2-4-8 Tax Blend

Prepared for the United States House of Representatives
Committee on Ways and Means Tax Reform Working Groups
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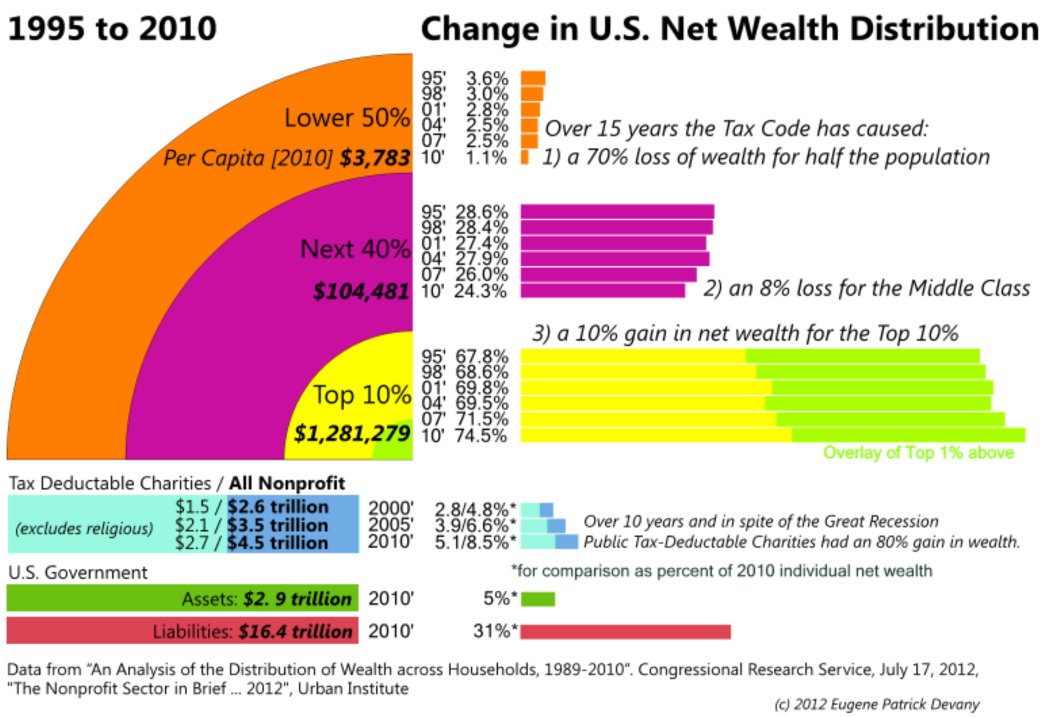
The **2-4-8 tax blend** is a proposed comprehensive tax reform plan for the U.S. that combines net wealth, sales/consumption (VAT), and income tax bases to produce the mathematically lowest rates possible. The annual $1.2 trillion in tax expenditures (credits, deductions, deferrals, special rates and exemptions) are replaced by more attractive target tax rates of approximately 2, 4 and 8 percent.[1]

> ***Individual tax reform*** replaces the payroll taxes with a 2% tax on net wealth (excluding $15,000 cash and $500,000 in retirement savings) and reduces the income tax rate to a flat 8%. Because the net wealth tax base attributes value to imputed income from capital it serves as a replacement for capital gains, estate and gift taxes.
> ***Corporate tax reform*** imposes a 4% value added tax (VAT) on all businesses and reduces the corporate income tax rate to 8%.



As this submission is being written a video posted on You Tube titled Wealth Inequality in America is going viral (with almost 4,000,000 views). The video professionally illustrates the

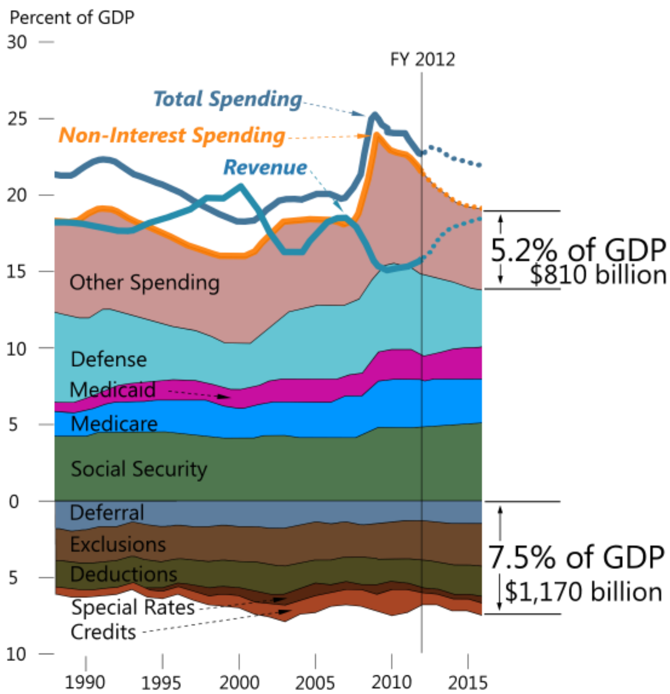
[1] Rates lower than 2, 4 and 8 percent may be needed to make the plan revenue neutral.

results of a survey conducted by Harvard University researchers showing how the public thought wealth was distributed, how it is actually distributed and what an ideal distribution might look like.[2] The video does not show the change in wealth (see chart above) and does not connect the dots to explain how tax policy provides the primary set of legal contingencies which alter the gross distribution of net wealth over time. Nevertheless, the seeds of once-in-a-generation tax reform are being planted as the public obtains accurate information about wealth and income.

Simplified Comparison with 2010 Tax Revenue
(in billions of U.S. dollars)

What is taxed?	**Tax Base**	**Revenue**	**% Actual**	**2-4-8 Tax Blend[3]**	**% Proposed**
Net Wealth	53,000[4]	0	0	1,060	2
Consumption/(VAT)	10,300	208	2	424	4
Payroll	12,500	865	7	0	0
Individual Income	12,500	898	7	1,000	8
Corporate Income	1,100	191	17	88	8
TOTAL	N/A	2,163	N/A	2,572	N/A

Extremely low tax rates are made possible by eliminating tax expenditures which inflate the nominal tax rates by 7.5% of GDP. It helps to view these tax programs as part of the budget.



Tax Expenditure data adapted from the Tax Policy Center, Trends in Tax Expenditures 1985-2016

The chart at left combines the U.S. Treasury's projections through 2016 with tax expenditure spending estimates for the same time frame. Short term projections suggest that budget and tax reform may not be quite as urgent as some in the "fix the debt" crowd claim. There is time to study and score all options before finalizing consensus on much needed tax reform. If tax reform is done right it will reverse the long term decline of the poor and middle class that has been an unintended consequence of current tax policy. It will also minimize reductions to future entitlements - (targeted because half the population has no other assets left to give).

[2] See post by Ezra Klein.
[3] The tax blend was first suggested to the President's Advisory Panel for Federal Tax Reform on August 28, 2005 with the title, "2-4-8 you may appreciate".
[4] Individual wealth has increased by 25% to $66 trillion in just two years as of 2012 Q4 (this excludes the continued rise in stock value in 2013 Q1). Most of the population has not shared the enormous prosperity.

A Net Wealth Tax Will Coerce Productive Business Investment

Harvard Psychologist, B. F. Skinner taught that incentives (“contingencies of reinforcement”) may take the form of positive reinforcement, negative reinforcement or punishment. In taxes most tax expenditures (loopholes, deductions, credits, exemptions, special rates, etc.) are associated with positive reinforcement because they reduce the tax burden. The United States Supreme Court has held that the Affordable Care Act health insurance penalty is really a tax. It may be understood as negative reinforcement which shapes behavior by reducing the threat or application of punishment. Psychologically, one can escape or minimize the tax penalty by obtaining health insurance. A net wealth tax also serves as a negative reinforcer (as in “use it or lose it”). People don’t like negative reinforcers because they include a threat of punishment and that is exactly why they work. A person who properly invests in business can expect a return in excess of 2% and thereby avoid a net loss in wealth. In other words, a net wealth tax is a coercive but effective way of getting people to invest. The negative reinforcement of the net wealth tax is complemented by the incentive of a reduced income tax rate and elimination of the capital gains and estate taxes. This gives a taxpayer both the incentive (92% return of profit) and the freedom to trade or reinvest without tax consequences. The President's Advisory Panel for Federal Tax Reform described the issue in terms of efficiency costs:

> ...the income tax imposes efficiency costs on the economy. These costs arise when high tax rates discourage work, savings, and investment; distort economic decisions of individuals and businesses; and divert resources from productive uses in our economy. Our tax code contains all kinds of incentives for taxpayers to favor activities or goods that are taxed less than others. Provisions for the taxation of wages, of gains on the sale of securities and homes, or of other economic activities influence how much people work and save. As one small business owner explained to the Panel, the tax code affects almost every business decision he makes: where to invest, when to invest, how much to invest, what kinds of machines and equipment to use in production, how to finance investment, etc. When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy. Economic growth suffers as taxpayers respond to the tax laws rather than to underlying economic fundamentals. These distortions waste economic resources, reduce productivity, and, ultimately lower living standards for all.

The elimination of tax expenditures under the 2-4-8 Tax Blend means that an investor will focus only on the bottom line without the distortion caused by the current tax code. A taxpayer who reinvests in his or her own business (not taking salary or dividends) will also avoid income taxes (as they do now). The growth in the value of the business that comes from reinvesting the profits is captured in subsequent years as part of net wealth taxation. The tax blend effectively creates a powerful carrot (low income tax rate) and stick (net wealth tax) approach to reinforce maximum productive investment.

Millions of New Jobs Created with No Government Spending

The "carrot and stick" incentives to invest noted above may be sufficient to encourage some job creation, but replacing the business payroll tax on labor is a more direct incentive by specifically eliminating the 7 1/2% tax on labor. University of Chicago Economics Professor, Casey Mulligan, estimated in September 2011 that each, "percentage-point reduction in employers' [payroll] costs raises employment by about a percentage point and real gross domestic product by about 0.7 percentage points". A literal 7 1/2% reduction in the unemployment rate (i.e. to 0.5%) according to Mulligan's calculation may be unlikely, but even a reduction to a 4% unemployment rate is generally considered as full employment. Elimination of the employee share of the payroll tax also results in a 7 1/2% increase in take home pay for workers. The employee share is over $400 billion and will boost the economy through increased consumer spending.

Reduce Tax Avoidance by Eliminating the Capital Gains Tax

A net wealth tax is a better way to tax and estimate gains because it ends the unfair delay and avoidance of tax payments. The current tax code permits many types of lawful tax deferrals for both individuals and corporations[5]. Many in the investment class do not rely on earned income and use capital gains (and other tax loopholes) to grow their wealth. The growth in value of certain assets (i.e. stock, real estate, gold, etc.) is taxed as capital gains only when the assets are sold (and at reduced tax rates). The taxation of capital gains began as an effort to have the investment class pay a fair share because their wealth was high but their earned income could be low. If assets are not sold for 10, 20 or more years the tax is deferred and often never paid at all. In 2005 The President's Advisory Panel for Federal Tax Reform analyzed the issue of tax fairness in the context of how all forms of income are measured:

> A comprehensive income tax base, which is perhaps the broadest tax base, would include all forms of income. Most people think of income strictly in terms of wages. But a comprehensive measure of income also includes anything that allows you to spend more, either now or in the future. Capital gains and losses, dividends, rental income, and royalties all represent income that does not come in the form wages.
>
> Income can also include noncash increases to wealth, such as health care insurance or other fringe benefits provided by an employer. Some components of income are accruals that do not involve any current cash flows. For example, a stock that has risen in value allows its owner to spend more in the future, and so the increase in value every year should be considered income even if the asset has not been sold. In a comprehensive income tax base, the increase in value of all assets, including homes, would be subject to taxation. In the case of housing, homeowners would also have to declare as income the value they receive by living in their houses rather than renting them out – something economists call "imputed rental income."

[5] The issue of corporate deferral of foreign profits is resolved by lowering the corporate income tax to 8%.

To illustrate, consider that Warren Buffett reportedly increased his wealth by $3 billion in 2011 and if “he had to realize those gains, even at 17.4%, he would have had to pay $522,000,000”[6]. If he had to pay the proposed 30% “Buffet Rule” rate the tab would be $900,000,000. The net wealth tax approach does not tax the capital gain but would assess 2% against the average principle of $41.5 billion (beginning with $40 billion and ending with $43 billion for the year). This computes to $830,000,000 – (an amount less than the “Buffet Rule” computation if deferral was eliminated and the capital appreciation was taxed as income). In fact Mr. Buffet only paid $7 million in taxes on income of $40 million. The $522 million in tax on the appreciation of $3 billion is deferred just as similar tax deferrals have accrued year after year. Mr. Buffet may owe more than $10 billion to the U.S. but he doesn't owe it yet, and the deferral process gives him the opportunity to give most of it away to charity to avoid taxes.

Tax fairness of capital gains looks at what, how and when the capital appreciation is measured. A capital gain tax measures the gain of specified capital assets only when (and if) the asset is sold. It computes the difference between the amount paid for the asset (known as tax basis) and the market price realized when the asset is sold. No adjustment is made for inflation or deflation in computing the appreciation. The gain might be taxed at the same rate as ordinary income (e.g. up to 35%) or at a reduced rate (e.g. up to 17.4%).

According to University of Pennsylvania Law School Professors David Shakow and Reed Shuldiner, “A wealth tax also taxes capital that is not productively employed. Thus, a wealth tax can be viewed as a tax on potential income from capital.” Supra. Under the 2-4-8 Tax Blend the net wealth tax provides both fairness and a better measure of value. It taxes the imputed income from all capital assets regardless of type. A 2% net wealth tax rate is the equivalent of a 33% income tax rate on a 6% return of investment (or a 25% income tax rate on an 8% return of investment, etc.). It is also important to keep in mind that while a one to twelve rate of return on investment may be a typical long term average, higher rates of return can be expected with a flat 8% income tax rate. By taxing the imputed income from net wealth on an annual basis, the unfair deferral and avoidance of tax payments by the investment class ends. As noted in the section on Business Investment above, the elimination of capital gains taxes also encourages productive trade which might otherwise be prevented by tax considerations.

Wealth redistribution

Any tax code redistributes income and over time it redistributes wealth. In 2005 some members of the President's Advisory Panel for Federal Tax Reform were "concern[ed] about substantial inequality of wealth in the country that has grown in the last decades. In the end, the Panel concluded that the appropriate burden of taxation was an issue that elected officials should resolve – and so the Panel decided to design reform options that would remain relatively close to the current distribution of tax burdens.”

According to a July 2012 report from the Congressional Research Service, in 1995 the top 10% of the country had 67.8% of the country’s wealth while the bottom 50% shared only 3.6% ($1,912 billion [in 2010 dollars]). The bottom share eroded to 2.5% before the Great Recession of 2007 and by 2010 it had tumbled to 1.1% ($584 billion) – (a 70% loss of $1,333 billion over 15 years). The loss of wealth to the bottom half the country was offset by a 6.7% gain ($3,558

[6] Reilly, Peter J., "Warren Buffett Benefits More From Deferral Than a Low Rate", Forbes.com, August 15, 2012

billion) for the top 10%. America has prospered over the last 15 to 20 years but the prosperity has not been shared by most of the country as can be seen in the table below.

Share of Wealth by Percentile Wealth Group 1995-2010

Wealth Group	*1995*	*1998*	*2001*	*2004*	*2007*	*2010*	*Billions*
Top 10%	67.8	68.6	69.8	69.5	71.5	74.5	39,560
50% to 90%	28.6	28.4	27.4	27.9	26.0	24.3	12,903
Bottom 50%	3.6	3.0	2.8	2.5	2.5	1.1	584
Total[7]	100%	100%	100%	100%	100%	100%	53,100

Economists do not know for sure if there is a causal relation between income inequality and economic recession but there is a correlation. Paul Krugman wrote that before the crisis of 2008 he often spoke about the concentration of income at the top and responded to questions about whether the country might be on the verge of a depression by saying it was not necessarily so. After the crisis this winner of the Nobel Prize in Economics revised his opinion to, "Well, whaddya know?". If there is an, "arrow of causation running directly from income inequality to financial crisis ... maybe, but it’s a harder case to make". Id. Krugman also speculated about potential common causes of income concentration and the economic crisis such as low tax rates and deregulation.

Half of America has $3 today for every $10 they had in 1995. An extended period of income inequality will lead to wealth inequality and the accompanying loss of consumer spending and economic resilience. To put tax transfers and wealth in perspective, consider that the $1.3 trillion in tax expenditures which the tax code redistributes each year is twice the $584 billion owned by half of America. The 2-4-8 Tax Blend avoids most of the income and wealth redistribution effects of the current tax code by levying the same rates on all taxpayers and eliminating the need for tax expenditures.

Notes for Specific Working Groups

Charitable/Exempt Organizations Workgroup
David Reichert (R-WA)   John Lewis (D-GA)
The 2-4-8 Tax Blend would impact nonprofits by eliminating the approximately $40 billion tax subsidy for charitable giving. Although more than two thirds of Americans give generously without itemizing deductions some modest reduction in charitable giving can be expected from those who itemize. Tax policy has resulted in a 70% loss of wealth for 50% of the population (the poor and lower middle class) between 1995 and 2010. Between 2000 and 2010 the nonprofits (excluding churches which do not report to the IRS) had a 75% gain in wealth. These nonprofits now have seven times the wealth of the poorer half of the country. The larger public charities such as universities and hospitals experienced enormous gains but did not reduce fees. They were also further subsidized by additional taxpayer funded health and education benefits.

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[7] Krugman, Paul, "End This Depression Now!", pages 82-85, W. W. Norton & Company 2012

Considering the interplay between poverty and high unemployment it is difficult to justify taxpayer support via the charitable deduction for removing investment in private job creating business and giving it to nonprofits which do not pay taxes. The shifting of $2 trillion over the last 10 years has the unintended consequence of eliminating millions of private sector jobs and adds to the cost of safety net programs.

At the risk of restoring hope in the American dream it may be worth considering government paid part time internships with local government, school districts and nonprofits willing to train and mentor any adult in need of a job. Consider that the $40 billion saved by the elimination of the charitable deduction could fund 2,000,000 jobs at $350 a week. A PhD in need of work might work only one day for the $350 and a telephone receptionist might need to work 4 days for the same $350. The salary and benefits for the positions would be adjusted sufficiently below private salaries to encourage a shift from public support to private sector. Most nonprofits would gain from the free labor and continued participation would require a showing of helping workers transition into private jobs. This of course would tend to disadvantage nonprofits with political agendas and interests in foreign causes.

Debt, Equity and Capital Workgroup
Kenny Marchant (R-TX)   Jim McDermott (D-WA)
The 2-4-8 Tax Blend imposes a 2% net wealth tax on the average value of all assets (excluding $15,000 cash and up to $500,000 in retirement savings). The proposal is the first time that such a tax has been suggested for the entire population rather than used to "soak the rich" on top of already progressive income tax rates. The tax coerces productive investment without directing any particular business investments as is done with the existing 250 tax expenditure programs. This broad based coercion insures that there will be sufficient capital available for both long term and risky investments. The elimination of both short and long term capital gains will also increase the availability of capital for reinvestment and the velocity of trade.

It is worth noting that while the 2-4-8 tax blend eliminates tax deductions and credits such as interest on mortgages and student loans, the net wealth computation reduces total assets by total debt which is the equivalent of a 2% tax subsidy for debt - but only to the extent there are offsetting taxable assets. Thus there is no incentive to incur debt beyond one's means.

Education and Family Benefits Workgroup
Diane Black (R-TN) Danny Davis (D-IL)
The 2-4-8 Tax Blend provides an expanded tax base and replaces the payroll taxes as the nominal source for funding Social Security and Medicare. This enables entitlements to be evaluated based upon need rather than by the strained saturation point of the income tax base. The addition of a net wealth component also enables the government to design need based programs on a combination of net wealth and income. This has the potential to exclude unnecessary tax subsidy and benefits to high wealth, low income persons.

The future of education appears to be internet based and recognizes that those with elementary skills are capable of educating themselves with digital textbooks, courses and tests. This leads to the obvious cost effective role for the federal government to supply copyright free materials to take advantage of the economy of scale and to reduce or eliminate support for teachers and schools which can be better met at the state and local levels.

The part time jobs program discussed above is the best replacement for most safety net programs. With two adults working even on a part time basis, there would be a real opportunity to raise a family and increase mobility into the middle class.

It is also worth mentioning that the elimination of the payroll taxes offsets the flat 8% income tax rate and eliminates the need for earned income and child care tax credits. A guaranteed job, even it is of the work from home variety, is better than a handout.

Energy Workgroup
Kevin Brady (R-TX) Mike Thompson (D-CA)
The 2-4-8 Tax Blend eliminates tax expenditures for all types of energy producers in exchange for a low corporate tax rate of 8% and a 4% VAT (and adjustment for any existing energy taxes). The 2-4-8 Tax Blend does not encourage or discourage any type of energy. To the extent energy policy may be accomplished through regulation and direct spending and leasing programs, there is no need for energy related tax expenditures.

Financial Services Workgroup
Adrian Smith (R-NE) John Larson (D-CT)
Because the 2% wealth and 8% income tax rates would be uniform for rich and poor it would be cost effective for banks and similar financial services companies to withhold taxes. This simple automated procedure, combined with payroll reporting, would provide the IRS with the ability to automatically prepare most non-business tax returns.

Income and Tax Distribution Workgroup
Lynn Jenkins (R-KS) Joseph Crowley (D-NY)
Tax policy has redistributed wealth to the top 10% at what appears to be an escalating rate. The problem, of course, is not the growth at the top but the devastating loss of net wealth at the bottom. The 2-4-8 Tax Blend achieves a fair balance of tax liability across the economic spectrum by measuring the tax burden with both income and net wealth. The low rates are intended to encourage rapid economic mobility for those at the bottom who have suffered as a result of current tax policy. A proportionately linier greater tax liability is imposed as disposable wealth and income increase. The tax liability is progressive even though rich and poor would pay the same tax rates because the top 10% hold 75% of the wealth while the poorer half of the country only has 1% of the net wealth.

International Workgroup
Devin Nunes (R-CA) Earl Blumenauer (D-OR)
The U.S. is the only developed country which does not use a value added tax (VAT) to reduce the corporate tax rate. A previous suggestion to replace the corporate tax rate with an 8 1/2% VAT failed to consider the interplay with pass through business. The 2-4-8 Tax Blend calls for a 4% VAT on all business and a reduction in the corporate rate to 8%. This minimizes the tax distinction between C corporations and other taxable entities.

The deferral of foreign subsidiary corporate profits is an issue with a 35% marginal tax rate but the problem goes away if the C corporation rate is reduced to 8%.

It also follows that there is no need to switch to a territorial tax system. Moreover the worldwide jurisdiction over both income and wealth will eliminate any temptation for U.S. taxpayers to avoid taxes.

Manufacturing Workgroup
Jim Gerlach (R-PA) Linda Sanchez (D-CA)
By eliminating the payroll taxes the cost of U.S. labor is reduced. Since the VAT would apply only within the U.S. exports would be encouraged.

Pensions/Retirement Workgroup
Pat Tiberi (R-OH) Ron Kind (D-WI)
Because of the 40 year reliance on 401k and similar retirement plans, the 2-4-8 Tax Blend maintains the tax free retirement savings but would limit the tax subsidy to savings of $500,000 ($1,000,000 for two people). While many want to save more, there is no right to be a millionaire and other taxpayers should not have to sacrifice.

Real Estate Workgroup
Sam Johnson (R-TX) Bill Pascrell, Jr. (D-NJ)
The 2-4-8 Tax Blend eliminates the deduction for mortgage interest but the net wealth tax computation effectively gives a tax credit equal to 2% of the mortgage principal. Arguably, this is a better incentive to home ownership.

Small Business/Pass Throughs Workgroup
Vern Buchanan (R-FL) Allyson Schwartz (D-PA)
The 2-4-8 Tax Blend imposes a 2% tax on net wealth and Warren Buffet has suggested that the valuation of private business may be the most difficult challenge for wealth tax administrators. Small businesses which rely largely upon the value of owner/managers might be valued entirely on the liquidation value of assets. Established businesses can also be valued based upon a comparison of sales, profits, payroll and assets of similar businesses. At present, locating valuation data may be difficult but an automated data base assembled from the first year or two of wealth tax returns would make a reasonable estimate of business value to be a relatively easy task. Mandatory digital filing of tax returns could fully automate the process.

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Date: March 8, 2013
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Plan: Scoring Outline