11. Federal Tax Reform

Congress should

- make permanent the tax cuts enacted in 2001 and 2003, including the income tax rate reductions and dividend and capital gains tax cuts;
- reenact the 50 percent expensing provision for business investment that was established in 2003;
- repeal the estate tax permanently;
- repeal the individual and corporate alternative minimum taxes (AMTs);
- turn Roth individual retirement accounts (IRAs) into large, all-purpose savings accounts available to every family by repealing withdrawal restrictions and liberalizing contribution and income limits;
- simplify the tax code by combining further rate cuts with the elimination of social engineering provisions, such as education and homeowner tax breaks; and
- replace the income tax with a low-rate consumption-based tax—either a Hall-Rabushka flat tax, a consumed-income tax, a national retail sales tax, or another tax that is flat, neutral, and simple.

The Burden of Taxes

At the beginning of the 20th century, federal taxes accounted for 3 percent of the nation's gross domestic product, and the tax code and related regulations filled just a few hundred pages. Today, federal taxes account for 17 percent of GDP, rising to 20 percent of GDP by 2014 if recent tax cuts expire as scheduled. According to CCH Inc., federal tax

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rules and regulations spanned 60,044 pages in 2004—48 percent more pages than when the Republicans took over Congress in 1995.

The extraction of $2 trillion in federal taxes from families and businesses each year comes at an enormous cost. The most obvious cost is that Americans are left with less money to meet their needs for food, clothing, housing, and other items, and businesses are left with fewer funds to invest and build the economy.

In addition, the tax system imposes large compliance burdens and ''deadweight losses'' on the economy. *Compliance burdens* are the time and administrative costs of dealing with the tax system's rules and paperwork. *Deadweight losses* are created by taxes distorting the market economy by changing relative prices and altering the behavior of workers, investors, businesses, and entrepreneurs.

Consider a working woman who is considering launching a small business on the side to earn more income. If the government raises marginal tax rates and dissuades her from those entrepreneurial plans, the nation loses the production and innovative ideas that she could have added to the economy.

Such economic damage increases more than proportionally as marginal tax rates rise. In particular, deadweight losses rise by the square of the tax wedge between pre- and posttax income. For example, a doubling of the tax wedge causes deadweight losses to quadruple. That is why a flatter tax structure with lower marginal rates would be much more efficient than the highly graduated rate structure that we have today.

In sum, every new $1 million government program costs taxpayers much more than $1 million. In addition to direct tax costs of $1 million, taxpayers are burdened by higher compliance costs and deadweight losses. Estimates of the size of deadweight losses vary, but generally each added dollar of income tax revenue creates a loss to the economy of 25 cents or more. Harvard professors Martin Feldstein and Daniel Feenberg estimated that the Bush tax cut in 2001 reduced deadweight losses by 38 cents for each dollar of the tax cut. Another Harvard professor, Dale Jorgenson, figures that deadweight losses of the income tax system are 35 cents on each added tax dollar and estimates that switching to a consumption-based tax system would reduce that burden substantially.

Congress should cut the overall size of the federal government to reduce these tax burdens. But even given the current level of federal taxes, the tax system can be redesigned to increase economic growth by reducing deadweight losses and compliance costs. The following sections look at

82978$CH11 12-08-04 07:49:51

key problems of the income tax and reforms that would create a simpler, fairer, and more efficient system.

Income Tax Complexity

In 1976 president-to-be Jimmy Carter called for ''a complete overhaul of our income tax system. I feel it's a disgrace to the human race.'' Since Carter's attack, the number of pages of federal tax rules has roughly tripled. More recently, President Bush's first treasury secretary, Paul O'Neill, called the tax code an ''abomination.'' Unfortunately, policymakers have done little to fix the problem, and Table 11.1 shows that complexity has risen in recent years.

The following are five types of costs created by the income tax's excessive complexity.

1. Compliance and Enforcement Burdens

Americans spend 6.5 billion hours annually filling out tax forms, keeping records, and learning tax rules, according to the Office of Management and Budget. A huge public and private ''tax industry'' is needed to administer, plan, and enforce the complex system, requiring the efforts of some of the smartest people in the country. The costs of complying with federal income taxes are roughly $200 billion per year. In addition to the costs of filing tax returns, taxpayers face the burden from audits, notices, liens, levies, seizures, and the 30 million penalties assessed each year by the IRS. Those burdens fall on individuals both directly and indirectly through the costs imposed on businesses. For example, the paperwork for a large corporation's tax return can run more than 10,000 pages. All Americans would gain if businesses spent less time on such paperwork and more time creating good products.

2. Errors

Tax complexity causes taxpayers and the IRS to make frequent and costly errors. The IRS routinely gets up to half the answers to taxpayer phone inquiries wrong. The problem is that Congress has filled the tax code with complex features such as the Earned Income Tax Credit. Almost one-third of EITC payments—about $9 billion annually—are erroneous. These EITC errors occur despite a big effort by the IRS to fix the problem with a special $200 million annual budget allocation.

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Table 11.1
Rising Tax Complexity

Item	Initial Year	Recent Year
a) Total pages of federal tax rules	1995 40,500	2004 60,044
b) Number of IRS tax forms	2000 475	2004 529
c) Number of income tax loopholes for education and training	1994 16	2004 28
d) Percent of taxpayers using paid tax preparers	1995 50%	2003 62%
e) H&R Block U.S. tax preparation revenues	1996 $740 million	2003 $1.9 billion
f) Hours Americans spend filling out tax forms	1995 5.3 billion	2004 6.5 billion
g) Pages in Form 1040 instruction book	1995 84	2003 131
h) Average time to complete Form 1040 and Schs. A, B, D.	1995 21.2 hours	2003 28.5 hours

SOURCE: Author, based on
a) CCH Inc. Includes tax code, regulations, and IRS rulings.
b) IRS, Tax Forms and Publications Division.
c) Author's count of official ''tax expenditures.''
d) National Taxpayers Union.
e) H&R Block. Annual reports for various years.
f) Office of Management and Budget, ''Information Collection Budget.''
g) National Taxpayers Union.
h) National Taxpayers Union.

3. Decisionmaking Complications

Tax complexity impedes efficient decisionmaking by families and businesses. For example, the growing number of saving vehicles under the income tax greatly confuses family financial planning. If a family makes the wrong savings choice, it could result in lower returns, less liquidity, and payment of withdrawal penalties. Saving would be vastly simplified under a consumption-based tax.

For businesses, the complex and always changing income tax rules inject uncertainty into decisions such as those about capital investment.

82978$CH11 12-08-04 07:49:51

Major tax laws can alter hundreds of tax provisions causing a flood of changes to tax forms, tax regulations, and IRS guidance notices. More complexity means more errors for everyone in the tax industry and more disputes between taxpayers and the IRS. Audits, appeals, and litigation over disputed business tax items can drag on for years.

4. Inequity and Unfairness

Although equality under the law is a bedrock American principle, individuals pay greatly different tax rates under the income tax. For example, IRS data for 2002 show that income taxes averaged 26.2 percent of adjusted gross income for those earning more than $200,000, but 10.5 percent for those earning between $50,000 and $100,000. Joint Tax Committee data for 2003 show that 60 million of 152 million U.S. households paid no income tax at all.

Even people with similar incomes are treated unequally by the tax code as a result of special exemptions, deductions, and credits. As Congress has added more special preferences for favored groups, inequities have increased. Tax incentives for education, home ownership, alternative fuels, and other items unfairly favor some Americans over others. Special tax breaks should be repealed and overall tax rates reduced.

5. Avoidance and Evasion

Tax complexity leads to greater noncompliance with the tax system. That stems partly from greater taxpayer confusion. But complexity also fosters multiple interpretations of the law, thereby stimulating more aggressive tax planning. Taxpayers take risks on their tax returns in the hope that complexity will hide their strategies from the IRS. The economy would be better off if tax rules were simple and transparent so that taxpayers focused on productive endeavors, rather than on playing cat-and-mouse games with the IRS.

Income Tax Bias against Saving

Saving is a key source of economic growth because it provides businesses with the investment funds they need to expand and modernize the nation's capital stock. The income tax system taxes saving and investment but not current consumption, which creates a damaging bias that reduces economic growth. Also, the income tax system applies different tax burdens to different forms of savings and investment, thus complicating and distorting economic decisionmaking.

82978$CH11 12-08-04 07:49:51

To solve those problems, all recent tax reform proposals would switch from an income tax base to a consumption tax base. That would remove the bias against saving, and it would create neutrality between different forms of savings and investment. The nation's saving would increase and investment would flow to the highest-valued uses in the economy. For individuals, a consumption-based tax would make saving simpler and more lucrative. With greater savings, families would be more financially secure and could rely less on government safety nets.

Different consumption tax reform plans would treat saving similar to either regular IRAs or Roth IRAs. In the first case, initial saving is deducted but withdrawals from saving are taxed. Reform proposals for a ''consumed-income'' or ''saving-deferred'' tax would treat all saving this way. In the second case, no deduction is given for initial saving but withdrawals are tax-free. The Hall-Rabushka ''flat tax'' adopts this treatment by taxing wages but exempting individuals from taxes on dividends, interest, and capital gains. To move toward tax reform, current Roth IRAs could be expanded into large, all-purpose savings accounts, similar to the Hall-Rabushka approach.

Short-Term Reforms

Make the Income Tax Rate Cuts Permanent

In 2001 Congress enacted the Economic Growth and Tax Relief Reconciliation Act based on President Bush's tax reduction plan. That act took a number of positive steps, including reducing individual statutory tax rates, liberalizing the tax rules on savings vehicles, and taking steps toward estate tax repeal. However, those provisions are set to expire at the end of 2010, thus creating the possibility of a massive tax hike in 2011. To avert such a tax shock, Congress should extend the 2001 tax cuts permanently.

Make the Capital Expensing Reforms Permanent

To spur economic growth, Congress enacted a business tax cut in 2002 that allowed companies to ''expense'' (or immediately deduct) 30 percent of the cost of qualified capital purchases. In the Jobs and Growth Tax Relief Reconciliation Act of 2003, Congress increased the expensing provision to 50 percent and extended it to the end of 2004. The 2003 act also increased the limit for small business capital expensing. Small businesses may now immediately deduct up to $100,000 of qualified

82978$CH11 12-08-04 07:49:51

investments. Those provisions should be made permanent to create sustained growth in business investment. Consumption-based tax plans, such as the Hall-Rabushka flat tax and the Simplified USA tax of Rep. Phil English (R-PA), incorporate 100 percent expensing for all capital investment.

Make the Dividend and Capital Gains Tax Cuts Permanent

The 2003 tax law cut the maximum capital gains tax rate from 20 to 15 percent and the maximum tax rate on dividends from 35 to 15 percent. Those tax cuts, which are set to expire at the end of 2008, should be made permanent as part of a general policy of reducing taxes on capital income. Most major nations have cut capital income taxes in recent years, but the United States has lagged behind (see Chapter 13). Before the 2003 tax cut, the United States had the second-highest tax burden on dividends among the 30 OECD countries, taking into account both corporate and individual taxes. The United States also lags behind the reform leaders on capital gains taxation. Austria, Belgium, the Czech Republic, Germany, Greece, Hong Kong, Mexico, the Netherlands, New Zealand, Poland, and Switzerland all have a tax rate of zero on individual capital gains, although holding periods and other conditions apply in some countries.

Expand Roth IRAs into Universal Savings Accounts

One approach to reducing taxes on savings would be to liberalize the rules on Roth IRAs. Contributions to Roth IRAs are from after-tax earnings, but qualified withdrawals are tax-free. Contribution limits on Roth IRAs were recently liberalized, but further reforms could revolutionize saving in America. The key is to repeal the Roth IRA restrictions on withdrawals. Currently, individuals face a 10 percent penalty on most withdrawals prior to retirement. The result is that the liquidity of IRAs is reduced and families are dissuaded from using the accounts for fear that they may need their money before retirement. This restriction especially affects moderate-income families, who may decide not to use IRAs at all so as to keep their savings in more liquid form.

Roth IRAs should be turned into all-purpose savings accounts that allow withdrawals for any reason, not just for purposes specified by the government. That was the idea behind the Bush administration's Lifetime Savings Accounts proposal. Such accounts would encourage families to build up larger pools of savings that could be used for any contingency, such as medical expenses, home buying, unemployment, college, or unexpected

82978$CH11 12-08-04 07:49:51

crises. All personal savings—not just retirement savings—creates greater individual financial stability and thus should be encouraged. Universal savings accounts would also simplify the tax code because the plethora of current special purpose accounts could be phased out.

Repeal the Estate Tax

The 2001 tax law repealed the federal estate tax, but only for the single year of 2010. After 2010 the ''death tax'' returns in full force with a top tax rate of 55 percent. The estate tax raises only about 1 percent of federal revenues, but it is very costly to the economy. The chairman of the Council on Economic Advisers, Greg Mankiw, noted at a November 2003 Treasury conference that as a tax on savings, the estate tax suppresses growth and reduces average workers' wages. He concluded that ''the repeal of the estate tax would stimulate growth and raise incomes for everyone.''

The estate tax is probably the most inefficient tax in America. It has created a huge and wasteful estate-planning industry to help wealthy Americans avoid the tax if they hire enough lawyers and accountants. Studies indicate that for every dollar raised by the tax, roughly one dollar is lost to avoidance, compliance, and enforcement costs.

In addition, the estate tax may not actually raise any money for the government, as noted at the Treasury conference by Mankiw. The tax has the effect of suppressing income tax collections, thus offsetting estate tax receipts. Mankiw concluded that ''estate tax repeal . . . could actually increase total federal revenue.'' Congress should complete the job it started and permanently repeal the estate tax.

Enact Simplification Measures

Nearly every member of Congress expresses concern about income tax complexity but puts little effort into actually simplifying the code. One place to start would be the Joint Committee on Taxation's 1,300-page report from 2001 that proposed more than 100 simplification reforms, including repeal of the corporate and individual AMTs. Congress should take seriously the proposals of its own experts at the JCT and enact those reforms.

Further progress could be made by assembling groups of narrow tax breaks to eliminate in a reform package that included substantial tax rate cuts. For example, education incentives, energy tax breaks, and the mortgage interest deduction could be repealed in combination with a large cut to middle-income tax rates.

82978$CH11 12-08-04 07:49:51

Certainly, Congress should not pass laws that make the tax code more complex. Yet that seems to be the fate of the Foreign Sales Corporation/Extraterritorial Income Exclusion tax legislation. The original FSC/ETI bill from Ways and Means chairman Bill Thomas (R-CA) would have simplified the complex tax rules on corporate foreign investments. But by the end of the 108th Congress, House and Senate versions of the bill were massive pieces of legislation that would add new complexities to the code. Congress should start from scratch and simply repeal the FSC/ETI tax break and enact a substantial corporate tax rate cut.

Repeal the Alternative Minimum Tax

The corporate and individual AMTs are complex income tax systems that operate parallel to the ordinary income tax. There is broad agreement that the AMTs should be repealed since they serve no economic purpose. Indeed, the corporate AMT adds distortions and uncertainty to business decisionmaking. AMT repeal has been recommended by the JCT and the American Bar Association. Former IRS national taxpayer advocate Val Oveson called the AMT ''absolutely, asininely stupid.'' Under JCT projections, 30 million taxpayers will be subject to the ''asinine'' individual AMT by 2010 unless Congress acts to repeal it.

Continue Reforming the Tax Policy Process

When Congress considers raising or cutting taxes, changes in federal revenues are estimated by the JCT. Those estimates are very important in policy debates, yet they are often erroneous and incomplete. A key problem is that JCT revenue estimates have traditionally been ''static,'' meaning that they do not take into account the effects that tax changes have on the macroeconomy. If marginal tax rates are cut, for example, the economy will grow and generate a partially offsetting increase in federal revenues. Such macroeconomic feedbacks are captured in ''dynamic'' estimates of tax changes.

In recent years, the JCT (and the Congressional Budget Office) has begun to modernize its tax-estimating apparatus, and some recent analyses have included macroeconomic modeling results. Economic modeling should be made a routine part of the tax policy process. One benefit would be to help members of Congress understand that tax changes are not just about gaining and losing money for the budget; they can create substantial impacts on the economy.

82978$CH11 12-08-04 07:49:51

Other aspects of the tax policy process also need reform. The estimating techniques used by government economists should be opened to peer review. In addition, the traditional presentation of tax estimation results in the form of ''distributional'' tables should be reexamined to ensure fairness and accuracy.

Cut Spending

Although President Bush and Congress have enacted some important tax cuts in recent years, they have let federal spending and the deficit soar. Federal outlays rose 31 percent under President Bush between FY01 and FY05. That has become a hurdle to future tax reforms because some policymakers will use the resulting deficit as an excuse to oppose tax cuts and to support tax increases. Chapter 9 describes how to restrain and reduce federal spending.

Fundamental Tax Reform

Raising the bulk of federal revenue from a broad-based income tax was a historic mistake. It has led to excessive complexity, multiple economic distortions, and a reduction in U.S. economic growth. To correct those problems, fundamental tax reform proposals would replace the income tax with a low-rate consumption-based system.

The difference between an income and a consumption-based tax is the treatment of saving and investment. The federal income tax is loosely based on a broad measure of income economists call Haig-Simons income. Taxing Haig-Simons income means imposing a heavy tax burden on saving and investment. For example, a full Haig-Simons-based tax would tax all capital gains accrued on paper every year, whether or not those gains were actually received by taxpayers. It would also tax items that individuals would not normally think of as income, such as the implicit rent received from owning one's home and the buildup of wealth in life insurance policies.

A few decades ago, many tax policy experts supported taxing such an expansive Haig-Simons income base. Yet there is no good economic argument for such a tax base. For example, the accrual taxation of capital gains would result in inefficient double taxation. (A rise in an asset's projected future return creates an immediate capital gains tax, which comes on top of taxes that will be paid when the asset generates income in the future.) The attraction of a Haig-Simons income tax base stemmed mainly

82978$CH11 12-08-04 07:49:51

from the egalitarian impulse to impose a heavy load of taxation on those with high incomes.

Today, there is much greater understanding that income-based taxes are both economically damaging and cannot be made simple. The current income tax relies on a huge array of ad hoc rules. Current tax law has no consistent standard for what constitutes income or when it should be taxed. Capital gains are treated on a realization basis, which creates planning difficulties for investors who must optimally time asset sales and try to offset gains with losses. Also, inflation wreaks havoc with income taxes by making capital gains, depreciation, and other items difficult to measure properly.

A consumption-based tax would be much simpler than the current income-based system, as summarized in Table 11.2. For example, capital gains taxation would be eliminated, as would depreciation deductions. Also, inflation is not a problem for consumption-based taxes. After 90 years of struggling with the complex and unstable income tax, it is time for America to try a different tax base. A consumption-based tax would be simpler, more transparent, and more favorable to economic growth.

Tax Reform Options

To replace the individual and corporate income taxes with a low-rate consumption-based tax, Congress can begin by enacting the short-term reforms listed above. At the same time, it should start considering consumption-based proposals, including the flat tax, a national retail sales tax, a consumed-income tax, and other ideas.

The flat tax was originally proposed by Robert Hall and Alvin Rabushka of the Hoover Institution and was most recently championed by former house majority leader Dick Armey. Leading retail sales tax proposals have included a plan by Rep. Billy Tauzin (R-LA) to replace individual and corporate income taxes with a 15 percent retail sales tax and Rep. John Linder's (R-GA) FairTax plan to replace those taxes plus federal payroll taxes with a 23 percent sales tax.

Other ideas include the Simplified USA tax of Rep. Phil English (R-PA) and the Inflow-Outflow tax plan of the Institute for Research on the Economics of Taxation. Rep. Jim DeMint (R-SC) introduced a plan that would replace the corporate income tax with a 9 percent consumption-based tax and the individual income tax with a 9 percent retail sales tax.

All those plans would reduce taxes on saving and investment. They would, however, differ in their mechanics and pose tradeoffs with regard

82978$CH11 12-08-04 07:49:51

to administration, simplicity, and civil liberties. Table 11.2 summarizes the advantages of a Hall-Rabushka flat tax, but similar gains could be achieved under other low-rate consumption-based systems.

Table 11.2.
Advantages of a Low-Rate Consumption-Based Tax

A Hall-Rabushka flat tax compared to the income tax

Advantages for Individuals

Low marginal tax rate: A consumption-based tax with a low rate would increase incentives for working, saving, and entrepreneurship. Many small businesses and the self-employed would face a lower marginal tax rate, spurring growth and investment.

Interest and dividends: Interest and dividends would not be taxed at the individual level. That would make saving simpler, enhance financial privacy, and increase incentives for families to save for retirement and other needs. Half a billion 1099s and other IRS forms would be eliminated. The tax code's complex and distortionary treatment of interest, such as the municipal bond preference, would be eliminated.

Capital gains: Capital gains taxation—perhaps the most complex part of the tax code—would be eliminated. Investor decisions would not be distorted by such capital gains issues as the timing of realizations, matching gains with losses, and calculating basis. Ending gains taxation would stimulate the birth and expansion of entrepreneurial growth companies, which rely on investors who earn returns through capital gains.

Savings vehicles: The current plethora of savings vehicles, including pensions, 401(k)s, and IRAs, would be phased out as tax hurdles to all types of savings were removed. Retirement would become individually based, ending the risks of being tied to company plans. Families could save for their own reasons, not just for reasons favored by Congress. Families could save as much as they wanted, would not have complex restrictions on their saving choices, and could withdraw their savings tax-free.

Social engineering: Social engineering through the tax code would end, and fairness would increase as tax provisions that favored narrow groups were eliminated. All taxpayers would face a simple, fair, and neutral tax system.

Advantages for Businesses

Low marginal tax rate: Lower corporate and small business tax rates would provide increased incentives for hiring and investment. A low corporate rate would make the United States a magnet for foreign investment inflows. A low tax rate would also reduce tax avoidance and evasion efforts and kill the wasteful corporate tax shelter industry. Compliance and enforcement costs of the tax system would fall.

82978$CH11 12-08-04 07:49:51

Capital income: All types of capital income would receive the same neutral treatment and be taxed only once. Structural distortions, such as the tax bias in favor of corporate debt financing, would be eliminated. Tax rates across industries and asset types would be equalized.

Depreciation: All capital investment would be immediately expensed, thus ending the complex and distortionary depreciation rules. Business investment would increase, leading to higher productivity and rising wages across the economy. A consumption-based tax would also eliminate other rules for the capitalization of assets, such as the complicated business inventory rules.

Capital gains: Elimination of corporate capital gains taxation would simplify business reorganizations and reduce distortions such as the ''lock-in'' of investment holdings. Ending capital gains taxation would mean that a main building block of corporate tax shelters would disappear.

Inflation: Distortions caused by inflation under the income tax for such items as depreciation, inventory, and capital gains would be eliminated under a consumption-based tax.

International tax rules: Under a consumption-based tax, businesses would be taxed on a territorial basis, thus eliminating many complex tax rules, such as the foreign tax credit. A territorial business tax would make the United States a great place to locate the headquarters of multinational corporations, thus spurring high-end job creation.

Business types: All businesses would be taxed under the same rules, thus ending the different rules for C and S corporations, LLCs, sole proprietorships, and partnerships. Business reorganizations would be simpler and opportunities for tax sheltering reduced.

Conclusion

Consumption-based tax proposals have gained widespread support because they would simplify the tax code and spur greater economic growth. Given the nine-decade reign of the income tax, it is surprising what a weak case there is for it compared with a consumption-based tax. In congressional testimony a few years ago, the former chairman of the Council of Economic Advisers, Glenn Hubbard, called the income tax ''fundamentally flawed'' because of its inefficiency, complexity, and unfairness.

Major tax reform will move back onto the Washington agenda for a number of reasons. First, tax complexity continues to spiral upward and the AMT will soon be hitting 30 million American households, which will create demands for change. Second, the corporate income tax is headed for a train wreck as other countries continue to cut their tax rates

82978$CH11 12-08-04 07:49:51

and global investment capital becomes ever more mobile. A U.S. response to rising global tax competition is needed.

Third, the last decade of tax policy debate has shown that tax cuts and tax reform ideas are very popular with the public. The tax reform ingredient that is needed right now is a bipartisan group of congressional leaders to move ahead with reforms. In the 1980s tax reform was a bipartisan concern. For example, Democrats Dennis DeConcini of Arizona and Leon Panetta of California introduced versions of the then-new Hall-Rabushka flat tax in Congress in 1982. Forward-thinking Democrats and Republicans need to work together to cut the high and rising burden of taxes by scrapping the income tax and adopting a simple and low-rate consumption-based system.

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82978$CH11 12-08-04 07:49:51