

# How to Stop the IRS...and Solve the Deficit Problem by Dr. X (Joseph George Caldwell)

Why the US tax system is not good for  
the country, and how to build a good  
tax system.

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# Outline

- This set of presentation graphics (“slides”) follows the order of the book.
- Slide headings correspond generally to the subsection headings of the book.
- All key points are cited here.
- The book was written in 1987. Data has changed, but the basic concepts are still valid.
- The “updating” on the front page refers to updating of data and facts (e.g., historical events such as mandatory health coverage)

# 1. Take Back Your Freedom!

- The US tax system is a mess
  - Complicated, burdensome, unfair
  - Cannot produce required revenue, unstable
  - Massive budget deficits and national debt
  - US is now (since 1985) a debtor nation
  - Administratively costly, invasive of privacy, encourages tax evasion, bad for int'l. trade, discourages saving, investment and production

# 1. Take Back Your Freedom! (cont'd.)

- Terminology
  - Will generally use the term “personal income tax” instead of “individual income tax” and “corporate profit tax” instead of “corporate income tax”
  - The so-called “individual income tax” is as much a tax on families as on individuals
  - The so-called “corporate income tax” is not a tax on income, but on profit

# 1. Take Back Your Freedom! (cont'd.)

- Why would the country keep a bad tax?
  - Tax literature is arcane
  - Public unaware of tax theory literature
  - Economists focus on economic viewpoint
  - Economists are, by and large, analysts, not systems engineers
  - US Government propaganda that the income tax system is a beneficial, voluntary tax
  - US Government enjoys the regimentation required by an income tax system

# 1. Take Back Your Freedom! (cont'd.)

- Systems engineering can develop a good tax system
  - There are many types of taxes: individual, corporate, income, sales, payroll, excise, import, property, inheritance, estate, many more.
  - The various taxes differ greatly with respect to many criteria, such as intrusiveness, equity, stability, ability to produce revenue
  - Development of a system that must satisfy multiple goals and constraints is the bailiwick of systems engineering (“tax engineering”)
  - This book shows how to use systems engineering to develop a good tax system for the US
  - The basic answer: a Value-Added Tax (VAT)

## 2. How Did It Happen?

- History of US tax system
  - Amalgamation of many methods
    - Income tax from England
    - Inheritance tax from France
    - Sales tax from Netherlands and Spain
    - Property taxes from China and Europe
- The US tax system has its roots in the US Constitution
  - No “taxation without representation,” therefore “direct” taxes must be apportioned to the states in proportion to population

## 2. How Did It Happen? (cont'd.)

- What is a “direct tax”
  - A direct tax is one imposed on the person (or entity) on whom the ultimate burden is expected to fall (i.e., on the taxpayer)
    - Income taxes, property taxes, capitation taxes
  - An indirect tax is shifted to someone else
    - Sales taxes, excise taxes, tariffs
    - These taxes raise the price of a product or service, passing the tax burden to the purchaser
  - Distinction not always clear (e.g., a city sales tax but no county sales tax – merchants can’t simply raise prices or lower wages)



## 2. How Did It Happen? (cont'd.)

- The original US Constitution outlawed the income tax
  - US Constitution did not specify which taxes were direct or indirect, nor provide a definition. Determination up to the Supreme Court.
  - In early version, all federal taxes to be apportioned in proportion to representation (population); in final version, just direct taxes.
  - Concept was for federal taxes to be mainly on commerce (indirect taxes, such as on imports and exports, on consumption, tariffs, excise taxes). These indirect taxes did not have to be apportioned in proportion to population.

## 2. How Did It Happen? (cont'd.)

- The history of the US federal income tax
  - Used in emergencies
    - During Civil War (1862-71). Discontinued:
      - No longer needed; inequitable; no agreement on definition of income; inefficient, obtrusive
    - In 1895. Declared unconstitutional (a direct tax not apportioned to the states per population)
    - 1909: Corporation income tax. Considered a tax on business, so no Constitutional problem
    - 1913: Sixteenth Amendment ratified, permitting a federal income tax without allocation to states in proportion to population

## 2. How Did It Happen? (cont'd.)

- History of the US federal income tax (cont'd.)
  - Originally, the federal income tax was a tax on the rich: a tax of 1-7% on about 1% of the population. (Single exemption of \$3,000; family exemption of \$4,000; 1% rate up to \$20,000 per year; 7% rate for over \$500,000 per year.)
  - Up to the 1930s, states used property tax. When property values fell, states and localities established retail sales tax.

## 2. How Did It Happen? (cont'd.)

- History of the US federal income tax (cont'd.)
  - World War II: massive increase in revenue needed. Income tax converted to a tax on rich (high earners) to a tax on the general population. Exemptions reduced, rates increased.
  - Employer withholding of taxes from wages and salaries established in 1943 (since taxpayers not expected to save money for taxes)
  - Income tax brackets were not indexed to inflation. Bracket creep moved total income tax (federal, state, local, and payroll taxes) from about 10% of total income to over 50% today.
  - Bracket creep eliminated with Tax Reform Act of 1986 (brackets adjusted each year per the Consumer Price Index)

## 2. How Did It Happen? (cont'd.)

- The current US tax system
  - Revenue demands of federal government: 25% of GNP in 1955 to 33% of GNP in 1981
  - Sources (1981)
    - Individual income tax: 38%
    - Corporate profit tax: 9%
    - Payroll: 26%
    - Goods and services: 17%
    - Property: 9%
    - Inheritance and gift: 1%

## 2. How Did It Happen? (cont'd.)

- The current US tax system (cont'd.)
  - Why so many taxes?
    - Several reasons:
      - Tradition
      - Many points of taxation tend to make total tax burden appear less
      - Place taxes on users (airplane tickets, gas tax)
      - Affect behavior, charge users for costs (cigarette tax, liquor tax)
      - Affect distribution of wealth (income tax, wealth tax, inheritance tax, estate tax)

## 2. How Did It Happen? (cont'd.)

- The current US tax system (cont'd.)
  - Tax base is narrow and volatile, leading to high tax rates, revenue instability, budget deficits and high national debt.
  - US tax system is not harmonized with international trade (under GATT and the “destination principle,” a country may remove indirect taxes (such as VAT) on exported goods: US at a substantial disadvantage

## 2. How Did It Happen? (cont'd.)

- Why is the current system so bad?
  - Framers of Constitution had a good idea in requiring apportionment of taxes per population (limit power of central government)
  - Serious inadequacies of an income tax were not apparent at the initial low rates on a small portion of the population
  - At the high rates to which the system has evolved, the income tax has many serious disadvantages



## 2. How Did It Happen? (cont'd.)

- Disadvantages of a high income tax
  - Strong national police force – the IRS – needed for enforcement
  - Reduced incentives to save and to work
  - Strong incentive for tax evasion
  - Disincentive for firms to save, to invest
  - Subsidizes debt financing over equity financing, increasing the risk of failure
  - Penalizes efficient, profit-making firms
  - Narrow, volatile tax base cannot produce sufficient, stable revenues, contributing to budget deficits and turning the US into a debtor nation

## 2. How Did It Happen? (cont'd.)

- Why is the US tax system so bad?
  - In all areas except taxation, government relies on experts to design, build and operate systems:
    - Interstate highway system
    - Computers, consumer goods
    - Man on the moon
    - Pharmaceuticals
    - Defense systems
  - For taxation, it designed the tax code itself (thousands of pages of detailed rules and regulations). The process is political, not based on modern principles of systems engineering. Resulting system is inadequate to produce required revenues and destructive of liberty.
  - The US Government is ostensibly inept at this job. It is time to “do the job right,” and design and implement a good tax system.

# 3. The Income Tax Monster

- The income tax has severe sociopolitical and economic drawbacks
  - Sociopolitical problems: perceived unfairness, heavy tax burden
  - Economic problems: discourages economic growth, stability, efficient use of resources, high employment
  - Inadequate source of revenue: unstable, and unable to raise sufficient revenue to cover the national budget

# 3. The Income Tax Monster (cont'd.)

- Nine major problems (the next nine chapters)
  - 1. The income tax has destroyed the privacy of the American Citizen
  - 2. The income tax has spawned an American Gestapo
  - 3. The income tax has weakened the Constitution
  - 4. The income tax is unfair
  - 5. The income tax is corrupting the country
  - 6. The income tax is too complicated
  - 7. The income tax has serious economic deficiencies
  - 8. The cost of administering and complying with the income tax is very high
  - 9. The income tax base is contributing to economic collapse

# 3. The Income Tax Monster (cont'd.)

- To date, all tax reform has failed
  - The last major tax reform was the Tax Reform Act of 1986.
  - The inadequacies of the income tax system were not addressed by that Act, and have continued.
  - Under Tax Reform, the income tax is even more complicated than before (the Act started out as the Tax Reform *and Simplification* Act of 1986!).
  - Meaningful tax reform will not come easy (government enjoys the high degree of individual monitoring and control required to implement the current system).
  - This book was written because the Tax Reform Act of 1986 (and all subsequent revisions) did not address the fundamental inadequacies of the income tax.
  - This book presents the top-level design for a good tax system, based on the principles of systems engineering.

# 4. The Assault on Privacy

- Privacy is a valuable asset
- Is there a legal right to privacy?
- The Social Security Number (SSN) was originally simply a retirement account number, not a universal citizen identification number
- The US Government's commitment to protect privacy is waning
- The computer age has created a demand for a unique, universal, permanent identifier
- The SSN is an ideal universal identifier
- Use of the SSN as an identifier is growing
- The information business is big business

## 4. The Assault on Privacy (cont'd.)

- The use of deceptive information-extraction procedures is common
- Coordination of Benefits – a very effective tool for privacy intrusion
- Coercion and harassment await those who resist submission of their SSNs
- The growing use of computers increases the demand for a permanent, unique, universal identifier
- Modern DBMSs need keys such as the SSN
- Concern over the loss of privacy in the US is mounting

# 4. The Assault on Privacy (cont'd.)

- The pressure on you to release your SSN is intense
- Submit to release of your SSN or face disenfranchisement
- Submit to release of your tax return – or lose your passport
- Release your SSN to the Government – or go without a job
- Release your SSN to your bank – or go without a bank account
- Protect your privacy at your peril



## 4. The Assault on Privacy (cont'd.)

- Modern computer technology can link together distributed data
- Use of the SSN identifier is increasing dramatically
- The move to SSNs for children
- Individuals have suffered a tremendous loss of privacy in the US
- Institutional defamation of character

# 4. The Assault on Privacy (cont'd.)

- The desire for privacy
- The argument for personal control of distribution of personal information
- Revealing well-kept secrets
- Forgive and forget
- “If you’ve done nothing wrong, you’ve nothing to hide”
- The move toward a national identification number
- Privacy of the individual represents protection of imperfect human beings from imperfect laws
- Most citizens don’t view changing the law as practicable; privacy is a buffer against unreasonable laws

# 4. The Assault on Privacy (cont'd.)

- The road to participatory democracy is rocky – and a slippery slope
- It is demeaning of human beings to be registered and monitored (like dogs and inmates!)
- Why the SSN survives
- The shift to an information economy has increased demand for information system identifiers
- Government intrusion on privacy may be warranted in some situations – but the income tax isn't one of them
- The potential for abuse of the SSN is profound

# 5. The American Gestapo?

- Tax court – guilty until proved innocent
- Many people regard the IRS as an American Gestapo – because it uses Gestapo tactics
- Two books: *Tax Revolt* by Martin A. Larson and *To Harass Our People* by George V. Hansen

# 5. The American Gestapo? (cont'd.)

- *Tax Revolt* by Martin A. Larson cites many abuses committed by the IRS against US citizens, and many practices of the IRS that are either illegal or in violation of the Bill of Rights:
  - Monitoring of private telephone conversations
  - Opening of private mail
  - Burglarizing of people's homes and offices
  - Electronic surveillance of private citizens
  - Use of undercover agents
  - Forcing US citizens to testify against themselves
  - Forcing US citizens to prove their innocence on pain of severe punishment
  - The widespread use of deceit, concealment, misrepresentation, threats, and lies

# 5. The American Gestapo? (cont'd.)

- Forcing full disclosure from taxpayers, in violation of the Fifth Amendment
- Requiring taxpayers to confer power of attorney on anyone representing them
- Using testimony of informants, who may not be questioned or cross-examined
- Seizure of property or money due taxpayers but held by others
- Payment of bribes to spies, informers, and undercover agents
- Entrapment
- The establishment of intentionally obfuscatory regulations which are contradictory and difficult to understand, and the use of these regulations to bluff taxpayers into paying more than is due
- Threatening fines and imprisonment
- Grants of immunity from prosecution to its agents
- Seizure of property of third parties who owe nothing to the taxpayer (warehouses containing taxpayer's property, for example)

# 5. The American Gestapo? (cont'd.)

- In his book, *To Harass Our People*, George Hanson cites the following IRS excesses, and characterizes the IRS as the American Gestapo:
  - Attachment of 100 percent of a taxpayer's wages, salary, and/or property
  - Invasion of the privacy of a citizen without a court order
  - Seizure of property on the basis of conjecture, without a court order
  - Trial of citizens in a special court governed by the IRS
  - Forced submission of documents, records, and other material without a court order

# 5. The American Gestapo? (cont'd.)

- Publication of a citizen's debt to the IRS
- Subjection of citizens to electronic surveillance without a court order
- Waiver of the statute of limitations
- Threatening of witnesses
- Violation of written agreements
- Reprisals against citizens
- Maintaining of lists of private citizens for the purpose of harassing and monitoring them
- The use of fear and intimidation as a technique in performing its function



# 5. The American Gestapo? (cont'd.)

- Gestapo-like tactics of the IRS
- Through the IRS, the US has established a police state. Hansen (and co-author Larrey Anderson Jr. of *How the IRS Seizes your Dollars and How to Fight Back*) summarize the secret-police activities of the IRS:
  - IRS procedures are set up to intimidate, harass, and bankrupt individuals and businesses. If the IRS decides you owe a certain amount, it can levy a "jeopardy assessment," which can impound all of your assets.
  - The IRS system makes it very difficult for the taxpayer to seek redress outside of the agency. Under its regulations, the IRS can seize property, confiscate records, and levy bank accounts without accusing the taxpayer of any crime. Within its own system, acting as judge, jury, and prosecutor, it can arraign and convict a taxpayer.
  - The IRS has ruined the careers of elected officials who attempted to expose its atrocities.
  - The IRS has allowed the Sixteenth Amendment (allowing the income tax) to take precedence over all other Amendments. In effect, current IRS procedures, ostensibly justified by the Sixteenth Amendment, nullify the First, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, and Tenth Amendments. The Sixteenth Amendment has had the effect, in the seven decades since its enactment, of virtually destroying the Bill of Rights.

# 5. The American Gestapo? (cont'd.)

- Night raids, arrests without warrants, incarceration without trial, beatings, and physical abuse have been part of the IRS' tactics. The IRS, by setting up its own separate judicial system, is in effect setting itself above the Constitution and outside of the law. By analogy, the KGB and Gestapo placed themselves above the law in the name of the security of the state. The IRS is a dreaded national police force with totalitarian powers and methods. The US citizens' attention has centered on the FBI and the CIA, and overlooked the threat to individual rights represented by the IRS.
- To promote secrecy, the IRS keeps much information on suspects on tape. Since the documents are not typed up as final documents, they are not subject to the Freedom of Information Act.
- Contrary to the statute of limitations principle that no one should be subject to contingent liability for crimes or civil wrongs indefinitely, the IRS uses threats of extortion to coerce citizens to grant extensions of time or waiver of the defense of statute of limitations. The extortion threat is that the agent will make an assessment without reference to any evidence then in possession. If it were not for the fact that the burden of proof in tax matters lies with the taxpayer, and that the IRS has its own courts, no one would agree to extensions.
- The IRS maintains an elaborate Data Services System that maintains files on over 115 million US citizens and 25 million businesses. The Data Services System collects newspaper clippings, police reports, court proceedings, personal correspondence, and tapes or transcripts of conversations obtained by electronic surveillance.

# 5. The American Gestapo? (cont'd.)

- The IRS needs resistors
- The case of Woody Herman
- The efficiency and dedication of the IRS are misdirected
- The IRS attack on churches
- The personal income tax forces businesses to act as tax collectors (impressment of firms, involuntary servitude)
- The US income tax system is in reality a payroll tax system

# 6. The Constitution Has Failed

- The personal income tax system has weakened the Constitution
- To implement a personal income tax system, the IRS has arrogated vast legislative, judicial and executive powers that nullify the personal freedom guarantees of the Bill of Rights.
- Because of passage of the Sixteenth Amendment to the Constitution (establishing the personal income tax) the following freedoms have been lost:

## 6. The Constitution Has Failed (cont'd.)

- the right to protection from unreasonable searches and seizures of their persons, houses, papers, and effects (Amendment 4)
- protection from being arrested and tried for a serious crime unless indicted by a grand jury (Amendment 5)
- the right not to be compelled to take witness against themselves (Amendment 5)
- to be deprived of liberty or property without due process (Amendment 5)
- to be confronted by the witnesses against them (Amendment 6)
- to obtain witnesses in their favor (Amendment 6)
- to a jury trial for cases involving amounts in excess of \$20 (Amendment 7)
- the right of privacy (implied in most of the amendments comprising the Bill of Rights, especially the tenth).

## 6. The Constitution Has Failed (cont'd.)

- The Constitution has failed to protect the citizen from a strong central government.
- The system of “checks and balances” of three branches (Legislative, Executive, Judicial) has been weakened (the IRS is in the Executive).
- There has been a dramatic shift in power from the states and the people to the federal government. The federal government budget now represents 20 percent of GNP.
- The Sixteenth Amendment has gutted the Bill of Rights.
- The US citizen will not regain his freedom until the Sixteenth Amendment is repealed.

# 7. The Income Tax Is Unfair

- Tax terms:
  - Marginal rate (“tax bracket”): tax paid on next dollar of income
  - Average rate (“effective rate”): proportion of total income paid in taxes
  - Graduated: tax rates change as income increases
  - Progressive:(average tax rate is higher for higher incomes)
- Current personal income tax system: graduated and progressive

# 7. The Income Tax Is Unfair (cont'd.)

- Personal income tax rates under Tax Reform Act of 1986:
  - Standard deduction of \$5,000
  - Personal exemption of \$2,000
  - Taxable income = total income less deductions and exemptions
  - 15% on taxable income \$0 - 29,750
  - 28% on taxable income \$29,750 – 71,900
  - 33% on taxable income \$71,900 – 149,250 (removes effect of deductions and exemptions)
  - 28% on taxable income over \$149,250
- Current rates and brackets adjust for inflation (“bracket creep”), but now a top rate of 39.6%; average rate is about 28% for many higher-income earners (earning about \$200,000 - 400,000 per year).



## 7. The Income Tax Is Unfair (cont'd.)

- Corporate profit tax rates under the Tax Reform Act of 1986. Taxable income = profit.
  - 15% on taxable income of \$0 – 50,000
  - 25% on taxable income of \$50,000 – 75,000
  - 34% on taxable income of \$75,000 – 100,000
  - 39% on taxable income of \$100,000 – 335,000
  - 34% on taxable income above \$335,000

# 7. The Income Tax Is Unfair (cont'd.)

Current (2015) corporate profit tax rate (from Wikipedia) (taxable income = profit):

For regular income tax purposes, a system of graduated marginal tax rates is applied to all taxable income, including capital gains. Through 2015, the marginal tax rates on a corporation's taxable income are as follows:

Taxable Income (\$)	Tax Rate[27]
0 to 50,000	15%
50,000 to 75,000	\$7,500 + 25% of the amount over 50,000
75,000 to 100,000	\$13,750 + 34% of the amount over 75,000
100,000 to 335,000	\$22,250 + 39% of the amount over 100,000
335,000 to 10,000,000	\$113,900 + 34% of the amount over 335,000
10,000,000 to 15,000,000	\$3,400,000 + 35% of the amount over 10,000,000
15,000,000 to 18,333,333	\$5,150,000 + 38% of the amount over 15,000,000
18,333,333 and up	35%

This rate structure produces a flat 34% tax rate on incomes from \$335,000 to \$10,000,000, gradually increasing to a flat rate of 35% on incomes above \$18,333,333. (These rates are similar to those specified by the Tax Reform Act of 1986 (which had a rate of 34% on taxable income over \$335,000).)

# 7. The Income Tax Is Unfair (cont'd.)

- Key points:
  - For individuals, top marginal rate is 39.6%.
  - For corporations, top marginal rate is 39%.
  - These rates are about equal to those imposed by the Tax Reform Act of 1986.
  - The numerical examples and arguments presented in the book that involve these rates remain valid.

# 7. The Income Tax Is Unfair (cont'd.)

- Why a progressive tax?
  - Economic theory provides arguments for and against progressive taxation, but no answer to the problem of determining the number of tax brackets and the bracket rates.
  - Why, for example, should a person earning only \$9,000 pay no tax? Does he have no responsibility for schools, social services, highways and defense? Or, being poor, does he have no ability to pay, and should be sent cash contributions?

# 7. The Income Tax Is Unfair (cont'd.)

- Economic considerations:
  - The utility of income
  - All people do not have the same utility functions
  - The progressive income tax discriminates against hard work, long hours, and self-improvement
  - The progressive income tax weighs heavily on working wives and mothers
  - The verdict: The progressive income tax is unfair
  - The politics of envy

# 7. The Income Tax Is Unfair (cont'd.)

- The personal income tax is not well suited to tax capital gains
- Capital gains may be more apparent than real
- “Tax Reform adjusts for inflation” – a myth.
- Under Tax Reform, older Americans can get socked with a 39 percent tax on lifetime earnings – or more!
- The real tax on your home’s appreciation may exceed 100%
- With its economic distortions and illogical incentives, the income tax is corrupt and is corrupting America.

# 8. The Income Tax Is Corrupting America

- High rates and complexity motivate tax evasion.
- This chapter explores how.

# 8. The Income Tax Is Corrupting America (cont'd.)

- The income tax system contains strong incentives for tax avoidance and tax evasion
  - Tax avoidance is legal, but wastes much time and money
  - Tax evasion is illegal
- People pay many taxes at low rates, without much objection (sales taxes, Social Security taxes, unemployment taxes, Medicare taxes, luxury taxes, cigarette taxes, alcohol taxes, gasoline taxes, airplane ticket taxes)
- Many people object to the personal income tax and invest considerable effort in trying to avoid paying income taxes.



# 8. The Income Tax Is Corrupting America (cont'd.)

- Reasons why people invest effort in avoiding income taxes:
  - The only tax that people can reasonably avoid.
  - To avoid a sales tax, must do without the good or service.
  - Income tax rates extremely high (strong incentive).
  - The complicated system demands that a prudent individual spend time determining how to structure income and investments to minimize the tax burden.
  - A “voluntary” income tax of 1% is one thing; a “voluntary” income tax of 50% is quite another – nothing more than an elaborate entrapment scheme (since other tax systems capable of raising the same level of revenue but not having this perverse incentive are available).

# 8. The Income Tax Is Corrupting America (cont'd.)

- The overall tax burden in the US is high, but no higher than in many other countries.
- As a percentage of GDP, the overall tax burden is among the lowest of the OECD countries.
- This book does not address the issue of whether the overall burden is too high.
- It objects to the attempt to extract revenue using a personal income tax.
- As a percentage of GDP, the US personal income tax is among of the highest.

# 8. The Income Tax Is Corrupting America (cont'd.)

- Tax rates under Tax Reform
  - The basic 28% marginal rate applies to about 20% of all families.
  - When combined with other income taxes, the total tax burden is high:
    - 28% federal income tax
    - 7.15% Social Security tax (“employee”)
    - [7.15% Social Security tax (“employer”)]
    - 10% state income tax
    - 5% of income for property tax
    - 3% of income for sales tax (7% of expenditures)
    - Total tax about 52% of income [58%]
  - With much of the tax burden in the form of income tax, there is a strong motivation for tax avoidance and tax evasion.
- Income taxes are too high!

## 8. The Income Tax Is Corrupting America (cont'd.)

- High-rate and high-hassle income tax, viewed as heavy, unjust and intrusive, gives rise to an underground economy (loss of tax revenue; corruption of society; waste of resources in enforcement)
- Enforcement is difficult and costly (100 million individual taxpayers vs. 15 million businesses (3 million corporations, 11 million proprietorships, 1.5 million partnerships))

# 8. The Income Tax Is Corrupting America (cont'd.)

- The complexity and vagueness of the tax code contribute to tax evasion
  - Line between tax avoidance and tax evasion is not always clear
    - Is a payment to the businessman a labor cost or a dividend?
    - How fast to depreciate?
    - Is use of a car business or personal?
    - Is an open house business (good-will) or fun (a party)?
    - Is a board meeting in Las Vegas business or fun?
    - Is a marketing visit to USAID in Haiti business or fun?
  - The tax system is a giant guessing game!

# 8. The Income Tax Is Corrupting America (cont'd.)

- The irrational, inequitable, heavy-burden income tax creates a lack of respect for the law
  - Four out of five taxpayers consider the tax system unfair
  - Three out of four consider income taxes too high
  - High proportion of US tax burden placed on individuals encourages tax avoidance and evasion
  - High income tax is not well suited for society
  - The US income tax system is unacceptable to the American people

# 8. The Income Tax Is Corrupting America (cont'd.)

- The income tax generates citizen resentment of the government
  - Income tax is unliked (tax rates too high, system too complicated and inequitable)
  - Unnecessary (US operated 100 years without it; same level of revenue can be generated in other ways, more simply efficiently and equitably from businesses)
  - No reasonable rationale for taxing 100 million individuals vs. 15 million businesses (set up to keep records)

## 8. The Income Tax Is Corrupting America (cont'd.)

- Double taxation: corporation earnings are taxed twice (first on the business and second on the individual)
  - Business profit tax = 49% (39% federal and 10% state)
  - Personal income tax rate = 49% (39% federal and 10% state)
  - Combined tax rate =  $1 - (1-.49)(1-.49) = 74\%$
  - Strong incentive to convert profit to income, to avoid paying the business income tax



## 8. The Income Tax Is Corrupting America (cont'd.)

- Determination of “reasonable income” is ambiguous
  - Is EpiPen CEO’s salary of \$19 million justified?
  - The tax base is not well defined – there is no unambiguous definition of “income.”
  - This is an absurd situation, placing the firm’s owner in the awkward position of not knowing what is right and what is wrong with respect to his tax responsibility. The high overall tax rate and high income tax rate motivate tax avoidance and tax evasion.
  - In a reputedly free or free-enterprise society, the “reasonableness” of a businessman’s salary should not be the business of the government.
  - The government has no business trying to tell a business what expenses are “legitimate” and therefore tax deductible.
  - The income tax is a bad tax, from both economic and social points of view.
  - Collecting an unobtrusive, economically neutral business tax is one thing; telling business how to run business is bad business.
  - The business profit tax and the personal income tax are ill-conceived ideas, and should be eliminated.

## 8. The Income Tax Is Corrupting America (cont'd.)

- The personal income tax and the business profit tax work together to create a strong incentive to evade taxes.
- Together, these taxes generate a strong incentive to make personal purchases through the firm and keep salary in the firm – a 74% reduction in tax). (Salary, insurance, cars, computers, trips, buildings.)
- This situation is completely unnecessary.
- Why would the government impose such a perverse tax?

## 8. The Income Tax Is Corrupting America (cont'd.)

- The government can eliminate personal tax evasion by eliminating personal privacy, or by eliminating the personal income tax.
- Why has it opted to do the former?

## 8. The Income Tax Is Corrupting America (cont'd.)

- The income tax system creates crimes that waste law enforcement resources.
- Three types of laws:
  - Prohibit offensive behavior (stealing, assault, murder)
  - Regulate morally objectionable behavior (gambling, prostitution, indecent exposure, pornography)
  - Enforce citizen compliance with government rules and regulations
- The crime of personal income tax evasion is an unnecessary, “artifactual” crime.
- The investigation, prosecution, and punishment of artifactual crimes costs money: is that money well spent?
- The income tax system encourages surrogate punishment (e.g., make a examples out of Woody Herman, Willie Nelson)
- The income tax system is an unnecessary incentive for crime.
- The country needs a tax system; it does not need an income tax system, and is not well served by the income tax system.

# 9. The Income Tax Is Too Complicated

- The income tax is out of control
  - Thousands of tax code and IRS regulations
  - In many cases, the rules and regulations are arbitrary and irrational, the product of the primitive, illogical process that designed the system.
  - The tax base (income) is unknown – an amorphous, intangible, constantly changing thing whose definition and interpretation require an endless series of court cases to interpret the unspecified intent and illogical rules of the tax code

## 9. The Income Tax Is Too Complicated (cont'd.)

- Tax form is complicated
  - Basic form contains 16 pages of schedules, 52 pages of instructions, and 54 additional schedule and instructions referenced
  - Many individuals consider it necessary to pay professional income-tax preparers to complete their returns
  - Internal Revenue Tax Code of 1954 contains thousands of pages of rules and regulations
  - The Tax Reform Act of 1986 simply added more pages

## 9. The Income Tax Is Too Complicated (cont'd.)

- Income tax base is elusive and ridiculous
- Inequities are constantly exposed, leading to new rules and regulations (exemptions, deductions, exceptions, incentives, disincentives, irrationalities, ambiguities, complexities)
- Books on tax advice sell well
- Tax liability is not known until the end of the year
- Fines imposed if income tax is not estimated well

## 9. The Income Tax Is Too Complicated (cont'd.)

- The income tax system has caused citizen resentment, suspicion and fear, and a contempt for the government
  - IRS is a multibillion-dollar investigation and audit service
  - Contrary to all other crimes, an individual accused of tax evasion is guilty until proved innocent
  - Because of absurd complexity of the tax code, likelihood of errors is high. IRS itself cannot consistently calculate a tax liability.
  - Current system causes the needless alienation of citizens. A frightening, antagonistic and destructive system.



## 9. The Income Tax Is Too Complicated (cont'd.)

- Why is the income tax so complicated?
- It is not possible to measure income.
  - Conceptual definition of income exists.
  - No practical means of measuring income relative to that definition: no satisfactory operational definition of income.
  - Last year's definition is always proved wanting, leading to new changes.
  - The process never stops, the tax code grows more and more complicated.
- Income reflects ability to pay, but economists cannot construct a satisfactory operations definition of ability to pay.
- The income tax will never be fair or simple.
- After 100 years of unsuccessful attempts to construct a fair and simple income tax, this futile search should be abandoned.

# 10. The Income Tax Is Economically Deficient

- The income tax has many economic disadvantages:
  - discourages saving and investment
  - discourages productivity
  - creates an incentive for businesses to go into debt
  - subsidizes inefficient firms
  - stifles economic growth (employment and production).

## 10. The Income Tax Is Economically Deficient (cont'd.)

- The income tax discourages saving and investment
  - With a consumption tax (e.g., a sales tax, a VAT), taxes are reduced by reducing spending. Hence the tax encourages saving.
  - With an income tax, taxes are reduced by reducing earnings. Hence the tax discourages productivity.
- US gross domestic saving rate is (2014) 17% of GDP compared to 34% for upper middle income countries.
- Interest deduction on home mortgages promotes spending on homes, contributed to economic collapse of 2007 (along with derivatives, bundled mortgages and repeal of the Glass-Steagall Act in 1999). The income tax caused a severe economic distortion.

## 10. The Income Tax Is Economically Deficient (cont'd.)

- The income tax discourages productivity
  - Massive expenditure spent on IRS enforcement related to the income tax
- The income tax encourages debt financing
  - Interest charges are tax deductible for a business
  - Incentive to make loans to acquire capital equipment (such as issue bonds) rather than to use equity financing (float stock issues)
  - This practice drives interest rates up and increases the risk of bankruptcy
- Another example of how the income tax causes economic distortions and reduces the economic efficiency of the allocation of resources.

## 10. The Income Tax Is Economically Deficient (cont'd.)

- The business profit tax subsidizes inefficient firms
  - Firms that show a profit are penalized
  - Firms that are not profitable are subsidized
- Profitable firms are employing resources more efficiently, and should be rewarded, not penalized

## 10. The Income Tax Is Economically Deficient (cont'd.)

- Use of the income tax places the US at a disadvantage in international trade
  - GATT is set up on the “destination principle,” under which a country may remove indirect taxes from goods that it exports
  - The income tax is a direct tax, and cannot be removed
  - About 150 countries use the VAT, an indirect tax (up from 39 in 1986)
  - This places the US at a distinct disadvantage in international trade

## 10. The Income Tax Is Economically Deficient (cont'd.)

- The US income tax distorts the economy
  - Under current income tax laws, firms may use “accelerated” depreciation
  - This practice places capital intensive firms at an advantage relative to labor-intensive firms
  - Another economic distortion, and more economic inefficiency (lower rate of consumer satisfaction on investment of economic resources)

## 10. The Income Tax Is Economically Deficient (cont'd.)

- The personal income tax and the corporation profit tax are not well integrated
  - Double taxation on dividend earnings
  - Substantial disadvantages with respect to economic impact and equity
  - A very heavy tax on the earnings from investment
  - Heavy tax burden on low-income earners who are dependent on dividend earnings, and a disincentive to invest
  - Discourages investment in corporations (compared to unincorporated business structures)



# 11. The Income Tax Is Too Costly

- The administrative cost of collecting the personal income tax is high
  - Administrative cost (to government)
    - Printing and distribution of tax returns, processing tax returns, making audits, tax court
  - Compliance cost (to individual)
    - Tax lawyers, tax accountants, tax preparation services
    - Effort expended by individual taxpayer in preparing his return (est. 1 week) (est. at \$35B in 1986)

## 11. The Income Tax Is Too Costly (cont'd.)

- The income tax system causes the waste of much productive effort in tax avoidance
- All of this productivity is unnecessary, and could be better spent
- The income tax system causes the waste of productive skills
  - Individual's time and money
  - Deprives society of the product of the labor of educated, skilled workers

# 11. The Income Tax Is Too Costly (cont'd.)

- The inevitable leakage in wage or income taxes drives collection costs sky high, creates citizen resentment, and narrows the tax base
  - Self-employed (physicians, waitresses, house painters) can avoid at least some tax
  - Marginal tax rates are high, creating a strong incentive to do so
- It is extremely costly to develop a system that ensures that all individuals pay their intended share
- 1986: IRS had 85,000 employees, budget of \$3B, yet failed to eliminate leakage, succeeding only in instilling anger and resentment in the US population

## 11. The Income Tax Is Too Costly (cont'd.)

- Not possible to enforce total compliance on 100 million citizens. In 1986 the “tax gap” was estimated at \$100B per year.
- With exemptions, tax base is very narrow, leading to high rates, strong incentive to avoid and evade, resentment.
- Businesses, not individuals, are the natural point of tax collection (there are 15 million businesses vs. 100 million individual taxpayers).

## 11. The Income Tax Is Too Costly (cont'd.)

- Summary: Income tax is an extremely costly and inefficient tax.
- Hall & Rabushka (*The Flat Tax*) estimate for 1984:
  - Lost output (tax-advantaged investments): \$100B
  - Compliance cost (filing and buying expert advice): \$35B
  - Tax evasion: \$100B
  - Total cost of \$255B vs. total income tax revenue (\$350 billion)

# 12. The Income Tax Is Contributing to Economic Collapse

- Inability to produce level of revenue sufficient to cover the government budget: annual deficits of \$0.5B, national debt of \$20T.
  - Massive borrowing or printing of money
  - Higher interest rates or inflation rates, or both
- Failure to prevent the development of extreme concentrations of wealth (one of the primary arguments for the income tax).
  - Higher demand for loans by nonwealthy
  - Riskier loans (nonwealthy have less assets)
  - More speculation and risky investments by wealthy
  - Unstable economic conditions (increased likelihood of extreme economic booms and depressions)

## 12. The Income Tax Is Contributing to Economic Collapse (cont'd.)

- The income tax causes government budget deficits
  - Cannot produce level of resources needed by a modern economy: Income tax base so narrow that rates are already high and cannot reasonably be raised
  - Revenue levels are volatile, leading to deficits that are not covered in surplus years (deficits now even in boom years)

# 12. The Income Tax Is Contributing to Economic Collapse (cont'd.)

- The income tax base is now too narrow (to produce the needed revenue at reasonable tax rates). (When introduced, was a low-burden tax.)
- Personal income represents only 40% of GNP.
- For the large revenue requirements of a modern economy, need a tax base that is most of GDP.
- Scrap the personal income tax and the business profit tax: they are too narrow for today's needs.



# 12. The Income Tax Is Contributing to Economic Collapse (cont'd.)

- Both the personal income tax and the business profit tax have small tax bases
- Raising tax rates to generate needed income is not practical
- Under the Tax Reform Act of 1986, the relative sizes of the tax bases did not change much (the Act addressed loopholes, envy, reduced use of taxes to accomplish social goals)
- The Act did not address the heavy and inequitable burden of the income tax

# 12. The Income Tax Is Contributing to Economic Collapse (cont'd.)

- The volatility of the business profit tax base contributes to government budget deficits
  - Profit fluctuates substantially from year to year – much more than the level of economic activity (GDP). Fluctuations in the business cycle are amplified
  - This volatility makes government planning difficult, leads to growing national debt (surpluses in boom years not used to cover deficits in recession years)
  - Massive (\$20T) US debt threatens collapse of US and world economies
  - Congress's inaction in addressing this issue is disgraceful, outrageous, unpardonable.

# 12. The Income Tax Is Contributing to Economic Collapse (cont'd.)

- The income tax contributes to extreme concentrations of wealth.
- Extreme concentrations of wealth are undesirable for a number of reasons:
  - Extreme concentrations of wealth cause envy, contributing to social unrest and instability
  - Private concentrations of wealth provide considerable power to the wealthy, potentially threatening the personal security of the nonwealthy
  - Concentrations of wealth contribute to recessions, and extreme concentrations of wealth contribute to severe economic depressions

## 12. The Income Tax Is Contributing to Economic Collapse (cont'd.)

- The US tax system is contributing to massive, persistent government deficits, and is enabling extreme concentration of wealth. (The Gini index for US household income increased from .36 in 1967 to .46 in 2011.)
- These conditions can result in an economic collapse.
- The US income tax system threatens the security of the nation, and *must* be replaced.

# 13. How to Design a New Tax System

- “Tax Engineering”: a systems engineering approach to designing a good tax system
- Will describe:
  - Tax policy goals
  - Current legislative process
  - Systems engineering process
  - Tax system goals / requirements / criteria

## 13. How to Design a New Tax System (cont'd.)

- Three basic goals:
  - The system must produce the required level of revenue, and the revenue levels should be stable
  - The system should have desirable economic impacts (promote economic growth, effective use of economic resources, stability of the economy)
  - The system should not have undesirable sociopolitical impacts (e.g., no unnecessary incentives for tax evasion, not unnecessarily invasive of individual privacy, equitable and perceived as equitable)

## 13. How to Design a New Tax System (cont'd.)

- The current system rates poorly in accomplishing policy goals
  - Inadequate revenue (budget deficits, increasing national debt)
  - Unstable (fluctuations make planning difficult and contribute to budget deficits)
  - Undesirable economic incentives for both individuals and businesses (already discussed)
  - Undesirable sociopolitical features (already discussed)

## 13. How to Design a New Tax System (cont'd.)

- The legislative process is inadequate
  - Joseph Pechman's book, *Federal Tax Policy*, describes the process
  - Unsystematic
  - Subject to special interests
  - Prone to develop a complicated system
- 100 years of using this system has demonstrated its serious inadequacy



## 13. How to Design a New Tax System (cont'd.)

- The current legislative process does not take advantage of America's talent
- A few hundred technical specialists, mainly lawyers and economists, determine the US tax laws:
  - Treasury Department (Office of Tax Analysis; Office of the Tax Legislative Counsel, Office of International Tax Counsel, Office of Management and Budget)
  - House Ways and Means Committee
  - Senate Finance Committee
  - Congressional Budget Office
  - IRS and others

## 13. How to Design a New Tax System (cont'd.)

- Salient feature: all government employees
- Egregious lack of systems scientists and systems engineering practice
- No major surveys to assess public opinion
- No award of major systems engineering contracts to design and analyze tax systems (such as contracts for military systems)
- Congress specifies tax law in complete and excruciating detail, resulting in a completely inadequate Rube Goldberg system that does not raise the needed revenue and alienates citizens

## 13. How to Design a New Tax System (cont'd.)

- The income tax system is an unstable system
  - As revenue requirements change, the definition of income is changed
  - Cannot just raise rates, since the tax base is too narrow and taxes are already too high
  - Major changes every few years (as of 1986 , 23 major tax bills and three major reforms since 1948)
  - Unstable environment for business (incentives and disincentives keep changing)
  - The VAT does not have these problems: large economic base, economically neutral

## 13. How to Design a New Tax System (cont'd.)

- The current tax legislative process is unsystematic
  - *Conference Report to Accompany H. R. 3838* describes the process
  - Vol. 1: Tax Reform Act (925 pages)
  - Vol. 2: Description of the legislative process (886 pages)
  - Mind-numbing monument to obfuscation
  - No cohesive theme, concept or goal, just a myriad collection of details: complicated definitions, rates, rules and exceptions to rules

## 13. How to Design a New Tax System (cont'd.)

- Systems Engineering is the discipline for developing systems
  - A country's tax system is a system, and the methodologies of systems analysis and systems engineering should be applied to develop an improved system
    - Systems analysis is methodology concerned with the analysis of a system from a comprehensive, multifaceted viewpoint
    - Systems engineering is a systematic procedure for developing a system to perform a desired function at reasonable cost

## 13. How to Design a New Tax System (cont'd.)

- Systems engineering has developed effective and efficient systems in industry, military, financial and social applications:
  - Reservations systems
  - Stock market
  - Internet credit-card purchases
  - Banking systems
  - Weapon systems
  - Man on the moon

## 13. How to Design a New Tax System (cont'd.)

- Systems Engineering can accommodate social institutions and cultural values
  - Can handle problems involving many considerations and interrelations
  - Can work in areas having far-reaching and controversial value judgments
  - Can incorporate knowledge from multiple disciplines
  - Can give full consideration to the structural and institutional elements of a problem

## 13. How to Design a New Tax System (cont'd.)

- Tax Reform Act of 1986 did nothing more than make a few patchwork changes to a Neanderthal system that has unequivocally proved its inadequacy and unworthiness
- For important military systems, the government awards parallel multimillion-dollar systems studies of alternatives
- Where are such studies for our tax system?
- The technology exists, but the government stubbornly refuses to utilize it



## 13. How to Design a New Tax System (cont'd.)

- A fundamental problem: The government confuses objectives with constraints and criteria.
- Primary objective of the tax system is to raise revenue.
- Other desires (equity, political acceptance) are secondary. They should be treated as limitations, constraints or evaluation criteria, not as the primary objective.
- The current legislative process for developing a tax system has failed.
- The situation will not improve until Congress scraps the current archaic tax-system-development process and adopts a modern tax-engineering methodology base on proven systems engineering concepts.

## 13. How to Design a New Tax System (cont'd.)

- Current methodology fails to achieve main objectives (sufficient revenue, stable revenue), as well as failing in the following respects:
  - Conditions in one area cause problems in another
  - Fails to consider relationship of tax system to other systems (social, economic). (E.g., a tax system may be regressive if other programs compensate.)
  - Lack of integration among international, federal, state and local tax systems; between business and individual taxes; among all of the taxes comprising the tax system
  - Failure to satisfactorily address cultural values, individual rights, right to privacy.

## 13. How to Design a New Tax System (cont'd.)

- Examination of existing alternatives
  - US public is upset over its tax system, but seems woefully ignorant of tax systems used by other countries
  - Large differences from country to country, with respect to both overall tax level and distribution over different types of tax
  - Public discussion of alternatives is noticeably absent (e.g., leading up to the Tax Reform Act of 1986)
  - Careful identification and consideration of alternatives is essential to the selection of a good solution to any problem

## 13. How to Design a New Tax System (cont'd.)

- Evaluation criteria (measures of performance) associated with tax policy goals. Three major categories:
  - Revenue-Producing-Ability Criteria
  - Sociopolitical Criteria
  - Economic Criteria

## 13. How to Design a New Tax System (cont'd.)

- Revenue-Producing-Ability Criteria
  - Produces adequate revenue (no deficits)
  - Produces stable revenue

# 13. How to Design a New Tax System (cont'd.)

- Sociopolitical Criteria:
  - Not invasive of privacy of individuals
  - Low incentive to engage in tax avoidance
  - Low incentive to engage in tax evasion
  - High degree of simplicity
  - High perception of fairness
  - High likelihood of acceptance by public
  - High likelihood of acceptance by states and local governments
  - Low tax rates
  - Reduces concentrations of wealth
  - High visibility of taxes to the citizen
  - No "marriage tax" or "marriage subsidy"
  - Constitutional: the tax does not itself violate the Constitution, and its implementation does not lead to violations of the Constitution

# 13. How to Design a New Tax System (cont'd.)

- Economic Criteria
  - High incentive to save
  - High incentive to produce
  - High incentive to be efficient
  - Low administrative cost
  - Low compliance cost
  - Promotes tax harmony in international trade
  - Promotes tax harmony among the federal, state, and local governments
  - High incentive to use equity financing over debt financing
  - High economic efficiency
  - Contributes to economic growth and stability
  - Does not destroy capital accumulation
  - Robustness; ability to accommodate rate changes without introducing complications or economic distortions, or necessitating changes in the structure or complexity of the tax system

## 13. How to Design a New Tax System (cont'd.)

- The objective in designing a new system is embodied in Criterion 1: the system must produce adequate revenue. The US must cease to be a debtor nation.
- All other criteria are secondary objectives. They are limitations, constraints, restrictions, evaluation criteria taken into account in evaluating and comparing systems that can produce adequate revenue
- Some criteria at cross purposes (e.g., reducing concentrations of wealth promotes security of democracy, but represents a danger of destroying economic capital and thereby slowing economic growth)



# 13. How to Design a New Tax System (cont'd.)

- The major steps of tax engineering methodology:
  - Requirements Analysis: Determination of the need for revenue, and other constraints that will be placed on the system
  - Top-Level System Design
    - Identification and Analysis of Alternative Tax Methods
    - Specification of Tax Architecture: Specification of the major components of the system and their relationships
    - Systems Synthesis: The top-level specification of alternative tax systems comprised of the various alternative tax methods
    - Specification of Performance Criteria: Specification of criteria (listed above) for evaluating the performance of alternative tax systems
    - Selection of Preferred Alternative: Selection of a recommended system, based on a comparison of the performance of the system alternatives relative to the evaluation criteria
    - Optimization: Completion of the top-down system design
  - Detailed System Design: Complete specification of the tax system (such as exact rates, exclusions, transition, administrative procedures)
- This book addresses only the requirements analysis and top-level design of a new tax system; it does not address the detailed design of the system.

## 13. How to Design a New Tax System (cont'd.)

- Next four chapters summarize tax alternatives and their principal characteristics
- A preferred system is constructed, using adopting a single goal:
  - Ability to raise revenue equal to 33% of GNP
- And taking all listed criteria into account (value judgment, weighting)

## 13. How to Design a New Tax System (cont'd.)

- What tax-type mix is appropriate? What rates (overall level and degree of progressivity) are correct?
  - Depends on amount of revenue desired, performance relative to criteria
  - Magnitude of total burden (33% of GNP) not addressed here
- Economists generally prefer taxes that do not distort the economy
- How to allocate taxes is a value judgment

## 13. How to Design a New Tax System (cont'd.)

- Some considerations:
  - Public opinion can be a major factor in tax policy
  - The acceptability of a tax burden depends on political philosophy
    - Should a person be left with the lion's share of the fruits of his labor?
    - Should economic growth and production be encouraged?
  - The US tax system allows for collections at several levels of government (federal, state, local)
  - Burden at each level, and how to share revenue, are not addressed here: depends on sharing of powers and responsibilities (Constitution and interpretation)

# 14. Tax Alternatives

- This chapter describes the major types of taxes and cites advantages and disadvantages of each, relative to criteria, or principles, for assessing performance.
  - Tax types: Personal income tax; corporate profit tax; payroll taxes; taxes on goods and services (consumption taxes: sales tax, VAT, excise taxes, import-export taxes, property transfer taxes, expenditure taxes); property and wealth taxes (including inheritance, estate and gift taxes)
  - Tax criteria: listed earlier

# 14. Tax Alternatives (cont'd.)

- How tax level and distribution are measured
  - Usually relative to GDP
  - GDP: total value of all goods and services produced by a nation
  - GNP: GDP + value of foreign goods used in production
  - Use GDP as a base since it is more meaningful to relate tax burden relative to a nation's own production
  - In the US, GDP and GNP differ by about 1% (GDP is much smaller than GNP for some countries)

# 14. Tax Alternatives (cont'd.)

- The US Constitution distinguishes between direct and indirect taxes
  - Indirect taxes raise prices (tariffs and transaction taxes, such as sales taxes, the VAT, export taxes, consumption taxes)
  - Direct taxes reduce income and wealth (income taxes, property taxes, capitation taxes)
  - Indirect taxes receive preferential treatment under the GATT (destination principle: indirect taxes may be removed from exports)

# 14. Tax Alternatives (cont'd.)

- Individual income tax
  - Attempt to address ability to pay and moderate recessions, but evidence is slim
  - Impossible to measure income or ability to pay
  - No consensus on overall rate or rate of progression
  - Many undesirable features:
    - Administratively costly
    - As a direct tax, does not qualify for GATT pref. treatment
    - Militates against saving and work
    - Tax base is narrow, so cannot raise required revenue
    - At high rates, oppressive burden, incentive for productivity wasting activity of tax avoidance and illegal activity of tax evasion
    - Volatility (fluctuating revenue) contributes to budget deficits and national debt



# 14. Tax Alternatives (cont'd.)

- Corporate income tax
  - A tax on profit, as defined by the IRS
  - IRS definition of profit does not correspond either to economic theory or standard accounting practice
  - Name is a misnomer. Tax is on a very small portion of income. Better name is “business profit tax”
  - Many disadvantages:
    - Investment of considerable resources in tax avoidance
    - No unanimity on where tax burden falls (stockholders, consumers or workers)
    - Not well integrated with individual income tax, so corporate profits are subject to double taxation
    - Encourages debt financing (increases risk of bankruptcy, drives up interest rates)
    - Penalizes efficient firms and subsidizes less-efficient firms
    - Narrow tax base, volatility cause unstable revenues (difficulty in planning, deficits)

# 14. Tax Alternatives (cont'd.)

- Payroll taxes
  - Used by many countries to fund social security (SS)
  - Social security (Old Age, Survivors, Disability and Health Insurance, or OASDHI, or Federal Insurance Contributions Act (FICA))
  - Unemployment Compensation
  - Social Security “contributions” are not contributions, and the Social Security Trust Fund is not a trust fund
  - Despite of nonprogressive character, workers do not voice strong objection to the Social Security tax
    - Lowest-paid workers receive largest benefits relative to their contributions

# 14. Tax Alternatives (cont'd.)

- Consumption taxes (taxes on goods and services)
  - Sales taxes, VAT, excise taxes, import and export taxes, property transfer taxes, expenditure taxes, other transaction taxes
  - Consumption taxes encourage saving (decrease tax bill by spending less)
  - Contrary to common argument, consumption taxes are equitable: over a lifetime, most people, rich or poor, consume about the same proportion of income (95-100%)
  - Three major types: sales tax, VAT, expenditure tax

# 14. Tax Alternatives (cont'd.)

- Sales taxes
  - Consumption tax imposed on the sale of an item (usually a flat-rate *ad valorem* tax)
  - A turnover tax is a sales tax imposed at several levels of production (manufacturing, wholesaling, and retailing). “Pyramiding” introduces an incentive for firms to merge with suppliers (leading to economic concentrations in industry and trade).
  - A retail sales tax is a single-stage tax that avoids pyramiding. Broad base enables collection of large amount of revenue at low rates.

# 14. Tax Alternatives (cont'd.)

- The Value Added Tax (VAT)
  - Proposed by Prof. T. S. Adams in papers published in 1911-21
  - Economically neutral: no economic distortions
  - Promoted by German industrialist Georg Wilhelm von Siemens in 1918
  - Implemented in Michigan in 1953
  - Adopted by France in 1954, 39 countries by 1986, 150 countries today
  - A consumption tax on the value added by a firm to the products it produces
  - Value Added = Sales – Purchases = (sales receipts) minus (amounts paid for goods and services purchased from other firms) = Labor (Wages + Salaries) + Net Rents + Net Interest + Profit
  - Applied at all stages of production
  - Broad base, therefore can generate much revenue at low rates
  - With broad base, as much a tax on production as consumption
  - Imposed on all sales, VAT applies as much to raw materials and capital goods as to goods and services intended for consumption
  - Represented as a consumption tax by France in 1954 to obtain preferential treatment under GATT
  - Confuses the issue to characterize it simply as a consumption tax (semantic distinction: is glass of water half empty or half full)

# 14. Tax Alternatives (cont'd.)

- **The VAT Is Economically Neutral**

- 
- From an economic viewpoint, the VAT is a good tax based on economic efficiency and equity considerations. The reason why a VAT is recommended is that, by taxing value added, it does not introduce economic distortions. It is described as a neutral tax because all of the factors of production (labor, land, and capital) or their returns (wages, salaries, interest, rents and profits) are taxed equally. Because the VAT taxes all factors of production equally, it does not create an incentive for the firm to change its choice of the factors of production from what it would be in the absence of the tax. The VAT does not interfere with the firm's economic decisions. The VAT avoids the pyramiding of the turnover, wholesalers', or manufacturers' sales taxes, because it is a tax on the *net* value added by each firm. In summary, a VAT (that is, a "pure" VAT, applied universally to all firms at a single rate) does not possess the economic disadvantages and introduce the economic distortions that the income tax does.
- 
- From an economic perspective, the VAT is very similar to the retail sales tax. The retail sales tax is simpler because it is not necessary to determine value added and there are fewer taxpayers. The VAT is preferred to the retail sales tax when a government needs large revenue, since the broader base of the VAT enables lower tax rates.

# 14. Tax Alternatives (cont'd.)

- Two ways to administer the VAT: the tax-credit method and the calculation method
  - Calculation method (used if VAT rate is the same for all products): VAT is not shown on each transaction. Firm calculates value added = total sales minus total purchased and applies tax rate to this amount. A hidden tax, like the payroll tax. Paid, e.g., once a month.
  - Tax-credit method (invoice method). The VAT is shown on each transaction (invoice or cash receipt). The firm shows the VAT on each transaction, pays the total VAT (say, each month), and receives a credit for all VAT included in its purchases (per the invoices or receipts for those purchases).

## 14. Tax Alternatives (cont'd.)

- If the VAT rate is the same for all products, both methods produce the same result.
- If the VAT rate differs by product, then the invoice method must be used in order to take advantage of the GATT (since the amount of the VAT must be known for each exported product). (This holds for the “destination principle.”)
- In 1986, only two countries (Denmark and Norway) had single-rate VATs. Now 22.



# 14. Tax Alternatives (cont'd.)

- The GATT is currently based on the destination principle: countries remove the VAT for exported goods and apply it to imported goods.
- Disadvantages: Favors inefficient nations with large public sectors, and must use the invoice method if use multiple VAT rates
- Origin principle: goods are exported including the VAT. No need for invoice method: large cost saving.

# 14. Tax Alternatives (cont'd.)

- Examples of a VAT

**Table 3. Administration of a Subtractive VAT Using the Calculation Method (VAT Rate = 20 Percent)**

	<i>Production Stage</i>				
	<i>Agric.</i>	<i>Manuf.</i>	<i>Wholesale</i>	<i>Retail</i>	<i>Total</i>
Sales	\$50	\$100	\$200	\$400	\$750
Purchases	0	50	100	200	350
Value Added	50	50	100	200	400
VAT	10	10	20	40	80

**Table 4. Administration of a Subtractive VAT Using the Tax-Credit (Invoice) Method (VAT Rate = 20 Percent)**

	<i>Production Stage</i>				
	<i>Agric.</i>	<i>Manuf.</i>	<i>Wholesale</i>	<i>Retail</i>	<i>Total</i>
Sales	\$50	\$100	\$200	\$400	\$750
Gross VAT on Sales	10	20	40	80	150
Purchases	0	50	100	200	350
VAT Credit on Purchases	0	10	20	40	70
Net VAT	10	10	20	40	80

# 14. Tax Alternatives (cont'd.)

- Expenditure tax: consumption tax levied on the consumer rather than the seller of goods and services.
  - Individual reports expenditures; may me deductions and a graduated rate.
  - As a consumption tax, has advantages over the income tax.
  - Like income tax, severely invasive of privacy of the individual, and the necessity of a national police force to enforce.

# 14. Tax Alternatives (cont'd.)

- Excise taxes: consumption taxes on sales of particular products, such as gasoline and alcohol
  - Inland taxes, not customs duties
  - Differs from general sales tax or VAT:
    - Narrow range of products
    - Higher tax rate
    - Usually a per-unit tax, rather than an *ad valorem* tax

# 14. Tax Alternatives (cont'd.)

- Property and wealth taxes
  - Property tax is on land, buildings, personal property
  - Wealth tax is on total wealth (assets minus liabilities)
  - Used to reduce private concentrations of wealth
  - US federal government does not use either
    - Reserved by custom since the 1930s as a revenue source for local governments
    - As direct taxes, the US Constitution would require apportionment to states in proportion to population

# 14. Tax Alternatives (cont'd.)

- Inheritance, Estate, and Gift Taxes
  - Special types of property taxes
  - Estate tax: federal tax on property transferred at death
  - Inheritance tax: tax levied on inherited property received (most states have)
  - Gift tax: tax imposed on the donor of a gift
  - Used to equalize the distribution of wealth (reduce concentrations to reduce envy, social discontent, and to mitigate recessions and depressions)

# 14. Tax Alternatives (cont'd.)

- Classification of taxes
  - Income taxes, consumption taxes, wealth taxes
    - Tax income or consumption to produce revenue
    - Tax wealth to reduce extreme private concentrations of wealth
- Classification of income and consumption taxes
  - Distribution over factors of production (economic incentives), size of tax base (taxable income is 40% of GNP; national income is 80% of GNP)
- Comparison of consumption taxes and income taxes
  - Equity (income taxes viewed as superior)
  - Economic impact (consumption taxes viewed as superior)
  - Administrative and compliance costs
  - Acceptance (public views consumption taxes as being more fair, less invasive of privacy)

# 14. Tax Alternatives (cont'd.)

- Advantages of business taxes over individual taxes
  - Business set up to collect tax revenue
  - Relatively small number of businesses (in 1986, 3 million corporations, 1.5 million partnerships, 10.7 million sole proprietorships vs. 100 million individuals)
  - Taxing 100 million individuals at high rates is very invasive of privacy and has resulted in the construction of a large police state



# 14. Tax Alternatives (cont'd.)

- The problem of determining the tax mix
  - Allocation of tax to factors of production: This potentially difficult issue is resolved automatically: tax can be applied uniformly on all factors of production; economic neutrality.
  - Allocation between national income and national wealth: tradeoff between reducing private concentrations of wealth vs. protecting capital
- Systems engineering can help develop a good tax system
  - The legislative process does not embrace this scientific discipline / methodology
  - Prefers a primitive, nonsystematic political process

# 15. The Value-Added Tax, or VAT

- Chapter 15 includes additional discussion of the VAT, including examples and discussion of advantages and disadvantages.
- Chapter 16 describes features of undesirable alternatives to the VAT
- Chapter 17 describes features of the payroll tax
- Taking all of this into account, Chapter 18 then presents the top-level design for a good tax system

# 15. The Value-Added Tax (cont'd.)

- What about income taxes for businesses?
  - My goal in proposing the abolition of the personal income tax is to promote and protect the privacy and freedom of the individual
  - This argument does not apply to business. In order for a government to function, it must have some knowledge of the economic activity within its borders
  - From a personal-freedom viewpoint, taxes on businesses are acceptable
  - The business profit tax is perhaps the worst of all business taxes (discourages saving and investment, incentive for debt financing, penalization of efficient firm, inefficient allocation of economic resources)

# 15. The Value-Added Tax (cont'd.)

- The regulated free-enterprise system has accomplished impressive economic growth
  - High standard of living, with much freedom
- Many problems that the free-enterprise system does not solve, or makes worse (through economic growth):
  - Sixth mass extinction of species
  - Destruction of the ozone layer
  - Pollution of land, air, and water
  - Acid-raid destruction of lakes and forests
  - Nuclear waste, overcrowding, unemployment, poverty and hunger
- The VAT promotes economic growth and stability, and is well matched to the goals of a free-enterprise system

# 15. The Value-Added Tax (cont'd.)

- The business profit tax has economic disadvantages, but it does not severely compromise the privacy of the individual
  - Taxes have to be collected from somewhere
  - Businesses are the natural collection points
    - Set up for accounting
    - Small number, compared to individuals
    - Less costly, less invasive of individual privacy
  - Current business income tax – a profit tax – is not a good business tax (complicated, incentive for tax avoidance, causes economic distortions)

# 15. The Value-Added Tax (cont'd.)

- A low-rate VAT reduces the incentives for tax evasion
  - Many items tax deductible for the business but not the individual
  - A nonretail businessman who evades the VAT places himself at a competitive disadvantage (he cannot provide invoices showing VAT; his customers receive no tax credit on purchases from him, and will turn to other suppliers)

# 15. The Value-Added Tax (cont'd.)

- Tax Reform Act of 1986 is move from using tax incentives to achieve social goals, to using spending policy. The VAT is a good tax on which to base spending policy, since it produces stable revenues.

# 15. The Value-Added Tax (cont'd.)

- Summary of VAT advantages
  - No penalty on efficiency (not a tax on profit)
  - Economically neutral (efficient)
  - With broader base, tax rates can be lower
  - Easier to administer: revenue and expense easier to monitor than profit
  - Incentive to make personal purchases in firm dramatically reduced
  - Incentive to shelter income in firm dramatically reduced
  - Is there any tax system that completely removes the incentive to make purchases through one's business? Yes, a turnover tax plus no personal income tax plus no payroll tax. Not a good solution (turnover tax is a bad tax: pyramiding / vertical integration or many rates, complicated).



# 15. The Value-Added Tax (cont'd.)

- Many types of VAT
  - Subtractive VAT (consumption-type VAT): total cost of capital goods produced by the firm is subtracted from revenues
  - Additive VAT (income-type VAT): a depreciation allowance is subtracted, not the full cost of capital goods
  - Subtractive VAT has strong incentive to purchase new capital goods (plant and equipment) (100% first-year depreciation allowance). Avoids problem of determining depreciation rates.
  - An additive VAT raises the unsolvable problem of defining income. Use of an additive VAT is not recommended.

# 15. The Value-Added Tax (cont'd.)

- Many types of VAT (cont'd.)
  - Single rate vs. multiple rates
  - Tax exclusions and preferences: exemptions and zero rating of retail firms:
    - Exemption (e.g., small businesses or family firms): firm pays no VAT, and receives no VAT credit for purchases
    - Zero rating: firm pays no VAT, but receives a full refund on all VAT paid by its suppliers and inputs. Eliminates the tax on an item (e.g., medicines, exports).
  - Causes economic distortions
  - Exemptions decrease tax revenues less than zero-rating.

# 15. The Value-Added Tax (cont'd.)

- Myths about the VAT (Charles E. McLure, *The Value-Added Tax*)
  - The VAT, as a consumption tax, is regressive (not true over a person's lifetime)
  - The VAT is a “money machine” (yes, but it would replace income taxes)
  - The VAT is inflationary (one-time jump in prices, offset by removal of income taxes)
  - Consumption taxes are the traditional preserve of state and local governments (So what? Recent (1930s); no Constitutional basis; revenue sharing)
  - The VAT is an administrative nightmare (simply not true, if use single-rate VAT (no invoices) or switch GATT to origin principle (exports taxed, imports not taxed))

# 15. The Value-Added Tax (cont'd.)

- Experience since 1954: Worldwide, the VAT is very popular
- No Constitutional problems
- Many advantages

# 16. Undesirable Alternatives to the VAT

- Payer-Collected Earnings Tax
  - On both labor and nonlabor earnings (rent and interest)
  - With respect to labor earnings, is equivalent to a payroll tax (discussed in next chapter)
  - As a tax on business, not individuals, the privacy intrusiveness on individual lessened
  - Progressive rates difficult for part-time workers or workers with multiple sources of income

## 16. Undesirable Alternatives to the VAT (cont'd.)

- Taxation of earnings from sale of property (capital gains) is not suited to a payer-collected tax
  - To determine earnings, need to estimate profit: too complicated
  - In many instances, capital gains represent inflation, not profit
  - Social and economic costs of attempt to tax occasional personal sales far outweigh the value of the taxes collected
- Payer-collected earnings tax less costly to administer than the personal income tax (15 million collection points, vs. 100 million)
- Use of payer-collected earnings tax eliminates the need for the SSN as a taxpayer identification number, unless Social Security (SS) benefits are tied to earnings rather than need

## 16. Undesirable Alternatives to the VAT (cont'd.)

- Overall, payer-collected earnings tax not recommended. Reduction of invasion of privacy of individual, but has all of the other disadvantages of an income tax
  - disincentive to save relative to a consumption tax
  - does not qualify for GATT preferential treatment
  - because tax base is narrow rates are high
  - because business income tax would still be in place, the many drawbacks of that tax would remain (incentive to use debt financing, subsidization of inefficient firms, disincentive to save and invest, incentives to retain earnings in business and make purchases through business)
- Conclusion: Payer-collected earnings tax does not address problems of current system, and is not recommended.

## 16. Undesirable Alternatives to the VAT (cont'd.)

- What's wrong with a flat-rate income tax (e.g., *Low Tax, Simple Tax, Flat Tax* by Hall and Rabushka)
  - Recall that a so-called flat-rate income tax is not a flat-rate tax at all, but a severely progressive tax system with two rates, zero and 19%
  - Not recommended for several reasons:
    - Perpetuates government invasion of privacy of individuals
    - Perpetuates taxation of profit (disincentive to economic efficiency and production)
    - A direct tax, so does not qualify for GATT preferential treatment



## 16. Undesirable Alternatives to the VAT (cont'd.)

- What's wrong with a net wealth tax (NWT)?
  - Net wealth = assets minus liabilities; property tax ignores liabilities; NWT applied annually
  - As invasive of privacy as the personal income tax (each year, individual must reveal all assets and liabilities to government)
  - NWT reduces private concentrations of wealth (but not as effectively as a property tax)
  - Justified on basis of ability to pay
  - Preferred to inheritance tax since it eliminates the waste of effort in estate planning to avoid financial shock of a major tax upon the death of the individual

## 16. Undesirable Alternatives to the VAT (cont'd.)

- The property tax is less privacy intrusive than the NWT (individual may remain anonymous, e.g., own the property through a corporation)
- The NWT promotes risky investments. An NWT of a low rate may represent an income tax at a high rate. E.g., a 2% NWT tax on an asset earning 8% is a 25% tax on income.
- Incentive to shift from safe, low-yield investments to risky, high-yield investments
- Because NWT generally places heavier burden on savings than an income tax, it is a stronger disincentive to save than an income tax

## 16. Undesirable Alternatives to the VAT (cont'd.)

- As a direct tax, the NWT would require a Constitutional amendment, and would face opposition from local governments (which use the property tax)
- Not a feasible alternative to the VAT for raising large amounts of revenue
- Not feasible to limit NWT to wealthiest population without compromising the privacy of the nonwealthy (in order to identify the wealthy)

## 16. Undesirable Alternatives to the VAT (cont'd.)

- Other undesirable alternatives to the VAT
  - Energy tax, oil import tax, excise taxes, Roth business transfer taxes (subtractive calculation-method VAT, with a FICA credit)
  - Do not raise sufficient revenue
  - Cause economic distortions
  - If not indirect (e.g., Roth BTT), do not qualify for GATT preferential treatment

# 17. Payroll Taxes: Good or Bad?

- As mentioned, most countries use payroll taxes to finance social security programs
- Although called employer contributions, payroll taxes are income taxes (burden falls on individual, not the business)
- Not seriously invasive of individual privacy (no requirement for individual to file a return)
- Taxpayers prefer benefits linked to contributions
- From economic viewpoint, better to fund SS out of general revenue from a VAT, to minimize economic distortions and qualify for GATT preferential treatment: not recommended (rate would be too high)

## 17. Payroll Taxes: Good or Bad? (cont'd.)

- The burden of the payroll tax is considered to fall on the individual
  - Tax is almost universally applied, worker cannot avoid the tax by changing employers, and is unlikely to move to a lower-rate country to avoid the tax, or to stop work because of the tax
  - Most countries use payroll taxes to fund Social Security; US SS tax rate is relatively low, so this tax does not put the US at a disadvantage in international trade (no GATT preference for payroll taxes)

# 17. Payroll Taxes: Good or Bad? (cont'd.)

- The payroll tax reminds citizens of the cost of social insurance
- Payroll taxes are regressive, but the social insurance that they “buy” is a good deal for low-wage workers
- If benefits are not tied to contributions, no need to keep files on each individual’s contributions throughout his lifetime
- Social insurance is a means of providing a minimal level of care for all US citizens in need: no need to keep track of individual’s earnings for this purpose.
- If used for retirement, and benefits are tied to contributions, then do need to keep track of contributions.
- Having no maximum makes the tax a flat rate tax, and easier to administer
- Incentive for business owner to retain earnings in the business, and make purchases through the business
- The payroll tax is not intrusive of personal privacy (does not require 100% inspection of employee’s financial affairs)

## 17. Payroll Taxes: Good or Bad? (cont'd.)

- Proposal: tie social insurance benefits to need, not contributions
  - Extend coverage to all citizens, and extend benefits to include basic, minimal-level benefits tied to need, not to contributions
  - Current benefits already in essence tied to need, but by a complicated administrative mechanism, and includes retirement benefits.
  - At a minimal level (excluding retirement benefits), program could be on a sound financial setting
  - Eliminates the need for government to monitor individual contributions; levy the tax solely on business
  - Remove retirement benefits from social insurance coverage



## 17. Payroll Taxes: Good or Bad? (cont'd.)

- Universal Trust Plan (UTP) proposed for retirement
  - Separate retirement insurance from social insurance
  - Set up a system of mandatory saving at e.g., 5 percent of earned pay for every worker
  - Deposited in a retirement savings account, same as IRA
  - Could not access until retirement; then could make withdrawals except for a minimal-level annuity
  - Upon death annuity terminates, but remainder of UTP is passed on to heirs as specified in will
  - Split contributions between employee's account and spouse's account; if divorce, spouse carries away his/her fund, without change.
  - This plan makes retirement part of SS more equitable; increases US savings rate (now one of lowest in the industrialized world)

## 17. Payroll Taxes: Good or Bad? (cont'd.)

- Universal Trust Plan (UTP) proposed for retirement (cont'd.)
  - Removes incentive to retire to cash in on SS benefits. If individual continues to work past the nominal retirement age, the UTP continues to grow (under current system, retirement benefits are lost)
  - Under UTP, people pay for their own retirements. Gets government out of the retirement business.
  - Demographically (actuarially) sound. Including retirement benefits in SS has driven cost sky high, and will, under the current “pay as you go” basis, eventually bankrupt the system.
  - Retirement pensions are the largest component of SS, so this single move would free vast amounts for broader social insurance coverage.
  - Reserves SS for extraordinary and unexpected expenses of sickness or accident, or those in need.

# 17. Payroll Taxes: Good or Bad? (cont'd.)

- Apart from the UTP, all other social insurance benefits are based on need:
  - Survivors' benefits
  - Disability benefits
  - National health insurance: Proposed that all US citizens be covered, for all health contingencies.
    - By shifting the retirement cost outside of the social insurance payroll tax, it will be possible to cover all of the cost from the payroll tax
    - Provide basic health insurance benefits, not “the finest medical care available”
  - Unemployment insurance: one month of coverage for all laid-off workers
  - Under UTP, some individuals may reach retirement age with insufficient funds to pay for a minimal retirement annuity. Provide supplemental retirement coverage and welfare for those having no assets and no family or church resources: pay out of general tax revenue.
  - Proposed social insurance plan includes all OASDHI programs (SS, including Medicare) as well as Supplemental Security Income (SSI), Unemployment Compensation (US), and Medicaid.

# 17. Payroll Taxes: Good or Bad? (cont'd.)

- Transition to a new system
  - Proposed to provide benefits equal to the larger of what would be received under current system or new system
  - Politically acceptable: benefits are not reduced for anyone
  - Somewhat costly, but some transition cost is unavoidable given the actuarially unsound pay-as-you-go nature of the current system (under which contributions of current workers are immediately used to pay benefits for current retirees)
- Proposed rate: 15-20% (pay transition costs out of general tax revenue)
- The 100% pay-as-you-go structure of the current Social Security system must be abandoned (not actuarially sound, financially irresponsible, unsustainable, irrational, will lead to system bankruptcy)
- Approximately 65% of SS payroll goes to retirement, rather than health and disability insurance. This is foolish and financially unsound. By shifting retirement from current workers to retirees themselves (through a mandatory UTP, a 15% payroll tax can easily accommodate universal health and disability insurance.

## 17. Payroll Taxes: Good or Bad? (cont'd.)

- The proposed Social Security and UTP retirement system is a radical departure from the present one, in which most US citizens are totally dependent on the government for their old-age support.
- The present system creates an unhealthy dolor/dolee relationship of the citizen to the US Government
- Under the proposed system, the individual will build his own retirement fund, preserve his independence from the government, and be an asset that can be transferred to his heirs upon his death.
- The current charity / dependency relationship of the state to the citizen will end.

# 18. A New Tax System

- A proposal for a new tax system, using the methodology of tax engineering
  - Significant improvement over current system, with respect to discussed criteria
  - Can provide the needed revenue
  - Based on economically neutral VAT: avoids severe economic distortions of current tax
  - A single-rate, calculation-type VAT applied to a high proportion (80%) of national income
  - State and local taxes subsumed into VAT, with revenue sharing
  - Eliminate the personal income tax; tie Social Security contributions to need, not contributions; replace SS retirement with a Universal Trust Plan.

# 18. A New Tax System (cont'd.)

- Summary of new tax system:
  - Personal income tax: none
  - Payroll tax for social insurance: 10% flat tax on employer, 10% flat tax on employee, no deductions, no maximum earnings limit. Payroll tax funds no longer earmarked for social insurance, but placed in general revenue. Provide minimal-level benefits tied to need, not contributions. Include all social insurance programs (OASDHI, worker's compensation, unemployment insurance. Split revenue with states to cover UC and human services programs
  - Universal Trust Plan (UTP): 5% flat rate mandatory contribution from employee, contributed to employee's *own* retirement fund

# 18. A New Tax System (cont'd.)

- Summary of new tax system (cont'd.)
  - Corporate Income Tax: None.
  - Value-Added Tax (VAT) on Business: 20-percent tax on value added. Allow for exemption of up to one fifth of total value added (national income), to account for ability to pay. Use subtractive (consumption-type) VAT (capital expenditures are fully deductible). Use calculation method of administration, that is, VAT is administered as a hidden tax on business, if single-rate VAT is adopted. Use invoice method only if a multiple rate VAT cannot be avoided and the GATT cannot be converted to the origin principle.
  - Proposed Changes to State and Local Income and Property Taxes: Eliminate income tax. Replace retail sales and gross revenue taxes with VAT. Replace the lost revenue from these taxes by sharing the revenue from the VAT between the federal government and the state and local governments. Retain property taxes on immovable real estate (land and buildings), but not on movable personal property or business equipment.
  - Net Wealth Tax: None. Consider a net wealth tax on the wealthiest one percent. Initiate a national dialogue on the desirability of a constitutional amendment to legalize a federal Net Wealth Tax.
  - Estate, Inheritance, and Gift Taxes: No proposed changes.
  - Excise Taxes: No proposed changes.
  - Export/Import Taxes: Impose in accordance with the GATT (that is, under current destination principle, subsidize all exports at the VAT rate and apply a border tax on imports equal to the VAT rate; under proposed origin principle, no border tax adjustments allowed).



## 18. A New Tax System (cont'd.)

- The following two slides show details of the distribution of tax revenue at the federal and state levels, for a 20%-rate VAT levied on 80% of total consumption (“Total Personal Consumption Outlays”). This VAT, along with the other taxes included in the system, produces a total revenue equal to 33% of GNP.
- Both tables include tax revenues as a percentage of GNP. The first table includes revenue amounts (and other amounts) for 1987.

# 18. A New Tax System (cont'd.)

**Table 10, Part 1. Distribution of Tax Revenue by Source, Proposed Federal Tax System (Estimates, 1987) -- Federal Revenue**

<i>Federal Revenue</i>	<i>Billions of Dollars</i>	<i>Percent of GNP</i>
Value-Added Tax @ 20% on 80% of Total Personal Consumption Outlays, split 12.5%/7.5% with states	287	6.5
Payroll Tax @ 20% on wages and salaries, split 19%/1% with states	504	11.4
Universal Trust Plan (UTP) @ 5% of wages and salaries	133	3.0
Excise Taxes	33	0.7
Estate and Gift Taxes	6	0.1
Customs Duties	14	0.4
Miscellaneous Receipts	19	0.4
Total	996	22.5

Notes: See book.

# 18. A New Tax System (cont'd.)

**Table 10, Part 2. Distribution of Tax Revenue by Source, Proposed Federal Tax System (Estimates, 1987) -- State Revenue**

<i>State Revenue</i>	<i>Percent of GNP</i>	<i>Percent of Total Revenue</i>
Transfers from Federal Government	2.83	15.7
--Public Welfare	1.04	5.8
--Highways	0.27	1.5
--Education	0.47	2.6
--Employment Security Administration	0.08	0.4
--Revenue Sharing	0.15	0.8
--Other and Unallocable	0.83	4.6
Property Taxes	2.67	14.8
VAT @ 20% (replaces Sales and Gross Receipts Taxes, Personal Income, and Corporate Income Taxes)	5.40	30.0
Other Taxes	0.81	4.5
Charges and Miscellaneous	3.35	18.6
Utility and Liquor Stores	1.10	6.1
Insurance Trust Revenue	1.88	10.5
Employee Retirement	1.12	6.2
Unemployment Compensation (from 1% split of Social Insurance tax)	0.60	3.3
--Other	0.16	0.9
Total	17.99	100.0
Total, excluding Federal Transfers, Utility and Liquor Store and Employee Retirement Revenue	12.94	71.8

# 18. A New Tax System (cont'd.)

- The proposed VAT is a 20% VAT on 80% of total consumption. This VAT is a “limited- exclusion VAT.” Examples of items that may be excluded (either exempted or zero-rated) include:
  - Food furnished to employees and food produced on farms
  - Standard clothing issued to military personnel
  - Purchases of used homes
  - Domestic services
  - Physician's services
  - Services furnished without payment by financial firms, except life insurance companies and expenses of handling life insurance

# 18. A New Tax System (cont'd.)

- The proposed change keeps state and local revenues at their current levels (as percentages of GNP)
- The proposed system manages social insurance without SSNs
  - Base benefits on need, not contributions (no need to keep track of individual's earnings history). (The return on many individual contributions is so poor that the current system, viewed as a retirement investment program, is a farce.)
  - Separate retirement benefits as an employee-owned retirement plan (UTP).

# 18. A New Tax System (cont'd.)

- Why not use the VAT as a means of reducing income tax rates?
  - The VAT can collect all the needed revenue
  - Continuing the personal income tax and business profit tax in addition to the VAT would continue the unnecessary waste in administrative costs and tax avoidance associated with these taxes, and the instability of the revenue produced by the business profit tax (which contributes to budget deficits and increasing national debt).
  - VAT qualifies for GATT preferential treatment
  - VAT avoids the privacy intrusion of the personal income tax, reduces incentives to retain income in firm and make purchases through firm

# 18. A New Tax System (cont'd.)

Performance of the proposed VAT-based system

- Revenue-producing ability criteria:
  - Produces adequate revenue (no deficits needed)
  - Produces stable revenue
- Sociopolitical criteria:
  - Not intrusive of privacy of individuals (no personal income tax, no tax returns, no SSN for Social Security benefits)
  - Low incentive to engage in tax avoidance (administratively similar to retail sales tax; strong economic incentive for pre-retail firms to participate)

# 18. A New Tax System (cont'd.)

- Sociopolitical criteria (cont'd.):
  - Low incentive to engage in tax evasion (incentive to make purchased in firm reduced from 74% to 40%)
  - High degree of simplicity
    - Second in simplicity only to retail sales tax
    - No complicated definitions about what is tax deductible
    - Payroll tax is a flat 20% of total payroll (no exemptions, no maximum taxable earnings ceiling, so no need to keep track of individual salaries for tax purposes)



# 18. A New Tax System (cont'd.)

- Sociopolitical criteria (cont'd.):
  - High perception of fairness
    - Experience shows that people view the progressive income tax as unfair, and flat-rate taxes (retail sales tax, essentially flat payroll tax) as fair
    - Income tax penalizes working longer hours; VAT taxes additional income at exactly the same rate.
    - Current system taxes additional income at horrendous rates (on the order of 50% for moderate-income families)

# 18. A New Tax System (cont'd.)

- Sociopolitical criteria (cont'd.):
  - High likelihood of acceptance by the public
    - Subtractive calculation-type VAT is a hidden tax on business
    - Income tax will disappear
    - Public would be aware of 20% payroll tax (current SS tax is about 15%)
    - New system would appear to be a dramatic reduction from the current system
  - High likelihood of acceptance by state and local governments (no loss in tax revenue)

# 18. A New Tax System (cont'd.)

- Sociopolitical criteria (cont'd.):
  - Low tax rate
    - Current marginal tax rate for individuals about 50%
    - Current marginal tax rate for business about 50%
    - Under new system, the tax on business is 20% of value added and 20% of payroll, and the tax on individuals is zero
- Reduces concentrations of wealth
  - Continue estate, inheritance and gift taxes
  - Consumption taxes do not reduce wealth concentrations
  - Adoption of net wealth tax not recommended (as a direct tax, would require a Constitutional amendment)

# 18. A New Tax System (cont'd.)

- Sociopolitical criteria (cont'd.):
  - No marriage tax or marriage subsidy
    - Neither pro-family or anti-family; family neutral
  - Constitutional: The tax does not itself violate the Constitution, and its implementation does not lead to violations of the Constitution
    - Current system leads to serious violations of the Constitution (Sixteenth Amendment has led to routine violation of most of the Bill of Rights amendments: search and seizure of property without due process, trial without a jury, Tax Court outside the Judicial Branch, indentured servitude of firms to collect individual taxes)

# 18. A New Tax System (cont'd.)

- Economic criteria:
  - High incentive to save
    - Corporate income tax discourages saving, because profits are taxed heavily
    - Individual income tax discourages saving because home mortgage interest is tax deductible and interest earnings are heavily taxed
    - VAT encourages saving for both individuals and businesses (under a 20% VAT, firm keeps 80% of every dollar saved on inputs; under current system, only 51%)
  - High incentive to produce
    - Current system discourages individuals from working longer, because of high marginal tax rate (about 50%); under proposed system worker keeps 90% of added income (losing only 10% to payroll tax)

# 18. A New Tax System (cont'd.)

- Economic criteria (cont'd.):
  - High incentive to be efficient
    - Current system taxes efficient, profit-making firms, and excuses inefficient, losing firms from the business tax. Current system is a subsidy for inefficient firms.
    - With a 20% VAT, firm keeps 80% of every additional dollar of profit, period. Strong incentive to reduce expenditures and earn profit.
  - Low administrative cost
    - Current system taxes all business (15 million) and all individuals (100 million). Proposed system taxes only businesses. Billions will be saved in administrative costs.
    - Businesses are set up to collect and pay taxes, individuals are not.

# 18. A New Tax System (cont'd.)

- Economic criteria (cont'd.):
  - Low compliance cost
    - Under current system \$35B wasted on compliance cost (legal tax avoidance). Under the proposed system, most of this waste is eliminated (all eliminated for individuals)
    - To keep compliance costs low, a calculation-type VAT is recommended (not an invoice-type VAT); use a single-rate, universally applied VAT, or convert GATT to origin principle.
  - Promotes tax harmony in international trade
    - Under the GATT, the VAT may be removed from exports (cannot do this under the current income-tax system, placing the US at a disadvantage in international trade)

# 18. A New Tax System (cont'd.)

- Economic criteria (cont'd.):
  - Promotes tax harmony among federal, state and local governments
    - Under the proposed system, the VAT would be imposed at a uniform rate over the nation
    - The VAT would replace all federal, state and local income taxes, and subsume all state and local sales taxes
  - High incentive to use equity financing over debt financing
    - Under current system, interest payments are deductible to business, but dividends are not; firms have strong incentive to use debt financing over equity financing
    - Under proposed system interest payments are still tax deductible, but at a lower rate (20% vs. 50%). The profit from which dividends are paid is also taxed at a lower rate (20% vs. 50%). Incentive for debt financing is dramatically reduced.



# 18. A New Tax System (cont'd.)

- Economic criteria (cont'd.):
  - High economic efficiency
    - VAT is economically neutral (no incentive to change the mix of the factors of production)
    - Incentives of current system create economic distortions and reduce the efficiency of allocation of resources
  - Contributes to economic growth and stability
    - Because of narrow base (individual taxable income and corporate profits), current system cannot produce required revenue at low tax rates. Progressivity and volatility of corporate profit base contribute to large tax deficits in recessions and an increasing national debt.
    - Massive government debt tends to drive up interest rates, reduces investment; printing money (“Quantitative Easing”) to pay off debt causes inflation.

# 18. A New Tax System (cont'd.)

- Economic criteria (cont'd.):
  - Does not destroy capital accumulation
    - Continue the present estate, inheritance and gift taxes
    - Continue property taxes on real estate and immovable property
    - Net wealth taxes not recommended, because of their privacy-intrusive nature
  - Robustness: The ability to accommodate rate changes without introducing complications or economic distortions, or necessitating changes in the structure of the tax system
    - Changing the VAT rate does not change the tax system structure, and does not distort the economy
    - Changing rates or the tax base in the current system introduces complexity and economic distortions, complicates business planning

# 18. A New Tax System (cont'd.)

- The US became a debtor nation in 1985
  - Money wasted in interest payments
  - Deprives poorer nations of loans
  - Under current system, government pays retirements out of tax revenue. Retirement expenditures are about 20% of all federal outlays. Establishment of UTP would do much to wipe out the annual federal government budget deficit.

# 18. A New Tax System (cont'd.)

- What about a National Wealth Tax?
  - Income and wealth distributions are becoming more extreme (Gini index)
  - Issue is not the number of wealthy people, it is one of having a small percentage of the population owning a large proportion of the nation's wealth.
  - Many countries use a national wealth tax (14 in 1986). NWT is as intrusive as an income tax, and produces little revenue (so no point to extending it to the general population).
  - Not recommended (would require Constitutional amendment)

# 18. A New Tax System (cont'd.)

- Modifications to estate, inheritance and gift taxes
  - Current system has been ineffective in reducing extreme concentrations of wealth
  - Should be modified to be more effective
  - These details are not addressed here
- The next step: the detailed design of a new tax system
  - Type of VAT, rate structure, exclusions and exclusion method (exemption or zero-rating); transition
  - Systems engineering is a proven, systematic, logical methodology for accomplishing this.

# 19. What Can Be Done?

- How to eliminate the personal income tax and business profit tax
  - Book proposed appeals to Congress; this has not worked.
  - The severe shortcomings of these taxes (intrusiveness, inequity, inefficiency, cost, destruction of freedoms) have not spurred a movement for change. As predicted in this book in 1987, continued use of the income tax has led to large annual budget deficits and a monumental national debt. The US is now the largest debtor nation in the world.
  - Legislators enjoy fiddling with current system, know that the system itself is flawed, that no amount of fiddling will fix it, but have no interest in replacing it with a better one.
  - Legislators use the present system as a “make work” project and a means of rewarding special-interest groups.
  - The Tax Reform Act of 1986 is a hoax, a fraud, a cruel deception. It has not solved the tax problem in this country; in many ways. Nevertheless, it continues. We have a complicated, costly, privacy intrusive system with serious sociological, political and economic shortcomings. What can be done?

## 20. What If Letter Writing Doesn't Work?

- How can meaningful tax reform be accomplished if pressure on Congress doesn't work?
  - This chapter explores additional efforts that may be considered, short of revolution.

## 20. What If Letter Writing Doesn't Work? (cont'd.)

- Does Congress not realize how much the income tax is despised?
  - US Revolution of 1776 was over “taxation without representation.” The Whiskey Rebellion of 1794 was over excise taxes. The US government appears set on pushing its people to rebellion and revolution again.
  - The income tax was forbidden under the original Constitution, but is now legal.
    - Has fundamentally changed the relationship of the citizen to the government. Sixteenth Amendment has gutted the Bill of Rights. Income tax system requires careful monitoring of the activities of all citizens, annual review and questioning.



## 20. What If Letter Writing Doesn't Work? (cont'd.)

- Decades of neglect of individual rights has caused the loss of much personal liberty in the US.
- An income tax system perverts the relationship of a citizen to his government, and characterizes his role as a revenue producer for the government (original Constitution considered mainly indirect taxes on business activity, not direct taxes on individuals, and severely restricted the latter).
- The framers of the Constitution tried to prevent the federal government from direct taxation, but Congress has thwarted their plan.
  - The Sixteenth Amendment has gutted the liberty safeguards of the original Constitution.

## 20. What If Letter Writing Doesn't Work? (cont'd.)

- Can a revolution be averted?
  - Historically, the response of Americans to tax oppression has been dramatic: revolution.
  - The original Constitution severely restricted the tax powers of the government, and outlawed the very type of tax system we have today.
  - A continuing series of Tax Reforms and regulations has not solved the serious deficiencies of the current system.
  - The US population has a high tolerance for bad laws.
  - The Sixteenth Amendment has nullified most of the Bill of Rights.
  - A Constitutional amendment is needed to protect privacy (an explicit right to privacy does not exist, but emanates from the Bill of Rights)
  - As predicted in 1987, the inadequate US income tax system resulted in large annual deficits and a massive national debt.
  - To date, despite this prediction fulfillment, no methods and no amount of effort has succeeded in eliminating the income tax system and replacing it with an adequate tax system.
  - The future does not look good.

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