

1. Meet the Federal Income Tax

The tax code has become near incomprehensible except to specialists.

Daniel Patrick Moynihan, Chairman,
Senate Finance Committee, August 11, 1994

I would repeal the entire Internal Revenue Code and start over.

Shirley Peterson, Former Commissioner,
Internal Revenue Service, August 3, 1994

Tax laws are so complex that mechanical rules have caused some lawyers to lose sight of the fact that their stock-in-trade as lawyers should be sound judgment, not an ability to recall an obscure paragraph and manipulate its language to derive unintended tax benefits.

Margaret Milner Richardson, Commissioner,
Internal Revenue Service, August 10, 1994

It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is to-day, can guess what it will be to-morrow.

Alexander Hamilton or James Madison,
The Federalist, no. 62

THE FEDERAL INCOME TAX is a complete mess. It's not efficient. It's not fair. It's not simple. It's not comprehensible. It fosters tax avoidance and cheating. It costs billions of dollars to administer. It costs taxpayers billions of dollars in time spent filling out tax forms and

other forms of compliance. It costs the economy billions of dollars in lost output of goods and services from investments being made for tax rather than for economic purposes. It involves tens of thousands of lawyers and lobbyists getting tax benefits for their clients instead of performing productive work. It can't find ten serious economists to defend it. It is not worth saving.

How large are the costs of the federal income tax? They are larger than the federal budget deficit, larger than the Defense Department, larger than Social Security, perhaps as large as the combined budgets of the fifty states.

The tax system was better in 1986. Not perfect, but better. That year, President Ronald Reagan signed the landmark Tax Reform Act of 1986. It reduced the top marginal rate of taxation on personal income to 28 percent—down from an appalling 70 percent in 1980. It did away with more than \$100 billion in wasteful tax shelters. It dramatically improved incentives to work, save, and invest. But it barely lasted four years.

What happened? Two presidents undid the 1986 act. First was George Bush. He stood side by side with the bipartisan congressional leadership as he signed the Omnibus Budget Reconciliation Act of 1990. He proclaimed \$500 billion in deficit reduction over five years, half in higher taxes, including a 31 percent tax rate on “the rich.” Second was Bill Clinton. In his 1992 campaign for the White House, he promised a middle-class tax cut. Once in office, he, too, became captivated with “deficit reduction.” On August 10, 1993, he signed the Omnibus Budget Reconciliation Act of 1993, which

passed the U.S. Congress by exactly one vote in the House of Representatives. It promised another \$500 billion in deficit reduction, half in higher taxes, and included two higher tax rates on “the rich” to ensure that “those who benefited unfairly in the 1980s from the Reagan tax-rate reductions paid their ‘fair share’ in the 1990s.” In 1986, the income tax had just two rates: 15 and 28 percent. By 1995, it had five rates: 15.0, 28.0, 31.0, 36.0, and 39.6 percent.

The Declaration of Independence was in large measure a bill of particulars against British taxation. Its roots are found in the first Stamp Act Congress of 1766, when colonial leaders met to protest the British Stamp Tax. Other unpopular British taxes included a host of customs duties on paper, dyes, glass, and tea and a disguised tax on owners of property.

It’s time for another Declaration of Independence, this time from an unfair, costly, complicated federal income tax. The alternative, as we argue in this book, is a low, simple flat tax.

WHAT’S AHEAD

The object of this book is to persuade you that a low, simple flat tax is the best possible replacement for the current federal income tax. Here’s how we intend to proceed.

This chapter indicts the current federal income tax. In it we document the follow charges:

- The federal income tax is too complicated for ordinary taxpayers to understand.

- The federal income tax costs taxpayers more than a hundred billion dollars in compliance.
- The federal income tax costs the economy tens of billions of dollars in wasteful investments.
- The federal income tax is responsible for more than a hundred billion dollars in tax cheating.
- The federal income tax encourages lawyers and lobbyists to seek tax favors from Congress instead of earning an honest living.

Chapter 1 concludes with a brief history of the federal income tax.

Chapter 2 is all about “fairness.” We have learned, during the past fifteen years, that the most dangerous critique of the flat tax is the emotionally laden charge that it’s not fair. We intend to dispose of this false, mistaken charge once and for all. Indeed, we claim that the flat tax is the fairest tax of all. To show that the flat tax is indeed fair requires a thorough discussion of tax terminology. We define such crucial terms as *tax base*, *marginal tax rates*, *tax burden*, *consumption taxes*, and *equity*, among others. In chapter 2 we also show that the flat tax is the only proposed replacement for the current income tax that has received support from opposite ends of the spectrum: in politics, from Jerry Brown and Dick Armey; in the media, from the *New York Times* and the *Wall Street Journal*. Thus, on the issue of a well-designed tax system, our flat tax commands a broader array of support than any other proposal.

Chapter 3 spells out the mechanics and logic of the flat tax. We would replace hundreds of forms and thousands of regulations with two postcard-sized tax forms, one for business firms and the other for wage and salary earners. Our flat tax solves many tax problems that have challenged academics and politicians for years: it eliminates double taxation; it improves capital formation; it correctly defines the tax base; it provides true simplification; it dramatically improves incentives; it removes millions of low-income households from the tax net; it lowers the costs of compliance; it puts a serious dent in tax cheating; it even reduces the adversarial stance of the Internal Revenue Service toward taxpayers. Chapter 3 also deals with the transition, how we get from the current federal income tax to the flat tax, including such issues as the loss of deductions for home mortgage interest and charitable contributions and the replacement of complicated depreciation schedules with straightforward expensing, 100 percent immediate write-off, of all investment.

Chapter 4 addresses the big economic issues. Adopting the flat tax will, first and foremost, increase economic growth; in other words, the economy will increase its output of goods and services. It will increase investment by promoting capital formation. It will create new jobs and increase real wages by improving incentives to work. It will reduce interest rates immediately. It will reduce future budget deficits. It will make Americans more respectful of their government. It will even reduce crime because taxpayers will become more hon-

est in filing their annual tax returns—a useful side effect of an intelligent approach to taxation.

Chapter 5 is a handy collection of questions and answers about the flat tax. During the past fifteen years we have presented our plan to more than a thousand audiences. We have heard, we believe, almost every single conceivable objection or concern that can possibly be raised about the flat tax. Here we assemble brief answers to the most frequently asked questions.

For specialists, we include an appendix with the language of our flat-tax law and a section on notes and references.

A NIGHTMARE OF COMPLEXITY

President Jimmy Carter called the income tax “a disgrace to the human race.” He was right. The best way we know to document Carter’s charge is to take you on a tour of the Law School Library at Stanford University. It’s a bit unnerving, as it reveals the nightmarish complexity of the income tax.

The Internal Revenue Code consumes enormous quantities of ink and paper. West Publishing Company, one of the official publishers of the federal tax code, published the 1994 code in two volumes. Volume 1 contains sections 1 to 1,000 (1,168 printed pages), and volume 2, sections 1,001 to 1,564 (210 pages). The table of contents displays 205 separate headings. West also prints a five-volume series entitled *Federal Tax Regulations 1994*, an essential companion to the tax code. Vol-

Meet the Federal Income Tax

7

umes 1–4, some 6,439 pages of fine print, apply to the income tax.

The *Code* and *Regulations* defy ready comprehension. A massive industry has grown up to service tax scholars, tax lawyers, tax planners, tax filers, tax accountants, and even tax collectors.

The Internal Revenue Service (IRS), the agency charged with collecting federal income taxes, has its hands full. It has in service about 480 tax forms—the best known of which is Form 1040—and has published another 280 forms to explain to you, the taxpayer, how to fill out the 480 forms. All told, it takes thousands of pages to explain the forms. Three publishing firms help out, each issuing three volumes of forms and explanations, each taking up almost a foot of shelf space.

Pausing in our tour, for the moment, we should note that the IRS sends about eight billion pages of forms and instructions a year to more than one hundred million taxpayers. Placed end to end, these pages would stretch 694,000 miles, or about twenty-eight times around the earth. The IRS despoils the environment, chopping down about 293,760 trees to print all of this paper. A postcard-sized tax form would go a long way toward saving America's forests.

The tour, in all, covers some 336 feet of shelf space. In addition to the laws and regulations, there are volume upon volume of tax court cases, journals for professors and practitioners, and books commenting on every conceivable aspect of federal income taxation. One benefit of our book is that it gives you a reasonably complete

list of sources on federal income taxation (see the notes and references).

There are dozens of textbooks explaining the federal income tax along with an ever-increasing number of annual tax preparation guides. There are such specialized volumes as *Bender's 1994 Dictionary of 1040 Deductions*, which contains a nineteen-page double-column index to refer to items in the text. No wonder the ordinary citizen feels overwhelmed and threatened by the Internal Revenue Service. This is no way to run a tax system.

By the way, the price of a share of stock in H & R Block, the nation's leading tax preparation firm, increased by 20 percent in the first month following passage of the 1993 federal tax increase.

WHAT THE INCOME TAX COSTS THE AMERICAN PEOPLE

It's hard to imagine that any group of experts, however hard they tried, could design a worse tax system than the one produced by our Congress. The main beneficiaries of the income tax appear to be, first, the members of the two tax-writing committees, the Senate Finance Committee and the House Ways and Means Committee. Their chairmen lead their respective chambers in campaign contributions; other members of the two committees typically collect twice as much in contributions as their colleagues in the Senate and House. Second, members of Congress share the benefits of the federal income tax with more than seventy thousand highly paid

lobbyists in Washington, D.C., and several hundred thousand lawyers, accountants, sellers of tax shelters, software suppliers, and others who earn a living on the tax system.

The federal income tax imposes two huge costs on the American people: direct compliance costs (record keeping, learning about tax requirements, preparing, copying, and sending forms, commercial tax preparation fees, audits and correspondence, penalties, errors in processing, litigation, tax court cases, enforcement and collection) and indirect economic losses from disincentives—economists call these “deadweight losses,” “excess burdens,” or “welfare costs”—due to the reduction in output incurred by the complicated, high-rate federal income tax (reduction in labor supply, reduction in capital formation, reduction in new corporate formations, reduction in new business formation, failure to expand existing businesses, investments designed to reduce taxes rather than produce income, commonly known as tax avoidance, and tax evasion, just plain cheating).

Studies of the *burden of the tax system*, what it costs the economy to administer the federal income tax, are relatively new. Studies of *tax burdens*, who pays what share of income taxes, are well established. This explains, in part, the obsession with issues of fairness and why every proposed change in federal income taxes is judged in terms of who wins and who loses.

In recent years, a growing spate of studies of the burden of the tax system, both in direct compliance costs and in indirect economic losses to the economy, reveals a disturbing result: The total costs are much

higher than anyone has ever imagined. To give but one example, about fifty years ago, the Internal Revenue Service estimated the compliance burden of individuals at 1.2 percent of federal tax revenues; in 1969, the figure was raised to 2.4 percent of income tax revenues; in 1977, the Commission on Federal Paperwork raised the estimate to 3 percent; and in 1985, an IRS-commissioned study by Arthur D. Little concluded that the 5.4 billion hours of work expended in the taxpayers' paperwork burden for filing business and individual returns amounted to a staggering 24.4 percent of income tax revenues, the incredible sum of \$159 billion. (These results, and the results of other academic and professional studies, are summarized in a 1993 book by James L. Payne, *Costly Returns*.)

The science of estimating compliance costs and indirect economic losses is, as noted, relatively new, and findings differ widely. Payne, for example, estimated the total costs of the federal tax system in 1985 at \$363 billion, or 65 percent of actual collections. Others have reached higher costs in some categories of compliance and lower costs in others. In this chapter, we try our hand at estimating these costs, some directly and others by citing the best evidence available.

DIRECT COSTS OF COMPLIANCE

Let's take the most familiar items, federal income tax Forms 1040, 1040A, and 1040EZ. In 1994, the IRS reported preliminary statistics on 1992 returns. Altogether, taxpayers filed 113.8 million returns; of these, 65.7 mil-

lion were the full Form 1040 (about 58 percent), 28.9 million Form 1040A (25 percent), and 19.1 million Form 1040EZ (17 percent). These percentages have been stable since 1990. Now turn to page 4 of the Internal Revenue Service *1993 1040 Forms and Instructions*, “Privacy Act and Paperwork Reduction Act Notice.” It includes a section titled The Time It Takes to Prepare Your Return. Here’s what it says.

We [the IRS] try to create forms and instructions that are accurate and can be easily understood. Often this is difficult to do because some of the tax laws enacted by Congress are very complex. For some people with income mostly from wages, filling in the forms is easy. For others who have businesses, pensions, stocks, rental income, or other investments, it is more difficult.

Page 4 includes a table titled Estimated Preparation Time, which is the average time required of taxpayers. We have reproduced it as table 1.1.

The table, of course, is incomplete. It omits numerous forms. The standard 1040 booklet includes, in addition to those in the table, Form 4562, Depreciation and Amortization, which includes eight pages of instructions in the 1040 booklet, and Form 8829, Expenses for Business Use of Your Home. The IRS estimates that it takes more than forty-six hours to complete Form 4562 and about two and a half hours for Form 8829. (Perhaps to avoid frightening taxpayers even more, the Form 1040 booklet does not include such commonly used forms as 2106, 2119, 2210, 2441, 3903, 4868, 5329, 8283, 8582,

Table 1.1 Estimated Preparation Time

<i>Form</i>	<i>Record Keeping</i>	<i>Learning about the Law or the Form</i>	<i>Preparing the Form</i>	<i>Copying, Assembling, and Sending the Form to the IRS</i>
Form 1040	3 hr., 8 min.	2 hr., 47 min.	3 hr., 44 min.	53 min.
Sch. A (1040)	2 hr., 32 min.	24 min.	1 hr., 9 min.	27 min.
Sch. B (1040)	33 min.	8 min.	17 min.	20 min.
Sch. C (1040)	6 hr., 26 min.	1 hr., 10 min.	2 hr., 5 min.	35 min.
Sch. C-EZ (1040)	46 min.	4 min.	18 min.	20 min.
Sch. D (1040)	51 min.	49 min.	1 hr., 19 min.	48 min.
Sch. E (1040)	2 hr., 52 min.	1 hr., 6 min.	1 hr., 16 min.	35 min.
Sch.EIC (1040)	40 min.	19 min.	50 min.	55 min.
Sch. F (1040): Cash Method	4 hr., 2 min.	34 min.	1 hr., 14 min.	20 min.
Sch. F. (1040): Accrual Method	4 hr., 22 min.	25 min.	1 hr., 19 min.	20 min.
Sch. R (1040)	20 min.	15 min.	22 min.	35 min.
Sch. SE (1040): Short	20 min.	13 min.	10 min.	14 min.
Sch. SE (1040): Long	26 min.	22 min.	38 min.	20 min.

Source: Internal Revenue Service, 1993 *1040 Forms and Instructions*.

8606, 8822, and 8829. If you don't need these forms, better you should remain ignorant of them.) A full accounting would require detailed knowledge of every tax form, how many of each schedule were attached, and how much estimated time each schedule requires. Nor have we yet mentioned business taxpayers, who must cope with a much heavier reporting burden.

To the arithmetic. The IRS estimates that the average total time to complete and file Form 1040A is six hours, thirty-three minutes. The time expands appreciably when it is necessary to attach any of Schedules 1 (Interest and Dividend Income), 2 (Child and Dependent Care Expenses), and 3 (Credit for the Elderly or Disabled) or any of the forms for EIC (earned income credit), IRA (individual retirement account) distributions, pension income, or Social Security benefits, so a reasonable average time is probably about eight hours. The time for Form 1040EZ is one hour, fifty-two minutes.

Few people treat filing tax returns as leisure activity; most people we know would rather fish, ski, or watch television. So we need to make some assumptions about the value of the time individuals expend complying with taxes.

For those who file Forms 1040EZ and 1040A, we use a conservative figure—the federal minimum wage of \$4.35 an hour. For those who file Form 1040, we use the average hourly earnings in private, nonagricultural industry of about \$10.80. These numbers are well below IRS costs of \$21 an hour to process tax-related information back in 1985, which would be much higher to-

day, or Arthur Andersen's employee cost of \$35 an hour, again from 1985.

For those who file Form 1040EZ: 19.1 million taxpayers times one hour, fifty-two minutes, times \$4.35 an hour totals \$155 million. For filers of Form 1040A: 28.9 million taxpayers times eight hours times \$4.35 an hour totals exactly \$1 billion.

For filers of Form 1040, the calculations require a rough estimate of the average time per return. To be conservative, we will add up the times shown in IRS Form 1040 (minus any double counting) and add an additional 50 percent to include forms not listed (the depreciation form alone amounts to another forty-six hours). Our arithmetic sums to about 45.0 hours, which we adjust up to 67.5 hours for unlisted forms. Adding up: 65.7 million taxpayers times 67.5 hours times \$10.80 an hour equals almost \$48 billion. Altogether, compliance costs for individuals in 1993, at reasonable estimates, amounted to about \$50 billion. Arthur Little's 1985 estimate was \$51 billion, derived from 1.8 billion hours of work at an average cost of \$28 an hour. (In 1985, eleven million fewer returns were filed compared with 1992. Also, the 1990 and 1993 tax increases significantly increased reporting requirements.) Our number, therefore, is extremely conservative.

The Arthur D. Little study concluded that twice as many hours were spent complying with business tax returns. It used a figure of \$28.31 as the hourly tax compliance cost for business taxpayers in 1985. The arithmetic sums to \$102 billion in business tax compliance costs in 1985. The Little study included commercial tax

preparation charges in its estimate of business taxpayer costs. (However, it did not include the costs of tax planning.) Even half of Little's business compliance cost estimate, without any adjustment for inflation or an increase in the number of business firms in the United States, amounts to more than \$50 billion. Any fair estimate of individual and business compliance costs must result in a twelve-digit number, more than \$100 billion.

It's painful to add in the other costs of compliance. They include audits and correspondence, litigation, forced collections, and the unquantifiable emotional costs of coercion, especially in the face of high error rates in IRS proceedings.

Every year, the IRS undertakes more than one million audits, which are heavily focused on high-income taxpayers and large corporations. The cost to taxpayers of office, field, and mail audits easily exceeds \$1 billion, with assessed penalties another \$2 billion. The IRS's own annual reports admit a high rate of errors, and the IRS telephone information service gives out wrong answers as much as one-third of the time. A General Accounting Office study of the IRS's business nonfiler program found an error rate of 75 percent. Keep in mind that the government does not bear the cost of its errors; they are shifted onto taxpayers who must defend themselves against IRS mistakes. Payne documents more than a dozen government investigations of IRS mistakes. The important numerical finding is that the private-sector burden of initial enforcement contacts is higher than the total budget of the IRS. Here the taxpayer pays twice: once, to pay IRS salaries and overhead, second,

to defend himself from the IRS. Estimates of tax litigation stemming from IRS contacts are again in the multibillion dollar range.

To be fair, the IRS is responsible for ensuring compliance with the tax code. Those who make mistakes or deliberately misreport income and deductions should be required to meet their lawful tax obligations. Therefore, a portion of these compliance costs is a legitimate burden of taxpayers. The difficulty arises from the complexity of the tax code. It's easy to make mistakes, even when taxpayers purchase electronic tax preparation programs. In addition, frustrated taxpayers are not likely to take extreme care with each of the hundreds of entries in as many as a dozen or more forms. Nor are taxpayers happy with high marginal rates, reaching over 40 percent, that result in the government taking a huge share of the fruits of their work. A simple system of low tax rates would remedy a good part of this.

The studies of compliance summarized in Payne's book were completed before the advent of computer software that permits taxpayers to record and save tax-related information throughout the year and that speeds up the entry and calculation of figures and the printing of final returns. No one has yet estimated how much time is saved from the use of tax preparation computer programs. It may be considerable. But some of these savings are offset by the purchase price of the software.

On balance, we think it fair to estimate compliance costs imposed on individuals and businesses at a minimum of \$100 billion but probably higher.

INDIRECT COSTS

Estimating the indirect costs of the federal income tax is a more challenging proposition than adding up direct compliance costs, because indirect costs, by their very nature, are not precisely knowable. Who can estimate how many businesses were not formed because of high tax rates and elaborate reporting burdens? Who can estimate how many owners were unwilling to expand their business activities? Who really knows the size of the underground economy? Who can compute how much larger the economy would be if every dollar invested in a tax shelter went into productive investment? Who can predict how many wives, husbands, or others might enter or leave the work force with each rise or fall in tax rates? How many entrepreneurs have really been discouraged because of unnecessary capital gains taxes? In short, what would the American economy look like if the current complicated, multiple-bracket, high-rate tax system were scrapped in favor of a low, simple flat tax?

These and related topics have increasingly come under the scrutiny of economists, lawyers, and even the IRS. We propose to make a pass at the total by relying, again, on the best available scholarly evidence.

The first component of these lost economic benefits could be called *disincentive costs*. A proper understanding of disincentive costs first requires some additional description of the current income tax. The federal income tax consists of two separate taxes: the corporation tax and the personal income tax. The two are not integrated (as they are in many countries). But it is impor-

tant to understand, in a conceptual sense, that corporations do not pay taxes. Rather, corporations are convenient legal devices that earn income and pay taxes on behalf of their shareholders. When a corporation files its annual income tax return, it pays profits tax on behalf of the firm's owners. But when the firm pays its shareholders dividends from its after-tax profits, the same stream of income is then subject to double taxation. The effective tax rate is the sum of the corporate tax rate plus the individual tax rate on ordinary income multiplied by the amount of dividends paid out plus the individual capital gains rate multiplied by the retained earnings. The retained funds increase the value of the shares and so generate capital gains. When the federal government taxes capital gains, it also constitutes double taxation of the same stream of income.

Moreover, under the current tax system, interest is deductible. This means that firms have an incentive to borrow, and deduct the costs, and a disincentive to issue equity because returns on equity are double taxed. This is not a healthy way to run a corporate sector.

Any increase in personal tax rates has a doubly pernicious effect because it simultaneously reduces returns from investment in ownership of the thousands of firms that trade on all the country's stock exchanges.

Since the 1970s, a number of prominent economists have attempted to identify the disincentive costs associated with taxation. The list includes Charles L. Ballard, Michael J. Boskin, Edgar K. Browning, Roger H. Gordon, Jane G. Gravelle, Arnold Harberger, Jerry A. Hausman, Dale W. Jorgenson, Laurence J. Kotlikoff,

Burton G. Malkiel, John Shoven, Charles E. Stuart, John Whalley, and Kun-Young Yun. Some tried to estimate the disincentive cost of taxation on labor, when people stop working or work less, some on capital gains, when people stop saving or investing, some on corporate formation and growth, when new firms are not established or when existing firms do not expand, and some on all federal taxation, which affects all forms of economic activity.

Most of these studies try to estimate the cost of raising one additional dollar of taxes from the existing tax level and system, in other words, how much lost output in terms of labor supply, capital supply, or total output is due to each new dollar of taxes. As expected, results vary widely. First, scholars study different taxes. Second, they use different models. Third, they make different assumptions about how those who supply capital, entrepreneurship, or labor will respond. The studies identify disincentive costs, as a percentage of taxes collected, that range from a low of 24 percent (taxes on labor) to an astonishing 151 percent (on the corporate income tax). Two studies that attempt to estimate the disincentive costs of all federal taxes, including Social Security, calculate a range of 33 to 46 percent of total federal taxes.

It's hard to translate these results into dollars because these studies try to estimate the disincentive costs of additional taxes imposed on the current system, not the total disincentive costs of the entire tax system or any part of the tax system. We try to get a better handle on total costs in the paragraphs that follow; for now, we want to observe that every scholarly study on this subject

concludes that there are strong disincentive costs associated with the current tax system. No one says that collecting taxes is cost-free to the economy. Every time the federal government takes one more dollar in taxes from private hands, it discourages another thirty cents of additional output.

Let's apply the conservative finding of 30 percent of disincentive costs associated with new taxation to the current system. In 1990 President Bush signed legislation designed to raise about \$250 billion in new taxes over five years. President Clinton repeated the exercise in 1993. On the 30 percent disincentive cost formula, the two tax increases will cost the economy \$150 billion in lost output, which is considerably larger than total corporate income taxes. It is more than all federal health expenditures. It is larger than total Medicare outlays. It's within hailing range of annual federal interest outlays to service the national debt.

Looked at in this way, the \$500 billion in new taxes amounts to a total tax increase of \$650 billion on the American economy. The truth, however, is that government collections of new taxes rarely meet projections. The reason is that taxpayers are not docile sheep. Rather, most are clever, enterprising managers of their own personal affairs, quick to take advantage of legal ways to reduce taxes, known as tax avoidance or shelters, while some are inclined to cheat after every new tax increase. This takes us to our next segment.

Tax Evasion

Tax evasion is a polite term for cheating, the failure to pay what the tax law requires. The IRS, which has studied tax evasion for a long time, relies on a periodic, in-depth tax audit known as the Taxpayer Compliance Measurement Program, TCMP, to estimate how much is owed but not collected in taxes. The TCMP breaks down unpaid taxes into the “legal sector tax gap” and the “illegal sector tax gap.” Failure to pay taxes on lawful activity constitutes about 90 percent of unpaid taxes, despite the high level of publicity for tax cheating on income from illegal drugs, gambling, prostitution, and other illicit activities. Most unpaid taxes stem from dishonest reporting of honest activity.

How large is the figure and what are the chief causes of tax evasion? IRS estimates range from about \$60 billion in 1973 to \$76 billion in 1981 to well over \$100 billion in the mid to late 1980s. In May 1994, the General Accounting Office, the U.S. government’s watchdog agency, reported that the IRS failed to collect \$127 billion in taxes in 1992, about 18 percent of what taxpayers owed. What are the main sources of cheating? In order of importance, they are underreporting income (about 70 percent), overstating deductions (17 percent), failing to pay obligations (9 percent), and failing to file (4 percent). If correct, these numbers are so large that the federal budget would have been in balance throughout the 1970s and 1980s if the tax code had collected every penny lawfully owed to the government. Given the prominence that some politicians attach to deficit

reduction, reforming the federal income tax as a means to reduce the deficit makes more sense than adding new and more-complicated levies to the current system.

In 1983 the American Bar Association (ABA) formed a Commission on Taxpayer Compliance, consisting of lawyers (including past IRS commissioners), certified public accountants, social scientists (including Rabushka), and business executives. In July 1987, the commission published its findings on the causes of “tax gap” and how to close it. We quote from page 8 of the report: “Explanations of individual noncompliance frequently focus on high tax rates, the perceived unfairness of the tax system and the complexity of compliance.”

We have so far discussed the complexity and costs of compliance; in chapter 2 we turn to “unfairness” and the consequences of high tax rates. The commission warned that the moral fabric that sustains our tax system, one of voluntary tax assessment and reporting, is fraying badly, meaning that citizens are increasingly willing to condone tax cheating among friends, relatives, and business associates.

The commission also minced no words about the benefits of reducing tax rates. It stated that “the Tax Reform Act of 1986, by sharply decreasing marginal tax rates and eliminating many tax preferences, should help to undercut many of the common justifications for tax cheating.” As noted at the outset of this chapter, the 1986 act barely lasted out the decade. The 1990 and 1993 tax increases have restored the common justifications for tax cheating by increasing rates and creating new preferences.

To summarize, the perceived unfairness of complex and high tax rates deprives the IRS of more than \$100 billion in lawfully owed taxes. This means that a fair, simple, low-rate tax system would collect far more in taxes than the current complex, high-rate system. The best remedy for future deficit reduction lies in replacing the current code with a simple, low-rate system, not in imposing new or higher taxes. In chapter 3 we make the case for the flat tax.

Taxpayers should not believe that Congress has their interests at heart. In late September 1994, Congress approved an additional \$2 billion over the next five years for the Internal Revenue Service to “crack down on tax cheats.” The U.S. government believes that more money spent on enforcement would collect an additional \$9.2 billion in revenue. Perhaps someday the government will recognize that lower tax rates are a better solution to taxpayer compliance than stricter enforcement.

We should be clear on one point. The billions that are not paid in taxes, which stay in the hands of taxpayers, add to private welfare. Tax cheating may mean that the federal government has to borrow more than it would like to balance its books, but it doesn’t necessarily make the individuals who cheat substantially worse off. The economy as a whole, and all of its participants, however, would be better off if federal borrowing were substantially reduced or eliminated—especially if a balanced budget stemmed from the greater efficiency of a low, simple flat tax rather than from an increase in tax rates or new taxes. In addition, there is a large social

cost from turning a nation of generally honest residents into criminals, as recognized in the ABA report. If residents won't obey the tax laws, it becomes much easier to disregard other forms of lawful authority. This cannot be healthy in the long run.

Tax Avoidance

Tax avoidance does not sound nice, but it is perfectly legal. The basic concept is to keep taxes as low as possible by taking advantage of every conceivable technicality in the tax law. Sometimes the line between tax evasion and tax avoidance becomes blurred, which is why many taxpayers pay fancy fees to lawyers and accountants to ensure that aggressive tax avoidance does not result in criminal charges for tax evasion.

The terminology of tax avoidance is extensive. We are all vaguely familiar with such words as *loopholes*, *tax shelters*, *tax expenditures*, *tax credits*, *exemptions*, *deductions*, *allowances*, and the like. How many opportunities exist in the federal income tax code to shelter income from taxation? The list appears in Special Appendix G, Tax Expenditures, in each year's federal budget. A tax expenditure is the government's estimate of the amount of money taxpayers would have paid into the IRS if specific items were not exempted from taxation. The number of such items rose from a relatively meager 50 in 1967 to 104 in 1981, and the estimate of lost tax revenues rose from \$37 billion to \$229 billion. By 1986, the figure had reached \$500 billion.

One popular loophole, or tax shelter, is the deduc-

tion for property taxes. Another is making gifts of appreciated stock to charities, whereby the market value can be written off against current income.

These common approaches to tax avoidance, which try to reduce taxes by taking advantage of specific deductions, are only part of the story. Most people don't even think of everyday deductions as tax avoidance. They believe that they are entitled to every category listed on Schedule A (Itemized Deductions) and on other forms, such as Schedule C (Profit or Loss from Business) and Form 4562 (Depreciation and Amortization).

What is the total value of all tax expenditures, or loopholes? In 1986, before the passage of the Tax Reform Act of 1986, tax expenditures totaled about \$500 billion. In 1989, this number fell to about \$400 billion. In part, the 1986 act closed certain loopholes, thereby eliminating some opportunities for tax avoidance. But the rate reduction in 1986, from a top bracket of 50 to 28 percent, meant that the total value of any deduction, such as home mortgage interest, was worth less. Whereas those in the top bracket received a tax refund of fifty cents on every dollar of mortgage interest deduction in 1985, that refund fell to twenty-eight cents after 1986. Lower rates, by themselves, reduce the total amount of tax avoidance.

Tax expenditures are back above \$500 billion. Higher tax rates on upper-income households have increased the value of all deductions and other tax benefits. At the same time, many tax shelters that were not worth getting into at a 28 percent top tax rate are again

attractive at top rates above 40 percent. Recent history suggests that the most constructive way to reduce or eliminate tax avoidance is to reduce tax rates to low levels, which encourages individuals to focus on productive work or investment rather than tax reduction measures.

Let's try to put a number on tax avoidance. We know that tens of billions of dollars flow into economic activities that receive preferential treatment from the tax code. If that money was entirely invested in productive economic activity, it would generate billions more in additional output.

Tax avoidance is a costly business to the U.S. economy. Some of the country's best minds in the legal and accounting professions work around the clock searching for loopholes in the tax regulations. Then they put together investment vehicles to exploit these loopholes, spend time and money to market tax-advantaged investment opportunities to potential investors, and finally stay on guard to fend off IRS challenges. None of this is productive activity in the sense of creating anything of value to society. Its sole objective is to help some taxpayers pay less in taxes. The real cost is the goods and services these talented people would have supplied if their lives were not devoted to mining the tax system, along with a better allocation of investment dollars to genuinely productive activities.

Sheltering income is a major industry. Tax lawyers number some 50,000 to 100,000; accountants who worry about tax-related issues number 100,000 to 200,000, and sellers of tax-advantaged investments sur-

pass 100,000. Tax planning has become a respected profession. A reasonable estimate is that as many as half a million people earn part or all of their living from helping taxpayers cope with, or take advantage of, the tax code. Using a conservative average figure of \$75,000 as annual income for members of the tax avoidance profession, taxpayers shell out as much as \$35 billion to support this industry.

Together we have presented our flat-tax plan on more than a thousand occasions since 1981. Jokingly, the most frequently asked question is how the country would cope with the white-collar recession that massive simplification of the tax code would create, throwing as many as 500,000 people out of work, not to mention the tens of thousands of part-timers who aid H & R Block and other tax preparation firms during tax-filing season.

There is another, often overlooked, cost of the current system. Businesses and individuals spend money and effort to influence Congress. The system of high rates coupled with hundreds of loopholes encourages factions to lobby for preferential treatment for themselves while persuading Congress to force other groups to pay more in taxes. But every group behaves this way. Overall, the economy is the loser, as more and more economic activities come under the sway of the tax system, either receiving special benefits or bearing disproportionate costs. A low flat tax on all income, to anticipate our argument, would eliminate this political game. It is an astonishing fact that there are more attorneys in Washington, D.C., than in New York City, whose pop-

ulation is triple that of the capital. Moreover, few attorneys in the capital practice law as we know it; most work at lobbying Congress and the executive branch. James Madison, who warned of the deleterious political effects of factions in *The Federalist* papers, probably regrets not having written a low flat tax into the U.S. Constitution.

Total Costs

It's time to sum the figures. Direct compliance costs, both in filing and in buying expert advice, exceed \$100 billion. Direct tax-planning costs—consulting with lawyers, accountants, purveyors of tax shelters, and financial planners—exceed \$35 billion. Revenue lost to the Treasury due to evasion exceeds \$100 billion. Distortions from pursuing tax-advantaged investments in the form of lost output may exceed \$100 billion. Finally, the lobbyists who inhabit Washington's K Street corridor probably cost the economy more than \$50 billion. Total individual and corporate income taxes for the 1993 fiscal year (October 1, 1992—September 30, 1993) were about \$625 billion. How politicians of both parties have been able to enact two major tax increases since 1990, supposedly to reduce future deficits, without first undertaking a complete reform of the current system must constitute one of the greatest political crimes of modern American history!

A BRIEF HISTORY OF THE
FEDERAL INCOME TAX

Two facts are paramount in understanding the present tax system. First, until the Great Depression of the 1930s, Americans held to the notion of a limited role for the federal government and correspondingly low taxes. In 1929, the federal government spent about 3 percent of the gross national product. (In sharp contrast, it spent almost 24 percent in 1993, an eightfold increase.) Save for periods of war or recession, revenues from customs and excises were sufficient to fund those activities widely regarded as proper federal functions. Excise taxes on domestic manufactured products and duties on imported coffee, tea, iron, cotton, and woolen goods provided the bulk of federal revenue.

Periods of war or recession, which strain federal finances, have led the government to seek additional sources of revenue. The Civil War, which produced an immediate need for new sources of funding, gave birth to the first American income tax. Enacted in 1861, it granted a \$600 exemption and imposed a 3 percent charge on incomes below \$10,000 and 5 percent on incomes above that level. The tax rates were increased to range from 5 to 10 percent in 1864. Receipts from this tax peaked in 1866, accounting for about 25 percent of federal revenue. The tax was allowed to lapse in 1872 on the grounds that it was an invasion of privacy and had a “socialistic tendency.”

Note three important features of the first U.S. income tax. Despite its prominence as a source of wartime

finance, the exemption of \$600 meant that poor and middle-class households paid no income taxes; only wealthy persons paid what was a highly progressive levy. Second, the top rate never exceeded 10 percent. Third, a modest income tax could generate large amounts of money. *The first U.S. income tax was a low, simple tax, with a large exemption.*

Members of Congress did not forget the chief lesson of the temporary Civil War income tax—its capacity to generate huge amounts of revenue. Between 1873 and 1893, they introduced, in vain, sixty-eight different income tax bills, ostensibly to reform and reduce federal tariffs but also to collect more money. Finally, in 1894, a 2 percent income tax on incomes over \$4,000 was attached to a tariff bill, which, after considerable controversy, became law. But, on a five-to-four vote, the U.S. Supreme Court declared the tax unconstitutional and in violation of Article 1, Section 2, paragraph 3, which says that all direct taxes must be levied among the states in proportion to their population.

Congress persisted. To circumvent the Supreme Court, it proposed the now famous Sixteenth Amendment on July 12, 1909, which was ratified by the states on February 29, 1913. It authorized Congress to tax incomes “from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” That year Congress enacted the first legal income tax, which provided a \$3,000 exemption for single persons and \$4,000 for married couples. The tax rate structure began at 1 percent on the first \$20,000 of taxable income. It imposed six “super

tax” brackets of 1 percent each on additional chunks of taxable income, reaching a top rate of 7 percent on taxable income over \$500,000. Corporate profits were taxed at a standard rate of 1 percent without provision for a surtax.

This first lawful federal income tax was truly the thin edge of the wedge. Only 0.4 percent of the population filed tax returns in 1913. The personal exemptions eliminated more than 99 percent of all individuals from the tax net. To put this tax in perspective, federal tax receipts in 1913 amounted to only 2.6 percent of the gross national product.

During congressional debate on the Sixteenth Amendment, proponents promised that the top rate could never conceivably surpass 10 percent. This “read my lips” pledge is one of the shortest-lived promises in U.S. tax history. The outbreak of World War I in 1914 led Congress to amend, almost overnight, the 1913 federal income tax. First, it reduced the large exemptions for single persons and married couples, thus extending the tax to one-fifth of the adult population. The income tax was transformed from a tax on the wealthy to a tax on the burgeoning middle class. Second, it raised the bottom rate from 1 to 6 percent, which previously only the wealthiest of the wealthy paid, and raised the top bracket from 7 to 77 percent on taxable income over \$1 million. Within five years of the ratification of the Sixteenth Amendment, the incipient federal income tax had shown its potential for what would become an insatiable congressional appetite for revenue.

But the times had not yet changed. During the

1920s, Secretary of the Treasury Andrew Mellon reduced the top rate from 77 to 25 percent even as total revenues, adjusted for inflation, increased 3 percent. Despite an apparent windfall to the rich, the system in fact became more progressive, that is, high-income taxpayers paid a greater fraction of total taxes than before. In 1921, taxpayers with incomes over \$100,000 paid 28 percent of total income tax revenues; in 1926, they paid 51 percent. Those at the bottom, with incomes less than \$10,000, paid 23 percent in 1921, declining to 5 percent in 1926. The main reason for the shift in the tax burden is that formerly high-bracket taxpayers shifted assets from tax-free bonds into productive outlets.

President Herbert Hoover could not leave well enough alone. The Great Depression slowed U.S. economic activity and reduced federal revenues. In pursuit of a balanced budget, President Hoover sponsored tax increases that raised the top bracket from 25 to 63 percent, while reducing personal exemptions. In the 1930s, the income tax became everyone's tax. With each reduction in personal exemptions, an ever-increasing share of the adult population was caught in the tax net.

World War II completed the transformation of what had once been a low, simple tax with a large personal exemption. The top bracket was increased to an astonishing 94 percent. This is as close to complete confiscation of personal income above a certain level as a tax system can get. The postwar Congress granted some relief to top-bracket taxpayers, lowering their rate from 94 to 85 percent. However, that relief was short-lived. Con-

gress raised the top rate to 91 percent during the Korean War, where it remained until the early 1960s.

President John F. Kennedy introduced legislation that reduced the rate structure from a range of 20 to 91 percent to an across-the-board range of 14 to 70 percent. In 1969, Congress modified the income tax so as to limit the top marginal rate on wages and salaries to 50 percent. In 1981, Congress passed President Ronald Reagan's three-year, 25 percent, across-the-board reduction, which replaced the 14 to 70 percent range with an 11 to 50 percent range for all types of income.

President Reagan was not consistent in his approach to federal income taxation. He signed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA 1982), which was designed to raise \$98 billion over three years, followed by the Deficit Reduction Act of 1984, to raise more than \$20 billion a year into the indefinite future.

In his second term, the president concentrated his political efforts on extending the rate reductions of the 1981 legislation. He succeeded with the Tax Reform Act of 1986, which, as previously noted, replaced the morass of multiple rates with two rates, 15 and 28 percent, and closed almost \$100 billion in loopholes, thereby broadening the tax base. Although the 1986 act dramatically reduced marginal tax rates, especially on the top tax bracket, it did not cut total taxes, and, almost immediately, Congress set about increasing total taxes. It enacted the Omnibus Budget Reconciliation Act of 1987 (OBRA87) to generate more than \$10 billion every year, the Omnibus Budget Reconciliation Act of 1990 (OBRA90), \$250 billion in new taxes over five years, and

the Omnibus Reconciliation Act of 1993 (OBRA93), \$241 billion in additional federal revenues over five years. President Reagan's top marginal rate of 28 percent is now President Clinton's top rate of 39.6 percent, a 41 percent increase in the top tax bracket.