

Taxing Ourselves

A Citizen's Guide to the
Debate over Taxes

fourth edition

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Over the last quarter of a century, tax policy has dominated economic policy in the United States. This is not surprising because no other economic issue (and perhaps no issue at all) more clearly defines the differences between the two major political parties. The tax policy era began with the presidency of Ronald Reagan, who made large tax cuts a linchpin of his campaign, presided over a historically large tax cut in 1981, followed in his second term by perhaps the most ambitious tax reform in American history—the Tax Reform Act of 1986—which significantly broadened the tax base by removing many deductions and loopholes in exchange for lower tax rates. Tax changes in 1990 and 1993 raised rates on upper-income taxpayers in an effort to reduce budget deficits. By the mid-1990s, a growing chorus of politicians and experts was calling for a fundamental overhaul—even complete abolition of the income tax and the Internal Revenue Service. Proposals to replace the income tax with a “flat tax” or a national sales tax began to appear in Congress and in the platforms of presidential hopefuls and gained unprecedented public attention.

Then the presidency of George W. Bush took Reagan’s approach a step further by enacting in 2001 large phased-in cuts in both the income tax and estate tax. This was followed in 2003 by reductions in the taxation of dividends and capital gains and an accelerated implementation of the tax cuts enacted in 2001. The 2004 act extended various tax cuts passed in 2001 that were scheduled to expire before 2010. By 2004, federal taxes as a percentage of gross domestic product (GDP) reached a forty-five-year low of 16.1 percent.¹

Because all of the tax changes enacted during the Bush administration are scheduled to expire in 2011, a future Congress will have to decide which of these changes to accept and which to reverse, so an important time of legislative reckoning looms. In addition, the

alternative minimum tax (AMT), which requires taxpayers to recalculate their tax bills using a completely different set of rules from the ordinary personal income tax and then to pay whichever of the two tax bills is larger, will apply to tens of millions of taxpayers by the end of this decade unless changes are made. Further in the future, an aging population and rising medical costs imply that promised spending on Social Security and Medicare will greatly exceed currently scheduled taxes for those programs, meaning that some combination of massive tax increases and substantial cutbacks in promised benefits will be required eventually.

Opinions differ on what the recent changes augur for the prospects of sweeping reform. Conservative commentator Bruce Bartlett conjectured that the tax changes of 2001 and 2003 were part of a long-term strategy to move the tax system toward something like the “flat tax” in gradual steps.² Len Burman of the Urban Institute offered the less sanguine opinion that the tax changes were part of a strategy to make the income tax such a mess that it would “collapse under its own weight.”³ Others argued that a truly fundamental tax reform would involve such difficult and politically unpopular trade-offs (and inevitably create winners and losers) that it might need to be accompanied by a significant tax cut as a sweetener. By giving away the tax cut before the reform and by adding ever more special preferences to the tax code, which develop their own constituencies, the prospects for anything deserving of the label “fundamental reform” might have grown dimmer.

In 2005, President Bush appointed an advisory panel to make recommendations about the federal tax system. Its report, issued in November of 2005, laid out two alternative tax systems—one a modified income tax and the other a hybrid of an income tax and a consumption tax. The report attracted little interest, and its recommendations have not prompted tax reform legislation.

Why the tax system attracts all this attention is no mystery. It is the aspect of government that directly affects more people than any other. Taxes at all levels of government take slightly less than one-third of people’s income. Although tax cuts and tax reform are appealing to many people, Americans also have a right to be apprehensive about big changes in the tax system. Some are concerned that tax cuts just create big budget deficits and trade better times now for much higher taxes, or even a financial crisis, later. Others are concerned that fundamental tax reform would trade the deductions and credits they rely on for lower tax rates and that rates would soon afterward climb back up

to where they were, leaving them worse off. In both cases, some people worry that big changes in the distribution of the tax burden will eventually shift more of it their way. Despite these concerns, there's plenty of frustration with the existing tax system and little doubt that we ought to be able to do better.

Complaints about the Current Tax System

The most common complaint about taxes is straightforward enough: they are too high. To some degree, this complaint just reflects self-interest; no one likes to pay taxes, just as no one enjoys paying utility bills. We all benefit in some way, however, from the government activities that those taxes finance. As U.S. Supreme Court Chief Justice Oliver Wendell Holmes, Jr., once noted, "Taxes are what we pay for civilized society."

Dissatisfaction with the overall level of taxes sometimes arises from a deep-seated opposition to allowing government to play an active role in society or from a belief that the government is wasting money. Many voters want to see a smaller government, with a correspondingly smaller tax bill.⁴ Such questions are naturally controversial and difficult to resolve. But even agreement on how big government should be—and therefore on how much tax money needs to be collected—would not resolve *how* those taxes should be raised. Similarly, people who disagree vehemently about the proper size of government might well find agreement on how our tax system ought to be designed. The *design* of the tax system sometimes gets short shrift in a political debate dominated by differences over the *level* of taxes, but it is a crucially important issue.

It Is Too Complicated

Another common grievance with the U.S. tax system is that it is too complicated. For many, complying with our labyrinthine tax regulations is frustrating, costly, and intrusive. Literally billions of hours are spent every year in the United States on fundamentally unproductive tax-related activities such as recordkeeping, wading through instructions, hunting for deductions and credits, and arranging personal and business financial affairs to avoid unnecessary tax payments and to take advantage of tax preferences.

The cost of this complexity is staggering. In total, individual taxpayers spend as much as 3 *billion* hours of their own time on tax matters,

or about 27 hours per taxpayer on average.⁵ That is the equivalent of over 1.5 million full-time (but hidden and unpaid) IRS employees! Many buy books or computer software programs such as TurboTax to help them through tax season. On top of that, well over half of all individual taxpayers purchase professional assistance from an accountant, a lawyer, or another adviser to help prepare their tax returns.⁶ Businesses also face a heavy compliance burden, with a typical Fortune 500 firm spending \$4.6 million per year on tax matters. The total cost of collecting income taxes, including the value of those billions of hours that taxpayers could have put to better use, is probably \$135 billion per year or more, which amounts to more than 10 cents for every dollar of revenue raised.⁷

Of course, the taxpaying process is not difficult for everyone. Millions of low-income households need not submit a return at all. Of the 132 million taxpayers who do file individual returns, 16 percent are able to use the very simple Form 1040EZ, and 22 percent use the fairly straightforward Form 1040A.⁸ All in all, survey evidence indicates that 45 percent of all taxpayers spend fewer than ten hours per year on their taxes.⁹ But for businesses and individuals with more complicated finances, the burden of compliance can be onerous indeed.

It Is Difficult and Sometimes Intrusive to Enforce

The IRS budget for 2005 was \$10.2 billion.¹⁰ In a single year, the IRS processes over 174 million returns, including 134 million individual returns. It audits or “examines” about 1.3 million tax returns and additionally sends 3.5 million computer-generated notices to taxpayers who are suspected of having reported incorrect tax liabilities. The IRS compares data from 1.5 billion documents—such as information reports from banks, stockbrokers, and mortgage lenders—to the numbers that taxpayers report on their returns.¹¹

Despite the significant expenditures on IRS enforcement, the massive compliance costs borne by the public, and the miseries suffered by those who are investigated by the IRS, a great deal of cheating on taxes apparently still occurs. Such things are hard to measure accurately, but the most recent estimate by the IRS suggests that about 16 percent of what should be paid in personal and corporate income tax, amounting to \$345 billion, is not paid and that \$290 billion of this will never be collected.¹² Other things being equal, this means higher tax rates and a heavier burden for the many people who are honest or who have few opportunities to cheat.

The flip side of tax evasion is that the IRS has sometimes been accused of using heavy-handed tactics to enforce the tax law. Televised congressional hearings in the late 1990s highlighted cases where the IRS appeared to overstep its bounds and led to new legislation that set up an oversight board for the IRS and shifted the burden of proof in a tax court case to the IRS, among other changes. Since then, the IRS has made progress in modernizing its operations, improving taxpayer service, and burnishing its public image. However, abundant evidence shows that this progress has been accompanied by a dramatic decline in the amount of auditing and enforcement activity undertaken by the IRS, raising concerns of a major adverse impact on tax compliance.¹³ Recently, the pendulum of tax enforcement appears to have begun swinging in the other direction. Spurred by highly publicized tax-shelter abuses by companies such as Enron and by prominent executives, in 2003 the Bush administration proposed to give the IRS a budget increase, including some funding for initiatives to improve enforcement of tax compliance for high-income taxpayers and businesses.¹⁴ Nevertheless, many indicators of enforcement are still quite a bit below their levels of a decade ago.

It Is Bad for the Economy

Political debates often revolve around how taxes affect the economy. Proponents of tax reforms or tax cuts almost always trumpet the economic benefits that they expect to result from their changes, and opponents argue that these claims are greatly exaggerated. During recessions, the focus turns to whether tax cuts will jumpstart the sluggish economy. Other times, the focus is on how the design of the tax system affects long-term economic prosperity.

The sheer size of taxes—in 2005, federal taxes were \$2.2 trillion, or 18 percent of the gross domestic product, while state and local taxes took up another 9.5 percent—suggests that they can have an important effect on the way the U.S. economy operates.¹⁵ But beyond the magnitude of tax collections, taxes affect the terms of almost every economic decision that an individual or a company makes. Taxes affect, and for the most part reduce, the rewards obtained from saving, working hard, taking a second job, and investing in education or training. The income tax reduces how much it costs to contribute to charity, buy a home, or put children in day care. Business decisions such as whether and how much to invest in a new technology or whether to locate a factory in the United States or India can hinge on the tax consequences of the

action. Because it alters the *incentives* associated with all these and scores of other decisions, the tax system can affect the *actions* people and businesses take. And the aggregate of all these actions comprises the economy.

Some critics of the current income tax charge that high tax rates on the wealthy discourage the hard work, innovation, and entrepreneurship necessary for a vibrant economy. Others stress that the tax system inordinately penalizes saving and investment, which are essential for maintaining and improving the country's long-run standard of living, and that it is at least partly responsible for a U.S. national saving rate that is low by both international and historical standards. Another criticism is that the preferences and penalties that are littered throughout the individual and corporate income tax codes can significantly distort economic choices. By capriciously changing the relative costs and benefits of various activities and investments from what they would be in the free market, goes this argument, the tax system causes us to channel our resources to the wrong places, hampering the efficiency of the economy and shackling long-term growth prospects.

It Is Unfair

Americans are understandably divided in their opinions on the fairness of the tax system. A 2003 poll found Americans almost equally split. Only 4 percent of people said the federal tax system was "very fair," but 47 percent thought it "moderately fair," so that just over half consider it to be fair to some extent. In contrast, 32 percent said it was "not too fair," and 16 percent felt that it was "not fair at all."¹⁶ Putting aside rounding error, this is very close to a 50-50 split.

What is it about taxes that people think is either fair or unfair? For one thing, people disagree about how the burden should be shared across families of different levels of affluence. The current personal income tax is "progressive," meaning that higher-income people typically pay a larger percentage of their incomes in taxes than do those with lower incomes. For some, a "fair" tax system means maintaining this progressivity and perhaps increasing the burden on those with high incomes. But others dismiss this as "soaking the rich" or "class warfare" and would prefer a less progressive system. Not surprisingly, people's views about whether the tax system is fair are strongly influenced by how hard the tax system hits their own families.

Even among families with the same income, the tax burden can differ widely depending on whether family members are married, how many dependent children they have, how much they give to charity, whether they own or rent housing, and whether their income is mostly from wages or salaries or from capital gains. Whether these and other characteristics and choices *should* affect one's tax burden is a contentious and often divisive issue and raises fundamental questions about the role of government in favoring or penalizing particular types of people and choices.

Finally, many believe that those individuals and corporations with good lobbyists, lawyers, and accountants are able to manipulate the tax code and take advantage of numerous loopholes and preferences to avoid paying their "fair share" of the tax burden. Such beliefs may lead to support for a streamlined tax system that eliminates opportunities for tax avoidance or for a more effective system of enforcement that prevents the tax burden from being shifted onto those taxpayers who do not have the influence, opportunity, or inclination to escape them.

A Different Way to Tax

One way to deal with these problems is to start over. Indeed, several congressional leaders, some Republican presidential candidates, a talk-show host or two, as well as some prominent economists have advocated *abolishing* the existing personal and corporate income tax systems and replacing them with something quite different. Consider, for example, this statement from recently retired House Ways and Means Committee chair Bill Archer (R-TX): "We've got to tear the income-tax system out by its roots. We have to remove the Internal Revenue Service from the lives of Americans totally."¹⁷ Or this from one-time Republican presidential hopeful Steve Forbes: "With a beast like this, the only thing to do is kill it."¹⁸

Archer, Forbes, and others would like to replace the personal and corporate income taxes entirely with some form of tax on consumption—that is, on the portion of income that people spend rather than save. Most attention has focused on two forms of consumption tax—a national retail sales tax and a so-called flat tax.

The more familiar of the two is the retail sales tax, since it is already used by all but five states. Proposals for such a tax have been presented

in Congress in recent years by Representatives John Linder (R-GA) and Collin Peterson (D-MN). Another adherent of this approach is a former Republican presidential candidate, Senator Richard Lugar, who supported a plan to replace the corporate and personal income taxes with a 17 percent national retail sales tax.¹⁹ Lugar argued that “the national sales tax would allow for the dismantling of the current IRS and the intrusive, inefficient, and costly enforcement of the current tax code” and that under it “Americans [would] enjoy a capital formation boom [with] . . . increased productivity, higher paying jobs, and new investment from around the world attracted by a policy of no income taxes.”²⁰

Another alternative to the income tax is the “flat tax” developed by Robert Hall of Stanford University and Alvin Rabushka of the Hoover Institution. Steve Forbes championed a 17 percent flat tax in his runs at the Republican presidential sweepstakes in early 1996 and 2000, and similar proposals have been put forward in Congress by Senator Richard Shelby (R-AL) and former House majority leader Richard Armey (R-TX). Under the flat tax, most individuals would still have to file a tax return, but it would differ from the current system on three key dimensions. First, the tax base would include wages, salaries, and pension benefits, but all other kinds of income (such as interest, dividends, and capital gains) would be completely excluded from taxation at the personal level. Second, all taxable income above an exempt level, based on family size, would be subject to a single, “flat” rate of tax. Finally, tax returns would allow no itemized deductions or other special preferences of any kind—no deductions for mortgage interest, charitable contributions, or child care and no Hope Scholarship Credit. Proponents emphasize that, as a result of this clean tax base, the flat-tax return for individuals could fit on a postcard! As we explain in chapter 7, although it looks like a simpler version of our current tax system, the flat tax is actually not an income tax at all. Instead, it is a kind of consumption tax and a close relative of a retail sales tax or a European-style value-added tax (VAT).

Advocates of the flat tax express great confidence in its potential benefits. Hall and Rabushka promise their flat tax “would give an enormous boost to the U.S. economy by dramatically improving incentives to work, save, invest, and take entrepreneurial risks”²¹ and assert that it is “fair to ordinary Americans because it would provide a tax-free allowance.”²² Finally, they pledge that the flat tax “would save taxpayers hundreds of billions in direct and indirect compliance

costs.”²³ In short, they and the other supporters of the flat tax argue that it would address the major complaints made about today’s tax system.

Objections to Radical Reform

Although almost everyone criticizes some aspects of the U.S. tax system, not everyone favors a complete overhaul. Over 80 percent of the members of the National Tax Association (the leading professional group of tax experts from academia, government, and business) favor retaining a personal income tax with rates that rise with income.²⁴ The most commonly expressed objection to radical reform proposals is that the average taxpayer would end up with the short end of the stick. Robert McIntyre of Citizens for Tax Justice says, “There is little or no disagreement among serious analysts that replacing the current, progressive income tax with a flat-rate tax would dramatically shift the tax burden away from the wealthy—and onto the middle class and the poor.”²⁵ Unless a national sales tax is accompanied by some difficult-to-implement form of rebate scheme, it could shift even more of the tax burden toward low-income families.

Are we willing to accept a big change in who bears the tax burden in exchange for the promised benefits of the reforms? The public appears to be ambivalent. Surveys consistently find that solid majorities of the public want taxes on upper-income people to go up instead of down. On the other hand, polls generally find that support for a flat tax is close to that for a progressive income tax and that the poll results can depend on precisely how the question is asked. A crucial factor is that many Americans apparently believe (incorrectly) that the current distribution of income tax burdens is not progressive (i.e., the rich do not pay a higher fraction of their income in taxes than others), perhaps because they think loopholes for the rich are pervasive. Survey evidence also makes clear that most people know relatively little about the current tax system or proposals for reform, so in the event of a serious reform effort, public opinion may change as people learn more about the details.

A second common critique of the radical reform proposals is that their promised economic and simplification benefits are overstated. Although proponents have touted their potential for improving long-run economic growth and simplifying the taxpaying process, the degree to which they would accomplish these goals is subject to

much debate among economists. There is much more uncertainty about the positive economic consequences of tax reform than advocates let on.

Even most skeptics admit that a flat tax could be significantly simpler than the current system. But much of the simplification that the flat tax promises comes at the cost of forgoing progressivity and the kind of personalized tax system that many Americans appear to favor. And while a national retail sales tax may appear simple on its surface, many experts are concerned that it would be impossible to administer equitably at the rates necessary to replace the revenues now generated by the income tax—rates probably in excess of 30 percent.

Finally, some skeptics are afraid that we're opening quite a can of worms. A free-for-all over tax policy, with special interests thrown into the mix, could conceivably end up producing legislation that is even more of a mess than what we have now. Similarly, some critics and advocates of reform are united by the concern that once we overhaul the system it will inevitably and gradually get messed up again. They argue that any one-time tax change ought to be accompanied by reforms in the policy process itself to prevent a gradual drift back to complexity, inefficiency, and unfairness.

Changes in the Context of the Current System

Don't hold your breath waiting for the Congress to dump the income tax and start over from scratch. In the meantime, big—if not radical—changes in the tax system are being debated and enacted all the time. Politicians are constantly fighting over and changing things like income tax rates, saving incentives, the tax treatment of capital gains, and special deductions and credits for all manner of politically favored items. These debates may not capture the imagination in the same way that throwing the whole system out and starting over might, but the resulting changes in the tax code can have important implications for the economy and for the fairness and complexity of the tax system. Indeed, it should be possible to reform the income tax in a way that makes it significantly simpler, better for the economy, and arguably fairer without running afoul of the objections to more radical reforms raised above and without necessarily throwing the existing system out altogether.

The Need for Objective Analysis

Sorting out the claims and counterclaims made for tax cut, tax increase, or tax reform proposals is a difficult task even for the most informed and interested citizens who must wade through a sea of self-serving arguments. Those groups that have the most to gain or lose from tax reform produce arguments that buttress their point of view. They don't trumpet the money that they (or their constituencies) stand to make but emphasize growth, productivity, and achieving the American dream. The potential losers seldom say they are opposing a policy simply because it skins their own hides but couch their argument in terms of how the national interest is hurt, how many jobs will be lost, and how unfair it is.

Making an intelligent judgment about tax policy requires seeing through the self-serving arguments to a clear understanding of the issues involved. Unfortunately, judgments and policy decisions must be made without the luxury of having definitive answers to many of the critical questions. For example, whether cutting taxes by 10 percent will cause the gross domestic product to rise by 2 percent, fall by 2 percent, or have no effect at all will never be definitely known, although economists can shed light on such questions and rule out certain outlandish claims. Some issues, such as what is "fair," ultimately rely on individual value judgments.

What's in This Citizen's Guide

This book offers a guide to the always contentious debate over tax policy and is designed to help the concerned citizen come to informed judgments. Our goal is to cut through the academic jargon, the "Washingtontspeak," and the self-serving arguments to explore the fundamental choices and questions inherent in tax policymaking. We have no tax plan of our own to push.

Chapter 2 offers some historical and international perspectives on taxation in the United States and a concise description of the current federal tax system. Chapters 3 through 5 examine the basic criteria by which tax policy should be judged—how fairly it assigns tax burdens, whether it promotes or inhibits growth and prosperity, and whether it is simple and enforceable. As we lay out the basic principles underlying these criteria, we also explore the controversies and difficulties that

arise and examine evidence on crucial questions, such as how the burden of our tax system is distributed and what is known about the economic effects of taxation. Such evidence is critical for evaluating the claims of various policy proposals and for weighing the inevitable trade-offs among criteria in any tax system. Chapter 6 goes over the key elements of many proposals for fundamental tax reform—a clean base (removal of all the deductions and exceptions of the current code), a single rate, and a consumption rather than an income base. Although reform proposals often contain more than one of these elements, they are indeed separable issues; in principle, we could adopt any combination of these elements without accepting the whole package. Chapter 7 provides a thorough examination of specific proposals to replace the income tax with a consumption tax. Chapter 8 addresses a variety of major policy changes that would stay within the general framework of the current tax system. Chapter 9 closes with a brief voter’s guide to tax policy that summarizes some essential points to keep in mind when considering the debate over how we should tax ourselves.