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The "SMART Tax"

Formula, Not "Code" – VAT Plus Progressive PIT

Gov. Mitch Daniels on accepting the Herman Kahn Award of the Hudson Institute (10/14/11), quoted Kahn: *"It would be most useful to redesign the tax system to discourage consumption and encourage savings and investment. One obvious possibility is a value added tax and flat income tax, with the only exception being a lower standard deduction."*

Daniels, who served as Director of the OMB under President George W. Bush and once headed the Hudson Institute, added: "*That might suit our current situation pretty well. It also might fit Bill Simon's line in the late '70s that the nation should have a tax system that looks like someone designed it on purpose."*

The Plan. Replace all federal income tax revenue - with the exception of Social Security Insurance - with a VAT (replacing the CIT and other taxes), and a progressive PIT (with a threshold of $50,000, eliminating two-thirds of tax filers). This straight-forward approach, with zero tax preferences would eliminate the complexity of the current tax system and the gaming of taxes employed by Washington lobbyists. Earned and unearned income are treated equally.

Revenue-neutral proposal. This is a pure replacement proposal. In the future, when the economy is no longer fragile – after the economy is growing and all prudent expenditure cuts have been made – taxes will likely still need to be raised to retire debt. The determination can then be made as to what should be the fair and balanced increase of VAT vs. PIT.

Replacing the CIT by a VAT will be stimulative (a component in a growth strategy):

1) Ends double-taxation of dividends;
2) Ends a competitive disadvantage in world trade, as all our trading partners and over 150 countries use the border-adjustable VAT, which is subtracted from exports and added to imports;
3) Ends incentive for multi-national corporations to park profits in lower-taxed countries, as the U.S. with zero CIT will be the best place to evidence profits;
4) U.S. becomes a stronger magnet for foreign investment;
5) As Brookings' Aaron and Sawhill have suggested, the implementation of a time-certain VAT would speed purchases, i.e., an off-budget stimulus.

One could also project replacing SSI with the VAT, but the VAT percentage would increase significantly. (This would be a good competitive move in this era of globalization; however, there is too much uncertainty as to whether employers would increase wages to offset the eliminated employer contribution).

A more progressive Personal Income Tax system. Attached is a chart (SMART PIT) showing revenue receipts by brackets of PIT with the following parameters:

- No deductions (not mortgage interest, charities, zero).
- No income tax for AGI under $50,000.
- PIT averages less than 10% (total) for AGI between $50,000 and $100,000

- No special treatment by income type. Earned & unearned income treated (taxed) equally. (No special rate for capital gains.)

- Three progressive[1] marginal rates (AGI):

Three progressive[1] marginal rates (AGI):	%Filers	Cum.% Filers	%AGI
0% for…under $50,000	66.1%	66.1%	25.2%
20% for…$50,000 under $100,000	21.5%	87.6%	28.1%
28% for…$100,000 under $200,000	9.6%	97.2%	23.6%
36% for…over $200,000	2.8%	100.0%	23.1%

Total PIT receipts will fall on aggregate for returns under $100,000 AGI, with the short-fall to be made up on the VAT side of the balanced plan. (See chart: "SMART PIT")

PIT receipts[1] in comparison with factored[2] 2009 PIT liability after deductions:

Eliminates PIT… 100% for AGI under $50,000 (no PIT)
Reduces PIT by… 56% for AGI between $50,000 and $75,000 (from 6.8% to 3.0%)
Reduces PIT by… 17% for AGI between $75,000 and $100,000 (from 8.1% to 6.7%)
Increases PIT by… 2% for AGI between $100,000 and $200,000 (from 11.8% to 12.0%)
No change for those between $200,000 and $500,000 (19.5%)
Increases PIT by... 3% for AGI between $500,000 and $1,000,000 (from 24.2% to 25.0%)
Increases PIT by… 8% for AGI between $1,000,000 and $1,500,000 (from 25.2% to 27.2%)
Increases PIT by… 14% for AGI between $1,500,000 and $2,000,000 (from 25.5% to 29.0%)
Increases PIT by… 12% for AGI between $2,000,000 and $5,000,000 (from 25.7% to 28.9%)
Increases PIT by… 17% for AGI between $5,000,000 and $10,000,000 (from 25.2% to 29.5%)
Increases PIT by… 33% for AGI above $10,000,000 (from 22.4% to 29.9%)

[1] each bracket calculated at its rate in sequence and cumulated.

[2] *IRS reported (Table 1.1, 2009) Net PIT of $727.06 billion. OMB stated 2010 Net PIT of $1,065.12 billion. IRS economist Emily Gross advised to use OMB numbers for 2010, and this ratio 123% was used to factor each bracket. The bracket breakdowns, however, cannot be expected to be affected equally, and absolute amounts by bracket need to be verified.*

9% VAT Needed to Balance.
The total PIT shortfall to be made up by the VAT totals $101.5 B. (Repeating, the income brackets below $100,000 all show substantial decreases in taxes relative to AGI vs. factored[2] 2010 net PIT.) According to Urban Institute/Brookings, Toder, et.al., the adjusted VAT Base contains protective offsets for the lowest income groups.

Urban/Brookings has calculated the Adjusted VAT Base at $7,410.7 billion. According to OMB (2010), receipts from the CIT amount to $329.3 B. Per OMB, "Other" taxes (excise, et.al.) amount to $232.5 B.

The PIT shortfall ($101.5 B), OMB puts CIT receipts at $329.3 B and Other at $232.5 B. The three sources total $663.3 B, which projects to a VAT mark-up of 8.95% (to be included in the pricing of goods and services). As a percentage of VAT-inclusive price, the calculation would be 8.22%.

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The "SMART Tax" plan is clear, understandable, fair, progressive, and, if implemented without tax preferences as outlined above, incorruptible. The VAT component will make the U.S. more competitive in this era of globalization, which will stimulate job creation as well as economic growth.