10. Replace the Tax System

Congress should

- repeal the capital gains tax, or at least index gains for inflation;
- abolish the federal estate tax;
- outlaw the passage of all retroactive taxes;
- end the withholding tax;
- send an annual tax disclosure form to all taxpayers;
- require a supermajority vote to raise taxes;
- abolish the Internal Revenue Service's lifestyle audit;
- enact a 25 percent "alternative maximum tax" for individuals and businesses; and
- replace the income tax with a national sales tax and close down the IRS.

Perhaps the single most urgent policy initiative for the 105th Congress is to replace America's arcane, anachronistic, and anti-growth tax code. Jimmy Carter had it right 20 years ago when he described the U.S. income tax system as a "disgrace to the human race."

The income tax system is unsalvageable. We have to start all over. Congress has "reformed" the tax system 31 times in the past 40 years—or once every 1.3 years on average. The code remains as unwieldy today as ever. Hundreds of thousands of small businesses pay more in tax preparation costs than they pay in taxes. Dale Jorgenson, chairman of the Economics Department at Harvard, calculates that moving to a flat rate tax on consumption would raise as much revenue as the current income tax system while increasing economic growth by more than $200 billion. That translates into an increase in average household income of more than $2,000 a year.

The personal income tax, the corporate income tax, the estate tax, and the capital gains tax would be replaced with a simple flat rate national retail sales tax. A sales tax rate of 15 percent could fully replace all of the revenues from the current income tax. With increased economic growth and appropriate spending cuts, the sales tax rate could be reduced to 10 to 12 percent after five years.

Defects of the Current Tax System

The current federal income tax system is harmful to our economy and our civil society in a variety of ways.

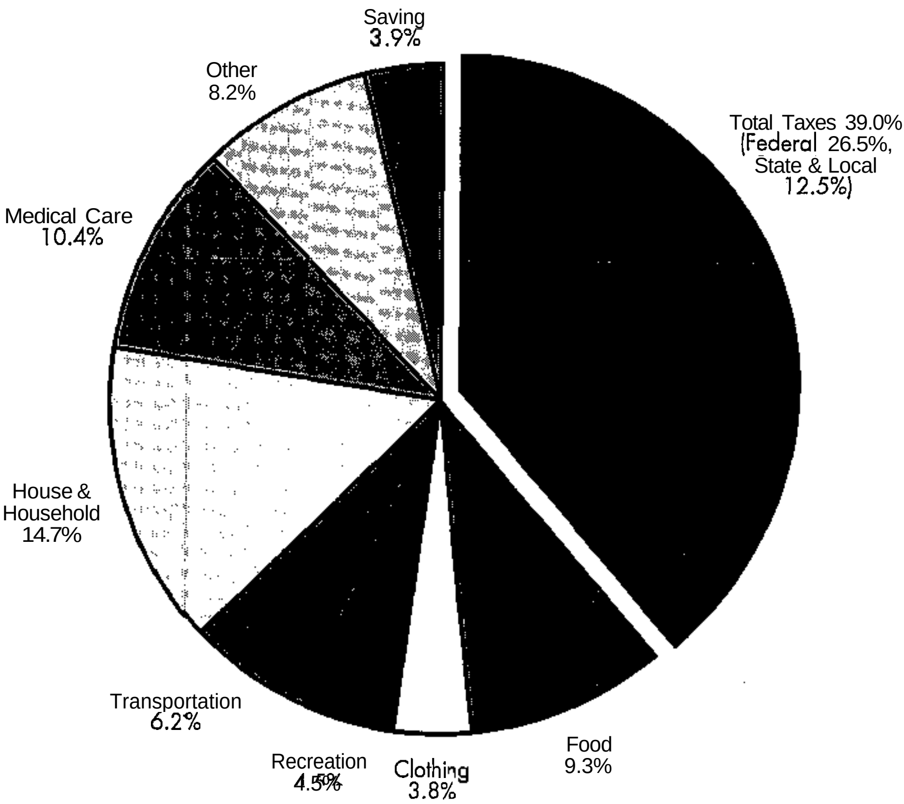
First and most obviously, taxes are too high. A founding principle of this nation was the idea of "no taxation without representation." The tragedy is that today we have immeasurably more taxation with representation than we ever had without representation. In 1900 the average U.S. household surrendered $1,500 a year in taxes. In 1950 that figure had risen to $7,000. In 1995 the average household paid nearly $20,000 in taxes.

The share of workers' paychecks devoted to federal, state, and local taxes rose from about 11 percent in 1930 to about 23 percent in 1950 to just shy of 40 percent in 1995. Figure 10.1 from the Tax Foundation shows that taxes now take a larger share of family income than food, clothing, and medicine combined.

Second, economically destructive tax rates are discouraging savings, investment, and work. George Hatsopoulos, chairman of Thermo Electron Corporation in Massachusetts, summarized the problem concisely: "The tax system of the United States is a major contributor to three of the most important economic problems confronting our country: (1) a disastrous rate of national savings, (2) a non-ending trade imbalance, and (3) a declining rate of investment."

It was never supposed to be this way. The very first income tax in 1913 had rates ranging from 1 to 7 percent—with the highest rate applying only to Americans who had the equivalent of a $5 million or more income today. Table 10.1 compares the original income tax with what it has become today. A proposed provision of the Sixteenth Amendment to cap the tax rate permanently at 10 percent was defeated on assurances that the language was unnecessary because the tax rate would never exceed that amount. As early as 1917, the start of World War I, the top marginal rate was raised to 67 percent, although it fell after the war. In 1944, during World War n, the top marginal rate was raised to 94 percent. In other words, the government took 94 cents of every additional dollar earned and the worker kept 6 cents. Today, the top tax rate stands at 42 percent.

Figure 10.1
Representative Budget of Two-Income Family, 1995



SOURCE: Tax Foundation, 1996.

Some economists resist the notion that high tax rates are economically harmful, but it was President John F. Kennedy who eloquently warned of the perils of soak-the-rich tax policies some 30 years ago when he unveiled his own tax cut plan:

> An economy hampered with restrictive tax rates will never produce enough revenue to balance the budget, just as it will never produce enough jobs.

It is instructive to note that America has experienced three periods of very strong economic growth in modem times: the 1920s, the 1960s, and the 1980s. Each of those growth spurts coincided with reductions in marginal tax rates. In 1923, after the end of World War I, President Calvin Coolidge cut income tax rates. In 1964 the Kennedy tax cut lowered the

Table 10.1
The First and Last Income Tax

	1914	1994
Income taxes paid (billions of 1994 dollars)	$6.7	$683.4
Per capita income taxes (1994 dollars)	$69	$2,622
Individual tax filers	360,000	113,829,000
Percentage of population filing returns	0.5%	45%
IRS budget (millions of 1994 dollars)	$110	$7,100
IRS employees	4,000	110,000
Pages of federal tax law	14	9,400
Pages of IRS forms	4	4,000
Top tax rate	7%	40%
Tax rate on median family	0%	28%

SOURCES: Cato Institute and *Harper's Magazine,* April 1977, p. 22.

top income tax rate from 91 percent to 70 percent. In 1981 Ronald Reagan cut tax rates 25 percent across the board, chopping the top tax rate from 70 to 50 percent (which was then lowered to 28 percent in 1986). What was the result?

- In the six years after the 1923 tax cuts, the American economy grew by 5 percent per year, and tax revenues nearly doubled.
- In the seven years after the Kennedy tax cuts, the economy grew by 5 percent per year, and income tax revenues climbed by 80 percent.
- In the seven years after the 1981 Reagan tax cuts, the economy grew by 4 percent per year, and federal revenues grew by 75 percent. The percentage of households with incomes above $50,000 rose from 18 percent to 23.5 percent.

After both the Kennedy and the Reagan tax rate cuts, federal revenues paid by the wealthiest Americans actually *increased.* After the Kennedy tax cuts in 1963, which lowered the top income tax rate from 90 to 70 percent, taxable income reported by the richest Americans rose by 40 percent. Between 1980 and 1990, the top income tax rate was chopped from 70 percent to 28 percent. Over that same period, the share of income taxes paid by the wealthy increased from 18 percent of the total in 1980 to 26 percent in 1990. In fact, real federal revenues increased by 24 percent in the seven years after the Reagan tax cuts (1982-89). They will have increased by only 20 percent in the seven years after the Bush and Clinton tax hikes (1990-97). That suggests that tax rates today are too high to expand the economy and to balance the budget

The economic evidence suggests that nations with flat and low marginal income tax rates outperform neighboring countries with steeply progressive tax systems. Economists at the World Bank, hardly a bastion of supply-side orthodoxy, examined evidence dating back to 1870 and discovered "a negative association between economic growth and . . . the marginal tax rate." The world's fastest growing economy over the past 20 years, Hong Kong, has the lowest marginal tax rates (15 percent maximum) on labor and capital.

A third defect of the tax system is that it has become a labyrinth of complexity. Jack Valenti, president of the Motion Picture Association of America, recently complained, "No other nation relies on such a cluttered mess of rules and regulations that are both contradictory and abrasive. We have given birth to a priesthood of lawyers and accountants who gravely inspect the entrails of our tax system and then charge outrageous prices for the knowledge they alone possess."

Just how unfathomable is the tax system? David Brinkley, in his recently published memoirs, cited this example from an instruction booklet for tax-payers:

> Subparagraph B in Section 1 G 7, relating to income included on parents' returns, is amended (1) by striking $1,000 in clause i and inserting twice the amount described in 4 A ii and (2) by amending subclause capital (II) of clause small ii——

That tortured language is surely not English. It is perhaps comprehensible to a small handful of lawyers on Capitol Hill and well-paid accountants and tax attorneys. But it is gobbledygook to most other Americans.

That is just one tiny example. Here's another. During a 1995 hearing before the House Ways and Means Committee on the U.S. income tax system, the chief tax counsel for Mobil Oil Corporation brought to the House office building a six-foot-high stack of bound papers. They weighed 150 pounds. They were Mobil Oil's tax forms for fiscal year 1993. It cost Mobil an estimated $15 million and more than 100 full-time man-years just to figure out how much they owed in taxes. Mobil is not unique. In 1994 the Internal Revenue Service received nearly 1 billion form 1099s as part of the government's effort to track income from dividends and interest and other forms of business income. Dick Armey has calculated that "the IRS sends out eight billion pages of forms and instructions each year, which if you laid them end to end would stretch 28 times the circumference of the earth."

Economist James L. Payne, author of *Costly Returns,* has calculated that American workers and businesses spend at least 5.4 billion man-hours a year figuring out their taxes. That is more man-hours than it takes to build every car, van, and truck manufactured in the United States. Sen. Richard Lugar (R-Ind.), an advocate of the national sales tax, reports that more man-hours are used each year to figure out taxes than are worked by every resident of his state of Indiana. Estimates of the dead-weight economic loss attributable to the complexity of the tax system range from $75 billion to $200 billion a year, or as much as $2,000 for every household in America.

Despite countless efforts at tax "simplification," most Americans do not view the tax code as user friendly. The *average* fee for preparation of a tax return is now almost $200. IRS data confirm that in 1992 more than 50 million individual returns were done by tax preparers at an average fee of $200. Eighty percent of those using professional preparers have incomes below $50,000 of adjusted gross income, according to tax litigation consultant Dan Pilla, author of *How to Fire the IRS. Money* magazine discovered in 1991 that 70 percent of the members of Congress on the two major tax-writing committees—House Ways and Means and Senate Finance—could not figure out their own returns and used professional tax preparers. All told, Americans spend about $30 billion a year for the services of tax accountants and lawyers. Those services do not add to the nation's wealth; they deplete it.

Perhaps the most troublesome consequence of our modern income tax system is the enormous investigative and prosecutorial powers we have conferred on the IRS. Constitutional rights to privacy are routinely subverted by the IRS. Today, without a search warrant, the IRS has the right to search the property and financial documents of American citizens. Without a trial, the IRS has the right to seize property from Americans—and it does so routinely. In 1994 the IRS was forced to acknowledge that hundreds of auditors were illegally scouring through the returns of American citizens. Congress has done nothing; our elected officials routinely turn a blind eye to the IRS's abuses.

No campaign against the excesses of big government in Washington is complete without a revamping of the IRS. Investigative reporter David Burnham reports, "The IRS is twice as big as the CIA and five times larger than the FBI. The IRS controls more information about more Americans than any other governmental agency. . . . With its unequaled authority to seize property and its unparalleled access to financial records, the IRS has become the nation's single most powerful instrument of social control."

The IRS has broad prosecutorial powers and can gain access to the most personal and private financial information of Americans. Today banks, investment houses, and employers are required to report 81 specific types of personal financial transactions.

Unfortunately, the IRS is one of the most error prone of all federal agencies. A recent Cato Institute study by Daniel Pilla finds that IRS information supplied to taxpayers is wrong about 20 percent of the time. When challenged, the IRS has been found to overcharge taxpayers an average of $2,000 per return. Yet in tax court the burden is on the individual to prove that the government is wrong in its assessment and fines.

No other institution is as great a threat to our civil liberties as the IRS. Its abuses will surely continue as long as we retain an income tax system.

Tax Reform in the 105th Congress

To make the tax system fairer, simpler, less intrusive, and more pro-growth, Congress should adopt nine reforms.

Abolish, or at Least Index, the Capital Gains Tax

The capital gains tax is an assault on the American dream. It is a tax penalty imposed on those who risk their money to start a business, operate a farm or ranch, invest in stocks, or build a better life for themselves and their families.

The capital gains tax also places the United States at a huge competitive disadvantage in the global race for capital compared to most of our international rivals. Almost no other developed nation punishes investment and capital formation as much as the United States. For example, the long-term capital gains tax rate in the United States is 28 percent; in Japan it is 20 percent; in France it is 18 percent; and in Germany it is 8 percent.

Although many Democrats complain that a capital gains tax cut is an "unfair" benefit to the rich, the truth is that 70 percent of the tax returns that show capital gains are from Americans with adjusted gross incomes below $70,000.

The capital gains tax is a grossly unfair tax for another reason as well. More than two-thirds of the taxes paid are on gains due purely to inflation. To understand the extent of the capital gains inflation penalty, consider the following hypothetical case. If an investor purchased $10,000 of stock in 1970 as a nest egg for retirement, and that stock appreciated in value at the same rate as the Dow Jones industrial average over the next 20 years, then by 1992 it would have had a value of roughly $31,000. Yet just to keep up with inflation over that 20-year period, the stock would have had to have been worth $34,000 in 1992. In other words, when inflation is accounted for, this investor suffered a real loss of $3,000 ($31,000 - $34,000). But Uncle Sam requires this investor to pay a $5,700 capital "gains" tax on his investment, *even though it lost money relative to inflation.* Hence, the real tax rate on the investment is over 100 percent! At the very least, such unfairness should be ended by indexing capital gains for inflation.

But ultimately, the tax on capital formation should be eliminated. That would liberate capital that could be reinvested in entrepreneurial, start-up businesses—the very kinds of businesses that might just be the next Microsoft or find a cure for AIDS.

Eliminate the Estate Tax

The U.S. estate tax is even more indefensible than the capital gains tax. The tax today brings in only $12 billion—or less than 1 percent of total federal revenues. Yet taxpayers spend many times that amount of money in estate planning to avoid paying the tax. The major victims of the 55 percent estate tax are small business owners, farmers, and others with medium-sized estates. Often family businesses have to be dismantled or sold to meet estate tax obligations. A 1993 study by economist Richard Wagner of George Mason University calculates that the federal government would collect more tax revenue over time if it simply abolished the estate tax altogether.

Outlaw the Passage of All Retroactive Taxes

One of the most offensive features of the 1993 Clinton tax hike was the retroactivity of the income and estate tax increases. Those kinds of unannounced retroactive tax hikes amount to nothing more than a partial government taking of private property, One might expect such seizures of money and property from the governments of authoritarian nations, but not in a constitutional democracy like the United States. James Madison described retroactive laws as "contrary to the principle of the social compact." Congress should consider legislation, introduced in 1995 by Sen. Paul Coverdell of Georgia, that would permanently ban the imposition of retroactive taxes.

End *the Withholding Tax*

The withholding tax was introduced in 1943 as part of the war effort to facilitate the collection of taxes at a time when even clergymen and Disney's Mickey Mouse were enlisted by the U.S. government to increase Americans' tax payments. Legislators spoke openly of taxes that needed to be "fried out of the taxpayers." One senator cheered the provision as a way to "get the greatest amount of money with the least amount of squawks."

Withholding was of dubious constitutionality during a period of crisis, such as war, but during normal times it is clearly an excessive power of government. The central objection to withholding is that it is the ultimate hidden tax. People don't miss what they don't see. Many Americans even regard the check they get that refunds excess money withheld as a gift from government. Income taxes should be paid monthly, or at the end of the year, by the earner's writing a check to the IRS, as proposed by Rep. Cliff Stearns (R-Fla.). That would allow Americans to calculate on a regular basis whether they are getting their money's worth from government.

Send an Annual Tax Disclosure Form to All Taxpayers

Each year when the IRS sends its tax forms to American families, it should be required to send a tax disclosure form listing all federal taxes and estimating all state taxes paid by the family in the previous year. The taxes listed would include federal income taxes; Social Security taxes (both employer and employee share); and estimates of state income, sales, and gas taxes. That also would allow Americans to see how much they pay each year for government.

Require a Supermajority Vote to Raise Taxes

Several states, including Arizona, California, and Nevada, have adopted measures requiring that any tax increase by the legislature pass by a two-thirds vote in both houses. Such a measure is needed at the federal level. It should apply to *all* tax increases, not just income tax hikes. A two-thirds-vote requirement for tax increases would allow Congress to raise taxes during time of war or national crisis but would help prevent the routine tax hikes that have been enacted in Washington over the past 20 years.

End the IRS's Lifestyle Audit

No feature of the IRS's broad investigative powers is more of an assault on privacy rights than the lifestyle audit, first launched in 1994. Under the new auditing procedure, the tax collectors will now ask taxpayers intimate questions about their lifestyles and spending behavior that have little or nothing to do with the financial information contained on the tax forms. What schools do your children attend? Where did you go for vacation last year? How often do you go out for dinner? What's your credit card balance?

As part of those audits, IRS examiners are now creating dossiers that profile the economic position of all American tax filers. In IRS training Aid 3302-102, titled "Components of Economic Reality," some 47 different aspects of a person's life are identified as elements of the dossier. Included are neighborhood, home, investment income, recreational vehicles, college tuition, trips, club memberships, weddings of children (perhaps Ross Perot wasn't so paranoid after all), and hobbies. Also included in the list are "level of sophistication and cultural background."

The IRS has no intention of relying solely on the citizen's own statements in creating the dossier. The IRS is lining up informants who may have information about the citizen under audit. Informants include landlords, employers, business and personal associates, ex-spouses, even next-door neighbors. In some cases the informants will be paid if the information leads to higher tax collections. The lifestyle audit is attempting to create a nation of snitches. Congress should terminate it immediately.

Enact an Alternative Maximum Tax

A March 1996 GrassRoots Research poll indicates that, by a two-to-one margin, Americans favor a constitutional amendment that would prohibit federal, state, and local taxes from taking a combined total of more than 25 percent of anyone's income.

That can be ensured through legislation creating an "alternative maximum tax." Until the income tax system is ended entirely and the Social Security system is privatized, the federal government should allow workers and businesses the option of bypassing the 9,000 pages of tax laws and instead complying with a postcard tax return with no deductions, no loopholes, and no credits. The taxpayer would simply be assessed a flat rate tax of 25 percent on total gross income as a substitute for income and payroll tax liability. Many millions of Americans who cannot take advantage of the myriad loopholes in the system now unfairly pay an average income/payroll tax rate of more than 25 percent. For millions of others, who might even pay slightly more tax under the alternative maximum tax, the savings in tax preparation costs and the lessened aggravation would make the alternative tax an attractive option. Hong Kong's highly successful flat tax is very similar in concept to this alternative maximum tax concept.

Replace the Income Tax with a National Sales Tax

There is a great debate brewing across America about whether a national sales tax or a flat tax, as Rep. Dick Armey (R-Tex.) and Steve Forbes have proposed, would be the ideal substitute for our current failed income tax system. Unquestionably, either would be vastly superior to what we have now.

But the flat tax suffers from one critical defect: it is still an income tax. As such, it does not eliminate the IRS from our lives (though it should reduce the IRS's role). It would still be the business of the government to monitor our incomes—thus impelling the government to continue to pry into the most private aspects of Americans' financial affairs. Although simpler, it would still require workers and businesses to fill out tax forms each year.

The best replacement for the income tax would be a national retail sales tax on all final-use goods and services. The retail sales tax is far preferable to the value-added tax (VAT), which is supported by many business groups in Washington and is the centerpiece of a bipartisan tax reform proposal by Sens. Pete Domenici (R-Nev.) and Sam Nunn (D-Ga.). European-style VATs have been disasters in virtually every nation in which they have been enacted. They have not increased savings rates. The tax rates have been continually raised. And, most important, they have served as engines of growth of government. That is because the VAT is a tax that is hidden from the consumer—imbedded in the costs of goods and services consumers purchase.

A recent Cato study by tax expert David Burton outlines the features of a national sales tax plan. The four components of the plan are as follows:

- **A 15 percent sales tax, which would eventually fall to 10 percent, on the final purchase of goods and services at the retail level.** The sales tax would be similar to the familiar state sales tax collected at the cash register in 45 states and the District of Columbia. Intermediate purchases would be exempt. The individual and corporate income tax, the estate and gift tax, and most non-trust-fund excise taxes would be repealed. The rate should decline in future years to 10 to 12 percent as economic growth allows more revenues to be raised at a lower rate and as government spending is reduced.

- **A universal rebate for every household exempting all consumption up to the poverty level.** A national sales tax need not be regressive. By allowing the first $18,588 of consumption each year for a family of four to be tax-free, the system protects low-income families from the tax. The rebate could be provided as a credit against the payroU tax, allowing all workers to be reimbursed for any sales tax paid on consumption up to the poverty level.
- **Reimbursement to states and retailers for the cost of collecting the national sales tax.** The national sales tax should provide an administrative credit to retailers to compensate them for the cost of collecting and remitting the tax. A credit of one-half of 1 percent would reimburse retailers about $4 billion for their compliance and collection costs. In a national system administered by the states, states should be compensated for their costs.
- **Abolition of the Internal Revenue Service.** The states should be primarily responsible for administering the national sales tax since they have the most expertise in sales tax administration. The IRS would be abolished, and a much smaller, less intrusive federal excise tax bureau would collect trust fund excise taxes such as the gasoline tax. The Social Security Administration would enforce and collect payroll taxes.

Boston University economist Laurence Kotlikoff has estimated the impact of a revenue-neutral replacement of the income tax with a retail sales tax. He calculates that, after just five years, the national savings rate would rise to two and a half times its current anemic level; the capital stock would grow by 8 percent above the level attained under the current tax system; output would be 5 percent, or $500 billion, higher than otherwise.

The abolition of the income tax should no longer be viewed as a Utopian fantasy but as a viable plan that is rapidly gaining political momentum. Last year Reps. Dan Schaefer (R-Colo.), Billy Tauzin (R-La.), and Dick Chrysler (R-Mich.) introduced a national sales tax bill that adopts many of the provisions noted above. Senator Lugar is likely to lead a parallel effort in the Senate.

Conclusion

The American public has quite correctly come to regard the current tax code as an arcane and unwieldy mess and the IRS as an intimidating nuisance in their lives. Almost no one—other than accountants, tax lawyers, and lobbyists, all of whom profit from the current convoluted mess—defends the tax code we now have in place.

To compete and win in the 21st century, America needs a tax system that is fair, simple, and pro-growth. The tax code ought to promote the national interest over special interests. It should be user friendly. And it ought to reward rather than punish work, saving, risk taking, and economic success. All of those objectives could be accomplished by abolishing the income tax and replacing it with a low national sales tax.

Suggested Readings

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