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The Search for a Simple, Efficient, Less Intrusive Substitute for Our Current Income Tax System

Aaron Sauerbrei

ABSTRACT. The subject of tax reform seems to emerge as a highly debated topic of discussion every few years because our current income tax system is too complex, inefficient, and intrusive. There are two unique proposals that would change the face of our tax system, the flat tax and the national sales tax. This paper examines these proposals on the grounds of complexity, efficiency, and intrusiveness to determine which plan would be the best substitute for our current income tax system.

Introduction

Every tax season Americans are reminded of the daunting task of filing income taxes, but most people are unaware of our current income tax system's inefficiencies. The income tax system as we know it today is a product of economically troubled times. The Great Depression and World War II created an immediate need for increased tax revenues to ensure a minimum level of economic security for U.S. citizens, and also, the protection of our nation's interests. The result of these troubled times is an income tax system that is economically inefficient, too complex, and an infringement of our civil liberties. There are two major proposals that would drastically overhaul our current income tax system, the flat tax and the national sales tax. On the grounds of economic efficiency, simplicity, and the protection of our civil liberties, does the flat tax or a national sales tax offer a viable remedy to our current income tax problems?

Our Income Tax History

When our government and its activities were small, revenues from tariffs and excises were sufficient to fund government operations. By the early twentieth century, government's assumption of limited social responsibilities increased revenue needs, thereby requiring the implementation of an income tax through the adoption of the Sixteenth Amendment in 1913. The United State's entry into World War I added to the financial needs that had to be funded through the income tax. In the 1920's, tax rates were low throughout the income distribution. While

government involvement in various new activities had expanded during the first third of the century, total government expenditures came to only 10 percent of gross national product in 1929, and three-quarters of this amount was attributable to state and local government spending [Simon, 1981, 13].

The expanded social objectives arising from the economic trauma of the 1930s increased the government's perceived need for funds. President Franklin Delano Roosevelt's New Deal created a new freedom from want and led the government into adopting new spending programs that guaranteed a minimum level of economic security. But the increase in the government's command over the resources of the society corrupted traditional philosophical notions of freedom as our leaders sought a middle ground between pure capitalism and pure socialism. Massive mobilization for World War II added to this, and tax rates rose sharply. As average rates of personal taxation were raised, the system became more steeply progressive, and corporate tax rates were also increased [Simon, 1981, 14]. For the most part, the structure of our existing system is the legacy of this economically troubled era.

With the tax rates on marginal income now very high and with the government assuming more social responsibilities, the progressive tax system came to be seen as an important tool for social engineering. Our current progressive income tax system is structured to take income from well-to-do people and corporations and redistribute that income to expand services to low and moderate income households. The early twentieth century was a very unique era in our nation's history. Policy decisions were made during troubled times including war and economic depression. But was this troubled environment conducive to making economically efficient decisions concerning an income tax system? The following section of this paper outlines some economic deficiencies associated with our current system.

The Economic Deficiencies of Our Current Income Tax System

Today the typical American household pays more than \$16,000 in federal taxes of all types. This constitutes roughly forty percent of family household income and is roughly twice (in inflation adjusted dollars) the level of taxes imposed in the 1960s [Institute for Policy Innovation, 1995, 2].

The problem has continued over the past forty years and is a heavy burden on families and businesses. American workers do not only carry the burden of taxes but are increasingly harmed by the destructive way that the government imposes taxes.

Another problem of the current tax code is the disincentive effects of high marginal tax rates. The highest marginal income tax rates in existence at the federal level today is 42 percent. After state taxes are added into the equation, many individuals face a marginal tax rate greater than 50 percent. Studies illustrate that these lofty income tax rates apply in large part to small business owners [Robbins, 1994, 7]. Paradoxically, punitive tax rates are designed to lay more of the tax burden on the rich, but lower tax rates usually lead to higher tax contributions by the wealthy. For example, after the Kennedy tax cuts in 1963 that reduced the top income tax rate from 90 to 70 percent, reported taxable income by the wealthiest Americans rose by forty percent [Lindsey, 1990, 15-27]. Similarly, in the 1980s, after President Reagan cut income tax rates, income taxes paid by the wealthiest 1 percent of Americans rose from 18 percent in 1981 to 25 percent by 1990 [Moore, 1991, 104]. But since the 1990 tax rate increases, the share of taxes paid by the rich has fallen slightly. The Joint Economic Committee of Congress estimated that the federal government lost about \$50 billion in tax revenues from 1987 through 1991 because of the increase in capital gains tax from 20 to 28 percent [Joint Economic Committee, 1993, 32].

The working elderly are not exempt from our punitive tax rate structure. Senior citizens that have to work for financial reasons or those who choose to keep active face high marginal tax rates, special earnings penalties, and recently enacted higher taxes on Social Security benefits. The National Center for Policy Analysis calculates that some working elderly encounter marginal tax rates of up to 80 percent [Robbins, 1992, 9]. Middle income earners also face high marginal tax rates. A majority of middle income earners are in a 28 percent federal tax bracket, a 15 percent payroll tax bracket, and a 5 percent state/local tax bracket. In summary, tax collectors are entitled to 48 cents of every additional dollar a middle income worker earns today [Moore, 1995, 82-91].

High marginal tax rates reduce economic output and national savings. A study by economist Robert Genetski illustrates that high marginal tax rates are inversely related to productivity growth [Genetski, 1986, 4]. Therefore, productivity, wages, and savings tend to increase when marginal tax rates are reduced. On the other hand, economic growth

stagnates or grows more slowly if marginal tax rates are increased.

High tax rates also discourage capital formation. The United States imposes some of the highest taxes on capital of any of the developed nations. For example, the federal government's 28 percent long term capital gains tax rate is unindexed for inflation. This is among the highest in the world; it compares with a 20 percent rate in Germany, a 16 percent rate in France; and a 0 percent rate in Japan [Moore, 1995, 93].

The income tax system also reduces long term economic growth by double taxing savings and investment through capital gains taxes, corporate income, and other taxes on capital formation. Our government taxes earned income and also the proportion of that income that individuals and families save. The result of this double taxation has been the alarming reduction in the American savings rate. The US savings rate is now about one-third what it was in the 1950s. Today the savings rate in the United States is one-half that of Europe and one-third that of Japan. A survey of twelve developed countries recently placed the US last in savings [Moore, 1995, 95-96]. Higher taxes are not the sole reason for decreased savings in the U.S., but higher rates are a major contributing factor.

For years economists have attempted to estimate the total lost output due to the growth disincentives in our current tax code. Harvard economist Dale Jorgenson suggests the efficiency loss could be more than \$200 billion per year [Jorgenson, 1991, 5]. In other words, Dr. Jorgenson finds that with a more economically efficient tax system, the federal government could collect roughly the same amount of tax revenues, and raise economic output by about \$2,000 per household [Moore, 1995, 98-99].

Current tax reform proposals confront the problems of economic inefficiencies involved with our current tax code. Later in this paper, efficiency will be major factor when analyzing tax reform proposals. Most Americans, however, are not aware of the economic problems associated with our current tax system. The most visible enigma is the complexity involved in filling out tax forms.

Complexity

The objective of simplicity has obvious merits to anyone who has labored to complete a tax return. A significant amount of skilled human labor is

needed to operate this complicated system from both the paying and collecting ends. This labor could be used in the production of goods and services that people would choose to purchase. While to some the preparation of annual tax forms are nothing but a nuisance, nearly two-thirds of the filing households had to hire professionals to complete their 1997 tax forms, including an astonishing 40 percent of the persons filing a simple 1040A [Iowa Taxpayers Association, 1998, 13]. 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—used professional tax preparers to figure out their taxes. Virtually all large business firms have to maintain full-time legal and accounting staffs for this purpose. If this complexity is unnecessary, then the mere operation of our present system imposes a deadweight loss on the nation. Any simplification would reduce this loss and increase the amount of discretionary income available to businesses and households. Americans spend about \$30 billion a year for tax preparation, which could be invested, saved, or spent on consumption [Jorgenson, 1991, 7].

It is important to note that in 1913, the original income tax used a two page form, with a two page instruction sheet and included just fifteen pages of tax law. The top tax rate was 6 percent (with some legislators complaining that it would soon reach the unthinkable level of 10 percent.) Less than one percent of Americans even needed to fill out an income tax return [Meyer, 1977, 22]. Today, almost everyone must file a tax return and there are now over 9000 pages of tax law.

A related issue is that much human ingenuity is devoted to legal tax avoidance of this incredibly complex system. Even more unfortunate is the effort given to illegal tax evasion because of the difficulty of discovery due to the complexities. The structure of many business firms, their types of transactions, and their choice of economic activity are often chosen on grounds of tax reduction rather than on the basis of pure economic efficiency. The choice that is the most profitable for the entrepreneur is not necessarily the one that is of greatest productive benefit to society. In economic terms, the social return on these activities is less than the private return. In some instances, cattle breeding, oil-well drilling, real estate investment, leasing, and financial intermediation are undertaken primarily to reduce tax burdens [Simon, 1981, 22]. The investor frequently gives far too little attention to whether these investments pay a positive rate of return before taxes. Not only do these endeavors waste tangible resources, but they also misdirect

entrepreneurial talents, perhaps the most important economic and social resource in a free society [Simon, 1981, 23].

The surge for tax reform is being propelled by those who are tired of the increasing complexity of our current tax system. Simplicity will no doubt be another major, if not the most important factor taken into consideration when analyzing tax reform policies. Another aspect policy makers will have to take into consideration is whether a tax reform policy infringes on the civil liberties of the people in our democracy. A growing school of scholars view our current progressive income tax system as being anti-democratic and essentially hypocritical in the “free” society in which we live.

A Civil Liberties Case Against Our Current Income Tax System

In 1848 Marx and Engels proposed that progressive taxation be used “to wrest, by degrees, all capital from the bourgeois, to centralize all instruments of production in the hands of the state”[Marx and Engels, 1964, 93]. Although communism has failed, the idea of progressive taxation, as a means of achieving “social justice,” remains ingrained in the modern psyche [Dorn, 1996, 1]. Our constitutional democracy rests on the principles that individuals are equal under the law, that consent is the basis of just laws, and that the powers of the federal government are strictly limited. None of those principles are consistent with taxing incomes at progressively higher rates [Dorn, 1996, 1]. Until the passage of the 16th Amendment in 1913, the Supreme Court struck down early attempts to legislate a federal income tax. When the first income tax was passed by Congress in 1894, the New York Times called the legislation, “a vicious, inequitable, unpopular, impolitic, and socialistic act”[Moore, 1995, 2].

James Dorn eloquently states a position shared by many in his paper, “Ending Tax Socialism,” when he says:

Conservatives and liberals alike fall into a populist trap by trying to justify some progressivity in order to satisfy the majority’s preference for greater income equality. Elevating the principle of democratic rule above the protection of individual rights to achieve equality of result, however, violates the very rules of just

conduct that lie at the heart of a free society. The flat-rate tax is consistent with a rule of law and with the principle of nondiscrimination [Dorn, 1996, 1].

Dorn makes an excellent point about nondiscrimination. We live in a society governed by laws that prohibit discrimination on the basis of race, gender, culture, religion, and now even sexual orientation in some places. But discrimination on the basis of wealth is seen as acceptable. Our Founding Father's purposely instituted a government based on the principle of majority rule, with protection for the rights of minority factions. If the minority's rights are ignored, then we are treading down a path where the meaning of the phrase "equal justice under law" is lost. We must not presume that the property rights of the wealthy are not as sacred as property rights of the poor and that the values of the majority are superior to the rights of the minority.

The growing civil liberties complaints about the Internal Revenue Service also can not be ignored. The IRS now has 115,000 auditors and agents. To put the size of this police force into perspective, the IRS has roughly the same number of employees as all the other federal regulatory agencies. That is, the IRS has more enforcement personnel than the EPA, BATF, OSHA, FDA, and DEA combined. 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. In 1995, Congress added 5,000 IRS agents even as it was forced to acknowledge that hundreds of auditors were illegally scouring through the returns of American citizens [Moore, 1995, 38-43].

There are many problems related to our current income tax system but economic inefficiency, complexity, and an infringement on civil liberties lead the pack. Any tax reform proposal must confront these difficult issues if any improvement is to be made. The remainder of this paper will be devoted to analyzing current tax reform proposals. They will be judged according to the three criteria that were laid out in detail earlier in this paper.

The Arme y-Shelby Plan (The Flat Tax)

The Arme y-Shelby plan is unique, unlike any plan that has ever been

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implemented. The Flat Tax would eliminate the bias against saving that is so prominent in the current tax system. It would also eliminate dozens of special interest rules. Its advocates point to the Flat Tax as a giant step towards tax simplicity.

Under the Flat Tax, individuals would pay a flat 17 percent rate (20 percent initially). Included in one's base would be wages and pensions, but not fringe benefits or income earned abroad. All capital income, including interest, dividends, and capital gains, also would go untaxed, even if the proceeds were spent on consumer products. If you earn \$30,000 from investments, you can celebrate by using it to buy a car without incurring a Flat Tax [American Institute of Certified Public Accountants, 1996, 14]. Every itemized deduction and tax credit under the current system would disappear. Besides cutting out deductions for mortgage interest, charity, and state and local taxes, the Flat Tax would eliminate:

1. Scholarship and fellowship income exclusion
2. Exclusion of employee awards
3. Casualty and theft loss deductions
4. Child care credit
5. Earned income credit
6. Credit for elderly and disabled

The standard deductions (projected for 1996 with indexing for inflation thereafter) for the Arme-y-Shelby Flat Tax are as follows:

Basic Standard Deduction	Amount
Married filing jointly	\$21,400
Head of Household	\$14,000
Individual	\$10,700
Married filing separately	\$10,700

In addition to the standard deduction, there would be a \$5,000 additional deduction for each dependent [AICPA, 1996, 18].

To fully appreciate the significance of the Flat Tax, compare a family of four's taxes under our current system to the Flat Tax system.

Wages	\$70,000
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<i>Less:</i> Basic Standard Deduction	\$21,400
Dependency Deduction (2 x \$5,000)	\$10,000
Taxable Wages	\$38,600
Flat Tax at 20%	\$7,720
Income tax under current system	\$9,655

In this case, a family of four would have an additional \$1,935 in their bank account. Their tax savings would increase in two years when the Flat Tax rate was lowered to 17 percent [AICPA, 1996, 24]. However, had this family of four taken advantage of more of the current income tax credits and exemptions, their income tax under the current system might look differently.

Flat Tax advocates point out that since it exempts income from capital, it entirely eliminates the bias against capital formation in general under current law. Others, however, raise the equity issue with regard to allowing capital income to go untaxed under the Flat Tax. Is it fair to tax earnings from someone's labors while exempting the earnings from investments and savings? This is just one of many disputes concerning the distributional effects of the Flat Tax. Flat tax proponents argue that a uniform tax rate that exempts investment and savings will create an incentive for all people, regardless of income class, to save and invest in their futures. This increased savings will lead to less dependence on the federal government for social security and other government programs. Of course, there is little certainty that savings and investments will increase, but a flat tax system does offer an incentive to do so.

Although there is much dispute about how to measure the distributional effects of the Armey-Shelby Plan, it is noteworthy that a recent Treasury study showed that the Armey-Shelby Flat Tax would hurt families with incomes below \$200,000 and help those with incomes above \$200,000 [Toder, 1995, 1]. This question of distributional effects deserves closer attention in the future. In any case, to the extent the current system is considered as an impediment to saving and capital formation, the Flat Tax could foster increases in productivity, wages, competitiveness, and economic growth [AICPA, 1996, 88].

So how does the Armey-Shelby Flat Tax fare when considering economic efficiency, simplicity, and infringing on individuals civil liberties? As far as economic efficiency is concerned, the Flat Tax is a step in the right direction and is much more efficient than our current income tax system. It ends the double taxation of savings and investment

and, because of the low marginal tax rates, the Flat Tax promotes work. Americans could also devote the twenty hours they spend per year sifting through receipts to more productive activities. However, the Flat Tax would not eliminate the Internal Revenue Service which accounts for the vast amount of waste of human capital that could be used in other needed areas.

The Flat Tax must also raise sufficient revenue. The Treasury Department claims that the 17 percent Armev Flat Tax would reduce tax collections by nearly \$250 billion annually. Given the unlikely probability of a reduction in government spending by this amount, it seems likely that any Flat Tax proposal would have to be higher than 17 percent. The Treasury Department estimates that the Armev proposal would require a rate of approximately 24 percent to raise the same revenues as the corporate and individual income taxes it would replace [Toder, 1995, 1].

A key attraction of the Flat Tax is its simplicity relative to the current law. The Armev-Shelby plan is often referred to as the postcard proposal. There can be little doubt that this proposal in its current form is simpler than current law for a large number of taxpayers. It is unlikely however, that the tax would be so absolutely simple as proponents claim. First of all, many issues under current law would remain problematic under the Flat Tax. For example, under either tax there is no bright line between business expenses and personal consumption in the case of self-employed individuals. Second, new issues arise that are not present under current law. For example, the value of employee fringe benefits, which business cannot deduct under the Flat Tax, must be calculated. Finally, it is often remarked that it is not really fair to compare a tax system functioning in the real world to an idealized system that has not yet been subjected to the political maneuvering necessary for passage into law. If history is any indicator, it seems likely that in the name of political expediency the proposal would rapidly be burdened with special exceptions and adjustments as it moved through the legislative process [AICPA, 1996, 93].

The Internal Revenue Service would still have the authority to infringe on peoples' civil liberties under a Flat Tax system. Because of the simplified postcard system, the responsibilities of the IRS may have to be expanded. For a Flat Tax system to succeed, a higher level of trust between Americans and our government must be attained. It is very unlikely with today's intrusive government that a relationship based on

trust can be forged. This distrust could create opportunities for the government, particularly the IRS, to expand their intrusiveness even deeper and allow them greater opportunities to search through private financial documents, search private property without warrants, and seize private property.

In summary, the Arney-Shelby Flat Tax is a substantial improvement over our current system. It is much more economically efficient than the current system, less complex, but still does not offer sanctuary from the intrusiveness of the government. However, there are inherent problems with the Flat Tax which can be improved upon. Is there a tax plan that confronts the problems of the Flat Tax and is economically efficient, less complex, and protects our civil liberties?

A National Sales Tax

A retail sales tax is a tax on final sales by retail businesses to consumers. Most Americans encounter retail sales taxes every day. They are levied by forty-five states and numerous local jurisdictions. Americans seem to have accepted the current level of state sales taxes, and they do not seem to bear the same hostility that they have for income taxes.

From the perspective of promoting economic efficiency, a retail sales tax should tax all consumption equally in order not to distort consumer choices and to keep tax rates low. Only final sales by businesses- that is, sales by businesses to consumers should be subject to tax. The taxation of sales by businesses to other businesses would result in over taxation of consumption because final sales would bear not only retail sales tax but also the costs of whatever taxes are paid on inputs used to produce, market, or distribute consumer products [AICPA, 1996, 9]. States, in some sectors, overtax because inputs are taxed at all production levels. This problem should be avoided should a national sales tax be adopted.

In 1993 the Cato institute commissioned a study by economist Lawrence Kotlikoff of Boston University to examine the economic impact of replacing federal income taxes with a national sales tax [Kotlikoff, 1993, 2-5]. Kotlikoff discovered that to completely replace federal income taxes would require an initial sales tax rate of 17.4 percent. After five years the rate could be reduced to 15.4 percent, and after ten years the rate could be lowered to 13.9 percent. The reason, Kotlikoff explains, the rate can be lowered is because of positive economic feedback from the tax change. Specifically, the Kotlikoff study finds that after ten years, a

national sales tax would: 1) More than double the national savings rate. 2) Increase the capital stock by 8 percent above the level attained under the current tax system. 3) Raise income and output by 6 percent more than would be achieved under the current tax system. That would increase national output by almost \$400 billion per year. 4) Lift the real wage by 3 percent. 5) Reduce interest rates by 8 percent.

There are potential political problems with a national sales tax. One of these problems is that a sales tax is said to be regressive. Another is that a sales tax of more than 15 percent is said to encourage large scale evasion. And a third potential problem is that the sales tax may not be a replacement, but rather a supplement to our current income tax.

Stephen Moore, in his article "The Economic and Civil Liberties Case for a National Sales Tax," offers possible solutions to these problems. First, the regressivity problem could be alleviated if rebates were provided on a generous portion of the tax that every American pays. Moore advocates that every individual receive a rebate on the tax paid on the first \$5,000 of purchases she makes during the year. This would mean that a family of five would pay no tax on the first \$25,000 of purchases each year. There are various ways of providing the rebate. Assuming that the sales tax were set at 18 percent, a family of five would be entitled to a rebate of \$4,500 ($\$25,000 \times 18$ percent) for the year. The government could send a quarterly rebate check of \$1,125 to every family of five. Another possibility is to provide every family with a "smart card" that would have a sales tax credit based on family size. A married couple with no kids would receive a \$10,000 credit on its card. Each time the couple made a purchase, the smart card would deduct that amount until the \$10,000 credit was used up. After the first \$10,000 of purchases, the family would begin to pay the sales tax [Moore, 1995, 90]. Regardless of how the rebate is offered, the main point is that a sales tax need not be regressive.

Can the problem of tax evasion be dealt with without a massive federal revenue collection police force? Many opponents of the national sales tax point to tax evasion as the most substantial argument against this form of consumption tax. Delegating tax revenue collection responsibility to the states could be the solution. Forty-five states already use the sales tax as a source of revenue, if a national sales tax were included, the total sales tax would be between 20 and 25 percent. A small IRS enforcement force could be retained for the purpose of ensuring that states were collecting the tax. Critics are right when they argue that a tax

rate this high would encourage evasion. But evasion is already a large scale problem with the income tax. An estimated \$150 billion of income tax goes uncollected each year [Moore, 1995, 91-93].

Another common criticism of the national sales tax is that America will end up with both a sales tax and an income tax. This has been the experience with the value-added tax in Europe. For this reason, some critics argue that the sales tax is only acceptable if the 16th Amendment to the Constitution authorizing a federal income tax were repealed. Stephen Moore insists this is not necessary. A condition of approval for the sales tax would be the outright repeal of all federal income taxes. To prevent the income tax from returning, a super majority requirement to raise taxes would seem to be ample protection against efforts to reintroduce the income tax.

The national sales tax plan fixes every one of the defects of the current income tax system and offers an economically efficient alternative. Because the sales tax exempts all savings and investment, double taxation would no longer be a problem. Also, the disincentive effects from high marginal tax rates would be eliminated because of the single flat rate. And compliance costs would be substantially reduced because the income tax would be eliminated entirely.

The sales tax proposal offers a much simpler method of taxation than that of our current income tax system. The elimination of the income tax would save individuals over twenty hours per year. But the most tantalizing aspect of the sales tax is that it protects our civil liberties by eliminating the government's involvement in our personal affairs.

Conclusion

Tax reform may not be a political certainty in the next few years because the state of the economy is good, but tax reform will be addressed in the future. The current income tax system has been too inefficient, complex, and intrusive for politicians to ignore forever. The Armey-Shelby Flat Tax Plan and a national sales tax have appealing features and would offer a viable substitution to our current system. Yet, both of these alternatives has its own problems.

A primary objection to flat tax proposals is the lack of deductions for mortgage interest, charity contributions, state and local taxes, and the earned income tax credit. But the most disputed aspect of the flat tax is its distributional effects. Treasury studies have shown that a flat tax

would help those with incomes above \$200,000 and hurt those with incomes below \$200,000. These problems will have to be addressed before a flat tax receives political support.

The sales tax also has potential political problems. The sales tax is said to be regressive in nature and would disproportionately hurt low income individuals and families. Rebates on a certain level of consumption may be a solution to this problem but the debate continues. Opponents of the sales tax believe this system would also encourage large scale tax evasion. However, tax evasion exists under our current system and is likely to persist under any tax system. And finally, some fear that a sales tax would be a supplement to our current income tax system.

Both plans are better than our current income tax system, but the sales tax is the better of the two options. The Flat Tax addresses the complexity and inefficiencies of our current tax code but does not offer protection from the intrusive nature of our government. The sales tax redresses each of these issues.

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