Tax Reform
To Fund Universal Health Care
(Summary: Rational Tax Reform by Jim Hartung)

Tax reform is needed to fund health care reform. Health care reform is needed to reduce health care costs and balance the federal budget. By reforming both at the same time, the country can improve health care, reduce its cost, and balance the federal budget without increasing the burden on taxpayers.

Stakeholder Needs and Desires

- Make government more efficient, control spending, and balance the federal budget. Reduce tax rates and the burden on taxpayers without cutting essential services.
- Encourage economic growth. Create more good jobs, especially for low-income and middle-income taxpayers, and reduce inequality or income and wealth.
- Simplify the tax system and make it fairer. Reduce opportunities and incentives for tax avoidance, tax evasion, influence peddling, and corruption.
- Improve the health care system. Reduce the cost of health care and expand coverage. Protect Medicare benefits and reform Medicaid.
- Restore Social Security to financial health without cutting benefits.

Tax Reform Objectives

- **Fiscally responsible:** Tax reform should balance the federal budget and reduce the national debt.
- **Pro-growth:** Tax reform should support economic growth, productivity, and competitiveness.
- **Realistic:** Tax reform should be evaluated with realistic assumptions.
- **Comprehensive:** Reform should be comprehensive- tax cuts are not tax reform.
- **Fair:** The benefits of tax reform should be widely shared with the most economically vulnerable protected.
- **Simple:** Tax reform should simplify the tax code.
- **Permanent:** Reform should enact permanent changes to the tax code.
- **Bipartisan:** Bipartisan tax reform is more durable and long-lasting.

Fundamental Questions to Think About When Developing a Strategy

- How much tax revenue does the federal government need to perform its required functions?
- What is the best way to obtain this revenue and ensure the government does not overspend?
- What strategy can best achieve all tax reform objectives?

Tax Reform Strategy

Individual Income Tax: Broaden the tax base and reduce tax rates.

- Tax all sources of income at the same (progressive) rates with fewer tax brackets and lower tax rates.

- Eliminate itemized deductions and increase the standard deduction.
- Provide a refundable tax credit for every taxpayer and dependent. Eliminate all other tax credits.

Corporate Income Tax: Replace the corporate income tax with a broader and more efficient Value-Added Tax (VAT) with a lower tax rate.

- Earmark all VAT revenue to fund Universal health care for all (Medicare Choice). Implement cost controls to keep the VAT tax rate as low as is practical.

Payroll Tax: Eliminate the cap on taxable income and reduce the tax rate.

- Earmark all payroll tax revenue for Social Security (no diversion for Medicare).

Estate Tax: Use estate tax revenue to improve the education system.

Excise Taxes: Index motor vehicle fuel taxes for inflation. Add a new revenue-neutral excise tax (carbon dividends) to address pollution/climate change. It is recommended to focus on air pollutions versus climate change because it is something people can understand better and better data for how many people are dying yearly right now.

Balanced Budgets: Balance the budget and include a feedback mechanism to encourage lawmakers to control spending.

Public Disclosure: Require candidates for high-level office to release their tax forms.

What is a Value-Added Tax (VAT)

The VAT is similar to a sales tax, except that it is collected from businesses at each step of the production process rather than at the time of the final sale. Businesses pay the VAT based on their “value added,” which is the difference between their sales and the cost of goods purchased.

Businesses calculate their VAT based on total sales but receive a credit for VAT included on the invoices for their purchases from other businesses. This credit is given to avoid taxing a product or service more than once. However, as a side benefit, businesses are incentivized to pay the VAT to avoid being “frozen out” of the supply chain.

Non-profit organizations and federal, state, and local governments that do not sell products cannot use the credit-invoice method to calculate their VAT. Instead, they calculate their value-added directly, by adding their cost for labor, fringe benefits, rents, and interest.

The VAT is the world’s most common consumption tax used by more than 160 countries around the world, including all developed countries except the U.S. The VAT is a popular form of taxation for several reasons:

1. It is easy to administer.
2. It creates few negative economic distortions.
3. It raises lots of money.
4. It encourages savings and investment by shifting part of the tax burden from income taxes to consumption.

5. It allows border adjustments for imports and exports.

Earmarking VAT revenue to fund Universal health care for all (Medicare Choice) has five major advantages:

1. It provides a reliable funding stream for Universal health care for all.
2. It prevents politicians from diverting funds to other (less important) programs.
3. It allows taxpayers to see clearly how their VAT dollars are being spent.
4. It creates a de facto limit on spending for Universal health care for all.
5. It enables Universal health care for all to continue, even if Congress and the President cannot agree on an annual budget.

Earmarked VAT revenue to fund Universal health care for all will also relieve businesses, non-profit organizations, and federal, state, and local governments of the need to fund their employees' health care.

<u>Why Replace the Corporate Income Tax with a VAT?</u>

The corporate income tax is complex. It is relatively easy to avoid and often causes companies to make poor business decisions merely to reduce taxes. A VAT is more difficult to avoid. It is a better way to tax corporate profits as part of a broad-based consumption tax.

Eliminating the corporate income tax avoids the problem of double-taxing corporate profits (once through the corporate income tax and again as capital gains and dividends). This simplifies individual income taxes, as it allows capital gains and dividends to be taxed as ordinary income.

Eliminating the corporate income tax will stimulate economic growth. Other developed countries are reducing their corporate income tax rates. By eliminating the corporate income tax, the U.S. will lead rather than follow this trend.

<u>VAT Advantages</u>

Three of the most important advantages are:

- Universal health care for all: The VAT is the best way to fund Universal health care. All other developed countries have both a VAT and universal health care. Without a VAT, they would not have sufficient tax revenue to fund universal health care. To fund Universal health care without a VAT (example, by significantly increasing individual and corporate income tax rates) would involve a considerable risk of increased tax avoidance and evasion. The VAT is the most practical and lowest risk approach to fund Universal health care for all.
- Economic growth: The VAT will make U.S. companies more competitive and stimulate sustainable economic growth for four reasons. (1) The VAT funds Universal health care for all, it will eliminate the competitive disadvantage that U.S. companies currently face when competing against companies in countries with lower-cost, government-funded health care. (2) The VAT replaces the corporate income tax; it will give U.S. companies a competitive advantage over companies in other countries with a corporate income tax. (3) The VAT will level the playing field in the global marketplace, since importers must pay the VAT for imports, and exporters receive a VAT credit for exports. (4) The VAT

taxes consumption, it will encourage savings and investment. Increased saving and investment will promote healthy, sustainable, long-term growth.

- More and better jobs: As U.S. businesses become more competitive and expand production, they will create jobs. The jobs created will often command higher salaries and wages, since businesses no longer need to fund their employees' health care. This effect will be most noticeable for low-income and moderate-income employees whose health care costs are large compared to their salaries. The VAT should spur a significant increase in the minimum wage to ensure that businesses share the benefits of their new-found competitiveness with their employees.

A key argument against a VAT is that it will decrease consumer spending. This is a significant concern since consumer spending is an important driver of economic growth. However, the tax reform proposed will maintain strong consumer spending by stimulating economic growth, creating more jobs, and increasing disposable income, especially for low-income and moderate-income taxpayers.

<u>Universal health care for all Cost Target= 14% of GDP</u>

The U.S. spends far more on health care than any other developed country even when you look at dollars spent per person. The U.S. currently spends about 18% of GDP. The proposed Universal health care for all cost target (14% of GDP) is roughly halfway between current health care expenditures in the U.S. and other major developed countries. This is achievable with health care reform mentioned above. This means that hospitals, medical centers, and doctors will still be making more compared to any other country.

<u>Financial Incentives to Control Health Care Expenditures</u>

Universal health care for all should use co-pays to encourage wise use of the health care system. It could require a 20% co-pay until a taxpayer's out-of-pocket cost exceeds 20% of income reported on their prior year's tax return. Wellness visits and preventive medicine such as vaccinations should be exempt from this co-pay.

High-income taxpayers should pay the co-pay when they receive health care. However, low-income, and middle-income taxpayers should be allowed to delay payment until they prepare their tax returns and deduct it from their refundable tax credit and carbon dividends. This will allow them to receive health care with no out-of-pocket expenses.

The co-pay is a very important feature of the proposed Universal health care for all. It will decrease cost and improve quality by reducing frivolous and inappropriate use of the system. The primary purpose of this co-pay is to encourage wise use of health care, taxpayers should not be allowed to eliminate this incentive by purchasing insurance.

<u>Universal Health Care For All Opt-Out Provision (One Option)</u>

Many people object to Universal health care for all because they believe:

1. It will decrease personal choice and force people to change doctors and health care plans.
2. Health care could deteriorate due to mismanagement and cost constraints.

Under Universal health care for all, Americans could choose any doctor or hospital as no doctor or hospital would be considered out-of-network. Universal health care for all would not cover elective medical treatments but private supplemental insurance would. This give Americans the option to pick their own supplemental health care plans. Currently the U.S. is having mismanagement issues with our health care system versus other developed countries that have their own universal health care systems. Cost constraints is currently on Americans with the inflated prices of health care in the U.S. that prevent people from seeking treatment, buying their medications, or being able to pay their medical bills.

To address the concerns about personal choice, the proposed Universal health care for all would allow taxpayers to opt-out if they provide health care insurance for themselves and their dependents (either as individuals or as part of a group plan). They would receive support equal to the average cost for Universal health care for all to provide for their health care. The support might be $3,000 annually for each taxpayer and dependent under 45 years old, $6,000 annually for those between 45-65, $10,000 annually for those between 65-85, and $20,000 annually for those over 85. The support could be adjusted for location and other factors.

Universal health care for all would only pay the support for those who opt out directly to the insurance companies. Taxpayers who select a higher-cost insurance plan will have to pay the additional cost. Universal health care for all will automatically provide health care coverage for all taxpayers and dependents who do not opt out of the system.

Allowing some type of opt-out option from the Universal health care for all program is more likely to receive bipartisan support versus having no type of opt-out program.

Tax Reform Will Not Increase the Economic Burden on Taxpayers

The Federal tax revenue plus the cost of health care paid by other is currently a little over 30% of GDP. Under the recommended Tax and Health Care Reform, the economic burden on taxpayers will remain at a little over 30% of GDP.

Tax Summary

- Federal tax revenue and expenditures are both 25.8% of GDP.
- VAT (tax rate 13%) revenue is 9.1% of GDP. It funds Universal health care for all, whose expenditures are also 9.1% of GDP.
- Payroll (tax rate 14%) tax revenue is 6% of GDP. It funds Social Security; whose expenditures are also 6% of GDP
- The individual income tax (9.3% of GDP) and other taxes (1.4% of GDP) fund all other federal expenditures (10.7% of GDP). The individual income tax rates (0-36%) are based on income levels, single taxpayer, married filing jointly, or head of household brackets that would equal 9.3% of GDP.
- Other taxes (1.4% GDP) include: excise taxes, estate and gift taxes, Federal Reserve remittances, customs duties, miscellaneous fees, and fines.

Principles of Income Tax to Simplify the Tax Code

- All income is treated as ordinary income and taxed at the same tax rates. The goal is to eliminate tax preferences and not allow any income to escape taxation.

- Itemized deductions and tax credits are eliminated. They are replaced with a standard deduction and a refundable tax credit for each taxpayer and dependent.

Taxable Income is Calculated by Adding Income From All Sources

- Wages, salaries, tips, and fringe benefits
- Interest and dividends
- Business income or loss (including self-employment and rental income)
- Capital gains or losses
- Pensions, annuities, and IRA distributions
- Social Security benefits
- Other income (such as alimony received, lottery winnings, etc.)
- The alternative minimum tax (AMT) is eliminated

Income Tax Example

- Low-income taxpayers- pay no income tax and receive a refundable credit ($500-$3,000).
- Middle-income taxpayers- pay some income tax, but only a little (1-4%).
- High-income taxpayers- pay 13-26%.
- Very-high income taxpayers ($1 million+)- pay 30-36%.

Estimated Income Tax Revenue

- The top 1% of taxpayers pay almost half of all income tax. The next 9% pay one-third of all income taxes and the bottom 50% pay no income tax.
- Income tax revenue is 10.1% of GDP before the refundable tax credit and 8.6% of GDP after the refundable tax credit. The difference between these two numbers is the refundable tax credit (1.5% of GDP).
- Part of the refundable tax credit (0.8% of GDP) will reduce the tax owed by high-income and middle-income taxpayers, and the remainder (0.7% of GDP) is refunded to low-income taxpayers. The refunded amount is included as a budget item under "mandatory payments". The net income tax collected is 9.3% of GDP.

Eliminate Itemized Deductions and Tax Credits

Our current tax system is complex, was difficult to design, implement, use, and maintain. The system has a long list of itemized deductions and tax credits that can have complex rules for who qualifies and how the rules are phased out for high-income taxpayers. Other problems include:

- They corrupt the political process with special interests frequently trying to "buy" favorable deductions and credits by contributing to politicians who support them.
- They cause other tax rates to increase (to offset revenue loss due to itemized deductions and tax credits)
- They have unintended consequences such as the cost of housing skyrocketing partly because the current tax code allows homeowners to deduct mortgage interest and property taxes (up to a limit) and pay no tax on capital gains (up to a limit). These tax preferences were enacted to help taxpayers afford home ownership, but they have also

increased the price of homes and priced some people out of the market for home ownership.

It is politically impractical to eliminate most itemized deductions and tax credits without eliminating them all. After eliminating them all then a standard deduction and a $1,000 refundable tax credit for each taxpayer and dependent can be added.

Capital Gains and Dividends are Taxed as Ordinary Income

It is simpler, fairer, and more efficient to tax corporate income as part of two broad-based taxes (VAT and Individual Income Tax) rather than as a separate corporate income tax with special rules for capital gains and dividends.

The tax loopholes associated with capital gains must be eliminated:

- No like-kind exchanges or real estate and other assets. Capital gains taxes are due when an asset is sold.
- No forgiveness of capital gains when an asset is given to a non-profit organization or charity.
- No step-up in value when the owner of an asset dies. Whoever inherits the asset pays the capital gains tax when it is sold. If an asset is sold by an estate, the estate pays the capital gains tax.

Eliminate the capital gains exemption on the sale of a primary residence ($250,000 for single taxpayer and $500,000 for married taxpayers filing jointly). To avoid spiking income too much in one year, homeowners may spread the capital gain equally over five years.

- This allows low-income and middle-income taxpayers to move up to better homes or sell their homes to fund retirement.
- Wealthy taxpayers cannot avoid taxes by purchasing and selling multiple high-cost homes.
- These changes should slow the rapid appreciation of house prices in “hot” markets, which is pricing many people out of home ownership.

Pensions, Retirement Accounts, and Social Security Benefits

The following will not be changed with tax reform:

- Pension plans
- Retirement Accounts (e.g., 401k plans)

The following must be changed under the new tax reform:

- Social Security income is taxed at the same rate as other sources of income.
- Roth IRA plans are eliminated since they allow income to escape taxation. Current Roth IRA accounts must be phased out as follows: no more contributions are allowed, they are closed and liquidated when the owner dies.

Fringe Benefit Tax Loophole is Eliminated

The VAT will inherently tax fringe benefits, just as it does corporate profits. This is a significant advantage of the VAT. It is a simple way to ensure that fringe benefits and other untaxed and underreported incomes do not escape taxation.

This fringe benefit exclusion includes the following:

- Pension and retirement contributions: The tax on these fringe benefits is deferred until the taxpayer receives the pension or withdraws money from a retirement account. This deferral is justified because (1) it defers but does not eliminate taxes, just like the treatment of capital gains; and (2) there is no other practical way to tax defined benefit retirement plans.
- Working condition benefits: This exclusion is limited to property and services a company provides so an employee can perform his or her job. This includes items such as work-related travel expenses, vehicles, uniforms, and safety equipment. It also includes items such as on-site meals, day care facilities, and education assistance, if they are provided primarily to improve employee performance.
- Minimal benefits: Small fringe benefits with little monetary value or cost are excluded because the expense of bookkeeping far exceeds the value of collecting taxes on these items.

Some employers may want to pay the income tax on taxable fringe benefits rather than burdening employees with this responsibility. They should be allowed to do this. However, since employees are in different tax brackets, employers would have to pay the highest income tax rate in the tax table (36%).

Interest Income is Taxes as Ordinary Income

Interest income is taxed at the same rate as income from other sources. This differs from the current tax code, which taxes interest at various rates.

Tax-free bonds issued by cities, schools, and other public entities are eliminated. This eliminates a significant tax loophole and ensures that all sources of income are taxed at the same rates.

Implementation: existing bonds remain tax-free, but after a transition period, no new tax-free bonds are allowed.

As a result of this change, cities, schools, and other public entities that currently use tax free bonds will pay higher interest rates. This increased cost will be partially offset by their reduced cost for employee health care. The higher interest cost will encourage them to “pay as you go” and issue fewer bonds.

Payroll Tax-Social Security

Restore Social Security to financial health as follows:

- The Social Security payroll tax is increased from 12.4% of GDP to 14% of GDP. Employers and employees each pay half of the payroll tax, as in the current tax code.

- The wage cap on taxable income is eliminated. Fringe benefit exclusions are also reduced as mentioned above.
- All payroll taxes are earmarked for Social Security. The current 2.9% Medicare payroll tax is eliminated since VAT fund Universal health care for all. As a result, the overall payroll tax rate is reduced from 15.4% to 14%.
- Social Security benefits are taxed as ordinary income.
- All new state and local government employees are required to join Social Security. This provision is included to simplify Social Security and get states and local governments out of the business of funding employee pensions.

Estate and Gift Taxes

This estate and gift taxes are similar to current estate and gift taxes, except that the exemption is reduced to $6 million, and revenue from the estate tax is earmarked for an Education Trust Fund. The key features are:

- Estates pay no tax on funds given to a spouse or non-profit organization. They pay a tax of 40% on other assets over $6 million. A taxpayer who does not use the full $6 million exemption may transfer it to a spouse. The $6 million exemption is indexed for inflation.
- The estate tax should generate revenue of about $20 billion to $40 billion annually, or 0.1% to 0.2% of GDP. This is much less than the U.S. currently spends for education (about 5% of GDP). It could significantly improve the education system. To achieve this objective, estate tax revenue is deposited into an Education Trust Fund.
- Gifts to spouses and non-profit organizations are not taxed. Gifts to others are taxed only if they exceed $15,000 per person per year and their cumulative value exceeds the $6 million lifetime estate tax exemption. The gift tax rate is 40%, the same as the estate tax rate.

This will help improve education, it will create better job opportunities for low-income and middle-income taxpayers and make U.S. companies more competitive. If they want to avoid the estate tax, they can donate their wealth to non-profit organizations of their choice, either while they are alive or in their wills.

In addition to estate taxes, estates must also pay the following: (1) income taxes and Universal health care co-pays owed by the deceased at the time of death; and (2) income tax on any income earned by the estate, including capital gains on assets sold by the estate.

Income earned by an estate can be either (1) taxed at the top rate in the individual income tax table (36%), or (2) distributed to the heirs and added to their income for tax purposes.

Excise Taxes

Current objectives of the current tax code with excise taxes would stay:

- Fund infrastructure and services. Example- the excise tax on motor vehicle fuels funds highways and mass transit systems. The excise tax on airline tickets funds airports and air traffic control.
- Discourage harmful products and activities and reimburse society for the cost of harm caused by them. Example- the tax on cigarettes discourages smoking and reimburses society for the added health care costs for cigarette smokers.

Tax reform must strengthen these objectives by making the following two changes to the current tax code.

Highway Trust Fund: Federal motor vehicle fuel tax rates have not changed since 1993 and are not indexed to inflation. The tax revenue they provide is insufficient to maintain and improve the transportation infrastructure. This has caused Congress and the President to periodically provide extra funding from general tax revenue. To fix this problem permanently, the Highway Trust Fund is renamed the Transportation Trust Fund, with two sub-funds: A Highway Trust Fund and a Mass Transit Trust Fund. These trust funds would be funded as follows:

- Motor vehicle fuel taxes (about $40 billion annually) are indexed for inflation, and all revenue from them is earmarked for the Highway Trust Fund.
- Two percent of income tax revenue (about $40 billion annually) is transferred to the Transportation Trust Fund each year. Half is deposited into the Highway Trust Fund and the other half is deposited into the Mass Transit Trust Fund.

Carbon Dividends: A new revenue-neutral excise tax.

Carbon Dividends

Carbon dividends are included to address air pollution/climate change. It is recommended to focus on air pollutions versus climate change because it is something people can understand better and better data for how many people are dying yearly right now. Key features:

- **Carbon fee:** A gradually increasing carbon fee is collected from fossil fuel companies. This fee is levied on oil, natural gas, and coal companies at the wellhead, mine, or port of entry.
- **Carbon dividends:** All fees collected are returned to the American people with quarterly or monthly carbon dividend checks.
- **Border adjustment:** Imports of carbon-intensive products pay a fee (and exporters receive a credit) to ensure a level playing field for American companies and workers.
- **Regulations:** Government regulations that are no longer necessary to address climate change are phased out.

Carbon-intensive products receive border adjustments for two reasons. (1) This will ensure that manufacturing does not move abroad just to avoid the carbon fee. (2) Border adjustments will trigger a global “domino effect” as other countries scramble to price carbon to avoid (legal) tariffs on their products. This will rapidly reduce air pollution/global greenhouse gas emissions.

The carbon fee can start at $20 per ton of carbon dioxide and increases $10 per ton annually for 18 years, until it is $200 per ton. Then the carbon dividend would decrease as air pollution and greenhouse gas emissions are reduced. Would stabilize somewhere between $500 to $1,000 per person per year, when the U.S. is carbon neutral.

The combined annual carbon dividends and refundable tax credits in this plan will allow: (1) single taxpayers to receive $1,500 to $2,500 annually, (2) married couples with no dependents receive $3,000 to $5,000 annually, and (3) married couples with two dependents receive $6,000 to $10,000 annually. These cash payments will increase with inflation and provide four important advantages which are:

- They provide valuable income support for low-income and middle-income taxpayers. This coupled with a strong safety net anchored by Universal health care for all and fully funded and sustainable Social Security, will help them move up the income ladder.
- Taxpayers must file tax returns to receive their carbon dividends and tax credits. This will encourage everyone to file tax returns, whether or not they owe taxes.
- Carbon dividends and refundable tax credits provide a simple and effective way for the government to collect unpaid fees. Example- Universal health care for all co-pays and unpaid child support can be deducted from carbon dividends and refundable tax credits before distributing them.
- The government can use carbon dividends and refundable tax credits to encourage good behavior. Example- (1) denied to anyone who is in jail, or (2) deposited into a supervised fund to assist with rehabilitation and re-entry into society.

Reference:

Hartung, Jim. (2020). Rational Tax Reform. Using the Systems Engineering Process to Fix America's Broken Tax System. Authority Publishing.