The Common Sense Tax – Revenue Neutrality

The Common Sense Tax is a comprehensive tax reform plan that features just two taxes. One is a 13 percent FICA payroll tax, but extended to all labor earnings by removing the earnings ceiling. The other is a personal income tax, which taxes household incomes above $100,000, in the case of married households, and above $50,000 in the case of single households, at a single 25 percent rate.

The reform is designed to be revenue neutral and progressive. It would eliminate annual income-tax filing for over two thirds of American households and kick start our ailing economy, primarily by eliminating the corporate income tax, whose burden arguably falls on workers, not American shareholders of U.S. corporations.

The Common Sense Tax preserves only three features of the current personal income tax, namely the Earned Income Tax Credit, the Child Tax Credit, and the charitable deduction. There are no other credits, deductions, or exemptions. In particular, there is no exemption for employer-paid FICA taxes. Also, The Common Sense Tax simply reforms taxes, with no changes to federal expenditures, including no changes to Social Security benefits, which will continue to be calculated based on the current definition of covered earnings.

This memo shows that the revenue-neutral income tax rate under The Common Sense Tax should be just 25 percent. But the Congressional Budget Office will need to score the proposal to determine whether the rate needs to be higher or lower to achieve revenue-neutrality.

Overall Common Sense Tax Revenue Target

In 2013, the federal government is projected to collect $2.595 trillion in taxes to be replaced by the CST.[1] This is the sum of $1.333 trillion in federal income taxes, $.952 trillion in FICA payroll taxes, $.291 trillion in federal corporate income taxes, and $.019 trillion in federal estate and gift taxes. Since each of these taxes is eliminated under the CST, the CST must cover this loss of revenue plus $.061 trillion to cover the costs of the Earned Income Tax Credit,[2] $.057 trillion to cover the costs of the Child Tax Credit, and $.040 trillion to cover the costs of the charitable deduction.[3]

Hence, the overall revenue target is $2.753 trillion = $2.595 trillion + $.061 trillion + $.057 trillion + $.040 trillion.

---

[1] http://www.cbo.gov/publication/44192

[2] http://www.eitc.irs.gov/central/abouteitc/

[3] https://www.jct.gov/publications.html?func=startdown&id=4503

The Common Sense Tax's Income Tax Revenue Target

The revenue target for the income tax component of the CST is $1.444 trillion reflecting the overall target of $2.753 trillion less $1.309 trillion to be raised by the new FICA tax.

The 2013 base for this payroll tax consists of an estimated $10.072 trillion sum of employee compensation plus proprietorship and partnership income.[4] Multiplying .13 -- the OASDHI FICA tax rate -- times this tax base gives $1.309 trillion.

Revenue Sources – The Common Sense Tax

The tax base, before application of the $100,000 married and $50,000 single exemptions, of the CST is total national income, measured at producer prices, apart from imputed rent on owner occupied housing plus gifts and inheritances received. This analysis ignores revenues from taxable gifts and inheritances and, thereby, overstates the size of the revenue-neutral income tax rate.

According to the Bureau of Economic Analysis, estimated 2013 national income valued at consumer prices is $14.307 trillion.[5] Subtracting estimated 2013 imputed rent owner-occupied housing of $1.163 trillion[6] as well as estimated 2013 net indirect business taxes of $1.102 trillion yields the CST income tax base of $12.042 trillion before exemptions and the charitable deduction.[7]

Adjusting for Exclusions

Based on the Internal Revenue Service's 2010 Statistics of Income,[8] the share of total gross, pre-tax income received by married households earning $100,000 or more plus single households[9] earning $50,000 or more in 2010 is 65.148 percent. Multiply .65148

---

4 http://www.whitehouse.gov/sites/default/files/docs/erp2013/full_2013_economic_report_of_the_president.pdf reports $8.5657 trillion in compensation of employees plus $1.2025 trillion in proprietorship and partnership income for 2012. Multiplying this by 1.0311 projected ratio of 2013 GDP to 2012 GDP gives us the CST payroll tax base of $10.072 trillion.

5 http://bea.gov/iTable/iTable.cfm?ReqID=9&step=1 gives $13.876 trillion for national income in 2011. Multiplying this figure by CBO's ratio of projected 2013 GDP to actual 2012 GDP of 1.0311 gives $14.307 trillion.

6 http://www.econstats.com/nipa/nipa_7__4___6y.htm The 2011 value of $1.085. Multiplying this figure by the ration of projected 2013 GDP to actual 2011 GDP of 1.0715 gives us $1.163 trillion for 2013 imputed rent.

7 http://bea.gov/iTable/iTable.cfm?ReqID=9&step=1 gives $1.069 for Indirect Business Taxes for 2012. Multiplying by 1.0311 – the CBO's projected ratio of 2013 to 2012 GDP – gives

8 http://www.irs.gov/file_source/PUP/taxstats/indtaxstats/10in12ms.xls

9 Single includes married individuals who file separately, individuals who file as heads of households, individuals who file as surviving spouses, and individuals who file as single.

by $12.042 trillion to get $7.845 trillion, the tax base under the CST, before accounting for the $100,000 for married and $50,000 for single exclusions. We adjust the $7.845 trillion up by $.400 trillion to $8.245 based on the assumption that married households earning $100,000 or more and single households earning $50,000 or more will accrue roughly 85 percent, not 65 percent, of corporate profits.

There were 16,096,661 married households in 2010 with incomes above $100,000. Multiplying this number of households by 1.12 to account for population and wage growth between 2010 and 2103, we arrive at an estimated 18,028,260 households in 2013 with incomes over $100,000. Thus, the value of the $100,000 exclusion for these households is $1.803 trillion. Stated differently, this is the 2013 estimated amount of married household income of households with incomes above $100,000 that is not subject to the CST. There were 10,705,813 single households in 2010 with incomes above $50,000. Multiplying this figure by 1.12 gives 11,990,051. Thus, the value of the $50,000 exclusion for these households is $.599 trillion.

The Common Sense Tax's Income Tax Base

Subtracting $1.803 trillion plus $.599 trillion from $8.245 gives $5.843 trillion. This is The CST tax base before the charitable deduction. Assuming that the charitable deduction is the same 2.5 percent of revenue under the CST as it is under the current income tax, the income tax base is $5.843 times .975 or $5.700 trillion.

The Common Sense Tax's Income Tax Rate

The requisite CST income tax rate is given by the target $1.444 trillion divided by the tax base of $5.700 trillion or 25.33 percent.

Additional Comments

In deciding what is and is not included in AGI, the Common Sense Tax is guided by one criterion, namely getting as close as possible to taxing all of national income, apart from imputed rent on owner occupied housing, as defined by the National Income Accounts and as it is generated each year.

Thus all wage income, regardless of whether it is spent on employee benefits, will be taxed as it is earned by those with total incomes above the relevant thresholds. The same applies to all partnership and proprietorship income, all corporate income, and all rental income.

The remaining component of national income is net interest income. In line with the current tax system, the Common Sense Tax will continue to tax interest income received, but not incorporate deductions for interest income paid, whether for mortgages, student loans, or any other type of borrowing. As a result, the CST tax base will exceed national income to the extent that gross interest income received exceeds net interest income. Since the above calculation of the CST income-tax rate incorporated only net interest income into the tax base, using gross rather than net interest income would lower the requisite CST rate below 25 percent.

Including annual gifts and inheritances received, which are part of the CST tax base, but aren't factored into the 25 percent tax rate, would further lower the rate below 25 percent. On the other hand, the 25 percent rate does not incorporate tax evasion that will arise under the CST and require a higher tax rate to maintain revenue neutrality.

The CST eliminates income taxation of all government transfer payments made to households, including Social Security and unemployment benefits. Were these transfer payments included in full or in part in the tax base, the revenue-neutral CST tax rate would be lower.

This memo ignores transition issues involved in moving to the CST, the most important of which is taxing existing tax-deferred retirement accounts and corporate profits made overseas, but not yet repatriated to the U.S. Taxing these retirement accounts and un-repatriated corporate profits would produce additional revenue that could be used to lower the CST rate.

Finally, the 25 percent rate does not factor in likely changes to the economy's performance associated with a) improved labor supply and saving incentives for the vast majority of Americans due to the complete elimination of income taxation for married couples with incomes below $100,000 and for singles with incomes below $50,000 and b) the elimination of the U.S. corporate income tax. The U.S. corporate income tax generates remarkably little revenue while greatly discouraging investment in the U.S. thanks to having one of the highest marginal effective corporate tax rates of any developed country. Assuming other countries maintain their corporate tax rates, the elimination of the U.S. corporate rate could dramatically increase foreign investment in the U.S. and, over time, raise U.S. national income by 10 percent or more. With no increase in federal expenditures, this would permit a 10 percent or more reduction in the CST tax rate.