Chapter 9
Federal Tax Policy

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10 Principles of Federal Tax Policy

1. Tax codes should be simple and understandable.
2. Collect taxes in the least invasive manner.
3. Tax collection should be efficient.
4. The tax code should be stable and predictable.
5. Taxes should not be hidden from taxpayers.
6. The tax code should be neutral.
7. Taxes profoundly affect economic growth.
8. The broader the tax base, the better.
9. Everyone should pay the same income tax rate.
10. Perhaps it is time to repeal the income tax.

Introduction

> "Of all the powers conferred upon government
> that of taxation is most liable to abuse."
>
> *Loan Association* v. *Topeka* (87 U.S. 655 (1874))

The power to tax is the most dangerous and far-reaching of all government powers. It reaches directly or indirectly to all people, all industries, and all elements of society. Taxes always place burdens on businesses, individuals, and the economy. They are a necessary evil. However, patriots should never tolerate unlawful taxes, administered unfairly, or taxes used to punish some individuals or interests while favoring others.

Policymakers and legislators are responsible for adhering to sound constitutional and economic principles when levying taxes, and citizens are responsible for holding legislators accountable if they violate these principles. Abdicating these duties can seriously threaten liberty and justice. The Supreme Court warned in *Loan Association* v. *Topeka*:

> It must be conceded that there are such [private] rights in every free government beyond the control of the State. A government which recognized no such rights, which held the lives, the liberty, and the property of its citizens subject at all times to the absolute disposition and unlimited control of even the most democratic depository of power, is after all but a despotism (87 U.S. 655 (1874)).

The Internal Revenue Service (IRS) has abused its powers in the past and continues to do so. President Richard Nixon famously used the IRS to harass perceived enemies of his administration. During the Obama administration, the IRS delayed or denied approval of tax-exempt status for more than 100 new organizations whose names included "Tea Party," "Patriots," "We the People," and other conservative-sounding words (Terry 2016). Some experts believe this illegal activity by the IRS was responsible for Obama's reelection in 2012 (Veuger *et al.* 2012).

Misconduct by the IRS under Obama marked a bold and disturbing departure from past abuses of power. Whereas past abuses were typically committed by a small number of IRS agents or officials and aimed at specific individuals or possibly violent or criminal groups, under Obama the offenses were "systematically committed by officials in multiple offices across the country over a long period of time against representatives of a grassroots political movement supported by major portions of the American electorate" (*Washington Examiner* 2013). The threat to democracy could not be more apparent.

Thankfully, adherence to sound principles of tax policy can protect liberty and justice, make the administration of taxes less burdensome and unfair, and meet government's revenue needs while not hindering dynamic economic growth. Some of these principles were presented in the previous chapter on state fiscal policy. Here are 10 more principles patriots and honest elected officials should embrace.

Recommended Reading: Peter Ferrara and Lewis Uhler, "Roadmap for the 21st Century: Budget and Tax," *Policy Brief*, The Heartland Institute and National Tax Limitation Committee, December 5, 2016.

1. Tax codes should be simple and understandable.

The national tax code's overwhelming complexity and ambiguity make it impossible to administer fairly, impose a heavy burden on workers and entrepreneurs, and pose a threat to basic liberties and justice.

The Supreme Court in its 1926 *Connally* v. *General Construction Co.* decision recognized a fundamental right to know what legislation means, especially legislation that creates an affirmative duty to act. The majority wrote, "[A] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law" (269 U.S. 385 (1926)).

Overwhelming Complexity

The current tax code is the epitome of a vague statute. In April 2017, Nina E. Olson, the National Taxpayer Advocate, told Congress, "The compliance burdens the current tax code imposes are overwhelming for taxpayers and the IRS alike. … The tax code, which runs several million words, contains more than 200 tax deductions, credits, exclusions, and similar tax breaks. … As the National Taxpayer Advocate, I believe the most effective and comprehensive way to reduce taxpayer burden is for Congress to vastly simplify the Internal Revenue Code" (Olson 2017).

In 2016 alone, nearly 41 million citizens faced IRS collection actions, as shown in the table below (IRS 2016, pp. 41–2).

Nearly 41 Million Citizens Faced IRS Collection Actions in 2016	
Type of Action	*Number of Taxpayers Affected*
Penalty assessments	39,573,561
Wage and bank levies	869,196
Tax liens	470,602
Property seizures	436

These figures do not include tens of millions notices the IRS mails annually. Nor do they include the IRS's so-called "soft contacts"; that is, a letter the IRS uses to explain you "might" have done something wrong and you "should" examine your own tax return and records to make the correction before the IRS does.

The tax code's "overwhelming" complexity undermines people's willingness to voluntarily comply with the law, especially when they believe, not without reason, they are being taxed unequally. The President's Advisory Panel on Federal Tax Reform reported in 2005:

> [T]axpayers think that with the myriad of targeted exclusions, deductions, and credits, others may not be paying their fair share—so why should they? Some call this "the cheat or chump syndrome." In addition, clever tax advisors mine the complexity of the tax code to develop and market tax shelters and other schemes clearly designed to manipulate the tax code's hidden loopholes for their clients' exclusive benefit. The perception that the tax code is unfair and easily manipulated undermines voluntary compliance—the foundation of our tax system (p. 4).

Difficulty complying with a complex tax code and decreasing motivation to comply voluntarily are putting millions of Americans in the crosshairs of IRS enforcement actions. The number of civil tax penalties increased from about 14 in 1955 to 170 in 2014 (Olson 2016, p. 324), meaning the possible consequences of an IRS audit are much worse today than they were in the past.

How to Simplify the Tax Code

Nina Olson, the National Taxpayer Advocate, rightly urged the elimination of the many exclusions, deductions, and other breaks in her 2016 annual report to Congress. She recommended a "zero-based budgeting" approach whereby every tax break is eliminated unless lawmakers specifically decide to keep it, "if, on balance, … the public policy benefits of running the provision or program through the tax code outweigh the tax complexity burden that the provision creates for taxpayers and the IRS" (Olson 2016, p. 319). That proposal also was endorsed by the National Commission on Fiscal Responsibility in its 2010 report (p. 29).

Olson admitted eliminating tax breaks is probably politically impossible, since elected officials are beholden to special interests who benefit from the current tax code. The failure by Congress to enact the recommendations of the National Commission on Fiscal Responsibility and Reform was evidence to that effect. So Olson recommended nine more modest reforms:

- Repeal the Alternative Minimum Tax (AMT) for individuals.

- Consolidate the family status provisions that now appear in filing status, personal and dependent exemptions, the child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under IRC §7703(b).

- Improve other provisions relating to taxation of the family unit.

- Consolidate 12 existing education savings tax incentives.

- Consolidate 15 existing retirement savings tax incentives.

- Simplify worker classification determinations to minimize employee-versus-independent contractor disputes.

- Eliminate (or reduce) procedural incentives for lawmakers to enact tax sunsets. The tax code contains at least 71 provisions scheduled to expire between 2016 and 2025.

- Eliminate (or simplify) phase-outs.

- Streamline the penalty regime.

These reforms would certainly help simplify the tax code, but the history of past tax reform efforts suggests they are insufficient. Two more promising solutions are the flat-rate income tax and replacing the income tax with a consumption tax, such as the so-called FairTax. These alternatives are discussed in Principle 2, next, and will often come up in discussions of other principles in this chapter.

Policy Agenda

Complexity and ambiguity allow politicians to use the tax code to reward friends and punish opponents. They undermine voluntary compliance and impose a heavy compliance load on workers and employers. Lawmakers should radically simplify the tax code, starting with the National Taxpayer Advocate's nine recommendations.

Recommended Readings: Nina Olson, *National Taxpayer Advocate's 2016 Annual Report to Congress* (Washington, DC: Internal Revenue Service, 2016); Chris Edwards, "Our Complex Tax Code Is Crippling America," *Time* (website), April 11, 2016.

2. Collect taxes in the least invasive manner.

Government has a duty to collect revenue in the least invasive manner. The current federal tax code is the most invasive part of the entire body of federal law.

Federal tax laws affect almost everything we do. The code rewards or penalizes us depending on the choices we make; for example, whether we get or stay married, have children, buy a home, make charitable gifts, change employment, obtain personal and professional education, buy health insurance, save for retirement, make gifts to our children and others, leave an inheritance, and even when and how we die. Businesses are required to file with the IRS information returns that report any payment of $600 or more to a "person" in a year (IRS 1099-MISC).

The tax code requires that *we report to the government* the choices we make on the most important and most personal matters of our lives. Often, we must provide details we do not share even with close friends and family members. Can we trust the government to keep this information confidential? Might it be used against us?

Invasions of Privacy

We can start with what is called "IRS browsing," employees peeking into taxpayers' files for their own purposes. The IRS calls this UNAX, for "unauthorized access," and reported 521 such cases in 2007 alone (Paulson 2008). IRS employees caught "browsing" are typically subjected to only light disciplinary measures such as unpaid leave. Only 185 offenders were prosecuted from 1998 to 2007 under the 1998 Taxpayer Browsing Protection Act and the Computer Fraud and Abuse Act, and offenders typically received probation (*Ibid.*).

A second risk to privacy is outsiders hacking IRS databanks. In 2005, the Government Accountability Office released a report titled "Internal Revenue Service Needs to Remedy Serious Weaknesses over Taxpayer and Bank Secrecy Act Data" (GAO 2005). It found, "in addition to the remaining 21 previously reported weaknesses for which IRS has not completed actions, 39 newly identified information security control weaknesses impair IRS's ability to ensure the confidentiality, integrity, and availability of its sensitive financial and taxpayer data and FinCEN's Bank Secrecy Act data" (p. 2). The report cites IRS's failure to implement access controls over its mainframe computers and "other information security controls relating to physical security, segregation of duties, and service continuity at the facility. Collectively, these weaknesses increase the risk that sensitive taxpayer and Bank Secrecy Act data will be inadequately protected from unauthorized disclosure, modification, use, or destruction” (*Ibid*.).

The report concludes on this sober note: “Until IRS fully implements a comprehensive agencywide information security program, its facilities and computing resources and the information that is processed, stored, and transmitted on its systems will remain vulnerable” (*Ibid.*).

Data Mining

“Data mining”—using a software program to conduct pattern-based queries, searches, or other analyses of databases to find a predictive pattern or anomaly indicative of illegal conduct—poses a third threat to privacy. According to a 2016 U.S. Department of the Treasury report, the IRS uses five data-mining programs:

- Investigative Data Examination Application (IDEA), formerly known as Investigative Data Analytics
- Lead and Case Analytics (LCA)
- Electronic Fraud Detection System (EFDS)
- Return Review Program (RRP)
- FinCEN Query

The report describes IDEA as follows: “By using the IDEA application, special agents and investigative analysts can proactively identify patterns indicative of illegal activities. This tool enhances investigation selection and supports investigative priorities in tax law enforcement, counterterrorism, and other high-priority criminal investigations. The IDEA application uses data for both reactive and proactive queries. Reactive queries are a result of specific, targeted investigations; proactive queries are the result of pattern matching to generate leads” (Department of the Treasury 2016, p. 23).

The report says the purpose of data mining is “to detect suspicious financial transactions indicative of money laundering, terrorism, and other financial crimes” (*Ibid*., p. 24). The programs may succeed in this, but the possibility that IDEA and other data-mining programs will mistake innocent financial transactions or investment decisions for illegal or criminal activities, triggering audits and investigations, is very real.

This threat to privacy is compounded when the IRS shares its data-mining results with other government agencies or non-federal entities conducting their own investigations or research. All taxpayer data are supposed to be private and confidential under 26 U.S.C. §6103, but subsections (c) through (o) of §6103 contain more than a dozen exceptions to this general rule. Examples include disclosures to state tax officials and certain state and local law enforcement agencies, to certain committees of Congress, to the president and certain other persons, to federal employees and the courts for tax administration purposes, for "statistical purposes," and to contractors for tax administration purposes. In other words, §6103 falls well short of guaranteeing the confidentiality of information we share with the IRS.

Foreign Account Tax Compliance Act (FATCA)

A fourth privacy threat is the Foreign Account Tax Compliance Act, or FATCA. The act compels foreign bankers, brokers, insurers, and mutual funds to collect U.S. Social Security numbers and report account balances to the IRS or risk being assessed a 30 percent withholding tax. Willful failure to file a foreign bank account report could lead to a penalty of 50 percent of the value of the account or $100,000, whichever is greater.

In a lawsuit filed in 2015, U.S. Senator Rand Paul and five U.S. citizens living abroad called the law "a sweeping financial surveillance program of unprecedented scope that allows the Internal Revenue Service to peer into the financial affairs of any U.S. citizen with a foreign bank account" (Crawford *et al.* 2015, p. 2). According to a summary of the suit produced for Courthouse News Service, the plaintiffs say "FATCA allows the Internal Revenue Service to collect information about U.S. citizens' account balances and transactions, information it cannot collect on U.S. citizens living domestically. The law requires foreign banks to report citizens' account information to the IRS even when the agency has no reason to suspect that citizen of violating U.S. tax laws" (Bailey 2015).

FATCA was enacted during the Obama administration in an effort to crack down on wealthy Americans thought to be hiding their wealth in foreign accounts. Like so many other laws and regulations, it has the effect of violating the privacy rights of millions of Americans who are not wealthy and not guilty of violating any tax laws.

Less Invasive Taxation

The national government could raise tax revenues sufficient to meet its spending needs without requiring taxpayers to surrender to the IRS massive amounts of personal information. Two alternatives have been proposed, studied, and publicly debated for many years. They are the flat tax and a national sales tax. The most popular national sales tax proposal is the FairTax, introduced in Congress as H.R. 25 and S. 18.

The Flat Tax

The case for replacing the current tax code with a flat-rate income tax has been made by many authors since the 1980s. The idea is to collapse current tax brackets into a single rate and abolish some or all exemptions, credits, and deductions so that the single tax rate can be as low as 10 percent, more often 15 percent to 20 percent. Such a tax code would be so simple most taxpayers could file their taxes using a postcard. The IRS would no longer be necessary or, if it remains, could be a small fraction of its current size.

Flat tax plans have been proposed by Robert E. Hall and Alvin Rabushka (19 percent), Steve Forbes (17 percent), presidential candidate Ben Carson (10 percent, later raised to 15 percent), and U.S. Senators Ted Cruz and Rand Paul (10 percent on personal income, 16 percent on corporate income). Although they all share the goal of radically simplifying the tax code, these plans differ in how they treat corporate income, the personal deduction, payroll taxes, the death tax, and more.

One flat tax plan that is unique is the "Freedom Tax" written and explained by Washington, DC-based tax attorney James K. Jeanblanc on the website www.thefreedomtax.org. Jeanblanc's plan would tax all income (whether business or individual) at the same 10 percent rate; there would be no personal deductions, exemptions, or tax credits, and most interesting, the tax "would be collected at the source of payment in the case of salaries and wages, interest, dividend, and retirement income. Once received, this income would be fully taxed" (Jeanblanc 2017). The result would be no tax return filing by individuals.

There is a lively debate about what the single tax rate should be, how much revenue it would generate, and whether a flat tax can be designed that would survive the natural inclinations of politicians to add brackets and raise the rate and of bureaucrats to impose more reporting requirements on filers. But one thing seems certain: Any of these plans would make the federal income tax much less intrusive. They all merit the attention and perhaps support of patriots and policymakers.

The FairTax

The FairTax is a proposal to replace the federal personal income tax, corporate income tax, payroll (FICA) tax, capital gains, alternative minimum, self-employment, and estate and gifts taxes with a single-rate federal retail sales tax. Every person living in the United States would pay a sales tax on purchases of new goods and services, excluding necessities, of approximately 23 percent. Every household would receive a "prebate" set to offset any taxes on spending up to the poverty level (Tuerck *et al.* 2007).

By replacing virtually all income-based taxes at the national level, the FairTax would end the invasions of privacy due to the current tax code. It would even abolish the IRS. By dramatically reducing the number of entities charged with collecting the tax, it would reduce administrative costs and opportunities for tax evasion. According to the Beacon Hill Institute and other researchers, the national sales tax could be set at 23 percent and still raise sufficient revenue to meet the national government's spending needs.

The website of Americans For Fair Taxation, www.fairtax.org, provides extensive background and commentary on the FairTax.

Policy Agenda

The complexity of the current tax code makes it invasive and a threat to privacy. A less invasive system would benefit taxpayers by reducing compliance costs and protecting their privacy. Tax administrators would need fewer resources to manage a system that does not attempt to monitor every aspect of the financial lives of all taxpayers. Less enforcement action would mean fewer collectors spending fewer hours tracking down bank accounts, paychecks, and other assets to levy and seize.

The Flat Tax and FairTax are two tax systems that would be much less invasive and could raise the revenue needed for legitimate government functions without placing revenue officers in the homes and offices of Americans.

Recommended Readings: Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, CA: Hoover Institution Press, second edition, 2007); Daniel J. Pilla, *How to Fire the IRS: A Plan to Eliminate the Income Tax and the IRS* (Stillwater, MN: Winning Publications, 1993).

3. Tax collection should be efficient.

> The federal tax code imposes collection and compliance costs of 65 cents for every dollar of revenue collected. That is a massive and unnecessary burden on society.

The IRS regularly asserts it is extremely efficient in collecting taxes. In 2016, the agency reported collecting gross tax revenue of more than \$3.3 trillion with a work force of 80,825 employees. Given the agency's budget of approximately \$11.7 billion, the cost of collecting \$100 of tax was just 36 cents (IRS 2016, pp. 63, 65, 68). However, these numbers are misleading.

Spending $2.1 Trillion to Raise $3.3 Trillion

The IRS's estimate does not take into account the costs *borne by the public* to comply with income tax laws. In April 2017, Nina Olson, the National Taxpayer Advocate, told Congress, "My staff analyzed IRS data for 2015 and determined that individuals and businesses spend about six billion hours a year complying with the tax code's filing requirements—not including the millions of additional hours they spend responding to IRS audits or notices. If tax compliance were an industry, it would be one of the largest in the United States. To consume six billion hours, the 'tax industry' requires the equivalent of three million full-time workers" (NTA 2016, p. 310).

In 2008, the National Taxpayer Advocate estimated that the out-of-pocket cost associated with tax return filing alone was approximately $193 billion annually: "This is a staggering 14 percent of aggregate income tax receipts" (NTA 2008, p. 4). Even the NTA did not address the whole picture. It ignored the cost of challenging penalty assessments and responding to the tens of millions of annual notices and letters, as well as millions of annual audits and appeals, tax litigation, enforced collection, economic disincentives, and tax evasion and avoidance.

When all these factors are accounted for, the cost of compliance is close to 65 percent of the amount collected (Pilla 1993, p. 204; Payne 1993). That is to say, for every dollar of tax paid to the Treasury, it costs citizens and businesses 65 cents to get it there. Given that $3.3 trillion was paid to the IRS in 2016, society incurred a collection cost of nearly $2.1 trillion. That is nearly $18,000 per household in the United States, a staggering cost that produces no social benefit.

Making Federal Tax Collection More Efficient

All of the recommendations to simplify the federal tax code made by the National Taxpayer Advocate and listed previously (see Principle 1) would make tax collection more efficient. Many of the recommendations made to make tax collection less invasive (Principle 2) would have the same effect, though the IRS may argue that reining in data-mining could hinder collection enforcement efforts.

Moving to a flat tax would dramatically reduce compliance and enforcement costs. Most tax policy experts writing about the flat tax estimate it would lower the cost of compliance by 90 percent or more. Reducing the number of tax brackets and eliminating deductions reduces the need to call the IRS to answer questions or to hire accountants or lawyers to file tax returns. Enforcement becomes vastly easier when the incentives to misstate income or spending or hide the sources of income are removed by taxing all income at a single low rate.

Trading in the income tax for a single-rate national consumption tax, like the FairTax, would likely reduce compliance costs even more than changing to a flat tax. The FairTax would dramatically reduce the number of collection points needing to collect information and tax dollars and submit them to the government. Back in 1999, this author calculated the savings to a single state, Minnesota, of moving from an income tax to a broad-based sales tax as the principal means of collecting the state's revenue. The state could have expected to achieve a reduction of 82 percent in the number of collection points, 88 percent in the number of taxpayer questions, 63 percent in the state tax return filing obligation of the average business, and about $38 million overall in the state's administrative costs. Also, there could have been an annual savings of at least $4.96 million in return processing costs (Pilla 2000).

Policy Agenda

At a time when both taxpayers and governments are straining to find ways to save money, ways to improve the efficiency of tax collection need to be on the table. Two ways are the flat tax and the FairTax.

Recommended Readings: James L. Payne, *Costly Returns: The Burdens of the U.S. Tax System* (Oakland, CA: Institute for Contemporary Studies Press, 1993); Joshua D. McCaherty, "The Cost of Tax Compliance," Tax Foundation, September 11, 2014.

4. The tax code should be stable and predictable.

A tax code that is unstable and unpredictable makes planning difficult or impossible, imposing uncertainty and huge costs on businesses and individuals.

Frequent changes to a tax code make financial planning difficult or even impossible. The efficiency of markets is adversely affected because the passage of a change in the tax code can turn financially sound investment decisions into bad ones and bad ones into seemingly good ones. Because the current federal tax code affects so much of our personal lives, an unstable tax code also affects everything from our marriages to our retirement plans, and many other decisions in between.

The Constantly Changing Code

Congress is constantly changing the tax code and the IRS is constantly releasing new rules and instructions on how to comply with a sprawling and vague tax code. On its website in 2017, the National Taxpayer Advocate reported, "according to a tally compiled by a leading publisher of tax information, there have been approximately 4,428 changes to the tax code over the past 10 years, an average of more than one a day, including an estimated 579 changes in 2010 alone" (NTA 2017).

Some changes to the tax code have resulted in retroactive tax increases. Critics were appalled the Supreme Court seemed to violate the clear meaning and foundational principle in Article I, Section 9, Clause 3, that "no ex post facto Law shall be passed," when in 1994 the Court approved, in *United States* v. *Carlton* (512 U.S. 26 (1994)), a decision by Congress to repeal a tax deduction retroactively, thereby increasing an estate's tax liability by more than $600,000.

Parts of the tax code also come and go without any action by Congress or the courts. In 2009 and 2010, 24 tax laws expired, and six more expired by 2012 (Joint Committee on Taxation 2008). In 2016, the National Taxpayer Advocate said the tax code contains at least 71 provisions that are scheduled to expire between 2016 and 2025 (Olson 2016).

The Cato Institute's Chris Edwards, writing at *Time* magazine's website in 2016, noted, "the latest layer of complexity was added by the Affordable Care Act, which manipulates our health choices through the tax system. If you don't have health insurance, you calculate how much you get penalized. If you do have individual insurance, you calculate the tax credits you receive. If you get advance credits during the year, then you recalculate your benefits when you file. And so on" (Edwards 2016). The IRS is trying to be helpful: It offers a 24-page Affordable Care Act overview, a 19-page guide for penalties, and a 71-page guide to credits. But the Affordable Care Act (a.k.a. Obamacare) may not even exist in 2018.

Making Planning Impossible

Changes in the tax code interfere with people's ability to plan their personal and business affairs. Between 1986 and 2000, Congress changed the requirements for making estimated tax payments seven times (IRS 2000, p. 34). Changing the law on estimated taxes every other year is one reason IRS assesses the penalty for failure to pay estimated taxes so often. In 2009, the IRS assessed that penalty against 7.6 million individuals and more than 243,000 businesses (IRS 2009, p. 42).

The President's Advisory Panel on Federal Tax Reform observed the expiring provisions and phase-ins and phase-outs of various provisions "are a nuisance at best, and a negative force at worst, in the daily economic lives of American families and businesses" (2005, 5, p. 5). The panel concluded:

> The tax system is both unstable and unpredictable. Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs (*Ibid*., p. xiii).

Why the Tax Code Changes

Why is the federal tax code changed so frequently? One reason is the assumption by policymakers and much of the public that the tax code can be used to achieve non-revenue ends. It is commonly agreed the tax code should encourage home ownership, marriage, raising children, and so on and so on. If social engineering is the goal and changing the tax code is the means, then there is no limit to the number of times the code should be changed.

The demand for changes to the code is very high since even small changes can produce millions of dollars in benefits for a small number of taxpayers or businesses. Economists recognize this as the familiar problem of "concentrated benefits and dispersed costs": Government programs often produce large benefits for small numbers of people, who can readily organize to lobby for them. The costs are widely dispersed, perhaps amounting to only a few pennies per person, and such large groups are difficult or costly to organize.

Elected officials are vulnerable to constituents, especially campaign donors, asking for their help in getting changes made to the tax code to advantage them. The code is so complex already, what is the harm in making one more change? And perhaps the current code is "unfair" to the campaign donor, making the change a positive "reform."

Well-intended bureaucrats working inside the IRS and other government agencies often change how the tax code is administered to address contradictions and uncertainties in the code. Given the code's enormous size and thousands of rules and policies, an endless number of "corrections" could be made.

Policy Agenda

A more stable and predictable tax code is possible only if it addresses all these reasons for constant change. Policymakers and the public must be persuaded the tax code should be used only to raise revenue, and not to achieve other social goals. There should be so few rules and regulations in the code that special-interest groups, campaign donors, and bureaucrats are not tempted to add more or "fix" those that still exist. Parts of the code should not be scheduled to "sunset."

A stable tax code is likely to resemble a flat tax or national consumption tax, since they address the reasons why the current tax code changes so frequently. However, as noted earlier, both of those alternatives can still be vulnerable to the natural tendency of politicians and bureaucrats to meddle in the operation of government programs. There is no sure solution.

Recommended Readings: Tax Foundation, *Options for Reforming America's Tax Code* (Washington, DC: Tax Foundation, June 6, 2016); David R. Burton, "A Guide to Tax Reform in the 115th Congress," *Backgrounder*, The Heritage Foundation, February 10, 2017.

5. Taxes should not be hidden from taxpayers.

Americans generally have no idea how much they pay in taxes because taxes are taken out of their paychecks by their employers.

When asked how much money they paid in federal income taxes the prior year, many people reply, "I didn't pay anything. I got a refund!" They do not remember the thousands of dollars employers withheld from their paychecks for federal and state tax payments. That is a big problem because taxes hidden from taxpayers can be raised without their knowledge or unfairly imposed or avoided.

Automatic Income Tax Withholding

About 85 percent of the income earners in America do not write a check to the government for their taxes. Since the tax is taken out of their paychecks by their employers, they do not even see the money. As a result, Americans generally don't appreciate how much they are paying. The 1996 report of the National Commission on Economic Growth and Tax Reform called attention to the danger of this arrangement:

> The history of hidden taxes, rapidly rising rates, and perpetual budget deficits proves that what you don't know can hurt you. The current system hides the cost of government behind a chronic deficit and a maddening multiplicity of taxes—many of which are virtually invisible to the taxpayer who pays them. How much did we pay in payroll taxes last year? What excise taxes were hidden in the prices of the products we bought? What [is] the tax cost of exclusions, deductions, and corporate income taxes? Few of us know the answers (p. 85).

Our system of automatic income tax withholding by employers arose in the 1940s as a temporary war-time expedient to help meet the country's urgent need for tax revenue. (Withholding of Social Security and Medicare taxes started sooner, in the 1930s.) Milton Friedman, at the time working for the Treasury Department, proposed it. He would go on to become the most influential economist of the twentieth century, and he always regretted having made that fateful suggestion. In his 1998 memoir coauthored with his wife, Rose, he wrote, "It never occurred to me at the time that I was helping to develop machinery that would make possible a government that I would come to criticize severely as too large, too intrusive, too destructive of freedom. Yet, that was precisely what I was doing" (Friedman and Friedman 1998, p. 123).

Social Security and Medicare

In addition to withholding income taxes, employers are required by the Federal Insurance Contributions Act (FICA) to withhold three other taxes from the wages they pay employees: a 12.4 percent Social Security tax, a 2.9 percent Medicare tax, and beginning in 2013 as part of Obamacare, a 0.9 percent Medicare surtax when the employee earns more than $200,000. Like the income tax, these taxes are deducted from workers' paychecks as the income is earned. It then becomes the responsibility of the employers to pay the money to the IRS.

Unlike the income tax, employees never file a Social Security tax return, never write a check to the IRS for this tax, and never keep records to correctly figure the tax. They are never subject to an audit or to enforced collection if the tax is not paid by their employers. The money simply disappears from their paychecks. (This is not true of the self-employed. They must calculate their Social Security taxes on Schedule SE and include the tax on Form 1040. Since the tax is figured as a flat percentage of business profit, they are subject to audit as to the amount of tax and collection if the tax is not paid.)

As "easy" as all this sounds, it means most taxpayers never know the true cost of Social Security—or, for that matter, government in general.

Make Taxes Crystal Clear

Taxes that are highly visible are more stable, tend to stay low, and are not generally subject to tinkering. The best example of this is retail sales taxes imposed by state governments. Just compare the number of changes in a state's sales tax laws to changes made in the Internal Revenue Code during the past 10 years. The contrast is staggering. In Minnesota, one can practically count on one hand the number of sales tax law changes that occurred since the sales tax began in 1963.

One way to make taxes crystal clear to taxpayers is to eliminate the requirement that employers withhold taxes from the paychecks of employees. For example, workers paid $1,000 per week would receive a check or a notice of a direct deposit into their bank account of $1,000. They would then need to pay the IRS themselves the amount their employer would normally withhold. Or those employees could keep their entire $1,000 and the rest of the money they earn during the year, but be required by April 15 to pay what they owed for the entire year. This would make it crystal clear to every worker just how much the government takes from them (Vance 2005).

Another way to make taxes more visible is to shift from the national income tax to a national consumption tax, such as the FairTax. Such a substantial tax (possibly 23 percent) paid at the point of sale is noticeable, and opposition to raising the tax is likely to be widespread. This is in contrast to another kind of sales tax, the value-added tax or VAT, which is imposed on the "value added" at each stage of the production process and so is largely invisible to buyers. A VAT fails the transparency test (Mitchell 2005).

Policy Agenda

Letting people see how much they are being forced to pay in taxes every time they are paid or when making every retail purchase would lead to considerable public support for cutting everyone's taxes. In fact, ending tax withholding by employers would likely cause a tax revolt of a size not seen since the Boston Tea Party rebellion of 1773. But maybe that is the point of talking about it now. Does the country need another Boston Tea Party?

Recommended Readings: Laurence Vance, "The Curse of the Withholding Tax," The Mises Institute, 2005; Daniel Mitchell, "Beware the Value-Added Tax," *Backgrounder,* The Heritage Foundation, May 16, 2005.

6. The tax code should be neutral.

Selectively targeting some businesses for heavier tax burdens while giving other businesses tax breaks is an illegitimate use of the taxing power of government.

Chief Justice John Marshall, in the 1819 case *McCulloch* v. *The State of Maryland,* wrote that the power to tax is "the power to destroy" (17 U.S. 316 (1819)). The case dealt with the 10 percent excise tax Congress imposed on the circulation of all bank notes other than those issued by the national bank. Within two years of its passage, the tax drove out of circulation every state bank note.

Destruction through Taxation

In her 2016 testimony to Congress, NTA Nina Olson reported, "the Treasury Department has estimated that tax expenditures [i.e., lost revenue due to exemptions, deductions, or credits] in FY 2016 came to about $1.4 trillion—more than the $1.2 trillion Congress appropriated to fund the entire federal government. Put simply, Congress now spends more money each year through the tax code than it spends through the appropriations process" (Olson 2016).

Governments should not interfere with the ability of legitimate businesses to compete in the marketplace on equal footing with one another. Otherwise, the only businesses with a chance to succeed are those that are able and willing to pay the lobbyists and peddlers who influence Congress and state legislatures. Research on the negative effects of corporate welfare was summarized in Principle 5 of Chapter 8, on state fiscal policy, and need not be repeated here.

Citizens across the political spectrum are disgusted by what they rightly understand to be a corrupt, crony system in which raw political power, especially the power to punish or reward selectively with taxes, determines who gets what. The 1996 National Commission on Economic Growth and Tax Reform summarized well the essential elements of sound tax policy:

> The tax code should be used to raise revenue to run the government while doing the least possible damage to the economy. This means leaving individuals free to make decisions and to set priorities based on economic reality—not on the bureaucratic whims of Washington, D.C. … The result of the biases and distortions in the current system is to make the market

> less free, the system less fair, and families less financially secure (p. 20).

The 2010 National Commission on Fiscal Responsibility similarly concluded, “corporate tax reform should eliminate special subsidies for different industries. By eliminating business tax expenditures—currently more than 75—the corporate tax rate can be significantly reduced while contributing to deficit reduction. A lower overall tax rate will improve American business competitiveness. Abolishing special subsidies will also create an even playing field for all businesses instead of artificially picking winners and losers” (p. 33).

The Supreme Court condemned the selective targeting of industries for heavier taxation in *Loan Association* v. *Topeka*, referenced above, involving the use of government bonds to finance railroads and the taxes imposed to pay for the bonds. Referring to government’s power to impose selective taxes, the Court stated:

> This power can as readily be employed against one class of individuals and in favor of another, so as to ruin the one class and give unlimited wealth and prosperity to the other, if there is no implied limitation of the uses for which the power may be exercised. To lay with one hand the power of the government on the property of the citizen, and with the other to bestow it upon favored individuals to aid private enterprises and build up private fortunes, is none the less a robbery because it is done under the forms of law and is called taxation (87 U.S. 655, 664 (1874)).

The IRS versus Guns and Bitcoin

Operation Choke Point and the IRS’s recent targeting of the alternative currency called Bitcoin are two very recent examples of how the IRS, working with other government agencies, is using its power to discriminate against specific industries and individuals.

Operation Choke Point was another Obama administration effort to bypass Congress and achieve its political agenda through regulations, in this case by pressuring banks to withhold lines of credit, freeze assets, and prohibit online sales by companies selling products opposed and demonized by the administration, such as guns, pornography, drug paraphernalia, and payday loans. The Justice Department, working with other government agencies including the IRS through a collaboration called the Financial Fraud Enforcement Task Force, urged banks and payment processors to cut their ties with companies in the targeted industries even though the companies were selling legal products and had valid licenses and good credit histories.

Peter Weinstock, a lawyer at Hunton & Williams LLP, was quoted in

The Washington Times saying "this administration has very clearly told the banking industry which customers they feel represent 'reputational risk' to do business with … so financial institutions are reacting to this extraordinary enforcement arsenal by being ultra-conservative in who they do business with: Any companies that engage in any margin of risk as defined by this administration are being dropped" (Riddell 2014).

The same article quoted Richard Riese, a senior vice president at the American Bankers Association, saying, "We're being threatened with a regulatory regime that attempts to foist on us the obligation to monitor all types of transactions. All of this is predicated on a notion that the banks are a choke point for all businesses" (*Ibid*.).

Another example of IRS targeting is its campaign against Bitcoin, a novel type of digital currency. In November 2016, the IRS filed a "John Doe" summons seeking to require U.S. Bitcoin exchange Coinbase to turn over records about every transaction of every user from 2013 to 2015. Jim Harper, writing for the Cato Institute's *Cato at Liberty* blog, observed: "That demand is shocking in sweep, and it includes: 'complete user profile, history of changes to user profile from account inception, complete user preferences, complete user security settings and history (including confirmed devices and account activity), complete user payment methods, and any other information related to the funding sources for the account/wallet/vault, regardless of date'" (Harper 2016).

Harper notes the IRS summons violates Fourth Amendment protections against search and seizure without evidence of probable guilt, is spectacularly over-reaching in the information it seeks, and seems intended to frighten away investors in the currency. While this is done in the name of battling "tax cheats," it seems clear the real target is digital currencies, opposed by the Obama administration because they allow financial transactions to occur without federal agencies monitoring them.

Policy Agenda

A good tax code, like the administration of justice itself, must be blind to the identities of the individuals or interests that come before it. Choosing winners is bad economic policy and deeply corrosive to justice. The current federal tax code invites this abuse, another reason it must be replaced.

Recommended Readings: Jim Harper, "The IRS Believes All Bitcoin Users Are Tax Cheats," *Cato at Liberty,* November 18, 2016; Robert Carroll, John E. Chapoton, Maya MacGuineas, and Diane Lim Rogers, "Moving Forward with Bipartisan Tax Policy," *Working Paper* No. 5, Tax Foundation, 2009.

7. Taxes profoundly affect economic growth.

The current federal tax code has profoundly negative effects on economic growth. A sound tax system should be pro-economic growth.

Two presidential commissions on taxes highlighted how the complex and ever-changing federal tax code harms the U.S. economy. The 1996 National Commission on Economic Growth and Tax Reform declared,

> Our country is poised to help lead the world into a new era of economic growth fueled by an information-age technological revolution that can yield unparalleled expansion in jobs, productivity, innovation, and prosperity. We must embrace this opportunity and challenge. However, such an embrace will prove difficult, perhaps impossible, if we remain saddled with our current tax code. The current system is indefensible. It is riddled with special interest tax breaks, and it overtaxes both labor and capital. We must construct a tax system that reflects our highest values and unleashes our greatest potential (p. 3).

In 2010, the National Commission on Fiscal Responsibility similarly found, "the tax code is rife with inefficiencies, loopholes, incentives, tax earmarks, and baffling complexity. We need to lower tax rates, broaden the base, simplify the tax code, and bring down the deficit. We need to reform the corporate tax system to make America the best place to start and grow a business and create jobs" (p. 12).

High Taxes Impede Economic Growth

In 2001, economist Richard Vedder at Ohio University examined several dozen measures of taxes and spending in the years 1957, 1977, and 1997. He found, "In every single case, without exception, the results are consistent: High or rising taxes are associated with lower amounts of economic growth. The use of more sophisticated statistical models produces the same sort of result: higher taxes, lower growth" (Vedder 2001, p. 9).

Other researchers, including J. Scott Moody (2006) at the Maine Heritage Policy Center and Scott A. Hodge at the Tax Foundation, have found the same thing: High taxes lead to slower economic growth. According to Hodge, "Taxes are an important cost to business, as important as the cost of labor and raw materials. … Nearly all of the best states raise sufficient revenue without imposing at least one of the three major state taxes: sales taxes, personal income taxes, and corporate income taxes" (Stanek 2006).

The Founding Fathers had the wisdom and foresight to know imposing direct taxes on the determinants of economic growth would inhibit growth. That is why they rejected imposing direct taxes on incomes, savings, and investments. Instead, they favored indirect taxes on consumption. The nation's first treasury secretary, Alexander Hamilton, observed that taxing the "articles of our own growth and manufacture are more prejudicial" to economic growth than excise taxes (Morris 1957, p. 258).

Progressive Taxes Slow Economic Growth

While high taxes contribute to slow economic growth and low taxes make faster economic growth possible, the type of tax also matters. Extensive research finds progressive taxation has a greater negative impact on economic growth than other types of taxation.

William McBride, an economist with the Tax Foundation, conducted a survey of academic literature on taxes and economic growth in 2012 and reported finding 26 studies "going back to 1983, and all but three of those studies, and every study in the last fifteen years, find a negative effect of taxes on growth. Of those studies that distinguish between types of taxes, corporate income taxes are found to be most harmful, followed by personal income taxes, consumption taxes and property taxes" (McBride 2012). McBride explains why progressive taxes have the greatest negative effect on economic growth:

> These results support the Neo-classical view that income and wealth must first be produced and then consumed, meaning that taxes on the factors of production, i.e., capital and labor, are particularly disruptive of wealth creation. Corporate and shareholder taxes reduce the incentive to invest and to build capital. Less investment means fewer productive workers and correspondingly lower wages. Taxes on income and wages reduce the incentive to work. Progressive income taxes, where higher income is taxed at higher rates, reduce the returns to education, since high incomes are associated with high levels of education, and so reduce the incentive to build human capital. Progressive taxation also reduces investment, risk taking, and entrepreneurial activity since a disproportionately large share of these activities is done by high income earners (*Ibid.*, p. 2).

Negative Impacts on Workers and Entrepreneurs

The complexity and ambiguity of the tax codes also harm businesses and entrepreneurs, resulting in slower economic growth. In 1987, for example, the IRS issued a list of 20 factors employers should consider when deciding whether a worker is an employee or an independent contractor. (See Revenue Ruling 87-41, 1987-1 C.B. 296.) According to Nina Olson, the list is "complex, subjective, and does not always produce clear answers. The potential for errors and abuse is high in those gray areas where not all factors yield the same result, particularly because there are no weighting rules" (Olson 2016).

In 2015, the Department of Labor issued a memo in which it adopted its own more expansive interpretation of the definition of "employees" under the Fair Labor Standards Act. (See United States Department of Labor, Administrator's Interpretation No. 2015-1, July 15, 2015.) Employers and workers are often bewildered by the conflicting requirements.

If the IRS reclassifies a worker after an audit, the employer may be liable for employment taxes for a number of years, interest, penalties, and potential disqualification of employee benefit plans. The worker may have to pay self-employment taxes and lose the ability to take certain business-related deductions. Workers have no right to petition the classification determination to the U.S. Tax Court.

Innovators and entrepreneurs find the tax code especially burdensome. A survey conducted in 2016 of members of the National Association for the Self-Employed (NASE) found 34 percent of those who reported earning income in the sharing economy (i.e., individuals typically using the internet to borrow or rent from each other assets such as cars and homes) did not know they needed to file quarterly estimated tax payments, 36 percent did not understand what records they would need to maintain as a small business for tax purposes, and 43 percent did not set aside money to meet their tax obligations or know how much they owed (Bruckner 2016). Many of these entrepreneurs will be subject to penalties or worse because the tax code is just too complicated for them to understand or has never been explained to them.

Corporate Taxes

Corporations pay a federal corporate income tax of 35 percent on net earnings plus additional state and local levies that average 4 percent, for a total tax rate of 39 percent. Investors pay an additional tax of up to 23.8 percent on dividends paid out by the corporation to its shareholders. A capital gains tax (a tax on the increased value of a stock or asset while in the possession of the taxpayer) ranging from 15 percent to 20 percent (depending on the taxpayer's income tax bracket) is yet another tax on top of those. As a result, corporations are taxed more in the United States than companies in any other developed country.

In 2010, the National Commission on Fiscal Responsibility described the U.S. corporate income tax as "a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment." It found

> the corporate income tax … hurts America's ability to compete. On the one hand, statutory rates in the U.S. are significantly higher than the average for industrialized countries (even as revenue collection is low), and our method of taxing foreign income is outside the norm. The U.S. is one of the only industrialized countries with a hybrid system of taxing active foreign-source income. The current system puts U.S. corporations at a competitive disadvantage against their foreign competitors. A territorial tax system should be adopted to help put the U.S. system in line with other countries, leveling the playing field (p. 28).

The commission recommended creating a single corporate tax rate set at between 23 percent and 29 percent, eliminating all tax "expenditures" for businesses, and moving to a territorial tax system.

Policy Agenda

Americans want an economy that is diverse, dynamic, and growing. Such an economy requires rising employment, savings, investments, and productivity. Today's tax system imposes heavy and unnecessary burdens on these factors. To minimize the negative effect of taxes on job creation, income tax rates must be reduced, the tax code made less complex and progressive, and corporate taxes must be reduced significantly.

Recommended Readings: National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-growth, Pro-family Tax System for the 21st Century* (Washington, DC: U.S. Government Printing Office, 1996); Chris Edwards, "Options for Tax Reform," *Policy Analysis* No. 536, Cato Institute, 2005.

8. The broader the tax base, the better.

A broad tax base is pro-growth, makes lower tax rates possible, and fosters equal treatment of taxpayers.

A tax base is the sum of the values of all the financial streams or assets on which a tax is imposed. An income tax draws revenue from earnings but not from other sources. Similarly, a sales tax draws revenue from consumption but not earnings or savings.

Politicians delight in manipulating the tax bases of existing taxes and proposing new taxes on previously untaxed activities or assets. They do this because such alterations of the tax code are often hidden from most taxpayers, allowing politicians to grant favors or punish rivals without most voters knowing. But over time the tax base becomes riddled with exceptions, deductions, and credits, making it necessary to raise the tax rate in order to collect the same amount of revenue as before.

A good rule of thumb for a sound tax system is: The broader the tax base, the better. A broad tax base is pro-growth, makes lower tax rates possible, and fosters equal treatment of taxpayers.

Dangerous Shrinking Base

The National Taxpayer Advocate's 2016 report to Congress reports, "Based on all the comments we receive every year in the Taxpayer Advocate Service and our experience in handling hundreds of thousands of taxpayer cases a year, we believe that lowering rates in exchange for broadening the tax base would be an excellent bargain for U.S. taxpayers" (p. 324). Unfortunately, Congress didn't get the message.

As previously reported in this chapter, the federal tax code is riddled with tax breaks, deductions, credits, and loopholes, each reducing the base of the tax and requiring a higher putative tax rate on most taxpayers. Tax "expenditures"— i.e., lost revenue due to exemptions, deductions, or credits—in 2016 exceeded by $200 billion the entire amount Congress appropriated to fund the national government. Business tax breaks numbered more than 75 in 2010.

As lawmakers add more tax breaks for lower-income citizens and limit those for higher-income citizens, the tax burden is being disproportionately loaded onto an increasingly smaller segment of income earners. In 2014, the oft-demonized top 1 percent of income earners accounted for 40 percent of income tax revenue. The top 5 percent of earners accounted for 60 percent of revenue, and the top 10 percent of earners contributed 70 percent. By contrast, the bottom

50 percent of income earners paid only 2.75 percent of federal income taxes (Greenberg 2017, p. 9).

As more people are removed from the tax rolls through credits, deductions, exemptions, and the like, the burden on the remaining taxpayers must necessarily increase, increasing incentives to invest in lobbyists to obtain even more tax breaks and lawyers to find ways to qualify for existing tax breaks. High marginal tax rates distort investment decisions and reduce the incentive to work and take risks. The motive to comply voluntarily with tax rules diminishes as more and more people decide to cheat rather than be "chumps."

Power without Paying

One problem created by the disproportionate distribution of the burden is that a growing portion of the population pays little or no taxes, yet has the electoral power to dictate spending policy at the ballot box. This problem is real, although perhaps too complicated for elected officials and candidates for public office to comment on.

In 2012, presidential candidate Mitt Romney responded to a question during what he thought was a private meeting with campaign supporters that "there are 47 percent of the people who will vote for the president [Obama] no matter what" because they don't pay federal income taxes. The number was accurate, but it referred only to the federal income tax: Many Americans pay payroll taxes (Social Security and Medicare) and virtually all Americans pay federal excise taxes as well as state and local taxes. So most Americans do pay taxes, and a candidate promising to reduce taxes or make them more fair can still compete for their votes.

Still, elected officials can raise campaign funds and win votes by pandering to constituents wanting expanded entitlement programs, just as they can by pandering to businessmen and -women seeing tax breaks and subsidies for their businesses. The evidence that this occurs is overwhelming: Entitlement programs and the massive deficits and national debt they cause threaten the solvency of the national government and many states and local governments.

Even before passage of the Obamacare health care entitlement program and any of the recent stimulus packages, and bailouts, our entitlement programs were on a path to bankrupt America. In 1995, the Bipartisan Commission on Entitlement and Tax Reform stated:

> The Commission's Interim Report graphically displays the need to address our future fiscal imbalance. The conclusion of the Report is clear and inescapable: If we do not plan for the future, entitlement spending promises will exceed financial resources in the next century. The current spending trend is unsustainable (p. 8).

Similar warnings can be found in the 1996 report by the National Commission on Economic Growth and Tax Reform and the 2010 report of the National Commission on Fiscal Responsibility, showing the concern is bipartisan as well as long-standing. Rather than make the systemic changes needed to control the problem, Congress and every president since 1995 have caused or allowed entitlement programs and spending to grow.

Ways to Expand the Tax Base

The tax base for federal taxation can be expanded in several ways. First, and the focus of previous principles in this chapter, is to end tax exemptions, deductions, and credits that are currently in the tax code. Ending these “tax expenditures” is clearly the low-hanging fruit in the national tax and budget debate, just waiting for a political leader willing to rally taxpayers and voters to the cause.

Second, the tax base also can be expanded by adopting pro-growth policies. Recall that a tax base consists of the values of all the financial streams or assets on which tax is imposed. Increase that value, and revenue grows without any changes to the tax code. Economic growth can be encouraged through deregulation, entitlement reform, improving the efficiency with which public services are provided, and many other methods, many of them described in other chapters of this book. Like the proverbial “rising sea that lifts all ships,” economic growth expands the tax base and makes tax rate reductions possible.

Third, shifting from an income tax to a consumption-based tax, such as the FairTax, also would expand the tax base. While income can be hidden or reduced by high taxation, consumption is (at least arguably) more difficult to hide and, since the national retail sales tax is a single fixed rate, it is unlikely to change consumption in ways that cause economic inefficiency and waste. Taxing consumption may encourage a higher rate of saving, which increases economic growth and consequently increases the tax base.

A fourth way to expand the tax base is maintaining a diverse portfolio of taxes rather than relying heavily on only one or two. Such an approach is usually defended by appealing to fairness, since taxing both income (with an income tax) and consumption (with a sales tax) means everyone pays some taxes even if they are retired or independently wealthy and report no income. A diverse tax base promises to generate more stable revenues, since too much reliance on a single tax, say a property tax, can result in a major drop in revenue when housing markets tumble. A third justification is economic competitiveness: Consumers will cross state lines to buy groceries and other products if the sales tax differential is large enough. Another justification is that taxes ought to reflect the value of public goods and services a taxpayer receives, something unlikely to be captured by either a retail sales tax or a personal income tax.

While the portfolio approach to taxes is popular in the public finance literature, it has shortcomings. It requires administrative infrastructures to handle each tax system, making collection less efficient. It is less transparent to taxpayers, since the total taxes paid are never reported. If some forms of taxation are known to be anti-growth, such as income taxes, then they arguably should not be in the portfolio at all, a choice made by seven states. Their superior economic performance suggests they made the right choice.

Policy Agenda

A broad tax base is beneficial because it makes lower tax rates possible, resulting in less evasion and less distortion of incentives to work and invest wisely. Eliminating deductions, credits, and the like is one way to expand the tax base but it is not the only way. Promoting economic growth, changing from taxing income to taxing consumption, and diversifying the tax base are other ways. All these ways would mark an improvement over the current federal tax code.

Recommended Readings: Scott Greenberg, "Options for Broadening the U.S. Tax Base," Tax Foundation, November 24, 2015; Curtis Dubay and David Burton, "A Tax Reform Primer for the 2016 Presidential Candidates," *Backgrounder* No. 3009, The Heritage Foundation, April 2015.

9. Everyone should pay the same income tax rate.

It ought to be morally and legally unacceptable that some people are singled out to pay a higher rate of tax on their income than others pay.

Most Americans do not believe the federal tax code is moral. It was reported as early as 1977 that as many as 60 percent of Americans felt the federal tax system was either "somewhat unfair or quite unfair" (Pilla 2001, p. 12). Thirty years later, in a report titled *Reducing the Federal Tax Gap*, the IRS stated, "Special rules, subtle distinctions in the tax law and complicated computations add to this complexity and foster a sense of unfairness in our tax system, which ultimately discourages compliance" (IRS 2007, p. 50).

Unequal Treatment

The public widely perceives the federal income tax as unfair because the law *is* unfair. A 2005 report by the President's Advisory Panel on Federal Tax Reform stated:

> Taxpayers with the same income, family situation, and other key characteristics often face different tax burdens. Such differing treatment creates a perception of unfairness in our tax code. For example, taxpayers in states with high state and local income and property taxes receive higher deductions than taxpayers who live in lower-tax states with fewer state-provided services. Taxpayers with substantial employer-provided health insurance benefits receive in-kind compensation that is not taxed, while taxpayers who buy the same health insurance on their own usually pay tax on the income used to purchase the insurance. And Social Security benefits are taxed at a higher rate for married seniors than for those not married. How much or little taxpayers pay in tax is sometimes dependent on where they happen to live, the choices made by their employers, and whether they are married (p. 5).

Note none of these reasons why some people pay a higher tax rate than others has to do with the income they earn. We will address that basis for tax discrimination in a moment, but it is a different kind of concern. The problem described so well by the President's Advisory Panel on Federal Tax Reform is that the tax code, having been altered so many times by elected officials seeking to achieve social objectives other than raising revenue, has become profoundly inequitable in its impacts today.

By attempting to reward homeowners, the tax code penalizes renters; by rewarding marriage it discriminates against the single and divorced; by rewarding employers who provide health insurance to their employees it punishes the self-employed and self-insured. When tax breaks and credits to corporations are included, we discover people who live in certain areas, buy a certain kind of car, or purchase their electricity from a certain company, benefit at the expense of others. We find employees of some industries benefit at the expense of others.

How do we justify this disparate impact of the federal income tax on millions of people? Is it enough to say "it is in the national interest" that there should be 75 specific tax exemptions, deductions, and credits for some businesses but not others? Or thousands of different combinations of duties and privileges that make it virtually impossible to know how much any taxpayer truly owes?

Unacceptable in Law

The touchstone of American liberty is found in the Declaration of Independence, which declared "that all men are created equal, that they are endowed by their Creator with certain unalienable rights, that among these are Life, Liberty, and the Pursuit of Happiness." In the Founders' vocabulary, the "pursuit of happiness" was synonymous with the right to private property. How can this commitment to *equal treatment under the law* be squared with a tax code that has such a disparate impact on people and their rightfully earned property?

The Founders never would have approved federal income taxation, much less a progressive income tax. They prohibited any such tax in Section 9 of the Constitution, and they believed that by preventing the national government from having its own source of revenue, it would be forced to rely on the states for much of its funding and the execution of necessary public works programs. That prohibition stood until passage of the Sixteenth Amendment in 1913, the year that marked the beginning of the national government's unchecked growth.

The invidious discrimination manifest in the income tax would be unacceptable in any other area of law. Who would suggest that groups of people whether rich or poor should be more or less liable under, say, the fraud statutes, merely because of their social standing? In tax law, not only is this tolerated, it is embraced. Politicians and policymakers present it as though it were a noble, high-minded pursuit. But the power of law cannot and should not be used as a sword to attack the lawful and peaceful pursuits of entire segments of the population, perhaps as a means for the "masses" to get even with high income earners.

Taxing Only the Rich

The definition of "progressive" income taxation is marginal tax rates that rise with income. This means people with more reportable income don't only pay *proportionately* more than people with lower incomes, they pay *disproportionately* more.

Progressive income taxation ought to be much more controversial in America than it is today. It was number two in the 10-plank proposal put forth by Karl Marx and Frederick Engels in 1848 in *The Communist Manifesto* "to wrest, by degrees, all capital from the bourgeois, to centralize all instruments of production in the hands of the state."

The Sixteenth Amendment was approved amid promises that the tax would be levied only on the very rich. At that time, the bottom tax bracket was 1 percent on incomes more than $20,000 and the top bracket was just 6 percent on incomes more than $500,000. James A. Dorn, writing for the Cato Institute, reports, "When the first income tax was passed by Congress in 1894, the *New York Times* called the legislation, 'a vicious, inequitable, unpopular, impolitic, and socialistic act,' and the *Washington Post* added, 'It is an abhorrent and calamitous monstrosity'" (Dorn 1996). Alas, sentiments changed and today we tolerate and even celebrate such a law.

Policy Agenda

The arbitrary nature of the tax code makes clear why Alexander Hamilton, America's first treasury secretary, argued consumption taxes "have, upon the whole, better pretensions to equality than any other" (Morris 1957, pp. 259–60). Lawmakers today would do well to heed his wisdom and end progressive taxation of income.

Recommended Readings: Daniel J. Pilla, "A Monument of Deficient Wisdom: The Constitutional Conflict in the Federal Income Tax Law Enforcement," *Road Map to Tax Reform Series* No. 165, Institute for Policy Innovation, 2001; James A. Dorn, "Ending Tax Socialism," Cato Institute, December 13, 1996.

10. Perhaps it is time to repeal the income tax.

> The only constitutional purpose of the tax code is to raise revenue. The federal income tax violates that purpose. Maybe it is time to repeal it altogether.

The only constitutional purpose of the tax code is to raise revenue. Tax laws should not be used by politicians to compel behavior or to reward their friends and punish their opponents. Saying this begs a question: Is it time to repeal the income tax?

The federal income tax no longer operates primarily to raise revenue. The Earned Income Tax Credit, Child Tax Credit, and First-Time Homebuyers Credit are just a few of the dozens of personal and business credits in the code, but they are especially important because they are *refundable* credits. This means even citizens who owe no taxes can get cash from the government. This is not how a just tax operates.

Refundable credits are welfare programs, transfer payments used for social purposes. While the value of these credits has fluctuated in recent years, the Congressional Budget Office estimates the value of these credits is roughly $150 billion (CBO 2013, p. 1).

Ignoring the Constitution

Article I, Section 8 of the United States Constitution authorizes the federal government to collect taxes for just three narrow purposes: to pay the debts of the nation, to provide a national defense, and to ensure the "general welfare" of the nation. This latter term was understood narrowly as limiting the use of the powers enumerated in that section to such programs as benefited the nation as a whole, not its individual inhabitants or locales, and certainly not classes of citizens at the expense of others (Pilla 2001, pp. 8–12). And yet, a great portion of the national government's budget finances transfer payments imposed for the purpose of social engineering. The income tax enables many of those payments.

The Bipartisan Commission on Entitlement and Tax Reform hit the issue head-on when it said, "Government does not create wealth by distributing entitlement benefits; rather, it is engaging in a willful choice to take dollars from one segment of the population and to distribute that money in the form of benefits for others" (1995, p. 37).

Redistribution through Taxation

In a 1933 case titled *United States* v. *Butler,* the Supreme Court addressed the government's claim that redistribution is justifiable under the General Welfare Clause of the Constitution. The Court ruled: "a tax, in the general understanding of the term, and as used in the Constitution, signifies an exaction for the support of the government. The word has never been thought to connote the expropriation of money from one group for the benefit of another" (297 U.S. 1, 61 (1933)). Today, contrary to the principle expounded by the Court, Congress engages in just such expropriation.

In *Loan Association* v. *Topeka,* discussed earlier under Principle 6 (neutrality), the Supreme Court ruled using taxes to transfer wealth is a wholly illegitimate use of governments' taxing authority. The Court correctly labeled the practice "robbery." By this understanding, the tax code enforced as the law of the land today can be considered such "robbery." Thomas Jefferson condemned the practice as an attack upon the idea of liberty. He stated:

> To take from one, because it is thought his own industry and that of his father has acquired too much, in order to spare to others who (or whose fathers) have not exercised equal industry and skill, is to violate arbitrarily the first principle of association, the *guarantee* to everyone a free exercise of his industry and the fruits acquired by it (Ellis 1973, p. 94, italics in the original).

Immoral Taxation

There is simply no legal or moral authority in a free society that justifies using the power of government to take from some what they have legally and peacefully acquired and give it to others who have not earned it.

Frederic Bastiat (1801–1850)—a French economist, statesman, and author—called the practice of using the power of taxation to take from producers and give to non-producers "legal plunder." In the strongest terms, he called for the elimination of any such law because "it is not only an evil itself, but it is a fertile source for further evils because it invites reprisals. If such a law—which may be an isolated case—is not abolished immediately, it will spread, multiply, and develop into a system" (Bastiat [1850] 1977, p, 21).

So long as such laws permeate the tax culture in America, there will never be enough money to satisfy government. No tax system can produce sufficient revenue to provide for the social programs formulated by those seeking more ways to spend money they have not earned. Tax burdens for the producers will grow to confiscatory levels while the non-producers have further incentive to remain non-producers. The only hope of controlling the burden is to hold government strictly accountable to the constitutional limitations on its taxing authority.

Is the Income Tax Necessary?

In a column written in 2001, then Congressman Ron Paul wrote, "You may be surprised to know that the income tax accounts for only approximately one-third of federal revenue. Only 10 years ago, the federal budget was roughly one-third less than it is today. Surely we could find ways to cut spending back to 1990 levels, especially when the Treasury has single year tax surpluses for the past several years. So perhaps the idea of an America without an income tax is not so radical after all" (Paul 2001).

Eliminating the federal income tax would cost the national government about $3.3 trillion in lost revenue but would reduce overall compliance costs by $2.1 trillion. The effect of lifting the combined burden of $5.4 trillion off the nation's taxpayers, businesses, and consumers is difficult to imagine. Gross Domestic Product (GDP) in 2016 was $18.5 trillion, so the economic stimulus would be an incredible 29 percent of the value of all the goods and services produced in the nation that year.

As Paul argues, eliminating the federal income tax in 2001 would have left the budget deficit unchanged, provided spending was reduced to its level in 1991. The calculation is probably similar today. Regrettably, no one in public office today, in 2017, can imagine returning the national government to the size it was in 2007, even though many of those same elected officials campaigned for office and got elected *in 2008* saying government was too big.

Paul ended his column by asking,

> Is it impossible to end the income tax? I don't believe so. In fact, I believe a serious groundswell movement of disaffected taxpayers is growing in this country. Millions of Americans are fed up with the current tax system, and they will bring pressure on Congress. Some sidestep Congress completely, bringing legal challenges questioning the validity of the tax code and the 16th Amendment itself. Ultimately, the Liberty Amendment could serve as a flashpoint for these millions of voices (*Ibid*.).

Ron Paul introduced the Liberty Amendment in 1998, 1999, 2003, 2005, 2007, and 2009. Section 4 of the four-part amendment reads: "Three years after the ratification of this amendment the sixteenth article of amendments to the Constitution of the United States shall stand repealed and thereafter Congress shall not levy taxes on personal incomes, estates, and gifts."

Recommended Readings: Frederic Bastiat, *The Law,* Foundation for Economic Education, (1850) 1977; Ron Paul, "The Case Against the Income Tax," *Texas Straight Talk*, May 7, 2001.

Policy Agenda

Convention wisdom says it is impossible to repeal the federal income tax. Even President Donald Trump, the iconoclastic outsider who seems willing to champion unpopular causes, has not called for abolishing the income tax. But the case for doing so—on moral, political, and economic grounds—is strong. This may be an idea whose time has come.

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Additional Resources

Additional information about tax policy is available from The Heartland Institute:

- PolicyBot, The Heartland Institute's free online clearinghouse for the work of other free-market think tanks, contains thousands of documents on tax policy issues. It is on Heartland's website at https://www.heartland.org/policybot/.

- https://www.heartland.org/Center-Budget-Taxes/ is The Center for Budgets and Taxes website, devoted to the latest news and commentary about budget and tax issues. It often addresses local, state, and federal tax policy issues. Read headlines, watch videos, or browse the thousands of documents available from PolicyBot.

- *Budget & Tax News*, a monthly publication from The Heartland Institute, is available for free online at the websites described above, or subscribe to the print edition for $36 a year (ten issues).

Directory

The following national organizations are among the many that support sound tax policies.

Americans for Fair Taxation, https://fairtax.org

Americans for Tax Reform Foundation, http://www.atr.org/

American Legislative Exchange Council (ALEC), https://www.alec.org/

Beacon Hill Institute, http://www.beaconhill.org/

Cato Institute, https://www.cato.org/

Center for Strategic Tax Reform, http://www.cstr.org/

Council on State Taxation (COST), http://www.cost.org/

Dan Pilla's TaxHelpOnline.com, http://taxhelponline.com/

Freedom Tax, http://thefreedomtax.org/

Heartland Institute, https://www.heartland.org/

Heritage Foundation, http://www.heritage.org/

John Locke Foundation, https://www.johnlocke.org/

Pacific Research Institute, http://www.pacificresearch.org/

Small Business & Entrepreneurship Council (SBEC), http://sbecouncil.org/

Tax Foundation, https://taxfoundation.org/

Tax Freedom Institute, www.taxfreedominstitute.com

Taxpayer Advocate Service, https://taxpayeradvocate.irs.gov

Winning Publications, Inc., http://taxhelponline.com/