10. Tax Reduction

Very few Americans would argue with the proposition that our current tax code is arcane and anachronistic. The American public wants a tax code that is fair, simple, and pro-growth. The current system fails miserably on each of those counts.

The source of the problem is the income tax itself. The past several rounds of "tax reform" should have taught us that the income tax cannot be fixed or simplified. It must be scrapped entirely. The Cato Institute has published a plan that calls for replacing the personal income tax, the corporate income tax, the estate tax, and the capital gains tax with a simple flat rate national retail sales tax. The incoming Ways and Means Committee chairman, Bill Archer of Texas, has cited the need for just such a fundamental restructuring of our tax system.

Replacement of the income tax would immediately jump-start the U.S. economy. The rate of savings, investment, and capital formation would be positively promoted. For the typical American worker who has suffered stagnant real wages over recent years, the abolition of the income tax would be the single most effective way to raise the standard of living, for both this generation and future generations. More important, if the GOP is genuinely committed to the idea that the federal government is too big, too costly, and too intrusive in the lives of American families and businesses, then it must close down the Internal Revenue Service. The IRS is the belly of the beast of big government.

To that end, Congress should

- **abolish the capital gains 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,**

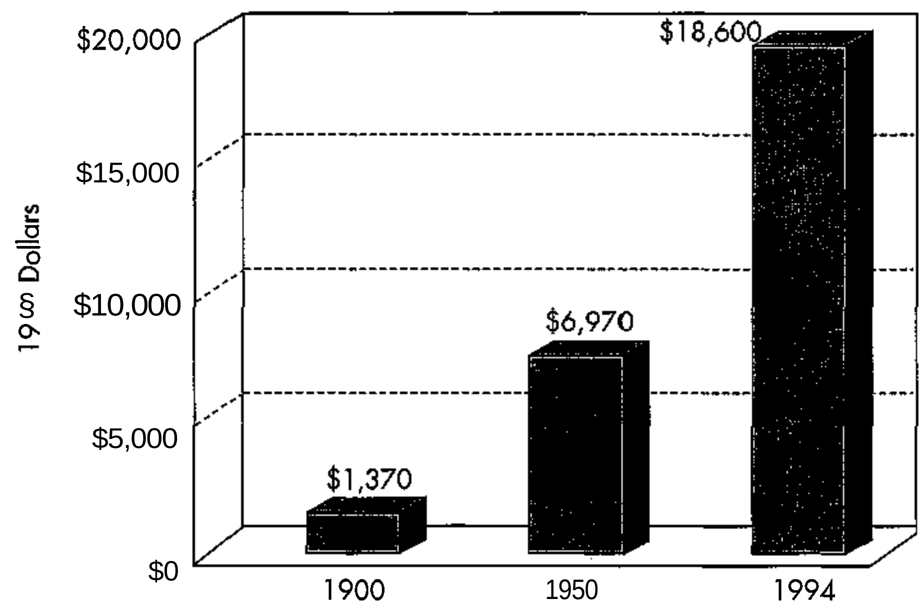
- **enact a flat tax,**
- **replace the income tax with a national sales tax.**

America's Taxes: How Burdensome?

Justice John Marshall wrote many years ago, "The power to tax is the power to destroy." He was referring to a 2 percent tax rate proposal. Today's tax system, which is undermining the nation's economy, would have been unimaginable in Marshall's day. Figure 10.1 shows how taxes at all levels of government have been relentlessly climbing over the 20th century. The typical household paid about $7,000 in taxes in 1950 (in 1990 dollars) and almost $19,000 in 1994. It is doubtful that many American households believe they are receiving $19,000 worth of benefits each year from government. (If the hidden taxes of federal borrowing are included in the calculation, the average American household pays closer to $23,000 a year for government.)

One reason Americans' take-home pay has been flat or even declined in recent years is that taxes are capturing an ever-larger share of workers'

Figure 10.1
Real Total Taxes per Household, 1900–94

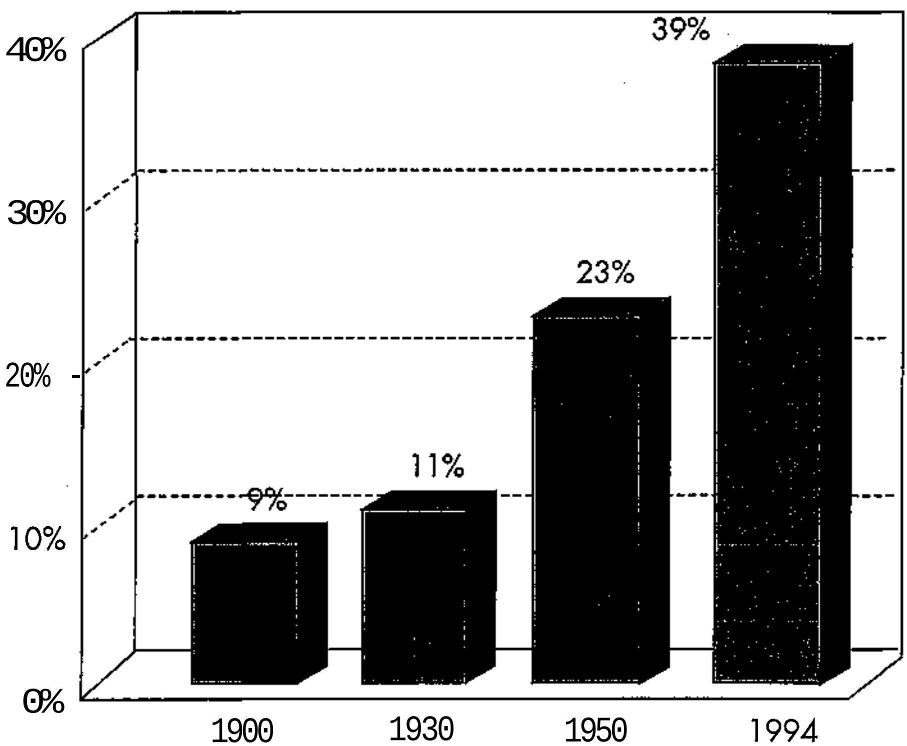


SOURCE: Tax Foundation, 1994.

earnings. Figure 10.2 shows that in 1930 American workers surrendered 11 percent of their paychecks to federal, state, and local government; by 1950 they surrendered 23 percent. In 1995, with the Clinton tax hike, they will surrender just shy of 40 percent of their incomes to taxes.

Those numbers are surprising to many Americans because we are repeatedly told by the media that President Ronald Reagan slashed taxes in 1981. Unfortunately, that tax cut proved to be short-lived. Congress raised taxes in 1982, 1983, 1984, 1987, 1988, 1990, and 1993. Every dollar of the tax cuts enacted by Reagan in 1981 has since been replaced with roughly $1.10 in new taxes. Consequently, from 1980 to 1991 total federal tax receipts more than doubled and tax burdens actually rose. What the right hand of the federal government giveth in tax cuts, the left hand taketh away with a relentless stream of tax hikes.

Figure 10.2
Federal, State, and Local Taxes as a Share of National Income



SOURCE: Tax Foundation, 1994.

The Victims of America's High Taxes

American workers and businesses are harmed not only by the overall *level* of federal taxes but also by the economically destructive way that the federal government collects taxes. The most destructive element of the current tax code is high marginal income tax rates.

Thanks to "soak-the-rich" tax hikes in recent years, the highest marginal income tax rate at the federal level today is 42 percent. If state taxes are included, many individuals pay more than half of their earnings in taxes. Studies show that high income tax rates apply in large part to small business owners, who are a major source of new jobs. Paradoxically, punitive tax rates designed to soak the rich have tended to erode economic opportunities for lower and middle-income workers. For example, in the 1980s, after Reagan cut income tax rates, the share of income taxes paid by the wealthiest 1 percent of Americans rose from 22 to 26 percent. But since the 1990 tax rate increases, the share of taxes paid by the rich has fallen from 26 percent to 23 percent.

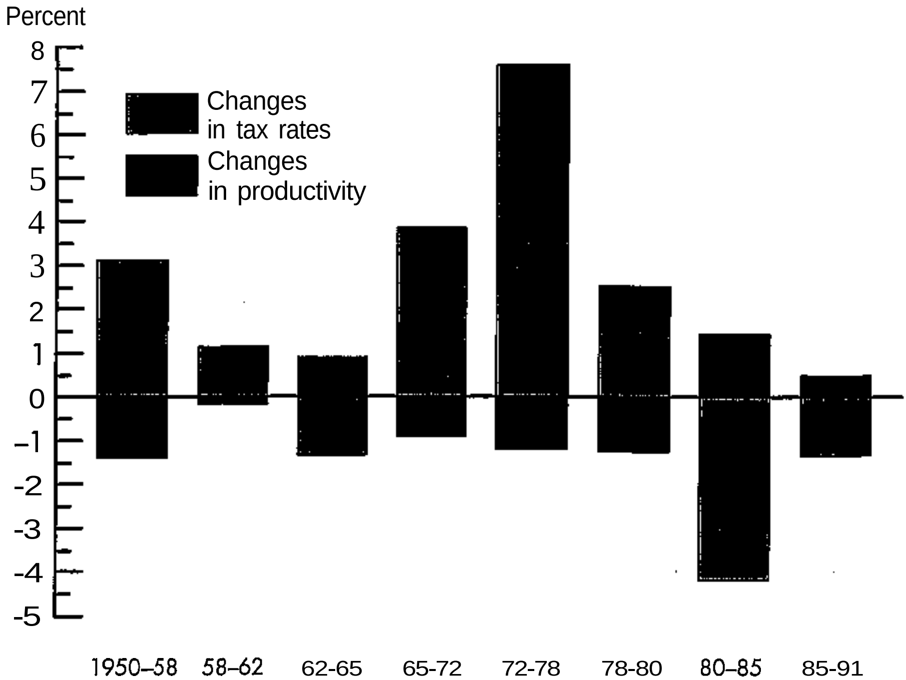
A study by economist Robert Genetski shows that high marginal tax rates are inversely related to productivity growth, as shown in Figure 10.3. Productivity and ultimately wages tend to rise when marginal income tax rates are low, but productivity and wages fall or grow very slowly when marginal income tax rates are high—as they are today. Harvard University economist Dale Jorgenson estimates that every additional dollar raised by Uncle Sam reduces the output available for other uses by about $1.34. Jorgenson calculates that the United States could raise roughly the same amount of tax revenue as we do today and increase the income of the average American family by more that $2,000 a year by simply moving toward a simpler, less punitive tax system.

The Capital Formation Tax

Capital—both human and physical—is the vital engine of growth for a modern economy. Capital is the equipment, the tools, the computers, and the skills that workers use on the job to expand their output.

Unfortunately, America's high income tax rates on the owners of capital, the corporate income taxes on the earnings of capital, capital gains taxes on the proceeds from capital, and taxes on the purchase of capital, through depreciation rules, conspire to make capital investment less attractive and thus less available. Table 10.1 shows that the United States has one of the highest capital gains taxes of the industrialized nations.

Figure 10.3
Changes in Tax Rates and Productivity



SOURCE: R. J. Genetski, *Taking the Voodoo Out of Economics* (Chicago: Regnery Gateway, June 1986).

NOTE: Tax changes are differences in effective marginal rates from beginning to end of period. Productivity changes are diferences in the annualized underlying trend from the previous period.

The capital gains tax, which should really be called the "capital formation" tax, is especially onerous. The following are among the problems with the capital gains tax.

- o The capital gains tax is a double and in some cases a triple tax on investment income.
- o The capital gains tax hurts the working men and women of the United States. Studies indicate that 80 to 90 percent of the gains from capital formation accrue to labor; the other 10 to 20 percent accrue to the owners of capital.
- o In large part, the owners of capital are today's middle-income working families. The ownership of capital is more widely disbursed today than ever before with the spread of 401 K plans, mutual funds, stock

Table 10.1
International Comparison of Individual Capital Gains Rates: United States versus 74 Other Industralized Nations, Maximum Rate

Country	Short-Term Capital Gains	Long-Term Capital Gains	Holding Period for Long-Term Gains
United States	28.00	28.00	1 year
Australia	49.25	49.25[a]	1 year
Belgium	0.00	0.00	N.A.
Canada	19.33	19.33	N.A.
France	16.00	16.00	N.A.
Germany	56.00	0.00	6 months
Hong Kong	0.00	0.00	N.A.
Italy	0.00	0.00	N.A.
Japan	20.00	20.00	N.A.
Netherlands	0.00	0.00	N.A.
Singapore	0.00	0.00	N.A.
South Korea	0.00	0.00	N.A.
Sweden	42.00	16.80	2 years
Taiwan	0.00	0.00	N.A.
United Kingdom	40.00	40.00[a]	N.A.

SOURCE: Data compiled by the American Council for Capital Formation, 1990.
[a]Capital gains indexed for inflation

ownership plans, and simply the increased numbers of Americans who own stocks individually.

- The capital gains tax is not indexed for inflation, meaning that much of the paper "gains" that Americans report when they sell a business, a property, or a stock is purely an inflation gain. For stocks that have been held since the early 1970s, most if not all of the "gains" disappear when inflation is taken into account. Hence, not taking into account the inflationary portion of capital gains is highly unfair.

- High capital gains tax rates create a "lock-in" effect, whereby the owners of assets hold on to them to avoid paying the tax rather than selling them and investing in new business enterprises. Estimates of the locked up capital in the United States are in the trillions of dollars. Reducing the tax on capital gains would unlock those assets and free hundreds of billions of dollars of start-up capital for new and medium-sized businesses that will be the future of our country.

In sum, the capital gains tax is a tax on the American dream. It makes Americans of every income group poorer.

The Income Tax: The Working Man's Burden

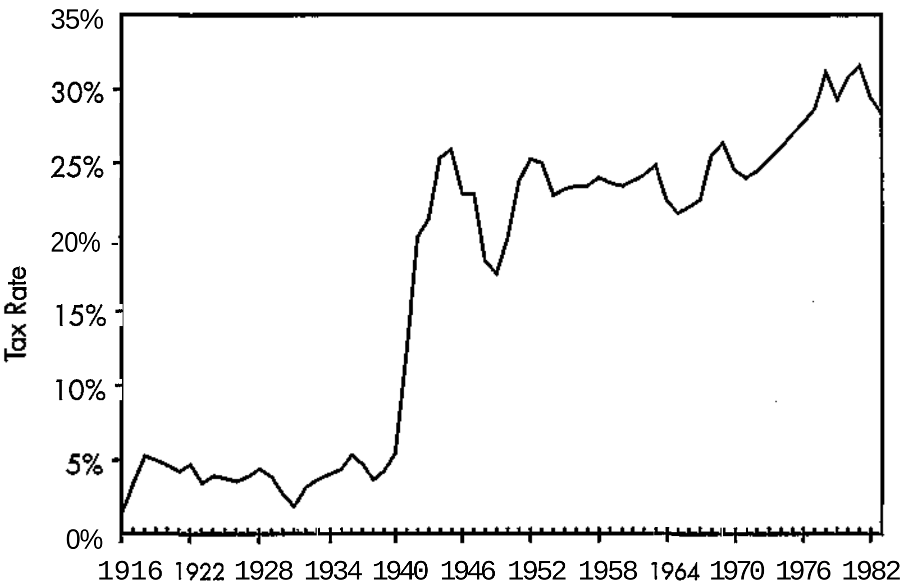
For the vast majority of Americans, the most dreaded and reviled tax is the income tax. Until the ratification of the Sixteenth Amendment in 1913, there was no federal income tax in peacetime—the Supreme Court had consistently ruled it unconstitutional. No law has contributed to the growth of government and the surrender of personal liberties and privacy rights more fully than the federal income tax. Today the IRS has broad and sweeping powers to investigate the personal activities, records, and finances of Americans. "When men get in the habit of helping themselves to the property of others, they cannot be easily cured of it," insisted the *New York Times* in a prophetic editorial slamming the constitutional amendment creating the income tax in 1909.

Today, without a search warrant, the IRS has the right to search the properly and financial documents of American citizens. Without a trial, the IRS has the right to seize property from Americans—and it does so routinely. Last year Congress added 5,000 IRS agents (to the 120,000 already on the job) even as that agency was forced to acknowledge that hundreds of auditors were illegally searching the returns of American citizens.

Rep. Cordell Hull, who drafted the first income tax, argued that its purpose was to force "the Carnegies, the Vanderbilts, the Morgans, and the Rockefellers with their aggregated billions of hoarded wealth" to pay a fair share of taxes. But the truth is that the income tax has always been the middle-income worker's burden. In fact, Congress has never been able to pump much additional money into the public coffers by raising income tax rates on the wealthy. Figure 10.4 shows that the effective income tax rate on a family with the equivalent of a 1991 income of $50,000 was never more than 4 percent until World War II. Since then, it has never fallen below 22 percent; it reached as high as 33 percent during the high-inflation, bracket-creep years of the 1970s. The original income tax required less than 1 percent of Americans to file a return; today virtually all American families must do so.

So for the middle class, the income tax has been the ultimate political bait and switch. Allowing politicians carte blanche to raise rates on the wealthy has punished the middle and upper middle income groups. Nobel laureate F. A. Hayek lamented that "the illusion that by means of progres-

Figure 10.4
Average Marginal Tax Rate, 1916–83



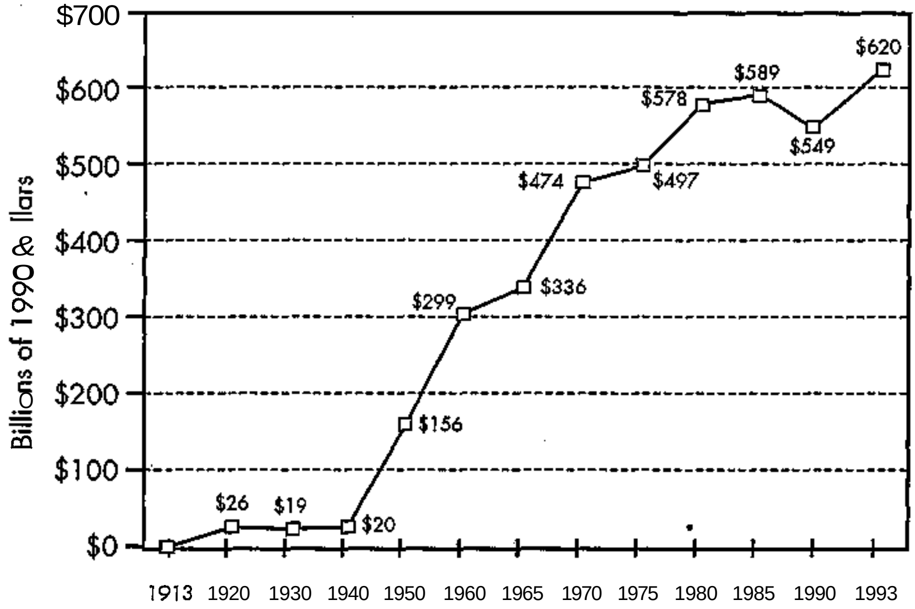
SOURCE: Bruce Bartlett, "The Futility of Raising Tax Rates," Cato Institute Policy Analysis no. 192, April 8, 1993.

sive taxation the tax burden can be substantially shifted onto the shoulders of the wealthy has been the chief reason why taxation has increased as fast as it has done. . . . Under the influence of that illusion, the masses have come to accept a much heavier load than they otherwise would have."

There is little question that the income tax has been an engine of government growth in this century. Here are some numbers to confirm that: the original income tax raised less than $50 billion in 1990 dollars. In 1995 the federal government will raise about $700 billion from the income tax. Figure 10.5 shows the increase over time. The first income tax amounted to about $150 per family (1990 dollars), whereas today the per household federal income tax burden is close to $7,000.

Another cost of the current income tax system is its dizzying complexity. The original income tax included a two-page form, which was printed on the front page of the *New York Times.* Today, after several rounds of congressional tax simplification, there are still dozens of tax forms, hundreds of pages of instructions, and tens of thousands of tax attorneys and accountants who are paid to figure it all out. In *Costly Returns,* James L. Payne reaches the following conclusions.

Figure 70.5
Federal Income Tax Receipts, 1913-93



SOURCE: Tax Foundation, 1994.

- American workers and businesses spend at least 5.4 billion man-hours a year figuring out tfieir taxes (Table 10.2). According to George Mason University economist Walter Williams, that is more man-hours than it takes to build every car, van, and truck manufactured in me United States.
- That generates a dead-weight output loss of some $100 billion to $200 billion each year. If a simpler system could reduce the complexity by just 20 percent, the savings would be as much as $40 billion a year.
- The average fee for preparation of a tax return is now almost $200. In 1985 about 45 million individual returns were done by tax preparers at an estimated cost to taxpayers of $6 billion.

Large numbers of Americans are concluding that there must be a better way to pay. They are right.

Tax Reform for the New Congress

In its first 100 days the new Congress should concentrate on (1) reducing selective taxes that are particularly odious and counterproductive and (2) ensuring that future Congresses cannot easily raise taxes.

Table 10.2
Time Spent on Taxes
(million man-hours)

Individual taxpayers	
Record keeping	783
Learning about tax requirements	313
Preparation	553
Copying and sending forms	164
Subtotal	1,813
Business taxpayers	
Record keeping	1,957
Learning about tax requirements	196
Obtaining materials	133
Locating and using preparer	207
Preparation	1,034
Copying and sending forms	86
Subtotal	3,614
Total	5,427

SOURCE: James Payne, *Costly Returns* (San Francisco: Institute for Contemporary Studies, 1993).

Abolish the Capital Formation Tax

The correct rate of tax on capital gains would be zero. The tax should be ended as part of any comprehensive tax restructuring. In the meantime, the following steps should be taken to end the worst inequities of the tax.

- Allow full indexing of the capital gains tax. The tax on inflation should end immediately both as a matter of simple fairness and as a boost to growth.
- Allow full deductibility of losses against gains. If gains are fully taxed, then losses should be fully offset.
- Allow investors to roll over their current asset holdings into new equities without having to pay a capital gains tax. The capital gains tax, to the extent there is one, should be paid only on funds that are withdrawn from capital markets.

Outlaw All Retroactive Taxes

One of the most offensive features of the Clinton tax hike was the retroactivity of the new income and estate taxes. The Supreme Court in the *Carlton* case upheld the constitutionality of retroactive taxation— which essentially gives Congress unlimited taxing authority.

In the final analysis, 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 pass legislation permanently banning the imposition of retroactive taxes. Sen. Paul Coverdell of Georgia has promoted mat idea.

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 refund check they get from too much withholding 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. That would allow Americans to calculate on a regular basis whether they are getting their money's worth from government.

This proposal will be difficult to enact, precisely because members of Congress and the spending lobbies recognize just how difficult it would be to get Americans to pay several thousand dollars in taxes at one time. But the government is not entitled to more revenue than citizens choose to assign to it, so making taxes visible is essential to making the tax system honest.

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 and Social Security taxes (both employer and employee shares) and estimates of state income, sales, and gas taxes. That would allow Americans to see how much they pay each year for government.

Congress should also require that employers list on employees' paychecks how much FICA tax the employer paid on the worker's behalf during that pay period.

Require a Supermajority Vote to Raise Taxes

Several states, including Arizona, California, and Nevada, have adopted measures requiring that any tax increase must pass by a two-thirds vote in both houses of the legislature. Such a measure is needed on the federal level. Currently, Congress operates under the perverse rules that it takes a three-fifths vote to cut taxes but a simple majority to raise them. In other words, it's less difficult for Congress to take people's money from them than to give it back. A three-fifths majority to raise income tax rates should become the law of the land, as suggested by the House Republican Contract with America. That law should apply to *all* tax increases.

Enact a Flat Tax

Dick Armey has proposed a 17 percent flat tax plan that would abolish virtually all deductions and loopholes, terminate tax withholding, end the double taxation of savings and investment, shorten the income tax form to the size of a post card, eliminate the capital gains and estate taxes, and reduce the overall tax burden by $50 billion a year. The Armey plan is simpler, fairer, and more pro-growth than our current tax code. The plan has broad populist appeal. That sensible reform should be the centerpiece of a 100-day agenda for improving America's tax system.

Replace the Income Tax with a National Sales Tax

Armey's flat tax would be a significant improvement over our current tax code, but it is not a final solution to problems with America's tax system. Armey's 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 its role). It would still be the business of the government to know how much money Americans make each year—to pry into the most private aspects of American's financial affairs. Although simpler, the Armey plan would still require workers and businesses to fill out tax forms each year—albeit, much simpler ones.

The best replacement for the income tax would be a national retail sales tax—exempting only real estate and securities. A retail sales tax is far preferable to the value-added tax (VAT) that many business groups in Washington support and titiat is the centerpiece of a bipartisan tax reform proposal by Sens. Pete Domenici and Sam Nunn. European-style VATs, in their various incarnations, have been a bust in virtually every nation that has enacted them. They have not increased savings rates. Their rates have been continually raised. And most important, their fatal flaw has been that they have served as engines of growth of government. That is because the VAT is hidden from consumers—imbedded in the costs of goods and services they purchase.

The retail sales tax has the virtue of being much more visible. It is paid at the cash register by the citizen-voters. The mechanism for collecting a sales tax is largely already in place, since all but a small handful of states impose a sales tax.

Boston University economist Laurence Kotlikoff has estimated the impact of a revenue-neutral replacement of the income tax with a retail sales tax. To protect the poor from the tax and to make it nonregressive, the first $4,000 of each person's purchases would be exempted from the tax. The rate would have to be set at around 16 to 18 percent. Kotlikoff calculates that after just five years the economic impact would be as follows:

1. The national savings rate would rise by 2.5 times its current anemic levels.
2. Capital stock would grow by 8 percent above the level attained under the current tax system.
3. Output would be 5 percent higher than otherwise for almost a $500 billion per year increase in output and incomes.
4. The interest rate would fall by 0.3 percentage points.
5. The impact on output and wages rises over time; after 20 years the national output rises nearly 25 percent higher than under the current income tax structure.

Critics complain that a 16 to 18 percent sales tax would be too high and unenforceable. However, if the dynamic economic growth impact of the plan is considered, the sales tax rate could fall to about 12 to 14 percent. Moreover, if spending were curtailed, as it should be, the rate could be lowered to as little as 12 percent. One of the virtues of moving toward a single retail sales tax would be that it would increase public pressure on government to reduce federal spending as a means of bringing down the sales tax rate.

The national sales tax is everything that Americans want in their tax system. It is simple. It is fair. And it is mightily pro-growth. The United States would attract capital, investment, and jobs from the rest of the world if it adopted the most pro-enterprise tax system in the world. Most important, unlike most of the counterfeit tax reform measures before Congress today, the retail sales tax would require a major retreat of government from the daily lives of American workers and their families.

Suggested Readings

Adams, Charles. *For Good and Evil: The Impact of Taxes on the Course of Civilization.* Lanham, Md.: Madison Books, 1993.

Kotiikoff, Laurence J. "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax." Cato Institute Policy Analysis no. 193, April 15, 1993.

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—Prepared by Stephen Moore