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July 25, 2013

The Honorable Max Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building

The Honorable Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building

Dear Chairman Baucus and Ranking Member Hatch:

It's befitting that 100 years after the ratification of the 16th Amendment, our attention is turned toward updating our federal tax system for the challenges of a 21st century economy. There is no doubt that our tax system is in need of serious reform. Our individual and corporate income tax rates limit our nation's economic prosperity. Taxpayers are forced to spend too much time and money navigating the tax code. In addition, the code is littered with "tax earmarks" that have accumulated over time and that create unnecessary disparity in tax treatment. It is my hope that your request for input is the first step in a process that will provide badly needed pro-growth reforms and deliver the tax code that taxpayers deserve – one typified by its fairness, simplicity, and competitiveness.

While I appreciate your willingness to tackle this challenging topic and the "blank slate" approach you are taking, questions regarding what that precisely entails and where it leaves the taxpayer make providing a complete prescription of which tax provisions should stay and which should go difficult. At this point in the process, I am pleased to provide the following recommendations regarding broad goals for comprehensive tax reform.

Lower Individual Income Tax Rates
A top marginal tax bracket of 39.6 percent presents a clear example of how our tax code creates disincentives toward economic growth. Christina Romer, President Obama's former chair of the Council of Economic Advisers, noted that "a tax increase of 1 percent of GDP reduces output over the next three years by three percent." Toward remedying our high tax rates with their negative effects on growth, the House budget proposes the low tax rate of 10 percent on income up to $50,000 for single filers and $100,000 for joint filers, and a 25 percent tax rate above those levels. By consolidating our current seven tax brackets – ranging from 10 percent to 39.6 percent – this budget recommends simple, low rates that greatly reduce the distortions in our tax code. Any significant tax reform effort must reduce the federal effective individual income tax rates and lower the tax burden on families in the United States to ensure that they have the resources to invest in their futures. Congress should consider proposals that will achieve that goal; for example, one, low flat tax for all taxpayers or proposals to consolidate our highly progressive system of seven tax brackets to one with fewer tiers and lower rates.

Lower Business Income Tax Rates
At a combined federal and state corporate income tax rate averaging 39.1 percent, the U.S. lays claim to the highest statutory rate in the world. In contrast, the average of other Organization for Economic Cooperation and Development (OECD) member countries equals 25 percent. Even our current effective tax rate, which takes into account tax earmarks and other exclusions, of 27.6 percent is significantly higher than the OECD average. One estimate suggests that this high rate of tax amid an environment of rate reductions abroad will shrink U.S. gross domestic product by up to 2 percent this year. In addition, businesses taxed at the individual income rates comprise 95 percent of all businesses in the nation and employ more than half of the private sector

workforce.[1] Yet, businesses such as subchapter S corporations, limited partnerships, limited liability corporations, and other pass-through businesses face a top income tax rate of 39.6 percent plus a limitation on their deductions and increased taxes on their investments. Ultimately, some of these businesses will pay a combined marginal tax rate in excess of 50 percent. In order to make U.S. businesses competitive globally and to spark economic growth at home, we must lower business income tax rates, and Congress must consider reforms that – at a minimum – bring them in line with the approximately 25 percent average tax rate of other developed countries.

Construct a Competitive International Tax System
U.S. companies are currently incentivized to set up abroad or to prevent the repatriation of their foreign-sourced income due to our high level of taxation. Comprehensive tax reform should contemplate the necessity of transitioning away from our hybrid system of worldwide taxation to a more competitive international system of taxation, which features low tax rates allowing for the end of deferral and debits foreign taxes paid. Doing so would further encourage reinvestment and job creation at home.

Eliminate Tax Earmarks and Unproductive Provisions
Upwards of 46 percent of U.S. households do not pay any federal income taxes due to numerous tax credits, deductions, exclusions, and other carve outs in the tax code, which reduce – or eliminate altogether – one's tax liability.[2] This is the result of the layering of years of incongruent tax policy, causing taxpayers in similar circumstances to pay significantly different tax bills. By cleaning house and eliminating tax earmarks, which benefit one group or activity over another, we could broaden the tax base and achieve lower individual rates while providing taxpayers with greater confidence that their tax system is equitable.

The elimination of tax earmarks and other unproductive rules and exclusions is also essential to lowering the corporate tax rate. These provisions modify behaviors – and not always in the most effective manner. Congress' adding of layer upon layer of preferential tax treatment for one industry or technology can give otherwise unattractive technologies a taxpayer-funded advantage and ultimately dis-incentivizes competition. The federal government should not be involved in picking winners and losers. For example, I've supported legislation to eliminate a host of tax earmarks for various energy industries, including the repeal of credits for both renewable and conventional sources of energy. There are countless other examples of distortions and inefficiencies in the code that should be removed.

Simplify the Tax Code
According to the National Taxpayer Advocate's 2012 Report to Congress, "it takes U.S. taxpayers – both individuals and businesses – more than 6.1 billion hours to complete filings required by a tax code that contains almost 4 million words and that, on average, has more than one new provision added to it daily." Compliance with this increasingly complex code takes precious time and resources away from families and businesses. By eliminating tax earmarks and other unproductive provisions as recommended, comprehensive tax reform provides the opportunity to greatly increase the simplicity and efficiency of our tax code, eliminate the incentive to shelter income, and spark more productive uses of our resources. In addition, we should seek to streamline

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[1] Carroll, Robert and Gerald Prante. "The Flow-Through Business Sector and Tax Reform." Apr. 2011. Web. 22 Jul. 2013. <http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf>.

[2] Johnson, Rachel, James Nunns, Jeffrey Rohaly, Eric Toder, and Roberton Williams. "Why Some Tax Units Pay No Income Tax." Urban-Brookings Tax Policy Center. Jul. 2011. Web. 22 Jul. 2013. <http://www.taxpolicycenter.org/UploadedPDF/1001547-Why-No-Income-Tax.pdf>.

the reams of tax rules and filing dates toward reducing the burden of tax compliance on U.S. households and businesses.

Address Double Taxation
Comprehensive tax reform should give careful consideration to the various provisions in our tax code that amount to double taxation. For instance, the taxation of dividends and capital gains discourages savings and investment in favor of consumption. Another culprit is the death tax which is neither sound economic nor moral policy. Contributing less than 1 percent of federal tax revenue, the death tax naturally falls on small, family-owned businesses. With assets being purchased with after-tax income, the death tax results in double, triple, or even quadruple taxation, depending on the layers of taxes throughout generations of inheritance. Sadly, there are those who are forced to consider actually selling the family business or farm simply in order to pay the death tax. The repeal of this onerous tax should be part of any credible, comprehensive tax reform debate.

In closing, Congress must reevaluate the goals of our tax system and seek to construct a pro-growth tax code that simply and efficiently meets those goals. The ultimate measure of success in this endeavor will be the level of confidence taxpayers have that their tax system promotes, not hinders, economic opportunity. Manipulating tax reform to allow for backdoor tax increases in order to pave the way for additional spending would run counter to these principles. Given its impact, the process for reforming our tax system will benefit from a full and open legislative process under regular order that invites future public and congressional input. I appreciate the opportunity to provide such input, and look forward to continued participation as the process moves forward.

Sincerely,

JEFF FLAKE
United States Senator