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RESTRUCTURING THE FEDERAL TAX SYSTEM

Introduction

A growing consensus in the tax policy community is that the existing federal income taxes must be drastically overhauled, if not, indeed, entirely discarded. Numerous proposals to replace these taxes have surfaced in the last two years; although differing in important respects, all of these proposals seek the same objective: to achieve a tax system that less impedes economic growth, that is fairer, and that is far less complex, less costly to comply with and to enforce than the existing income taxes.

The existing federal tax system ... fails to perform the basic function of taxation for a free society: to tell the public what they must pay for the services they ask government to provide.

This objective is certainly appropriate, but in itself offers little guidance for the design of a new tax structure. To this end, federal policy makers need to spell out and to be guided by the basic tax principles and criteria on which tax restructuring efforts should be based. These principles and criteria are those that have been developed to meet the requirements of a free society whose economic activities are directed primarily by the operations of free market system. The ad hoc approach that has characterized most past tax reform efforts is virtually certain to fail to provide much improvement over the existing tax structure.

Deficiencies of the Existing Tax System

Hiding the cost of government

The existing federal tax system fails every test of an acceptable tax system for a free society. For one thing, it fails to perform the basic function of taxation for a free society: to tell the public what

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they must pay for the services they ask government to provide. If we don't know what government costs us, we will ask for more and more of it. But government services and activities aren't free. To provide those services and activities, government takes resources that would otherwise be available to households to improve their living standards and to businesses to produce the products and services we would seek in the market place. In the process, government drives up the cost and reduces the quantity of goods and services available in the private sector.

The existing federal tax system falls far short of telling us what we pay for our government. Who among us knows how much corporate income tax he or she pays, one way or another? Does anyone have even a ballpark estimate of what he or she paid in federal excise taxes last year? Ask your friends how much payroll tax was deducted from their gross wages or salaries last year; indeed, ask yourself how much you paid in payroll taxes last year. Do you know, as you read this, how much federal income tax you paid last year or are likely to pay this year? Everyone in a self-governing, self-reliant society should be able to answer these questions and to decide whether the amount and character of the government they're getting is worth what they're paying for it. The existing tax system fails this test. Because it does and because we don't insist that government limit its outlays to what we are willing to pay in taxes, we get too much government at too high a cost. This excess government costs us the more valuable products and services we would otherwise have. The result is that we have a smaller economy that grows more slowly than otherwise.

We need a tax system that does a vastly better job than the one we now have of telling us what government costs. This is reason enough to scrap the existing system and enact a tax system that performs this core function adequately.

INCOME AND INCOME TAXES, 1993
(Dollar amounts in billions)

	All taxpayers	Top 10%	Bottom 50%
Adjusted gross income	$3,775.6	$1,474.8	$563.3
Share of income	100%	39.1%	14.9%
Income tax	$500.7	$294.4	$24.1
Share of tax	100%	58.8%	4.8%
Tax rate	13.3%	20.0%	4.3%

Source: Internal Revenue Service

Imposing tax burdens unfairly

We have a tax system that virtually no one believes is fair. The popular view, embraced by most policy makers, is that fairness should be judged in terms of the share of the total tax that is paid by people at various income levels. According to this view, fairness calls for imposing tax burdens that are disproportionately greater the higher is one's income or wealth. Many of those who assert the tax system is unfair base that judgment on the belief that the "rich" don't pay their "fair share" of the total tax burden. Few, if any, of those who hold this view, however, identify what fraction of the total tax burden they think is the fair share for the rich to bear.

In the taxable year 1993, the top 10 percent of the income earners, people who accounted for 39 percent of the nation's adjusted gross income in 1993, paid a disproportionate share – almost 59 percent – of the total individual income tax revenues collected by the federal government. Their effective tax rate was 20 percent of their income. The bottom 50 percent of income earners had almost 15 percent of total adjusted gross income but paid only 4.8 percent of the total individual income tax that year. Their income taxes were 4.3 percent of their income, only slightly more than a fifth the effective rate paid by the top 10 percent of income earners.

What do these data tell us about the fairness of the federal individual income tax? On what basis might one assert that fairness requires that the top ten percent of income recipients should pay more than 58.8 percent of the total income tax or that it would be unfair to decrease their share to, say, 55 percent?

This approach to tax fairness derives from the notion that the tax system should be used to redistribute income and wealth from the affluent to the poor. The redistributive thrust of this fairness standard is without solid basis in analysis or in ethics. Changing the income-level distribution of income and wealth is not an appropriate function of government nor in a free market economy is it a function that government tax and spending policies can effectively perform. Redistributive tax policies impel market adjustments that substantially offset changes in after-tax incomes sought by those policies, while limiting gains in output and income for the society as a whole.

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For some who favor a redistributive tax policy, the implicit if not explicit ethical justification is that the rich people are rich only because they've deprived the poor. There is, however, no factual basis for this notion. In fact, the rewards people receive for active participation in the free market economy closely match what each person has contributed to aggregate output. Moreover, those rewards are not earned at other people's expense. Indeed, the contrary is true; the efforts one makes to increase one's productivity and earning capacity virtually always benefit others as well. The free-market economy is not a zero-sum game in which one person's gains are obtained at another person's expense. What one does to enhance one's income-producing ability is sure to provide expanded economic opportunities for others.

Nor does a redistributive tax system reflect a nation's charitable character. There is no element of charity in taxes which are, by their very nature, involuntary exactions, no matter the uses to which the tax revenues are put. Charity is a personal, not a collectivized, function.

A far more meaningful way of looking at tax fairness is to call to mind one of the oldest, most basic principles on which this nation was founded. Throughout our history we have insisted that everyone in this society should stand equally before the law, that no personal attribute should either give a person a legal advantage or disadvantage in dealing with fellow citizens. Applying that principle in the field of taxation leads us to a superior standard of fairness: if the government is to tax income, everyone should be exposed to the same rate of tax on his or her income.

Against this standard, upward-graduated income tax rates should be seen as the utmost in unfairness. As one of the major features of a redistributive tax policy, such a system of tax rates asserts that the more productive one is, the more one contributes to society's well being, the greater is the rate of tax one should pay on any additional income one produces. Constructive tax restructuring must be based on critical rethinking about fairness and embody a fairness standard that respects personal achievement.

Excessively complicated

One of the acid tests of the acceptability of a tax system is that it imposes the lowest possible costs of compliance, administration, and enforcement. The existing tax system is totally unacceptable on these grounds. Every element of that tax system is extremely complicated, requiring an enormous number of man hours and hundreds of billions of dollars of manpower, machine, and paper costs.

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The statutory provisions encoded in our tax laws are the source of this costly complexity. The complexity of the tax laws inevitably results in harsh and complex rules and regulations imposed to ensure compliance with those laws, and enforcement of those rules and regulations in turn generates arbitrary, often cruelly harsh procedures by the tax administrators – the Internal Revenue Service (IRS). The history of the contemporary tax system, in particular, that of the income tax, provides a laboratory example of the process of making the tax laws more and more costly to comply with, to administer, and to enforce. Virtually every tax bill enacted in recent years has increased the law's complexity in efforts to reach every last dime of what tax policy makers believe should be taxable income. The consequence has been huge increases in taxpayers' compliance costs and in the IRS budgets for administration and enforcement personnel.

This process has also led to enforcement procedures that increasingly invade our property rights; the IRS can and does seize the property of people it deems to have evaded paying the taxes they owe without first going to court. No government agency should have the power to confiscate one's property without a finding by a court of violation of the law.

We tend to overlook the fact that we pay for these enormous compliance, administration, and enforcement burdens by giving up products and services that we would otherwise produce to satisfy our current consumption demands and to add to our capacity to produce more products and services in the future. We pay for the complexity of our tax laws by suffering lower living standards today and less gain in those standards over time than we would otherwise be able to achieve.

It should be abundantly clear that simplification of the tax laws and reducing compliance, administration, and enforcement costs lie beyond so-called tax "reform." Since the adoption of the 16th Amendment of the Constitution, the federal income tax has been reformed and reformed. Each reform has produced more and more statutes that have made the tax laws more and more complex and have led inexorably to more and more rules and regulations that have exponentially increased costs of compliance, administration, and enforcement.

The classic case of reform gone wildly astray is the Tax Reform Act of 1986. That legislation simplified compliance only for the several million people it dropped from the income tax rolls; it hugely increased complexity and compliance costs for virtually all business-income taxpayers and for individual taxpayers receiving income as returns on their saving and investment.

Tax restructuring, that is, producing an entirely new tax system, not mere tax reform, that is, modification of existing tax laws, is needed if tax simplification is to be achieved. The focus of efforts to reduce compliance, administration, and enforcement costs must be on the underlying tax laws, not on the misbehavior of some Internal Revenue Service agents. Realization of real economies in these respects requires replacing existing taxes with a tax system that is guided by the basic principles discussed below.

Distortionary and biased against saving and investment

A tax system acceptable to a free society should to the least possible extent disrupt the operations of the market system. Every tax ever designed has the effect of raising the cost of what is taxed compared to the costs of other things. Because every tax has this "excise" effect, every tax changes the signals the market system would otherwise give us about the costs of alternative uses of the resources we have at our disposal. Every tax, therefore, changes the incentives each of us would otherwise confront concerning the most efficient use of our talents, energies, other production capabilities, and time. In the aggregate, the nation winds up with a less satisfying, as well as a smaller, basket of products and services than it would otherwise have available. Minimizing tax-induced distortions of the free market's operations, therefore, is a hallmark of acceptable taxation.

Regrettably, the existing tax system is a hodgepodge of tax provisions, each with its own excise effects that grossly interfere with efficient market operation. For one thing, our income taxes severely increase the cost of saving out of our current income compared with using that income for current consumption. Saving is the way in which each of us can add to our future earning power; relying on taxes that make saving more costly impairs the ability of each of us to attain a more prosperous future, to provide a financial cushion against economic misfortunes, and to ensure our families' economic well being. And in the aggregate, this punitive treatment of saving imposes on us a smaller and less dynamic economy than we would otherwise enjoy.

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A visitor from another planet would conclude from examining our tax structure that we believe saving to be a sinful activity to be taxed out of existence. The existing income tax not only taxes the income we save, it also taxes the income produced by the investment of that saving. In contrast, the income tax falls on the income we use for current consumption but doesn't fall as well on the consumption outlays and the services and the enjoyment they provide.

Moreover, if we commit our saving to buying shares in a corporate business, the income that business produces for us is separately taxed under the corporate income tax; if distributed to us, those dividends are taxed to us again under the individual income tax. If instead the business retains and reinvests those after-corporate-income-tax earnings and the market value of our shares goes up to reflect the business's increase in earning power, that increase in value will also be taxed if and when we sell the shares.

If, notwithstanding these tax barriers to our saving and investing, we accumulate even a modest amount of assets during our lifetime, that accumulated saving becomes subject to extremely heavy transfer – estate and gift – taxes when transferred by gift or at death.

And paralleling this piling of federal tax after federal tax onto our saving and the income it produces, many of our states impose the same sort of taxes on the same income, the same saving, the same returns on that saving, and the same estates transferred by gift or at death, as well as some taxes, e.g., property taxes, imposed only by the states and their subdivisions. Our friend from outer space would shake its head in utter amazement.

Our income taxes also include features that distort our choices about how we save, where we invest, and the types of capital into which we direct our saving. In a few cases, such tax provisions are subsidies that lower the cost of the saving and investment relative to what these costs would be in a tax-free world. For the most part, however, these distortions are produced by tax provisions that differentially penalize saving and investment compared with consumption uses of income.

The existing income tax also exerts a severe bias against innovative, high-risk entrepreneurial activity compared with business-as-usual activities. Economic progress depends critically on the willingness of people to undertake cutting-edge enterprises and on their ability to attract saving to finance the creations of such enterprises and their growth. By their very nature, such business ventures tend to be much riskier – to face much larger possibilities of losses – than established businesses pursuing more conventional activities. The riskier is the investment or business, the greater has to be the reward to justify the undertaking. With graduated rates, the income tax takes a bigger and bigger bite out of the these rewards the more successful is the investment or business venture. The existing income tax also imposes limits on the current deductibility of business losses and those from the sale of capital assets. In combination, these features slant the income tax severely in favor of the nonventuresome and against the highly innovative business, and increase the risks and the costs confronting the entrepreneur.

In these and many other ways the existing tax system erects barriers to economic progress. It is a testimonial to the vigor and strength of American workers and businesses and to the free market system that the nation has made continuing and substantial advances, despite the obstacles thrown up by our long-standing anti-growth tax policies. The goal of tax restructuring should be to replace the existing income taxes with a tax system that will unleash the growth impulses in American households and businesses.

A Tax System For a Dynamic, Free America

Creating a new federal tax system to replace the unacceptable system now in place must be guided by fundamental principles, rather than by the ad hoc approach that has characterized past reform efforts. The core objectives of tax restructuring are (1) to achieve a tax structure that effectively performs the basic function of taxation in a free society and (2) does so with the least adverse effects on the growth-generating activities of households and businesses.

All taxes are paid out of income ... The correct concept of income is the common sense definition: all of one's revenues less the full amount of the costs one necessarily incurs to produce those revenues.

Telling us what we must pay for government

As discussed earlier, the core function of taxation in a free society like ours is to tell the people what price they must pay for the activities and services they want the government to provide. To perform this function effectively, the tax system must have certain essential attributes. One of these is that taxes must be visible to the people who pay them. If we aren't aware of paying a tax or of how much we pay, clearly the tax isn't telling us anything about what we must pay for government.

To satisfy this requirement, the nation should rely on taxes that are paid directly by the *real* people on whom their burden rests. This means that we should minimize the use of taxes on corporations. The burden of those taxes, borne initially by the people who own the corporations' shares, ultimately is imposed as well on people as employees, in the form of fewer job opportunities, lower productivity, and lower real wages, and by people as consumers. In the final analysis, it is people, not corporations, that pay the tax. Notwithstanding that only real people pay corporate taxes, few of them are aware of the fact that they shoulder this burden. Such taxes, therefore, fail to perform the basic function of taxes, in addition to erecting barriers to employment and economic growth.

The new tax system should rely principally on taxes we are acutely conscious of paying. Many of the taxes that real people pay directly nonetheless escape their awareness. Whatever taxes may be included in a restructured tax system, we should insist that they are levied in a way that makes those who pay them keenly aware of doing so.

A tax system that performs the core tax function effectively will require the largest possible number of people in the society to pay something in taxes. Responsibility for paying for government and for deciding how much of what kind of government we want should be shared by all of us, excluding only those of us who are truly destitute. One of the most important determinants of whether a tax system is acceptable is whether it is levied on as many of us as possible.

True tax fairness calls for imposing the same marginal rate of tax on every person's income.

Defining income correctly

All taxes are paid out of income. An acceptable tax system for a free and progressive society recognizes this fact and the corresponding necessity to define income correctly for tax purposes. The correct concept of income is the common sense definition: all of one's revenues less the full amount of the costs one necessarily incurs to produce those revenues. This real world view leaves no room for differentiating on the basis of where the revenues came from and what type of costs were incurred or who earned the income. Moreover, this concept of income dictates that costs of generating revenues are taken fully into account when they are incurred, not spread over time in a mistaken effort to match their timing with the timing of receipts. Accordingly, the amount a business spends for machinery, for raw materials, for additions to its inventory, for the labor services it employs, etc., should be deducted in full when the expenditures are made. All such outlays, in other words, should be expensed instead of capitalized and written off over a period of years, as under existing law.

Interest paid on borrowing by businesses or individuals should be deductible, and the interest received should be taxable to the lender. This guideline should apply in the case of mortgages on one's residence, as well as in the case of non-mortgage borrowing.

Only income over which one retains control should be treated as one's income for tax purposes. You should not include in your taxable income other taxes you have paid, either to the federal government or to another taxing jurisdiction. It is a basic tax principle that you shouldn't pay tax on taxes. Neither should you include in your taxable income amounts such as alimony, child support, or damages that a court of law has ruled you must pay to someone else. Moreover, if you give some of your income to some one else, you should exclude that amount from your income and the other person should include it in his or hers.

[T]he multiple layers of income taxes on saving and investment that characterize existing law must be eliminated.

Application of this principle requires the deductibility of charitable contributions. When you make a charitable contribution, you relinquish control over that amount of your income and assign it to someone else. You should, therefore, be able to deduct any such contribution. The recipient would take the contribution into its income but is likely to spend what it receives on deductible research, wages, and other costs it incurs in carrying out its charitable activities, including the donations and gifts it makes to its beneficiaries. All of these payments would be deducted by the charitable organization and included in the income of the recipients, some of whom will be too poor to owe tax.

Graduated tax rates have the effect of making it more and more costly to earn additional income, whether by saving or by increasing one's personal effort, the more productive a person has been.

The same basic principles dictate that if the income is yours to use as you choose, it should be included in your taxable income and you should pay the tax due on it. The tax visibility, tax consciousness requirement for a tax that does its core job of telling us what we must pay for government rules out having someone else make the tax payment on your income. Proposals to exclude from your taxable income the interest, dividends, or other income you earn on your investments and to deny the corporations making these payments a deduction for such payments are clearly at odds with tax visibility and tax consciousness.

Treating everyone equally and fairly under the tax law

The acceptable tax for a free America must satisfy the public's tests of fairness. It is widely assumed that the American people are convinced that tax fairness means using the tax system to redistribute income and wealth from the well-to-do to the poor, but there is little if any factual basis for this assumption. It is doubtful that people of modest means would agree that it is fair to tax them at a higher rate than their next-door neighbors whose income is somewhat less. This mistaken income-redistribution notion of fairness can only be foisted on the public by comparing the extraordinarily wealthy with the tragically poor, comparisons that have no operational relevance in the design of a tax system.

The appropriate fairness standard should take account of the facts of economic life in a free market economy. With very few exceptions, the income a person receives closely matches what that person has contributed to the economy's total output and income. Rich people are rich because they are more productive than people who are less rich, not because they've deprived poorer people of the income or wealth they've earned. Imposing a higher rate of tax on a person the greater that person's productivity satisfies no meaningful criterion of public policy. Indeed, taxing away a larger share of the income of the rich to transfer income to the less rich or the poor is utterly unfair.

Much of the complexity in the existing tax system, giving rise to its extraordinary manpower and dollar costs of compliance and enforcement, is the result of legislative efforts to differentiate tax liabilities on the basis of attributes, characteristics, and activities of taxpayers that should not be considered relevant for tax purposes ... The [new] tax system would be virtually free of these complexities, hence would entail much lower compliance and enforcement costs.

True tax fairness calls for imposing the same marginal rate of tax on every person's income. To insure that no significant amount of tax is imposed on the truly destitute, some personal exemption or standard deduction should be provided to create a zero-rate bracket of income. On income in excess of that zero-bracket amount, however, the same tax rate should apply.

A system conducive to saving and growth

The new tax system should to the least possible extent distort the incentives that are cast up by the operation of the free market price system. Of particular importance, taxes should not raise the cost of using our income to save and invest in order to have more income than otherwise in the future, compared with the cost of consumption uses of income. Similarly, taxes should not increase the cost of saving in one way compared to another or of investing one's saving in a particular form of capital compared to another or in one form of business organization compared to any other.

To achieve this result, so important to pursuit of the nation's growth objective, the multiple layers of income taxes on saving and investment that characterize existing law must be eliminated. There are two basic, equivalent ways of achieving this result. One approach is to exclude from taxable income the amount saved out of one's current income and to include in taxable income all of the returns realized on that saving. In this case, the returns would include the full amount of the proceeds from the sale of the assets in which the saving is invested. The alternative approach is to include the current income you save in your taxable income and to exclude from taxable income any and all returns that saving provides. Each of these approaches is exactly the same in terms of eliminating the extra tax on income that is saved. Each has some practical advantages and drawbacks, but the first conforms more closely than the latter with the principle that the costs of producing revenues should be deducted in the year in which the costs are incurred.

No one tax structure may be uniquely qualified to meet the goals of a fairer, simpler, less growth-obstructing tax system ... Nevertheless, the prospects for finding the right mix of provisions are bright.

Under either approach, capital gains as such would vanish as a tax issue. This is obvious in the case of the second approach, since *none* of the proceeds from the disposition of one's assets would be subject to tax. In the first approach, because the purchase of the assets would be expensed, i.e., excluded from taxable income, the assets would have no basis for tax purposes, and all of the sales proceeds would be properly included in taxable income. Since asset purchases would be deductible, reinvestment of the sales proceeds would provide rollover treatment – deferral of tax – until the assets were liquidated to finance consumption spending. To exclude the proceeds from the sale of the assets from taxable income or to subject these proceeds to a lower rate of tax would go beyond providing equal tax burdens on income that is saved and income that is consumed and would subsidize saving.

The same anti-distortion criterion dictates that only a single statutory tax rate should be imposed. Graduated tax rates have the effect of making it more and more costly to earn additional income, whether by saving or by increasing one's personal effort, the more productive a person has been. With graduated tax rates, the greater is one's income, the greater is the amount of consumption or leisure the person must give up to earn an additional dollar of after-tax income. There is no principle or social policy goal that validates such a bizarre result. An acceptable tax system, one that minimizes tax obstacles to economic progress, will impose its liabilities at a single marginal tax rate.

The new tax system should seek to minimize costs of compliance, administration, and enforcement. Much of the complexity in the existing tax system, giving rise to its extraordinary manpower and dollar costs of compliance and enforcement, is the result of legislative efforts to differentiate tax liabilities on the basis of attributes, characteristics, and activities of taxpayers that should not be considered relevant for tax purposes. In addition, statutory provisions governing depreciation and other capital recovery, capital gains and losses, and income obtained from foreign business operations and investments, among others, are the source of much complexity, compliance, and enforcement costs. The tax system meeting the standards presented above would be virtually free of these complexities, hence would entail much lower compliance and enforcement costs.

Conclusion

No one tax structure may be uniquely qualified to meet the goals of a fairer, simpler, less growth-obstructing tax system. Each of the tax restructuring proposals that has been advanced in the last few years has much to commend it in terms of the principles and attributes presented in this discussion. By the same token, however, each of the proposed new tax systems fails to meet one or more of the standards against which an acceptable tax system for the next century should be evaluated. Nevertheless, the prospects for finding the right mix of provisions are bright. There is every reason to believe that a new tax system, guided by the principles and standards discussed above, will help to achieve the goals of individual freedom and responsibility, greater and more sustained economic progress, and effective constraint on the growth and composition of government activity to which the nation aspires.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.