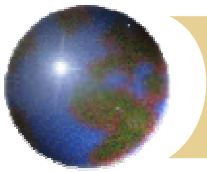
- ✦ The marginal tax rate – the burden on the next increment of income – must be kept low.
- ✦ A low marginal tax rate rewards productive behavior. People will work more, save more, and invest more.
- ✦ Incentives to hide, shelter, under-report income are lower when the marginal tax rate is reasonable.
- ✦ Research indicates that the marginal tax rate should be no higher than 20 percent.



## *Why Tax Income Only One Time?*

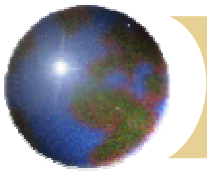
- ✦ Many nations impose multiple layers of tax on income that is saved and invested.
- ✦ This is the wrong definition of the tax base.
- ✦ Taxes on interest, dividends, capital gains, and inheritances are examples of the discriminatory treatment of capital.
- ✦ This is a self-destructive policy since it harms the activity – capital formation – that all economic theories agree is necessary for economic growth and rising living standards.





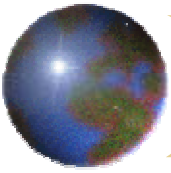
## *Why Neutrality?*

- ❖ Government should not pick winners and losers.
- ❖ Special preferences and penalties distort the allocation of capital and undermine efficiency, leading to lower incomes.
- ❖ Special preferences and penalties also encourage taxpayers to squander time and energy in search of political advantage instead of concentrating on productive behavior.



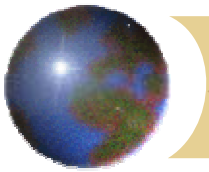
## *Why Territoriality?*

- ✦ Governments should only tax income earned inside national borders.
- ✦ The other alternative – worldwide taxation – imposes high compliance costs and undermines competitiveness of companies and entrepreneurs.
- ✦ Territoriality respects the sovereign right of nations to control the taxation of income earned inside national borders.
- ✦ Worldwide taxation is superfluous for nations with competitive tax rates.



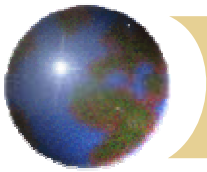
# *Benefits of Tax Reform*

- ✦ Liberty
- ✦ Simplicity
- ✦ Prosperity
- ✦ Competitiveness
- ✦ Opportunity
- ✦ Equality
- ✦ Privacy
- ✦ Enforcement



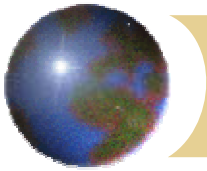
# *Liberty*

- ✚ Individual freedom is the key benchmark of a civilized society, and a flat tax is the revenue-collecting mechanism that preserves and protects liberty.
- ✚ Under a flat tax, the government is not trying to control peoples' lives.
- ✚ Under a flat tax, there is no attempt to penalize or reward people based on the level of income, source of income, or use of income.



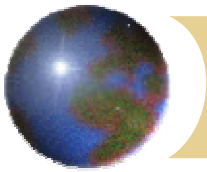
## *Simplicity*

- ❖ Simplicity is a consequence of good tax policy, particularly the elimination of double-taxation of income that is saved and invested.
- ❖ Labor income can be taxed in a simple manner at the individual level, with an family-based exemption to protect low-income residents.
- ❖ Capital income can be taxed in a simple manner at the business level, using a simple definition of income, akin to cash-flow expenditure tax.



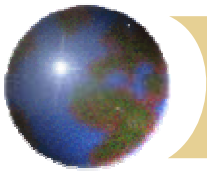
# *Prosperity*

- ✦ Lower tax rates will encourage more productive behavior.
- ✦ The elimination of double-taxation will encourage more capital formation.
- ✦ Neutrality will encourage the more efficient allocation of capital.
- ✦ Territoriality will boost competitiveness of nation's companies.



## *Prosperity...continued*

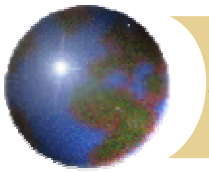
- ✦ The aggregate benefits would be large. Academics have found that a flat tax in the U.S. would boost long-term living standards by as much as 15 percent compared to baseline.
- ✦ the OECD has estimated that economies grow one-half of 1 percent (0.5 percent) faster for every 10-percentage-point reduction in marginal tax rates.



# *Equality*

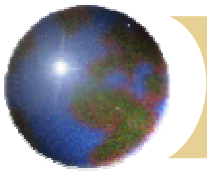
- ✦ Tax reform is not just about economics, it also reflects a society's principles.
- ✦ A flat tax advances the principle that the law should treat everyone equally, with no special privileges or penalties.
- ✦ A flat tax eliminates special interest exemptions and preferences.
- ✦ All taxpayers pay the same tax rate, regardless of the number of lawyers, lobbyists, and accountants they can afford.





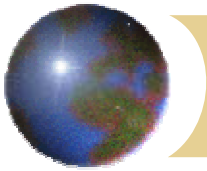
# *Opportunity*

- ✦ A simple, low-rate, neutral tax system removes barriers to upward mobility.
- ✦ The goal is to have a system that creates more rich people.
- ✦ People should be able to rise as far and as fast as their talents, abilities, and willingness to work hard will take them.
- ✦ A productive, self-reliant people is a critical form of social capital for a productive society.



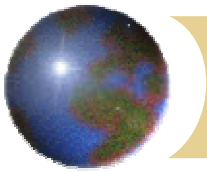
## *Competitiveness*

- ✦ Today's global economy makes good tax policy much more important.
- ✦ Lower tax burdens is one reason why the U.S. is doing much better than the E.U., with faster growth and more employment.
- ✦ Tax reform is particularly important for transition economies since good tax policy will entice both direct and indirect foreign investment.



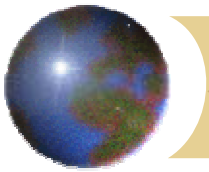
## *Competitiveness...continued*

- ✦ Tax competition is a powerful force for economic liberalization, one that should be celebrated rather than persecuted.
- ✦ The rewards for good tax policy have never been greater.
- ✦ Central and Eastern Europe are changing history with pro-growth tax reforms.
- ✦ Don't let Western Europe undermine reform.



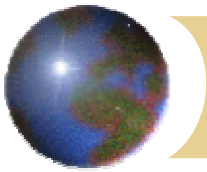
## *More competitiveness*

- ✦ OECD economists have written that “the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively.”
- ✦ Gary Becker observed that “...competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations.”



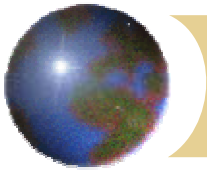
# *Privacy*

- ✦ Tax reform – specifically the proper definition of taxable income – dramatically enhances the right to privacy.
- ✦ If capital income is taxed at the business level, nobody has to tell the government about their savings, investments, or assets.
- ✦ In a free society, people should not have to tell the government about their private affairs without a compelling interest.



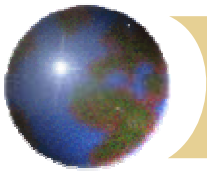
# *Enforcement*

- ✚ Flat tax systems are easy to enforce.
- ✚ OECD economists note that “legal tax avoidance can be reduced by closing loopholes and illegal tax evasion can be contained by better enforcement of tax codes. But the root of the problem appears in many cases to be high tax rates.”
- ✚ Taxing capital only once – especially at the source – is especially conducive to enforcement.



# *Key Obstacles to Tax Reform*

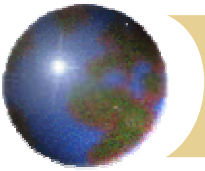
- ✦ Class Warfare
- ✦ Revenue Demands
- ✦ Special Interests
- ✦ Political Power



## *Class Warfare Hurts the Poor*

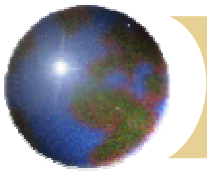
- ❖ Opponents of tax reform also argue that high tax burdens on saving, investment, and assets prevent an “unfair” concentration of wealth.
- ❖ No evidence for this hypothesis.
- ❖ These policies diminish economic growth and capital formation, and this primarily hurts lower-income people.
- ❖ Opponents fail to realize that the goal is upward mobility and economic expansion, not simply new ways to divide an existing pie.





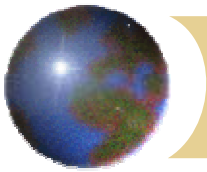
## *Growth, Not Redistribution*

- ✚ Compassion is not defined by seizing and spending someone else's money.
- ✚ It is far more compassionate to create a society that gives people the opportunity to get a good job that pays a good wage.
- ✚ In the U.S., there is dramatic income mobility as many rich people lose wealth and many poor people climb out of poverty.
- ✚ Winston Churchill defines socialism as the equal sharing of the misery.



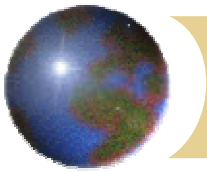
## *The “Supply-Side” Effect*

- ✚ A low-rate flat tax does not necessarily mean lower revenue, particularly in the long run.
- ✚ When people work more, save more, invest more, the tax base is bigger and government gets more money.
- ✚ When people have less incentive to hide, shelter, and under-report, the government gets more money.
- ✚ Evidence from around the world is strong.



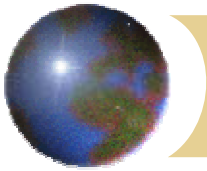
## *Overcoming Special Interests*

- ❖ Many groups benefit from special loopholes and preferences.
- ❖ Transition economies have an advantage – these special provisions are not firmly embedded in young tax systems.
- ❖ But special interests will still resist tax reform, which is why a bold system is needed to capture the public's imagination.



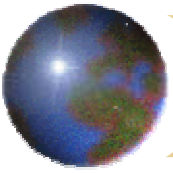
## *Controlling political corruption*

- ✦ Simple and fair flat taxes reduce the power of government and this means politicians have less ability to exchange special tax provisions for campaign cash and other forms of political support.
- ✦ This is the biggest obstacle to tax reform in America.
- ✦ But it is one of the best reasons to adopt the flat tax.



## *Conclusion*

- ✦ Tax reform is good politics and good economics.
- ✦ It reduces distortions and minimizes corruption.
- ✦ The flat tax will give growth a major boost – assuming anti-tax competition schemes don't hinder the flow of jobs and capital.
- ✦ Western Europe's welfare states are not necessarily on your side.



## *For More Information:*

- ✦ [www.heritage.org](http://www.heritage.org)
- ✦ [www.freedomandprosperity.org](http://www.freedomandprosperity.org)
- ✦ [www.heritage.org/taxcompetition](http://www.heritage.org/taxcompetition)