

The Neutral Tax

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www.neutraltax.com

Introducing The Neutral Tax

The Neutral Tax is a fresh approach to federal tax policy which streamlines the current system and puts more control of the nation's tax system into the hands of taxpayers.

The Current Tax System is Hopelessly Broken

The current US federal tax system has grown over time from humble beginnings to become the bloated, inefficient, and cumbersome drag on the economy that it is today. Elected representatives in Washington D.C. have consistently expanded the tax code over time in an attempt to micromanage the economy and solicit campaign donations and political favors from those receiving preferential treatment under the code. Most people would agree that the current federal tax code is a convoluted mess, in desperate need of reform.

Federal tax reform is difficult because any major changes will necessarily affect the “winners and losers” enshrined in the current tax code. These inequities built in to the tax code enable parties with a vested interest in keeping the code complex to demagogue any common sense reform proposals. Federal tax code reforms that have been implemented over the years have usually centered on relatively minor tweaks to rates and/or brackets, most of which were subsequently returned to their previous levels – or raised even higher. The federal tax code has survived and grown, relatively undisturbed, for many decades.

Most current tax reform proposals continue in the vein of suggesting new tweaks or even new methods of computing and collecting federal taxes, yet none address the core issue: any federally imposed tax structure is monopolistic by its nature and thus will not dynamically adapt to the changing needs of the electorate and the economy.

How The Neutral Tax Works

The Neutral Tax is deceptively simple. It eliminates all current federal taxes on citizens and businesses (including federal income, payroll, personal income, unemployment, corporate, gift, estate, capital gains, alternative minimum, self-employment, gasoline, etc.) and replaces them with **a singular flat tax on the gross revenue of each state government** (including all local taxes & fees).

The Neutral Tax gets its name from the fact that it is completely neutral with respect to revenue, collection methods, progressivity and politics; it simply moves the bulk of the tax policy debate down to the state level. The only decision required at the federal level is the percentage share of state and local revenues that the federal government will collect, between 0 and 100%.

The Neutral Tax brings all parties seeking meaningful tax reform under the same umbrella. The Neutral Tax is compatible with most existing tax reform proposals, including the Flat Tax, Fair Tax, “9-9-9” and others. A state could even adopt the entire legacy federal tax code, if it so chose. The Neutral Tax enables each state to develop its own tax structure so that it can be tested and fine-tuned in the real world.

Note that The Neutral Tax does not directly address entitlement reform, but it would be complementary to such proposals.

Calculating The Neutral Tax

Assuming revenue neutrality with the current federal tax system is desired, the initial Neutral Tax ratio would be determined by calculating the current federal/state revenue mix using the immediately prior year’s revenue, as follows:

$$\text{Tax Mix \%} = \frac{\text{(gross federal revenues)}}{\text{(gross federal revenues) + (gross state \& local revenues for all states)}}$$

Using 2011 figures, the federal/state tax mix is 47% ($\$2.3\text{T}/(\$2.3\text{T} + \$2.6\text{T})$)¹. This means that 47% of an average taxpayer’s taxes currently go to the federal government and 53% of their taxes go to their state/locality.

Here is an example to show how the current tax mix is used in calculating the change to a state’s tax rates: assuming a state previously had a flat of 10% tax on income and it wanted to apply The Neutral Tax equally across all taxpayers while collecting the same revenue for itself, the state’s tax rate would increase to a flat 18.9%. 10% would still go to the state and the additional 8.9% would go to the federal government. Put another way, the state/federal mix would be 47% (8.9%/18.9%) going to the federal government and 53% (10%/18.9%) going to the state. At the same time, direct federal taxes on individuals and businesses would go to zero, fully offsetting the tax increase at the state level.

Unlike just about any other tax reform proposal, it cannot be argued that The Neutral Tax inherently falls more heavily on one group or another. It will be up to the states to determine how they modify their existing tax/fee structures to collect the additional federal tax and how they want the tax burden to fall on their citizens. Some states may

¹ USGovernmentRevenue.com: http://www.usgovernmentrevenue.com/total_2011USrt_13rs ln

choose to implement progressive mechanisms, while other states may elect to add a flat, across-the-board surcharge to existing taxes/fees, as illustrated in the example above.

Finally, any fees or taxes collected by the federal government that do not come from the Neutral Tax would be refunded back to the states on a pro rata basis in order to keep The Neutral Tax ratio constant. This ensures that all revenues are accounted for on both the federal and state/local sides of the equation.

Benefits of The Neutral Tax

The Neutral Tax will have significant benefits on many different levels, including: to the nation as a whole, the federal government, state governments, individuals and businesses.

Benefits to the Nation

The Neutral Tax will enable the US to become more competitive globally. Some states would likely choose to act as enterprise zones, enabling the US to compete more effectively in many sectors, such as manufacturing, where the existing tax code has made the US weak in relation to its global competitors. The degree to which a state can do this on its own today is limited because federal taxation is such a large component of the overall tax equation. Vesting 100% of the taxing authority at the state level will result in more creative and dramatic tax solutions that will make the nation more competitive in the global marketplace.

Benefits to the Federal Government

The Neutral Tax will alleviate the federal government from concerns about tax policy minutia and will enable it to focus its attention and resources on its other constitutionally defined duties. It will also reduce the potential for corruption -- the federal government will no longer have direct control over tax policy details, so federal politicians will no longer be able to peddle tax loopholes. Since the only tax decision at the federal level will pertain to the size of the federal government's share of state and local tax revenue, The Neutral Tax has the potential to reduce partisanship at the federal level on this one major issue.

Benefits to the States

The Neutral Tax complements the constitutionally-defined governmental structure; states will continue to have direct taxation relationships with their citizens, while the federal government will have its primary tax interactions solely with the states.

Elected state representatives of both parties will welcome more control over their state's tax structures. Because The Neutral Tax does not impose a "one size fits all" structure, it enables the states to experiment with different tax structures to arrive at the most efficient level of taxation and corresponding governmental services.

For many decades, the federal taxation structure has distorted state fiscal policy, with the federal government acting as the “godfather” by collecting revenue from state citizens and then returning money back to the states, with strings attached. The Neutral Tax reinforces the fact that all tax revenues ultimately come from the citizens of the states and thus there will be less incentive for states and localities to request and/or accept “free money” from the federal government in order to engage in activities that the states would not otherwise engage in on their own. Over time, The Neutral Tax will enable the states to become more self sufficient and enable them to solve government’s problems in unique ways.

The Neutral Tax enables states and localities to compete to create the most efficient and pro-growth tax policies for their citizens.

Benefits to Individuals

If an individual considers their state’s tax burden to be too great, they can move to a more competitive state. Contrast this with any federally imposed, monopolistic tax structure, where it is virtually impossible for citizens to “vote with their feet” as the ultimate remedy to oppressive taxation.

The Neutral Tax fully integrates the federal tax system with the state and local tax systems, making it easier for citizens to control their total tax burden via the ballot box and to both understand and control the allocation of resources between the federal, state and local governments.

The Neutral Tax will increase accountability in state and local governments. Currently, citizens must closely monitor and analyze tax policies on at least three levels, federal, state and local, to determine how those policies will impact their situation. The Neutral Tax enables citizens to focus primarily on the tax system of their state and locality as a way to monitor and control their overall tax burden.

The Neutral Tax will enable a dramatic reduction in the size of the IRS and completely eliminate its interaction with individual taxpayers and businesses. The primary function of the IRS will become collecting tax revenue from the states, which can be accomplished with a relatively small staff.

Conclusion

The time is right for The Neutral Tax. It is a straightforward approach to federal tax reform, which makes it easier for taxpayers to understand, monitor, and control tax policies at all levels. The Neutral Tax is completely non-partisan; it simply moves the primary debate over tax policy to from Congress to the statehouses, which are closer to the people. It will make the US more competitive with other countries and ensure the most efficient allocation of tax revenues.