

The Value-Added Tax: A New Tax System for the United States

by

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Originally published as
How to Stop the IRS...and Solve the Deficit Problem
November 16, 1987
Printed in the United States of America
ISBN 0-944848-00-1
This e-book edition November 8, 2000

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Dedication

To the memories of George Orwell and Dr. E. Fritz Schumacher

To Mom and Dad, in Spartanburg

To Timigale

To Jay, Chris and Steve

Contents

Summary	xi
About the Author.....	xii
1. Take Back Your Freedom!	1
Meaningful Reform Is Sorely Needed	1
The Income Tax Is a Bad Tax.....	2
Why Would the US Government Keep a Bad Tax?	2
The Income Tax Can Be Replaced by a Good Tax -- The Value-Added Tax	3
The Tax System Proposals of This Book Were Developed Through Systems Engineering	4
A Personal Word from the Author.....	4
2. How Did It Happen?	6
The US Tax System Has Its Roots in the US Constitution	6
What Is a Direct Tax?.....	6
The Original Constitution Outlawed the Income Tax.....	7
The US Tax System Changed as Conditions Changed	7
The Income Tax Began as a Low Tax on the Rich	7
The Revenue Needs of World War II Prompted the Expansion of the Personal Income Tax to the General Population.....	8
For Many Years, Inflation-Caused Bracket Creep Increased the Effective Rate of Taxation	8
The Current Situation: Tax Revenues Are Derived from a Narrow, Volatile Base	9
Having a Large Variety of Taxes Helps Hide Taxes by Keeping Tax Rates Low.....	9
The Current Tax System Promotes Budget Deficits.....	10
The Current Tax System Is Not Well Suited for International Trade.....	10
The Framers of the US Constitution Had a Good Idea when They Outlawed the Income Tax ..	11
The Serious Inadequacies of the Income Tax Were Not Initially Apparent.....	11
The Inadequate Revenue-Producing Ability of the Income Tax Has Turned the US into a Debtor Nation.....	12
3. The Income Tax Monster	14
The Income Tax Has Severe Sociopolitical and Economic Drawbacks.....	14
Problem 1. The Income Tax Has Destroyed the Privacy of the American Citizen.	14
Problem 2. The Income Tax Has Spawned an American Gestapo.	14
Problem 3. The Income Tax Has Weakened the Constitution.....	14
Problem 4. The Income Tax Is Unfair.	15
Problem 5. The Income Tax Is Corrupting the Country.....	15
Problem 6. The Income Tax Is Too Complicated.....	15
Problem 7. The Income Tax Has Serious Economic Deficiencies.....	16
Problem 8. The Cost of Administering and Complying with the Income Tax Is Very High.	16
Problem 9. The Income Tax Base Is Contributing to Economic Collapse.....	16
Tax Reform Is a Failure	17
Tax Reform Perpetuates Economic Distortions	18
Under Tax Reform, the Income Tax Is Even More Complicated Than Before	19
Meaningful Tax Reform Will Not Come Easily	19
4. The Assault on Privacy	21
Privacy Is a Valuable Asset	21
5. The American Gestapo?	41
Guilty Until Proved Innocent	41
The Income Tax System Has Spawned a Big-Brother Watchdog Agency	42
The Income Tax System Has Been Converted from a Tax on the Rich to a Tax on the General Population	42

Many People Regard the IRS as an American Gestapo	43
Larson's Case Studies.....	44
Through the IRS, the US Has Established a Police State	46
The IRS Needs Resisters	48
The Case of Woody Herman	48
The Efficiency and Dedication of the IRS Are Misdirected	49
The IRS Attack on Churches	49
The Personal Income Tax Forces Businesses to Act as Tax Collectors	50
The US Income Tax System Is in Reality a Payroll Tax System	51
6. The Constitution Has Failed	52
The Personal Income Tax System Has Weakened the Constitution	52
7. The Income Tax Is Unfair	55
Tax Terms: Marginal Rate, Average Rate, Graduated, Progressive	55
Why a Progressive Income Tax?	56
The Utility of Income.....	57
All People Do Not Have the Same Utility Functions.....	57
The Progressive Income Tax Discriminates against Hard Work, Long Hours, and Self-Improvement	58
The Progressive Income Tax Weighs Heavily on Working Wives and Mothers.....	58
Tax Reform Imposes a Heavy "Marriage Tax" on Many Families	59
The Verdict: The Progressive Income Tax Is Unfair.....	60
The Politics of Envy.....	61
The Personal Income Tax Is Not Well Suited to Tax Capital Gains.....	62
Capital Gains May Be More Apparent Than Real	62
"Tax Reform Adjusts for Inflation" -- a Myth	63
Under Tax Reform, Older Americans Can Get Socked With a 38 Percent Tax on Lifetime Earnings -- Or More!.....	63
The Real Tax on Your Home's Appreciation May Exceed 100 Percent!.....	64
8. The Income Tax Is Corrupting America	66
The Income Tax System Contains Strong Incentives for Tax Avoidance and Tax Evasion.....	66
The <i>Overall</i> Tax Burden in the US Is High, But No Higher Than in Many Other Countries.....	67
Tax Rates Under Tax Reform.....	67
High Income Tax Rates Have Given Rise to an Underground Economy	68
Tax Reform Will Not Dismantle the Underground Economy.....	69
The Complexity and Vagueness of the Tax Code Contribute to Tax Evasion	70
The Irrational, Inequitable, Heavy-Burden Income Tax Creates a Lack of Respect for the Law	71
The Income Tax Generates Citizen Resentment of the Government	71
Double Taxation	72
The Personal Income Tax and the Business Income Tax Work Together to Create a Strong Incentive to Evade Taxes	73
"I Bought It Through My Business"	74
Cars Are Not the Only Thing a Businessman Can Buy Through His Business	75
The IRS Can Eliminate Personal Tax Evasion by Eliminating Personal Privacy, or by Eliminating the Personal Income Tax System.....	77
The Income Tax System Creates Crimes That Waste Law Enforcement Resources.....	77
The Investigation, Prosecution, and Punishment of Artifactual Crimes Costs Money: Is That Money Well Spent?	78
The Income Tax System Encourages Surrogate Punishment.....	79
The Income Tax System Is an Unnecessary Incentive for Crime	80
9. The Income Tax Is Too Complicated.....	81
The Income Tax Is Out of Control.....	81

Books on Tax Advice Sell Well	81
A Rash of Books on the New Tax Law Attests to Its Complexity.....	82
Under Current Law, the Tax Assessment Is Not Known for a Year.....	83
The Income Tax System Has Caused Citizen Resentment, Suspicion and Fear, and a Contempt for the Government	83
Why Is the Income Tax So Complicated?	84
It Is Not Possible to Measure Income	84
Complexity Destroyed the Turnover Tax, and Will Destroy the Income Tax.....	86
10. The Income Tax Is Economically Deficient.....	88
The Income Tax Discourages Saving and Investment.....	88
The Income Tax Discourages Productivity.....	89
The Income Tax Encourages Debt Financing.....	90
The Business Profit Tax Subsidizes Inefficient Firms	90
Use of the Income Tax Places the US at a Disadvantage in International Trade	91
The US Income Tax Distorts the Economy	91
The Personal Income Tax and the Corporation Income Tax Are Not Well Integrated	92
11. The Income Tax Is Too Costly	94
The Administrative Cost of Collecting the Personal Income Tax is High	94
The Cost of Compliance With the Personal Income Tax Is Very High.....	94
The Income Tax System Causes the Waste of Much Productive Effort in Tax Avoidance	95
The Income Tax System Causes the Waste of Productive Skills	95
12. The Income Tax Is Contributing to Economic Collapse	98
The Income Tax Causes Government Budget Deficits	98
The Income Tax Base Is Too Narrow	98
Both the Personal Income Tax and the Business Profit Tax Have Small Tax Bases.....	100
The Volatility of the Business Profit Tax Base Contributes to Government Budget Deficits	100
The Income Tax Contributes to Extreme Concentrations of Wealth.....	101
13. How to Design a New Tax System	103
Tax Policy Goals	103
The Current System Rates Poorly in Accomplishing Tax Policy Goals	104
The Tax Legislative Process Is Inadequate	104
The Current Legislative Process Does Not Take Advantage of America's Talent	105
The Income Tax System Is an Unstable System	106
The Current Tax Legislative Process Is Unsystematic.....	106
Systems Engineering Is the Discipline for Developing Systems.....	106
Systems Engineering Has Achieved Success in Developing Modern Social and Economic Systems	107
Systems Engineering Can Accommodate Social Institutions and Cultural Values	107
The Government Uses the Systems Approach with Demonstrated Success	108
Examination of Existing Alternatives.....	111
Criteria Associated With Tax Policy Goals.....	111
Tax-Engineering Methodology.....	112
What Rates Are Correct?; What Tax "Mix" Is Appropriate?.....	114
Economists Generally Prefer Taxes That Do Not Distort the Economy.....	115
How to Allocate Taxes Is a Value Judgment.....	115
The Government Must Set the Overall Tax Rate and Decide on Progressivity	115
Public Opinion Can Be a Major Factor in Tax Policy.....	116
The Acceptability of a Tax Burden Depends on Political Philosophy.....	116
The US Tax System Allows for Collections at Several Levels of Government	116
Powers Reserved to the States	117
14. Tax Alternatives	120

Descriptions of Alternative Taxes	120
Criteria, or Principles, for Choosing a Tax	120
How Tax Level and Distribution Are Measured	122
The US Constitution Distinguishes Between Direct and Indirect Taxes	123
Indirect Taxes Raise Prices; Direct Taxes Reduce Income	124
Indirect Taxes Receive Preferential Treatment Under the GATT	124
The Individual Income Tax	125
The Personal Income Tax Attempts to Address Ability to Pay and to Moderate Recessions....	125
The Personal Income Tax Has Many Undesirable Properties	126
The Corporation Income Tax	126
The Corporate Income Tax Is a Tax on Profit	126
The Corporate Income Tax Has Many Economic Disadvantages	127
The Corporate Income Tax Produces Unstable Revenues	127
Payroll Taxes	127
Social Security Contributions Are Not Contributions, and the Social Security Trust Fund Is Not a Trust Fund.....	128
In Spite of Its Nonprogressive Character, Workers Do Not Voice Strong Objection to the Social Security Tax	128
Consumption Taxes (Taxes on Goods and Services).....	129
Consumption Taxes Encourage Saving.....	129
The Sales Tax	130
The VAT -- "Born In the USA".....	130
Two Ways to Administer the VAT: the Tax-Credit Method and the Calculation Method	132
Examples of a VAT.....	133
Three Major Types of VAT: the Subtractive (Consumption-Type) VAT, the Additive (Income-Type) VAT, and the Gross-National-Product-Type VAT.....	135
Synonyms: Additive VAT = Income-Type VAT; Subtractive VAT = Consumption-Type VAT....	135
Single-Rate Versus Multiple-Rate VATs	136
Two Final VAT Terms: Tax Inclusive Versus Tax Exclusive.....	137
There Are Many Types of VAT	138
The "Personal-Exemption-Type VAT" Is <i>Not</i> a VAT.....	138
The VAT Is Economically Neutral	139
The Expenditure Tax	139
Excise Taxes	140
Property and Wealth Taxes	140
Inheritance, Estate, and Gift Taxes.....	141
Classification of Taxes; Income and Consumption Taxes Versus Wealth Taxes	141
Classification of Income and Consumption Taxes	142
Comparison of Consumption Taxes to Income Taxes.....	143
Advantages of Business Taxes over Taxes on Individuals	144
The Problem of Determining the Tax Mix.....	144
Systems Engineering Can Help Develop a Good Tax System.....	145
15. The Value-Added Tax, or VAT	147
What About Income Taxes for Business?	147
The Free-Enterprise System Has Accomplished Impressive Economic Growth.....	147
The Business Profit Tax Has Economic Disadvantages, but It Does Not Severely Compromise the Privacy of the Individual.....	148
A Low-Rate VAT Reduces the Incentives for Tax Evasion	148
The VAT Is a Good Tax on Which to Base Spending Policy	149
The VAT	149
Taxable Items Are More Simply Defined Under the VAT Than Under the Income Tax	150

Under a VAT, the Incentive to Make Purchases Through One's Firm Can Be Dramatically Reduced.....	150
Use of a Low-Rate VAT Would Dramatically Reduce the Incentive to Shelter Income in One's Firm.....	151
Is There Any Tax System That Completely Removes the Incentive to Make Purchases Through One's Business?	152
Elimination of the Personal Income Tax and Business Profit Tax Probably Will Face Government Opposition.....	153
Replacing the Personal Income Tax and the Business Profit Tax by a VAT Would Reestablish the Privacy of Individuals.....	154
The VAT Includes a Tax on Labor	154
Effect on Wages.....	154
Alternative Ways of Administering a VAT: The Tax Credit Method Versus the Calculation Method.....	155
The Calculation-Type VAT, Like the Income Tax, Is Hidden From Consumers.....	155
The Subtractive VAT Has Advantages Over the Additive VAT.....	156
The Temptation to Allow Exemptions to the VAT Seems Irresistible.....	157
Tax Preferences Under the VAT: Exemption Versus Zero Rating.....	158
Packaging of the VAT Is an Important Consideration	161
Criticisms of the VAT.....	162
The VAT Is Criticized as a Regressive Tax, but the Evidence for This Is Slim.....	163
The VAT <i>Can</i> Address Ability to Pay	163
The VAT Has Been Called a "Money Machine"	166
The Consensus: The VAT Is <i>Not</i> Inflationary.....	166
"Consumption Taxes Are the Traditional Preserve of State and Local Governments" -- Are They Really, and So What?.....	166
A VAT Is <i>Not</i> an "Administrative Nightmare".....	167
Implementation of the VAT Causes No Constitutional Problems	168
Worldwide, the VAT Is a Very Popular Tax.....	169
16. Undesirable Alternatives to the VAT.....	170
What About a Payer-Collected Earnings Tax?.....	170
Taxation of Earnings From the Sale of Property (Capital Gains).....	170
The Payer-Collected Earnings Tax Is Less Costly to Administer Than the Personal Income Tax	171
Use of a Payer-Collected Earnings Tax Eliminates the Need for the SSN as a Taxpayer Identification Number.....	171
The Payer-Collected Earnings Tax Is Not Recommended, Since It Exhibits the Same Economic Problems of the Current Income Tax System	171
What's Wrong With a Flat-Rate Income Tax?	172
Why Not a National Retail Sales Tax?.....	173
What's Wrong with a Net Wealth Tax?	173
How the Net Wealth Tax Differs from an Ordinary Property Tax.....	173
The NWT Is Justified on the Basis of Ability to Pay	173
The Property Tax Is Less Privacy Intrusive Than the NWT.....	174
The NWT Promotes Risky Investments.....	175
The NWT Would Require a Constitutional Amendment, and Would Face Opposition from States	175
Other Undesirable Alternatives to the VAT	176
17. Payroll Taxes: Good or Bad?	178
Payroll Taxes Do Not Have to Be Intrusive.....	178
The Burden of the Payroll Tax Is Considered to Fall on the Individual	179

Social Insurance Is a Responsibility of a Civilized Society	179
The Payroll Tax Reminds Citizens of the Cost of Social Insurance.....	180
Payroll Taxes Are Regressive, but the Social Insurance That They "Buy" Is a Good Deal for Low-Wage Workers.....	180
A Flat-Rate Payroll Tax Is Easier to Administer	180
The Payroll Tax Is Not Intrusive of Personal Privacy	181
Proposal: Tie Social Insurance Benefits to Need, Not Contributions.....	181
Levy the Payroll Tax Solely on Business	182
Some Additional Recommendations.....	182
Universal Trust Plan (UTP) Proposed for Retirement	183
Survivors' Benefits.....	184
Disability Benefits	185
National Health Insurance	185
Unemployment Insurance.....	186
Supplemental Retirement Coverage and Welfare.....	186
Transition	187
Payroll Tax Rate.....	187
The 100-percent Pay-as-you-go Structure of the Current Social Security System Must Be Abandoned.....	187
18. A New Tax System.....	190
A Proposal for a New National Tax System	190
The Proposed Change Keeps State and Local Revenues at Their Current Levels (as Percentages of GNP)	195
How to Manage Social Insurance Without SSNs	195
Why Not Use the VAT as a Means of Reducing Income Tax Rates?.....	196
Performance of Proposed VAT-Based System.....	197
What About a National Wealth Tax?.....	204
Modifications to Estate, Inheritance, and Gift Taxes	206
The Next Step: The Detailed Design of a New Tax System.....	207
19. What Can Be Done?	208
How to Eliminate the Personal Income Tax and Business Profit Tax.....	208
Transition Problems	209
Impact of Elimination of the Income Tax on Tax Lawyers, Accountants, Tax Preparers, and IRS Agents.....	209
Transition to a VAT Will Cause a Temporary Economic Dislocation	211
The Impact of the Tax Reform Act of 1986 on Abolition of the Personal Income Tax and Institution of a VAT	211
20. What if Letter Writing Doesn't Work?.....	214
How Can Meaningful Tax Reform Be Accomplished if Pressure on Congress Doesn't Work?.....	214
Does Congress Not Realize How Much the Income Tax Is Despised?	214
Decades of Neglect of Individual Rights Has Caused the Loss of Much Personal Liberty in the US.....	215
An Income Tax System Perverts the Relationship of a Citizen to His Government, and Characterizes His Role as a Revenue Producer for the Government	215
The Framers of the Constitution Tried to Prevent the Federal Government from Direct Taxation, but Congress Has Thwarted Their Plan.....	216
Can a Revolution Be Averted?	217
The Long Wait for Tax Reform	218
The US Population Has a High Tolerance for Bad Laws.....	218
A Constitutional Amendment Is Needed to Protect Privacy	219
Changing the Tax System May Require Changing Our Form of Government.....	221

The Difficulty in Changing the US System of Government.....	222
The US Is a Democratic Republic.....	223
Our System Accommodates the Majority Very Well.....	223
Minorities Have No Leverage	223
A Parliamentarian Form of Government Provides Greater Flexibility	224
The Parliamentary Form of Government Would Eliminate Lame Duck Presidencies	225
Some Americans Favor a Parliamentary Form of Government for the US	226
The US System Worked Well, As Long as the "Pie" Was Growing.....	228
The Likelihood of a Constitutional Convention Is Increasing	228
Fundamental Tax Change May Require Fundamental Change in Our System of Government.....	229
The US Government Exists at the Pleasure of the People.....	230
On the Matter of Rights	230
The Tax System Will Be Significantly Changed Only If People Fight for Change.....	231
The Supreme Court: Major Threat to Constitutional Democracy.....	234
American Illiteracy and the Destruction of the American Republic	234
Bibliography	236

Tables and Figures

Table 1. Relationship of Gross National Product, National Income, and Personal Income, 1983	99
Table 2. Distribution of Tax Revenues by Source, Selected Countries, 1983	123
Table 3. Administration of a Subtractive VAT Using the Calculation Method (VAT Rate = 20 Percent)	133
Table 4. Administration of a Subtractive VAT Using the Tax-Credit (Invoice) Method (VAT Rate = 20 Percent)	134
Table 5. Effect of Zero Rating at the Retail Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Zero Rated at the Retail Stage)	159
Table 6. Effect of Zero Rating at an Intermediate Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Zero Rated at the Manufacturing Stage)	159
Table 7. Effect of Exemption at the Retail Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Exempted at the Retail Stage)	159
Table 8. Effect of Exemption at the Intermediate Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Exempted at the Manufacturing Stage)	160
Table 9, Part 1. Distribution of Tax Revenue by Source Under the Current Tax System (Estimates, 1987) -- Federal Revenue	191
Table 9, Part 2. Distribution of Tax Revenue by Source Under the Current Tax System (Estimates, 1987) -- State Revenue	192
Table 10, Part 1. Distribution of Tax Revenue by Source, Proposed Federal Tax System (Estimates, 1987) -- Federal Revenue	192
Table 10, Part 2. Distribution of Tax Revenue by Source, Proposed Federal Tax System (Estimates, 1987) -- State Revenue	193
Figure 1. Sample Letter to Congressman	208

Summary

The Value-Added Tax: A New Tax System for the United States proposes elimination of the personal and corporate income tax system in the United States. The central theme of the book is that the income tax system is not only a bad tax system from an economic viewpoint, but that it has severe political and sociological drawbacks as well. The book describes how the invasion of privacy and authoritarian tactics on which the current system is based have seriously damaged the relationship of the US citizen to his government.

The book describes the inadequacies of the current US tax system; its incredible complexity; its undesirable economic incentives which discourage saving, investment, and economic growth; the high administrative cost; the instability in government revenues caused by a narrow, volatile tax base; the incentive for wasting productivity in tax avoidance; the problem it causes in international trade; the invasion of privacy; and the tyranny of the IRS. The book shows how the Tax Reform Act of 1986 has not solved the fundamental problems of the income tax system, and explores why the US Government has perpetuated such a bad tax system for so long.

A major problem with the current US tax system is its inability to produce a sufficient level of revenue to cover desired government programs. The current system has resulted in massive government deficits and extreme wealth concentrations that threaten US and world economic collapse. The new tax system proposed in this book addresses these problems; it can help avoid economic collapse and reduce the severity of depressions.

The historical development and inadequacies of the US tax system are summarized. The archaic legislative process by which the current system was developed is described, and a modern approach to "tax engineering," based on the concepts of systems analysis and systems engineering, is presented. Alternative tax methods are identified, and the advantages and disadvantages of each method are discussed. A new tax system, based on the value-added tax, or "VAT," is proposed. The book shows how the VAT can raise the same or greater revenues as the current income tax system, but with far less economic, political, and sociological cost. The new system takes a humanistic approach to taxation: the tax system is viewed as a servant of the citizen, rather than his master. The VAT is a practical and feasible alternative to the income tax system.

Through the income tax system, the US Government has set up an elaborate and powerful police-state system for regimentation of the individual citizen. You are registered and monitored, and have lost not only your privacy but also most of your Bill of Rights personal liberties to the IRS. This book tells how you can help eliminate the income tax and stop the intrusion of the IRS into your life.

About the Author...

Joseph George Caldwell is the author of *The Value-Added Tax: A New Tax System for the United States*. A variety of experience has forged his views on taxes and privacy.

He has conducted, directed, and supervised a variety of economic studies, including studies in cost-benefit analysis, public finance, and tax policy analysis, in the US and foreign countries. He directed studies to develop alternative state allocation formulas for the vocational rehabilitation program and alternative matching formulas for the Medicaid and Aid to Families with Dependent Children (AFDC) programs. In Haiti, he supervised tax policy studies of agricultural commodities (coffee, cotton, sisal, mangoes, and meat); the goal of these studies was to develop tax policies that could improve the incomes of small farmers and increase the country's foreign exchange earnings. In the Philippines, he directed efforts to assess the social and economic impact of development projects, including the role of women as beneficiaries and facilitators of development.

A professional statistician, he has designed numerous national sample surveys, and is familiar with the constraints that the Privacy Act of 1974 and the Freedom of Information Act place on the use of information about individuals, both by the government and other organizations. He designed the statistical sampling systems for several state/federal programs. Having made heavy use of the computer since 1960, he is well aware of its power in storing, merging, and retrieving data on individuals.

He has supervised economic development projects in the Caribbean, Southeast Asia, and Africa. In his work as an international development consultant, he has had the opportunity to observe foreign governmental systems firsthand, and to consider both the restrictions that they place on the freedom of their citizens and the opportunities that those systems afford their citizens to effect political change.

As a university professor, he has had the time and resources to reflect on the problem and formulate a solution. Based on his experiences, the income tax / privacy situation in the US is an alarming one, and needs correction.

Dr. Caldwell holds a PhD degree in mathematical statistics from the University of North Carolina at Chapel Hill and a BS degree in mathematics from Carnegie Mellon University.

1. Take Back Your Freedom!

This is a book about freedom -- your freedom to be a private individual, unmonitored by government. That freedom has been lost in this country -- slowly but deliberately taken away -- ever since the advent of the personal income tax and the requirement to register for the Social Security Number, or SSN.

The only way to regain your freedom is to fight back now. You can stop the IRS by expressing the conviction that it is time to eliminate the personal income tax and the requirement to register for personal identification. This book tells why and how.

But wait! you may say. The government needs tax revenue to pay for everything that the citizens of a modern country demand: defense, roads, environmental protection, education, public safety, public health, and social services. That is true. Government revenue *is* needed, and this revenue is derived from taxes. What is objected to is the type of taxes used and the structure of the tax system.

Meaningful Reform Is Sorely Needed

The US tax system is a mess. The Tax Reform Act of 1986 has not addressed the fundamental inadequacy of the income tax system. The problem is not simply one of a complicated, burdensome, unfair income tax system. The US tax system cannot produce the level of revenue needed by a modern economy. It resulted in such massive deficits that the US domestic credit market could not cover them; as of 1985, the US is now a debtor nation, owing vastly more to foreign nations than they owe to us. Furthermore, the US tax system has failed to prevent extreme concentrations of wealth. The massive US debt and extreme concentrations of wealth contribute to an unstable situation that threatens US and worldwide economic collapse.

It is clear that leaving the selection of the tax system to politicians and economists has produced a disaster. Not only has an incredibly complicated tax system resulted, with the tax base defined by thousands of IRS regulations, but the system cannot raise the needed revenue. It is time for us to demand a simple, fair system that has good economic and sociological features.

This new tax system does not have to be complicated; taxes can be as simple as sales taxes and yet be very effective from an economic viewpoint. The tax base and rates do not have to be defined by thousands of IRS regulations. Having a complex tax system may serve to produce income for the tax lawyer, tax accountant, and tax preparer. But it does not serve you, the US citizen, well.

A complicated tax system is an economist's delight. A thousand PhD dissertations can address the intellectually stimulating tasks of defining income, measuring the "equity" associated with particular taxes, or predicting the economic impact of various tax changes. The federal government employs legions of economists concerned with the study of tax impact. Much of this effort is wasted on a tax system that is needlessly complicated. The evolution of the current tax structure, with its profound faults, demonstrates that tax policy is too important to leave to politicians and economists. The tax system that has evolved is a monstrosity. It is going to be up to us -- the US citizenry -- to correct this situation. And the way to begin is to advocate elimination of the income tax.

The Income Tax Is a Bad Tax

The idea of eliminating the income tax is not new. Until now, however, the idea has surfaced primarily through scholarly treatises on tax policy, or through news accounts of "crackpots" who refuse to pay on the basis of their claim that the income tax is unconstitutional. The objective of this book is to describe, in plain language, why the personal income tax is a bad tax and should be eliminated. It shows you how this tax is very costly to administer, is invasive of the privacy of individuals, encourages the waste of billions of dollars in tax avoidance efforts, and places the US at a disadvantage in international trade. You'll also learn why the personal income tax is impossible to justify on the basis of equity, or "ability to pay," and has undesirable economic side effects, including the discouragement of saving, investment, and production.

Throughout this book the term "personal income tax" is used rather than "individual income tax." Since the tax is levied on your family as much as on you as an individual, the term "personal income tax" is more descriptive of its true nature.

The corporation income tax creates as many problems as the personal income tax. This book tells you why it, too, should be eliminated. Actually, the term "corporation income tax" is a misnomer; the tax is not a tax on income; instead it taxes business profit. For this reason, in this book it is generally referred to as the "business profit tax."

In a free-enterprise economy, the last thing the government should tax is profit. The business profit tax discourages you from earning a profit while it encourages you to distort your business decisions and accounting to minimize your gains. Like the personal income tax, the business profit tax encourages the waste of productivity in tax avoidance efforts. Effort is also wasted in the attempt to estimate profit.

The business profit tax has the additional disadvantage of volatility (extreme fluctuations from year to year). This volatility makes government budget planning difficult and contributes to an increasing national deficit. When you have finished this book, you will not only have a full understanding of this weakness of the business profit tax; you will also be prepared to advocate an alternative that can improve the health of the national economy.

Why Would the US Government Keep a Bad Tax?

You may ask, if the income tax system is so bad, why does the US Government cling to it so tenaciously? As later chapters will show, the government's commitment to maintaining the income tax is based on the fact that the system provides a justification for intruding on the privacy of the entire population of the US.

In a situation such as a national health threat, large-scale invasion of personal privacy by the government may be warranted. In the case of the income tax, however, the government has set up an arbitrary system of rates and regulations that is totally unnecessary from an economic or other general-welfare viewpoint. The IRS then rigorously monitors all citizens to enforce compliance with these rules. The reason behind this monitoring and its dependence on the use of the SSN as a universal unique identifier are explained in detail in this book.

If the income tax is so bad, why has it lasted so long? There are several reasons. First, tax literature is arcane. The discussions about the inadequacies and costs of the income tax are found in academic journals and economic textbooks that are not widely read. Academic economists have criticized the income tax for years, but no one is reading their books. The US public is, in general, simply unaware of this literature, although it spans decades. Furthermore, the analyses of economists center on the assessment of the worth of a tax from the point of view of economic criteria. Except for the concept of ability to pay, their writings on alternative tax systems have essentially ignored sociological considerations such as regimentation, loss of personal rights, invasion of privacy, and the establishment of what amounts to a national police force for tax enforcement.

Second, the US Government has waged a propaganda campaign of massive proportions, touting the income tax as a beneficial, voluntary tax. It has steadfastly refused to give serious consideration to more humane forms of taxation, leading to the erroneous belief on the part of the public that an income tax is an absolutely necessary component of the country's tax system. The public now confuses the government's need for tax revenue with the need for an income tax. The former is necessary, the latter is not.

Through the income tax system, the US Government has set up an elaborate police-state system of regimentation of individual citizens. You are registered and monitored, and have lost not only your privacy but most of your Bill of Rights individual liberties to the IRS. This book tells how you can help eliminate the income tax and stop the intrusion of the IRS into your life. It describes a practical alternative to the police-state income tax system.

The Income Tax Can Be Replaced by a Good Tax -- The Value-Added Tax

This book is not concerned with the issue of how much money the government needs to conduct its operations. It addresses only the manner in which it collects that money, and the identification of a system that can collect sufficient revenue to avoid deficits. □ There are many types of taxes: individual income taxes, sales taxes, corporate income taxes, payroll taxes, excise taxes, import taxes, property taxes, inheritance and estate taxes, and many more. Some of these taxes are more intrusive than others; that is, they require the government to obtain more information about you.

The personal income tax and property tax are especially intrusive taxes. They require the government to know who you are, how much you earn, how you spend it, who your family members are, what you possess. Other taxes, such as sales taxes, are nonintrusive -- they can be collected while protecting your privacy or even maintaining your anonymity. The value-added tax, or VAT, popular in Europe and around the world, is a prime example of a fair, efficient, nonintrusive tax. Details regarding the success of this "good" tax are presented in Chapter 15.

The worldwide growth of the VAT has been astounding. Since 1954, 39 countries have adopted VAT-based tax systems. It is a superior tax system that deserves consideration in this country. This book aims to overcome the problems that have prevented its acceptance in the US for so long, by taking the case for the VAT to the American people. The target audience for this book is the US public. It brings the issues out in the open and explains them in detail. It describes the drawbacks of the income tax in plain language, exposes the excesses of the enforcement system that is necessary to implement it, and shows how the VAT can avoid these problems.

Given the fact that the VAT is a tried-and-true tax, the basic proposals of this book are simple. First, eliminate the personal income tax and the business profit tax, replacing both with a VAT. Second, eliminate the requirement for individuals to possess a unique identifier, such as the SSN, and prohibit the government at every level from maintaining general systems of records on individuals.

The Tax System Proposals of This Book Were Developed Through Systems Engineering

These basic proposals have been derived from an analysis of a wide range of possible tax systems, using the principles of systems engineering. This scientific approach is a vast improvement over the archaic, unsystematic, hit-or-miss legislative procedures that have produced the hodge-podge of our current income tax system.

If these simple systems-engineering-based proposals are adopted, the government can collect exactly the same amount of tax revenue that it currently collects (or more), but without the need for maintaining files on individuals. IRS tracking of individuals is, at the very least, a severe intrusion into the private affairs of US citizens, and, in the long run, is a serious threat to liberty. Furthermore, it is not necessary.

This book is not against taxes -- it maintains that everyone should pay his fair share. The current system, however, is not fair. It is very costly to administer, has extremely high compliance costs, is extremely intrusive of privacy, and creates undesirable economic incentives. It is time for this system to change. This book shows how you as a private citizen can finally stop the IRS.

The day of reckoning has arrived. American citizens must choose, now, between continuing on a course that subjects them to constant monitoring, forced exposure, and control by a central government and dooms them to a future of oppressive regimentation, versus striking out on a bold, new, humanistic course -- based on a concern for the private dignity of the citizen and oriented toward the development and fulfillment of US citizens as unique individuals.

A Personal Word from the Author

By now you must realize that this book is not simply a primer on tax policy analysis; it advocates the implementation of a particular tax system, which, although derived from the results of scientific analysis and systems engineering, is essentially a value judgment. The preferences that I express may not be your preferences. Because of the critical importance of tax policy to our society, I strongly encourage you to use this book to become aware of the basic concepts of tax policy. You can then use these concepts to form and express your own preferences regarding the choice of a new tax system.

Books on tax reform do not sell well. Books on the abuses of the IRS do not sell well. Then why another book on the IRS and the inadequacies of the US income tax system? Well, there's a big difference. This book offers a solution to the problem. It presents a feasible replacement for the income tax that eliminates the need for the IRS to enforce tax collection on individuals. You can spend a lifetime complaining about IRS abuses and how constitutionally guaranteed freedoms have been trampled on by the government. Unless an alternative method is found to collect the needed revenue, however, these offenses are going to continue. If you want to stop the IRS from

interfering with your life, liberty and pursuit of happiness, and if you want to regain the freedoms that were promised US citizens by the Constitution, this book tells you how. But freedom is not free. Your help is needed to restore the Constitution and make America once more the land of the free.

The task of eliminating the income tax will not be easy. As has been done in the past, the government will attempt to summarily dismiss consideration of the proposal to eliminate the income tax with a variety of responses that dodge the issue: "impractical" ... "not a serious alternative" ... "the proposal to repeal the income tax is naive" ... "taxes *have to be* complicated to be fair" ... "all developed countries have income taxes." Faced with strong arguments for elimination, and having no strong arguments for continuation, the government will attempt to perpetuate the income tax system by "stonewalling": by refusal to discuss and consider its replacement, just as it has refused to hear constitutional arguments against the tax in its "Tax Court." This book rejects those emotional appeals for continuation of the current system and challenges you to consider factual arguments why the income tax system can and should be replaced.

Some may criticize this book, saying, "If you don't like the way it is in the US, then leave." Before continuing, let me emphasize one point. In spite of its imperfections, I consider the US to be the greatest country in the world. In my opinion, there is no other country that surpasses it, overall, in terms of personal freedom, economic opportunity, freedom of expression, encouragement for self-development, diversity of opinion, technical and marketing creativity, scenic splendor, abundance of natural resources, efficiency of agriculture, tolerance of nonconforming points of view, standard of living, freedom of mobility, geographic and climatic variation, cultural diversity, ambition, generosity, courage, compassion, and independence.

And, I want to keep it that way.

With the exception of war and the human population explosion and the potential for global environmental disaster that it has spawned, the current unwarranted intrusion of the US Government into the lives of its citizens is the greatest threat to our freedom and democratic system that currently exists. This book describes the nature of that threat and ways that you can act to reduce it. I urge you to actively use this information today to take back your freedom.

2. How Did It Happen?

The US Tax System Has Its Roots in the US Constitution

The US tax system has an interesting history. The current system is an amalgamation of tax methods from many times and places: the income tax from England, the inheritance tax from France, sales taxes from the Dutch and Spanish, and property taxes from China and medieval Europe. The initial direction of the US tax system was set by the drafters of the US Constitution. They were concerned, in proposing a federal government with considerable power, that its tax powers be restricted. A principal cause of the US Revolution was "taxation without representation." To ensure a strong link between taxes and representation under the new government, the framers of the Constitution specified that all collections from "direct" taxes be apportioned, or allocated, to the states in proportion to their populations.

What Is a Direct Tax?

A direct tax is a tax exacted directly from the person (or entity) on whom the ultimate burden of the tax is expected to fall. In other words, it is a tax for which the ultimate burden falls primarily on the taxpayer: it is not "shifted forward" to others. Examples of direct taxes are income taxes, property taxes, and capitation taxes (a capitation tax is a head tax, such as a poll tax). An "indirect tax" is one for which the ultimate burden is shifted to someone else. Examples of indirect taxes are general sales taxes, excise taxes, and tariffs. When these taxes are generally applied, they have the effect of raising the price of a product, so that the tax burden is passed along to the purchaser.

It is not always easy to determine whether a tax is a direct tax or an indirect tax. In many cases, the burden of a tax levied on one source is shared by several sources. Consider, for example, the case of a city sales tax in an area where there is no county sales tax. Because consumers have the option of shopping in the county, merchants in the city may not be able to shift the entire tax forward to consumers. City merchants will have to absorb some of the sales tax (by lowering their profits, wages, or cost of other inputs) to remain competitive. It may be troublesome for consumers to travel to the county, however, so that many do not bother. In this case, part of the sales tax will be borne by the merchant and part by consumers.

In addition, part of the burden may be borne by the workers if the merchant tries to absorb some of the tax by lowering wages. The extent to which the merchant can do this depends on how sensitive workers are to wages. If they are willing to relocate to the county, the merchant will not be able to suppress wages. If they are unwilling to relocate (or to change jobs to a nonretail firm that does not pay the sales tax), he will be able to.

In general, the determination of the "incidence" of a tax (that is, determination of where the burden of the tax falls) is difficult. It is not only difficult to characterize qualitatively how the burden is distributed, but in some cases economists are even in disagreement about on whom the primary burden probably falls.

Unfortunately, the US Constitution did not specify which taxes were considered direct or indirect, nor did it provide a definition; the Supreme Court has had to make this determination.

The Original Constitution Outlawed the Income Tax

The Constitution established a strong central government, and the framers of the Constitution wanted to limit its taxing authority, both to ensure a strong correspondence between taxes and representation and to preserve the sovereignty of the states. Also, the framers were wealthy landowners, who wished to restrict the ability of a strong central government to tax land. The framers originally required that all federal taxes be apportioned in proportion to representation (population), but modified this in the final version to the requirement that all federal *direct* taxes had to be allocated proportional to representation.

At the time the US Constitution was framed, the principal federal taxes were expected to be taxes on commerce, imports, and consumption, such as tariffs and excise taxes. The framers did not require that these taxes -- which were indirect in nature -- had to be apportioned to the states in proportion to population.

The US Tax System Changed as Conditions Changed

For many years, the US Federal Government was able to support federal activities through various indirect taxes, primarily the tariff. To meet the extraordinary costs of the Civil War, however, the federal government imposed a temporary federal income tax (1862-71). The income tax was levied as a temporary war measure. It was objected to as a permanent measure for several reasons: after the war, it was no longer needed; it was inequitable; agreement could not be reached concerning a definition of income; and its administration was inefficient and intrusive.

The federal income tax was reinstated in 1895, but was declared unconstitutional because it represented a direct tax that was not apportioned to the states.

In 1909, the corporation income tax was established. Represented as an excise tax on business, its imposition circumvented the constitutional difficulties relative to an income tax. It was imposed at a very low rate -- 1 percent.

In 1913, the Sixteenth Amendment to the US Constitution was ratified. This amendment permitted the federal government to levy and collect a federal income tax, without the requirement to allocate the collections to the states in proportion to population.

Income taxes were established as the result of a quarter-century effort to promote tax equity and reduce great concentrations of wealth. Federal tariffs were considered to impose an unfair burden on certain sectors (labor and agriculture), and income taxes were viewed as a means of redistributing income and wealth.

The Income Tax Began as a Low Tax on the Rich

The personal income tax started out as a tax on a very limited portion of the income of high-income earners -- a tax of only 1-7 percent on a very small proportion (about 1 percent) of income earners. The personal exemptions (\$3,000 for single persons, \$4,000 for families) exempted most families from taxation. The 1 percent rate applied to income up to \$20,000 -- a very large income in 1913. The 7 percent rate applied to people earning over \$500,000 per year.

Until the 1930s, state and local governments depended primarily on the property tax for revenue. When property values fell during the Depression of the 1930s, tax revenue fell correspondingly. It was not possible to raise the needed state and local revenue from property taxes, and the state retail sales tax was established as a major new source for state and local revenue.

The Revenue Needs of World War II Prompted the Expansion of the Personal Income Tax to the General Population

A massive increase in revenue was needed in order to cover the massive cost of World War II. In response to this need, the federal personal income tax was converted from a tax on relatively few high-income earners to a tax on the general population. Exemptions were reduced, and taxes were withheld from income as it was paid. Aware that few families could save the large sums now required to pay the income tax, the government passed the Current Tax Payment Act of 1943, which required employers to withhold the anticipated amount of the income tax from wages and salaries.

Since World War II, federal income tax levels have fluctuated around an average of 10 percent of total personal income. Many changes have occurred, however, in the nature of this tax. Since income tax brackets were not indexed to inflation, the phenomenon of "bracket creep" occurred -- moderate-income earners (skilled workers and professionals) were driven into high tax brackets. The total income tax (including federal, state, local, and payroll taxes) has risen for these taxpayers from 20 percent of total income in the 1950s to over 50 percent today.

For Many Years, Inflation-Caused Bracket Creep Increased the Effective Rate of Taxation

Under a single-rate, or flat-rate tax, the tax burden remains constant over time, regardless of the rate of inflation. Under a graduated (multiple-rate) system having higher rates for higher incomes (that is, a progressive system), however, the tax burden increases if inflation occurs and would decrease if deflation occurred. Inflation occurs in virtually all economies, and the tax burden corresponding to a specified set of tax brackets hence increases as incomes grow due to inflation and individuals are forced into higher and higher brackets. This phenomenon is called bracket creep.

Bracket creep was an important vehicle by which the US Government implemented massive increases in the income tax rates for many taxpayers over the last half-century. From the viewpoint of the government, bracket creep is a highly desirable way of raising taxes because people do not notice that it is happening. It goes largely unnoticed because it happens slowly -- rates in nearby brackets are close in magnitude and the rate of inflation is relatively low.

Most inflation is due to government monetary policies. It occurs when the government prints new money at a faster rate than the economic growth of the economy. It does this when it wants to spend more than it receives in the form of tax revenue. Inflation can occur from factors beyond the government's control, such as when a foreign government increases the price of a commodity we want, such as oil or platinum. For the US economy, the effect of inflation from exogenous, or foreign, factors is generally small, compared to the effect of the government's spending more than it receives. Essentially, the US Government caused most of the US inflation and was principally responsible for the effects of bracket creep.

US taxpayers accepted bracket creep, generally without a whimper, even though its effects have been dramatic. They objected vociferously to the 10 percent tax surcharge imposed during the Vietnam War, but hardly complained over much greater tax increases because of bracket creep.

After more than 50 years of bracket creep, with much of the population now in high tax brackets, the problem has finally been addressed in the Tax Reform Act of 1986. Tax brackets will henceforth be adjusted each year for the effects of inflation, by shifting the brackets by the percentage change in the US Department of Labor's all-urban Consumer Price Index. Why did the government wait so long to implement this change? Now that the horse has escaped, the Congress has closed the barn door.

The Current Situation: Tax Revenues Are Derived from a Narrow, Volatile Base

The revenue demands of the US Federal Government have been steadily growing, for example, from about 25 percent of gross national product (GNP) in 1955 to about one-third of GNP today. Currently (1981 data), the breakdown of US tax revenues is individual income (37.7 percent), corporate income (8.6 percent), payroll (26.5 percent), goods and services (17.6 percent), property (8.6 percent), and inheritance and gift (1 percent). Individual income and payroll taxes account for 64.2 percent of total revenue, and corporation income taxes another 8.6 percent. As the revenue requirements of the US Government have increased, the burden of income taxes has become very heavy (50 percent) on a large portion (20 percent) of income earners. The base of the business profit tax is narrow and sensitive to economic conditions. The business profit tax is highly volatile; the amount of revenue it produces fluctuates wildly from year to year.

Having a Large Variety of Taxes Helps Hide Taxes by Keeping Tax Rates Low

One of the features of the tax system in the US (and, indeed, in most countries) is that the government imposes taxes on a very large number of sources. A practical benefit of having many tax sources is that the tax rates may be kept low; low tax rates lessen citizen objection to taxes; lessen the incentive to spend time in tax avoidance; and lessen the incentive to engage in tax evasion. Having many tax sources also enables the government to hide taxes and promote the impression that the total tax burden is not very high.

There is a large variety of ways in which the government may tax its citizens. The decision about how to allocate taxes among these possible sources is arbitrary. From the viewpoint of the government, it is preferable to tax many points in the economy to make it appear that the total tax burden is not great. That is why there are income taxes, payroll taxes, sales taxes, property taxes, luxury taxes, gasoline taxes, telephone bill taxes, natural gas bill taxes, electricity bill taxes, water and sewage bill taxes, cigarette taxes, alcohol taxes, motel room taxes, federal income taxes, state income taxes, local income taxes, Social Security taxes, unemployment compensation taxes, real estate taxes, personal property taxes, severance taxes, and automobile license taxes. One of the reasons why the government will resist abolition of the income tax is that it will then have one less tax source, and some other tax rate (for example, a business tax rate or a payroll tax rate) will have to be increased to obtain the same total revenue. The government may very well go along with adding another tax, such as a VAT, but it will likely fight the abolition of the personal income tax and the business profit tax. Most taxes, once established, last for a very long time. This is true even of temporary taxes, such as excise taxes levied in wartime.

The government generally prefers to hide taxes from the consumer to make it appear that the tax "bite" is less than it really is. That is, it prefers that the tax component of the price of an item not be indicated to the consumer. Traditionally, US citizens prefer to see a sales tax or an excise tax explicitly indicated as an "add-on" to the pretax price. They do not mind, however, having other taxes (for example, payroll tax, corporation income tax) hidden in the price. A few years ago, a 10 percent tax was imposed on airline tickets. The government did not want consumers to be reminded of this tax, and it was initially hidden in the ticket price. In response to consumer objection, however, the tax is now explicitly shown. □ A number of previously explicit excise taxes are now hidden. Gasoline taxes are no longer displayed on gasoline pumps, and cigarette and alcohol tax stamps are no longer displayed on these products.

The Current Tax System Promotes Budget Deficits

Today, the US Government has large revenue requirements (one-third of the GNP), and the tax base is too narrow and too volatile to dependably provide the needed revenue at reasonable tax rates. Large federal deficits have occurred because of this narrowness of the current tax base and its instability from year to year. The narrowness of the tax base makes it necessary for rates to be unreasonably high; the volatility of the tax base causes revenue to fluctuate from year to year. Fluctuating revenues have contributed to deficits because during boom times the government does not use the surplus revenues to cover the deficits of lean times. Instead, it introduces additional spending programs or reduces taxes, causing budget deficit increases with each recession.

A large federal deficit is undesirable for several reasons. It causes inflation, cruelly eroding the lifetime savings of older citizens. Government borrowing to cover the deficit uses up available credit and forces interest rates up, possibly to very high levels. Lack of private-sector credit at reasonable rates stifles business development. If uncorrected, the large federal deficit can ultimately lead to economic collapse, both here in the US and abroad.

The Current Tax System Is Not Well Suited for International Trade

While the US has been struggling with its income-tax-based system, the rest of the world has moved on to tax systems that are better suited to modern economies and the international economic community of nations. Following World War II, many of the world's nations have agreed to a set of international trading rules, or code of commercial conduct, called the General Agreement on Tariffs and Trade, or GATT. The purpose of the GATT is to promote world peace and development by promoting international trade. Countries that agree to follow GATT rules are called contracting parties; as of December 1986, there were 92 contracting parties, including all developed Western nations, numerous developing nations, and several Eastern-bloc countries. The members of GATT account for 85 percent of international trade today. A brief history of the GATT is presented in the 1987 Economic Report of the President.

The GATT specifies permitted tariffs; it defines the ways in which a country can subsidize its exports and impose border taxes on imports. Generally, the GATT prohibits quantitative restrictions on international trade and outlaws export subsidies for nonagricultural products. Under the GATT, a nation may exempt its exports from indirect business taxes that it has imposed on

them, and may impose a border tax equal to that amount on its imports from other countries. These procedures are called border tax adjustments.

The rationale for this approach stems from the view that a generally imposed indirect tax raises the price of an item approximately by the amount of the tax. While a government may impose indirect taxes on its domestic products in ways that cause few problems, there is a drawback, however, in attempting to levy indirect taxes on citizens of other countries. Other exporting countries may not tax their exports, placing them at a significant competitive advantage. By similar reasoning, the border tax is imposed on imports to ensure that untaxed foreign goods are not given an unfair competitive advantage relative to domestic goods, which have to pay indirect taxes. As an indirect business tax, the VAT qualifies for this type of preferential treatment.

Since many of the world's nations have switched to the VAT, the US is now "out of harmony" with many of its international trading partners. They subsidize their exports and impose border taxes on imports at the VAT rate, which averages about 20 percent worldwide, but the US cannot do the same with its income tax. The income tax is a direct tax, which does not qualify for GATT preferential treatment. It is not possible to estimate the extent to which the income tax raises the price of an item intended for export, so there is no reasonable basis for establishing a border tax adjustment. Even in the face of the rapid spread of the VAT to nations around the world, the US Government steadfastly has refused to consider a VAT. By clinging to its income-tax-based system, it thwarts efforts aimed at international tax harmonization. The prices of our products may be affected by the income tax; no adjustment is made for this effect. Our products do not compete in the world marketplace on the same basis as products from VAT-using countries.

The Framers of the US Constitution Had a Good Idea when They Outlawed the Income Tax

In retrospect, whatever their reasons may have been, the framers of the US Constitution made a good choice in prohibiting the federal government from imposing an income tax. While the original concept of the income tax may have been to tax only a few high-income earners, the tax base has been expanded to include most of the population as the revenue requirements of the government have grown. Had the income tax not been established, the growth in federal tax revenue would have been in constitutionally approved indirect taxes, such as the sales tax or the VAT.

Use of the personal income tax as a mass tax has violated the privacy of virtually all US citizens, for no good purpose. This lost privacy could be recovered if the Sixteenth Amendment were repealed, and if the federal government were to return to the use of indirect taxes. Of course, since the states have followed the example of the federal government in imposing state personal income taxes, they too would have to be denied the use of the personal income tax, to restore individual privacy.

The Serious Inadequacies of the Income Tax Were Not Initially Apparent

When it was first established, the serious drawbacks of the income tax were not anticipated. Simply defined and imposed at low rates on a small proportion of the population, the tax did not result in serious social or economic problems. In introducing the income tax, however, the creators of the Sixteenth Amendment had no idea of the Pandora's box they were opening. As the rates were raised, the drawbacks became evident. At low rates, a voluntary collection system

worked; at high rates, a strong national police force -- the IRS -- was needed to enforce collection. By its very nature, the income tax reduces the incentive for the individual to work and to save. At low rates, these incentives are negligible; at high rates, they cause noticeable changes in behavior. At low rates, there is little incentive for tax avoidance and evasion; at high rates, the incentive is strong and many taxpayers succumb. Applied to a small proportion of the population, the income tax invades the privacy of only a few; as a mass tax, it invades privacy on a grand scale.

The income tax creates disincentives for firms to save, to invest, to be productive and efficient; the income tax subsidizes debt financing over equity financing, increasing the risk of business failure; the income tax penalizes efficient, profit-making firms; the income tax favors incorporated businesses over other business organizational forms. At low rates, none of these problems is noticeably manifest; at high rates, the income tax seriously distorts the economy.

Before World War II, the US Government's requirement for revenue was modest, the income tax was quite able to produce adequate revenue at low tax rates, and none of the above problems surfaced to a noticeable degree. When, during World War II, the rates were raised to high levels and expanded to the whole population, all of these problems surfaced. Furthermore, in recent years the income tax, with a narrow tax base, has been totally unable to produce sufficient revenue to cover the national budget. The result has been massive federal budget deficits, averaging about \$200 billion per year, or about 5 percent of GNP. The gross federal debt is now \$2.4 trillion, or about half of the nation's GNP of \$4.4 trillion.

The Inadequate Revenue-Producing Ability of the Income Tax Has Turned the US into a Debtor Nation

The massive deficits have turned the US into a debtor nation. The US Government's insatiable demand for credit to cover the deficits is sucking credit markets dry and choking private investment. The tax system is bankrupt, and the results threaten the collapse of the economy. The country needs a new tax system that is not based on the income tax.

As income tax rates were increased in a futile attempt to raise sufficient revenue, the tax code became more and more complicated. The inequities and social and economic deficiencies of the income tax surfaced. In an attempt to remedy these problems, new rules and regulations were adopted. A massive, complicated system of tax deductions, or tax shelters, evolved. These changes created incentives for still more changes, resulting in a tax code so complex that no one any longer knows the definition of taxable income. In thousands of cases, it is now necessary for the IRS Tax Court to make arbitrary rulings on what is taxable and what is not.

At high rates, the government can no longer collect the income tax on a voluntary basis. To escape the heavy burden of high income tax rates, many citizens now operate in an "underground economy," conducting their affairs in private cash or barter transactions to avoid a tax widely perceived as oppressive and unfair. Desperate to close the "tax gap," the government has created a massive bureaucracy -- the IRS -- with police-state powers outside the Constitution. The Supreme Court, alarmed that limiting these police-state powers might cripple the government's ability to raise revenue, exempted the IRS from complying with the personal-freedom guarantees of the Bill of Rights and endorsed the operation of the IRS outside of the Constitution.

The US Process for Developing Tax Systems is Archaic, Primitive, and Inadequate

Since World War II, Congress has passed over 20 major tax bills, including three tax reforms. Despite the concern of Congress, meaningful reform has not been achieved. The Congress is simply incapable of establishing a satisfactory system. One of the reasons for this inability is that the system used by Congress to develop a tax system is archaic, primitive, and unworkable. Instead of passing a law that represents a general statement of congressional intent and that charges the Treasury Department with working out the details, Congress itself defines every detail of tax law. By its very nature, the legislative process responds to pressures from numerous pressure groups. The resulting tax law is complicated, inconsistent, and illogical.

After the US introduced the income tax as a major revenue source, much of the rest of the world followed. In contrast to the US situation, however, most industrialized nations have now adopted a business tax -- the VAT -- as the main source of tax revenue. This type of tax can solve the US' current tax and deficit problem. Although the VAT was first implemented in the US (in 1953 in Michigan), since then the US steadfastly has refused to consider it as a tax at the national level. This refusal flies in the face of the experience of many of the world's nations, who have switched to the VAT. Since 1954 when France became the first nation to adopt the VAT, a total of 39 nations have adopted it. Because of its demonstrated superiority as a tax for modern economies, the spread of the VAT has been nothing short of phenomenal.

If Congress itself had to build the interstate highway system, we would not have one, or at least not a very well designed one. If Congress itself had to build the moon rocket, we would never have landed men on the moon. If Congress had to fight World War II by itself, we would never have won. Unlike every other area of governmental concern, in which Congress passes general legislation and charges an executive department with responsibility for getting the job done, Congress takes upon itself the job of completely defining the tax system. The result is a disaster that threatens to destroy the US economy and with it the world economy.

The country is in desperate need of meaningful and fundamental tax reform. This book presents a solution to the tax problem.

3. The Income Tax Monster

The Income Tax Has Severe Sociopolitical and Economic Drawbacks

This chapter summarizes the problems associated with the personal income tax. These problems may be classified into three general areas. First, there are sociopolitical problems, such as the perceived fairness of the tax or the resentment that a heavy tax burden may cause. Second are problems associated with the economic impact of the tax. A good tax system should promote economic growth, stability, efficient use of economic resources, and high employment. Third, there are problems associated with the government's need for an adequate and stable source of revenue; the tax system should be a stable source of revenue of sufficient magnitude to cover the national budget. The current tax system fails miserably in all three areas of concern.

Within the three general problem areas -- sociopolitical impact, economic impact, and revenue-raising ability -- the problems associated with the income tax are further divided into nine specific categories. The next nine chapters describe and discuss each of these. In summary, the nine problem categories are as follows.

Problem 1. The Income Tax Has Destroyed the Privacy of the American Citizen.

Implementation of the income tax requires that the government know the financial affairs of 100 million income-earning citizens, as well as 15 million income-producing business establishments. This feature of the income tax is in contrast to some other types of taxes, such as sales taxes, in which the taxpayer may remain anonymous. The government has imposed the requirement that each taxpayer use his SSN as a taxpayer identification number. The widespread use of this identifier, which was originally prohibited from use as a general identification number, as a key to a large number of data files has resulted in a serious erosion of privacy. Through the use of a "Writ of Entry," by which the IRS may enter a home and seize property without a court order, the government is in violation of the Fourth Amendment guarantee against unreasonable search and seizure.

Problem 2. The Income Tax Has Spawned an American Gestapo.

Though originally intended as a tax on the rich, the personal income tax was transformed into a mass tax by the massive revenue requirements of World War II. The enforcement of this tax has resulted in the creation of an American national police force -- the IRS -- that operates outside constitutional law. It uses a variety of police-state tactics that violate constitutional rights of individuals, including search without a warrant, confiscation of property without due process or a court order, trial without a jury, presumption of guilt, threats, intimidation, defamation, the use of informers, entrapment, spying, monitoring, and harassment. It uses these tactics to intimidate taxpayers; to destroy their reputations, careers, and estates; and to silence their opposition.

Problem 3. The Income Tax Has Weakened the Constitution.

The original Constitution outlawed the income tax. The Sixteenth Amendment authorized it. In the years since its enactment, the Sixteenth Amendment has, in essence, resulted in the nullification of the First, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, and Thirteenth Amendments. The passage of the income tax amendment has virtually stripped the US citizen of his right to privacy, his right to be let alone. □ Under the tax code, the burden of proof rests on the citizen -- you are assumed guilty until you prove your innocence. The IRS can force you to produce documents without a court case being in process. You are tried in a special tribunal, without due process, outside the Judicial Branch, in patent violation of Article I, Section 8, Paragraph 9 of the Constitution, which requires all lower courts to be under the Supreme Court in the Judicial Branch. The IRS may seize your property and subject you to electronic surveillance without a court order.

Problem 4. The Income Tax Is Unfair.

Since knowledgeable taxpayers can often make the system work to their advantage, the complexity of the tax system has led to a strong feeling on the part of many citizens that the system is unfair. □ The income tax system allows for confiscatory taxation of the lifetime savings of older citizens. Under tax reform, older Americans who sell their homes are socked with tax bills that can exceed 100 percent of the increase in real value of their homes since purchase, because the government taxes capital gains whether they are real or due to inflation.

Problem 5. The Income Tax Is Corrupting the Country.

Because of its substantial unfairness and unnecessarily high tax rates, the income tax system has spawned a large underground economy, which conducts cash or barter transactions to avoid tax payment. The Congress has implemented an unfair tax and allowed the Executive Branch's IRS to employ draconian measures to enforce it. Perceived as unfair, many US citizens no longer pay their income taxes voluntarily, as they once did.

The income tax system includes very strong, yet unnecessary, incentives to evade taxes. Under tax reform, the corporate (federal) income tax rate is up to 39 percent. Payroll taxes on the employer are up to 7.15 percent. State corporate-income-tax rates may be 10 percent. The personal federal-income-tax rate is up to 33 percent; state and local income tax rates may be another 10 percent; the employee's payroll tax rate may be up to 7.15 percent. The combined effect of all of these taxes is an effective rate of up to 76 percent on the businessman's earnings. Because of these very high rates, an incredible incentive exists for businessmen to make personal purchases (such as automobiles) through his firm to avoid this confiscatory level of taxation. These high levels of taxes are completely unnecessary; the needed tax revenue may be raised with alternative taxes at much lower rates. No good purpose is served by setting up a system with incredible incentives to evade taxes.

Problem 6. The Income Tax Is Too Complicated.

The income tax is defined in thousands of complicated tax code rules and regulations. No one knows the code's intent, which must often be arbitrarily determined through the Tax Court. The tax law is so complex that 40 percent of all taxpayers find it necessary to hire tax preparers. A major problem with the income tax is that economists cannot agree on a definition of income. In fact, some leading theoretical economists state unequivocally that it is impossible to develop a

satisfactory definition of income. The government's definition of income is continually changing, as the rules for defining income become more and more complex.

By using a progressive income tax system, many inequities, illogical constructs, and economic inefficiencies are introduced. In an attempt to remedy these problems, additional rules and regulations are passed. After seven decades of this process, the income tax system is now so complicated that no one fully understands it.

Problem 7. The Income Tax Has Serious Economic Deficiencies.

Both the personal income tax and the business profit tax have serious economic deficiencies. Although these deficiencies have been recognized for a long time, the US population has been unsuccessful in prodding Congress to enact meaningful tax reform. Even under the Tax Reform Act of 1986, many serious economic problems continue.

As income taxes (as opposed to consumption taxes), the personal income tax and the business profit tax encourage consumption and discourage saving because they tax the return on investment from saving. The economic incentives caused by income taxes result in serious distortions of the economy. Income taxes distort the choice of business financing (by favoring debt financing over equity financing), business organization (penalizing corporations relative to other business forms), production technology (favoring the use of capital over labor), and consumption decisions (favoring tax-deductible purchases over others).

Problem 8. The Cost of Administering and Complying with the Income Tax Is Very High.

To administer the income tax, the IRS maintains a bureaucracy of 85,000 employees and expends an annual budget of \$3 billion. The IRS administrative cost is, however, just the tip of the iceberg. In addition, the full administrative cost includes the labor expended by firms impressed into service by the IRS to collect the personal income tax for the IRS, since it has proved infeasible for the government to tax individuals directly. The administrative cost of executing the personal income tax is just too great.

As great as it is, however, the administrative cost of the income tax is dwarfed by the compliance cost; that is, the cost incurred by firms and individuals to determine their tax liability. Individuals expend their own time and hire paid preparers for two reasons. First, the tax code is so complicated that errors are likely. Second, the tax code is so complicated that there is a good chance that the taxpayer may inadvertently overpay his taxes by considerable amounts, if he does not hire a tax expert. This cost is called the cost of tax avoidance. The cost of tax compliance -- forms preparation and tax-avoidance activities -- has been estimated to be on the order of \$35 billion.

Problem 9. The Income Tax Base Is Contributing to Economic Collapse.

The personal income tax base is relatively small -- only 39 percent of GNP is subject to tax. For this reason, if the government relies mainly on the personal income tax as the major revenue source, very high rates are required to produce the revenue needed by the country (which is about

31 percent of GNP). These high rates cause citizen anger, resentment, and frustration; contribute to tax evasion and the growth of the underground economy; lead to escalation and excesses of IRS enforcement activities (as the government grows more desperate for cash); and substantiate the perception that the government is oppressive.

The corporate income tax base is very small -- about 7 percent of GNP -- and what is more, it fluctuates considerably from year to year, as economic conditions fluctuate in the business cycle. Consequently, the corporate tax revenues fluctuate from year to year. Not only does this make planning for continuing government programs difficult, but also, as mentioned in Chapter 2, it contributes to growing budget deficits.

Since income tax rates are already far too high, the government is reluctant to raise them higher, and the deficit continues to grow to astronomical levels. As of 1985, the US became a debtor nation, so that it, one of the wealthiest nations in the world, is absorbing capital (savings) that is desperately needed by poorer countries to further their own economic development.

The current US income tax system cannot raise the level of revenue needed for a modern economy. The income tax base is too narrow. The result has been massive government deficits, on the order of \$200 billion per year. The US government can no longer cover these massive deficits through the domestic credit market, and it now owes a massive debt to foreign governments.

The current system has not succeeded in preventing extreme concentrations of wealth. One percent of the US population now owns over one third of the nation's wealth. This situation is undesirable from the point of view of stability. Extreme concentrations of wealth generate envy and social discontent; they represent private concentrations of power that may threaten the security of the nonwealthy; they are also believed to contribute to the severity of economic recessions.

The federal tax system imposes a heavy burden on US citizens and affects the lives of us all. Billions of dollars are wasted in unnecessary administrative and compliance costs. Billions more are lost in tax avoidance efforts in response to unnecessary incentives, and in tax evasion motivated by a complicated, burdensome system. The privacy of all citizens is unnecessarily intruded upon. Citizens are outraged by the complexity of a system that discourages work, saving, and investment. The business profit tax also acts as a disincentive to save, invest, and be efficient. The inadequacy and instability of revenue have contributed to deficits, inflation, high interest rates, and low economic growth. The stakes are extremely high, and yet the process used to develop the tax system is old-fashioned, unsystematic, inferior to available alternatives, and inadequate.

Tax Reform Is a Failure

How did the Tax Reform Act of 1986 help solve the preceding problems? Hardly at all; in fact, some problems were made worse. The Tax Reform Act was an effort to expand the income tax base so that adequate revenue could be raised at low tax rates. The Act is a failure, on two counts. First, the tax rates are not low. Second, even with the current high rates, the tax revenue is inadequate to cover the national budget. Since the US overall tax level (as a percentage of GNP) is one of the lowest in the industrialized world, this is a clear indication that the structure of the tax system is simply inadequate. The US pioneered the income tax system at a time when the

country's revenue needs were low. The income tax system is simply inadequate to support a modern economy with high revenue needs. The US should pioneer the elimination of this malicious, inhumane, and inadequate form of taxation.

The major thrust of tax reform was to remove tax preferences, or tax shelters. The goal was to achieve a tax system in which people with similar incomes would pay similar tax; that is, to achieve "horizontal equity" with respect to income. The motivation for this thrust was that the rich and tax-wise could take advantage of these shelters, whereas others could not. The ability of some to shelter most or all of their income led many to perceive that the system was unfair.

While the Tax Reform Act of 1986 may have in large measure accomplished its goal, that goal was totally inadequate. A review of the problems identified in this chapter shows that virtually all of the problems will continue to exist when tax reform is fully implemented. The system is still a costly, complicated, privacy-intrusive one, with many undesirable economic, social, and political drawbacks. It needs to be scrapped, and a new system should be developed that is responsive to today's revenue needs and does not alienate the US public.

A major shortcoming of the Tax Reform Act is that, while it can raise the level of revenue generated by the system before tax reform, it cannot produce sufficient revenue to cover the national deficit without income tax rates of intolerable levels.

Tax Reform Perpetuates Economic Distortions

Under tax reform, the government has abolished many tax shelters for individuals. Unfortunately, many of the investments that, under the previous law, represented tax shelters for individuals will still represent tax shelters for businesses, so that the economic inefficiencies may continue. Business and personal-finance decisions should rest on sound economic principles and the efficient allocation of resources. What is needed is an economically neutral tax that does not interfere with rational economic decisions. The current income tax system is not such a system.

The problems of the previous income tax system (that existed before the Tax Reform Act of 1986) are essentially unresolved under tax reform. The burden and complexity of the system is reduced for some low-income earners, but they are actually increased for many taxpayers. Many US citizens will probably still find it necessary to retain tax advisors and tax preparers. The cost of collection will remain essentially unchanged. The unnecessary invasion of privacy will continue. The incentive for businessmen to purchase items through their businesses will be, in fact, significantly increased because of the elimination of many tax deductions for items that may reasonably be characterized as business related.

Unfortunately, the Tax Reform Act failed to address the many ills of the income tax system. The new tax reform laws retain many of the same fundamental problems as the old tax law. First, the income tax rate is progressive (that is, a higher income is taxed at a higher rate), so that the government still needs to keep track of each person's total income. Second, there are still deductions, so that if a person is to pay no more than his fair share, the government needs to keep track of other personal information, such as the number of dependent children, how much is saved for retirement, and how much is spent on one's home mortgage. In short, the tax will still be an *income* tax, and the government will still require that individuals be registered and monitored.

Under Tax Reform, the Income Tax Is Even More Complicated Than Before

The government has meddled significantly with the economic market forces in its incredibly complicated collection of deductions, exemptions, and credits. US tax law is a fantastic and complicated collection of rules which accomplishes little but a redistribution of income to tax lawyers, tax accountants, and tax preparers. For many years, these rules so favored the wealthy that the US tax system was characterized as a massive welfare system for the wealthy. While the recent tax reform simplifies some of these rules for individuals, it still allows to remain in place a mechanism -- the personal income tax -- that is intrusive and inefficient. Moreover, the tax law for businesses will remain complicated and complex, perpetuating the loss of productivity by businesses in tax planning, analysis, and avoidance.

The tax system under tax reform is not a good system. It is still an income tax system, and a seriously burdensome one at that. Moreover, the business income tax is poorly coordinated with the personal income tax, resulting in substantial inequities and undesirable economic incentives. The US income tax system causes economic waste and seriously violates the privacy of individuals.

In *The Price Waterhouse Guide to the New Tax Law*, former IRS Commissioner Roscoe L. Egger, Jr., discusses the Tax Reform Act of 1986. He states that the objective of simplification has not been met and, in fact, that simplification of the income tax is virtually impossible. He states that all taxpayers -- individuals, corporations, and others -- now face complicated new rules; that this is an inevitable and necessary transition from how it used to be to how it should be.

It does *not* have to be this way. The US tax system does not have to be complicated. The government simply has refused to consider simple, fair, efficient alternatives.

Meaningful Tax Reform Will Not Come Easily

Many governments desire to maintain a high degree of control over their citizens. This desire appears to be a normal result of the evolutionary process of governments. Given this desire, there is hence from the government viewpoint a very substantial political advantage in the income tax. The government has convinced people that an income tax is necessary, to support public expenditures. Taxes *are* necessary; an *income* tax is not. The government will not readily give up the income tax, however, because it justifies their monitoring of individuals. Without the income tax, there is little justification for monitoring of individuals other than the desire to control them, and our government would be reluctant to admit this as a goal.

The government will fight the abolition of the income tax, not because it fears a loss of revenue, but because it fears the loss of control of individuals through registration (through your tax identification number, the SSN), and knowledge of your personal and financial affairs. The government can collect the desired level of tax revenue in other, less costly, more economically efficient, more equitable, less intrusive ways. It has not chosen to do so and will not choose to do so, however, in order to justify its continued monitoring of individuals.

The high degree of individual monitoring that US citizens experience is not present in many less-developed countries, since the governments of such countries do not have the resources available to monitor every individual. The estimated \$35 billion cost of implementing the personal income

tax works out to a cost of \$150 for every man, woman, and child in this country. That amount exceeds the total per-capita income tax for many countries.

A US citizen who travels abroad is often struck by the fact that the citizens of many foreign countries often have considerably greater individual freedom than individuals in the US. The citizen may have less *political* freedom in many countries, but, as long as he doesn't threaten the government's security, he is often far less "hassled" by the government than is the citizen of the US. Thirty-five billion dollars can buy a lot of hassling!

Many US citizens are fed up with the intrusive activities of government, especially at the federal level. They perceive that the Orwellian era of "Big Brother" has in fact arrived. The major factor underlying the monitoring and control of individuals is the income tax, whose implementation requires identification of individuals. The monitor of Orwell's *1984* turned out not to be a video monitor -- it is the personal income tax.

4. The Assault on Privacy

Privacy Is a Valuable Asset

This chapter discusses the loss of privacy that has occurred, and is growing more severe, because of the availability of the Social Security Number (SSN) as a near-universal, near-unique identifier. It describes the ways in which the SSN is used to facilitate compilation, storage, and retrieval of personal information about you, and to assist monitoring of you.

To many people, the issue of privacy is a "nonissue." They do not feel uncomfortable with the current situation vis-à-vis privacy, they have not previously been slandered by a false credit report, and they do not perceive the loss of privacy as a loss of or potential threat to freedom.

To me, privacy is an important personal asset. I value it and want to maintain it. Some degree of privacy, such as the desire to wear clothing, is valued by almost everyone. If privacy does not mean much to you, the arguments presented in this chapter in favor of protection of privacy and curtailing the use of the SSN will seem irrelevant. These arguments are presented in this book because the loss of personal privacy is a major social cost of the personal income tax. As the discussion of this chapter will show, your loss of privacy is not associated simply with the government's knowledge of your income. Rather, the availability of a unique, universal, permanent identifier -- the SSN -- has enabled a comprehensive and organized assault on the privacy of US citizens.

Harvard law professor Arthur Miller, author of the book, *The Assault on Privacy*, was quoted recently (*Time*, July 6, 1987, p. 33) as stating that the threat to individual privacy in this country arises from entities that are not governmental: hospitals, corporations, each other. That position is open to debate. Both governmental and nongovernmental threats are very severe, as this chapter will show.

The US Government now monitors all financial transactions of over a few thousand dollars (bank deposits and withdrawals, interest payments, stock purchases and sales) under the guise of ensuring that everyone pays his fair share of the income tax. Through the Sixteenth Amendment and the income tax, the US Government has been able to accomplish what it would otherwise never have been permitted to do. The US public has been duped into believing that only the income tax can provide the revenue needed by the government; in this belief, it has grudgingly submitted to monitoring of its financial affairs. The income tax is *not* necessary; government monitoring of the financial affairs of individuals is *not* necessary; individual taxpayer identification numbers are *not* necessary. This chapter explains the many ways in which the availability of a personal tax identification number, the SSN, has led to the loss of personal privacy in the US -- in your personal dealings, not just in your dealings with the government.

Is There a Legal Right to Privacy?

In his book, *Civil Liberties and American Democracy*, John Brigham discusses the legal aspects of privacy. In certain areas, such as marital privacy, a right to privacy has existed in common law since long before the Bill of Rights. Although a general right to privacy was not explicitly stated in the Constitution, it has, in the twentieth century, been institutionalized by the opinions of the Supreme Court. The legal origin of a constitutional right to privacy begins with Judge and

Professor Thomas Cooley, who, in 1888, articulated a "right to be let alone." In 1890, Samuel Warren and Louis Brandeis published a law review article in which they advocated a right to privacy based on Judge Cooley's concept. This article has been cited in numerous Supreme Court decisions. In 1965, a constitutional right to privacy was formally and conclusively recognized by the Supreme Court, in the case of *Griswold v. Connecticut*. The right to privacy is considered to derive from the First, Third, Fourth, Fifth, and Ninth Amendments.

Brigham notes that apart from constitutional law, the right to privacy has been implicit in American ideology, tradition, and common law. By 1960, a right to privacy was recognized by 31 states.

In summary, under US law, a right to privacy exists, both in common law and constitutional law.

The SSN Was Originally Simply a Retirement Account Number, Not a Universal Citizen Identification Number

The SSN is used to expedite the collection of personal income taxes. Each person is assigned a unique account number to facilitate keeping track of his tax contributions. (The SSN is actually not unique. A number of people have the same numbers, but most individuals have numbers that differ from everyone else's.) Originally, the purpose of the SSN was to keep track of each individual's Social Security account. An employee pays into the Social Security Trust Fund during his productive years, and he is (or his survivors are) paid out of this fund when he is no longer able to work (retired, disabled, or deceased). Because the amount of the payment depends on his earnings history, it is necessary to maintain a record of that history.

A strong central government can be a very effective force in accomplishing activities that are of national or regional concern or scope, such as national defense, regional environmental protection, and public health. It can also be effective in preventing or reducing major concentrations of power, such as very large businesses or unions or extremely wealthy families, which threaten the security and freedom of the individual. The US Government has accepted this role in breaking up very large businesses, but it has been unwilling to break up very large unions.

The government can, however, accomplish all of these beneficial activities without intruding in the privacy of each and every American family. Philosophically, the Jeffersonian concept of democracy is that the welfare of the citizen is best protected by minimal interference of government in private affairs. From this viewpoint, the personal income tax is one of the worst taxes ever devised; it causes the unnecessary intrusion of the government into the affairs of all individuals, when the same (or a greater) level of tax revenue could be collected as nonintrusive business taxes.

Originally, the SSN was intended as nothing more than an account number for a person's Social Security retirement account. It was adopted as an individual's taxpayer identification number (TIN), after passage of the Current Tax Payment Act of 1943. Today, it has become a universal citizen identification number. As this chapter will show, the existence and use of a government-sponsored citizen identification number has resulted in the significant loss of privacy of the individual and in control of information about his personal affairs. It is the linchpin of a comprehensive information system that stores and distributes personal information. Both the US Government and the private sector use the SSN to monitor individuals to a degree that would be very different without government sponsorship. Because many decisions affecting the individual are made by government and private organizations based on information that is assembled using the SSN, the SSN identification system has led to a significant loss of control by the individual of his own status and affairs. This chapter explains the many changes that have occurred in the

individual's privacy, independence, and autonomy, because of the government-sponsored implementation of the SSN as a general citizen ID number.

The US Government's Commitment to Protect Privacy Is Waning

When the US Government first attempted to introduce the SSN, there was a loud outcry against the introduction of a numerical identifier for US citizens. A friend of mine told me that she remembered the reaction and the government's promise that it would never be used as a general identifier - every Social Security card was to bear the legend, "NOT FOR IDENTIFICATION." Evidently, that promise was a lie, or has been forgotten. The government has, in fact, deleted that legend from recently issued Social Security cards. The Privacy Act of 1974 ostensibly restricted the use of the SSN as a general identifier, but its use in that regard is now widespread and growing.

The Computer Age Has Created a Demand for a Unique, Universal, Permanent Identifier

The reason for the increasing use of the SSN as an identifier is that it enables very easy storage and retrieval of personal data and the matching and merging of data stored in different data files. Whenever an organization wishes to store information about you, it needs to identify you in some way. Previously, a person's name, address, and age or date of birth (DOB) were widely used to uniquely identify him. This information uniquely identifies the individual because it is virtually certain that no two people have exactly the same name, address, and date of birth. A person's name alone is not a useful identifier because many people have the same name.

A problem associated with the name/address/DOB identifier is that a person's name has many different forms, and he may change his name and address often during his lifetime. In other words, although the name/address/DOB may identify a unique person, there may be many different versions of this identifier (that is, it is not uniquely determined, or "single valued"), and it is not permanent. For example, there are usually many different versions of a person's name (such as, Francis Allen Smith, F. A. Smith, Frank Smith, F. Allen Smith III, and so on); a person could own two homes and therefore have two addresses; or move, and have a new address; and a person may change his name (such as, when a woman marries and adopts her husband's surname).

The fact that the name/address/DOB is not a single-valued or permanent identifier causes problems in storing and retrieving information. For example, a credit-reporting service might end up with five different records on the same individual, each under a different version of his name or under a different address. Or, a woman may have changed her name last year, and the identifier used in the service's file would be obsolete. Or, information about another person having the same name may be entered into your file. Unfortunately, this happened to a friend of mine -- disparaging information about someone else was inadvertently entered into a credit-reporting service file maintained on him. This information was released by the credit-reporting service to a bank, his credit reputation was damaged, and he was denied a loan.

The SSN Is an Ideal Universal Identifier

These problems are avoided if your SSN is used as the identifier. First, it is nearly unique: very few individuals have the same SSNs. Second, it is virtually permanent. Once assigned to an individual, it is almost never changed. If a credit-reporting service identifies individuals by SSN, data entered into its files can be easily maintained in a single record. If a creditor specifies your

SSN, the credit-reporting service can retrieve your complete record quickly and easily. It can retrieve information that was originally stored when you had a different name or address.

Furthermore, whenever the credit-reporting firm obtains new information about you, it can readily enter it into your record, once it knows your SSN. If the firm obtains a new set of data, for example, notices of bankruptcies, it can quickly merge this information into its computer data files in a matter of seconds or minutes, when the information is identified by SSN.

Information maintained by two different organizations can easily be combined, if both organizations use the same identifier. The process of combining information contained in different data files requires the "matching" of records that correspond to the same individual in the two files. Once two matching records are found, the information contained in those two records is combined, that is, the files are "merged."

For example, suppose that your state motor vehicle department sells information about all of the automobile owners in its state to a direct-mail marketing company, and that the company wishes to merge that information with information already available in its data files. It is an easy job to merge files that are identified, or "indexed," by the SSN. The record match and subsequent merge can be done very quickly and at very low cost, automatically, by a computer program.

Use of the SSN as an Identifier Is Growing

The US Government makes heavy use of the SSN for matching. For example, it matches income tax records to assistance payment (welfare, Medicaid) records, child-support payment records to income tax and employment records, student-loan repayment records to income tax and employment records, and so on, in an attempt to monitor the activities and status of its citizens. State governments routinely enforce liens against citizens by tracking them down through their SSNs and garnishing their wages.

There is a growing use of the SSN as a universal identifier: an identification number that is used by many organizations to identify people. This use is growing in spite of the fact that every Social Security card (except those issued recently) contains the legend, "NOT FOR IDENTIFICATION," and the federal government has restricted the use of the SSN as an identifier. According to the Privacy Act of 1974, for example, no federal grantee (an organization receiving a federal grant, such as a university research grant or funds for social services) is permitted to set up a system of records based on the SSN.

Despite the fact that the federal government recognizes the loss of privacy that is inherent in the availability of a universal identifier, it itself is one of the greatest offenders of the spirit of the Privacy Act of 1974. The Privacy Act generally prohibits use of information for purposes other than that for which it was collected, without the consent of the individual. A recent report by the government's Office of Technology Assessment notes that computer matching of records has become common in the government, without the consent or awareness of the individual. Recently, a former student of mine told me the number of times he had been asked for his SSN as identification in the past few weeks: the telephone company, the University registrar, the University financial aid office, the Border Patrol at the Nogales border crossing, and the bank.

The term "Social Security Number" is a misnomer. Originally, the number was intended to serve as a sort of account number to enable government determination of the size of the retirement, disability, or survivors' payment to or on behalf of an individual whose employer had participated in

the Social Security program. Now, its primary use is to identify individuals, enabling easy income monitoring by the government.

The Information Business Is Big Business

As the US transforms from an industrial economy to an "information" economy, both the demand for and supply of information on individuals has skyrocketed. Governments at all levels (federal, state, and local) maintain files on individuals: tax records, property records, automobile registrations, Social Security records, assistance program records. Credit-reporting services and medical-reporting services maintain extensive, up-to-date information about your personal and family credit history, health, and medical background. Mail order firms maintain personal and financial information about a large portion of the population. Department stores, credit card companies, credit unions, and banks maintain files on their customers. Physicians and hospitals maintain records on their clients. Companies maintain records on their employees.

A large segment of the economy is involved in information processing, a large portion of which is concerned with the storage and retrieval of data on you.

The Use of Deceptive Information-Extraction Procedures Is Common

Information on individuals can now be stored and retrieved with tremendous ease, and big profits can be made in the large and growing market for personal information. Because of the profits available to the personal-information-trafficking market, firms in the business of maintaining files on individuals are generally very aggressive in trying to learn your SSN. They have devised schemes for obtaining your SSN by "high pressure" tactics and obtain much personal information by means of deceptive practices.

For example, suppose that you are submitting an application or claim to a medical insurance company. The insurance company will no doubt ask you to sign a "standard information release" form, permitting them to obtain a variety of information about your past from various medical-information services. Information about your past is kept in data files that are indexed by your SSN. What many people do not realize, however, is that the "fine print" in the release agreement doesn't simply allow doctors and others to release information to the insurance company -- it usually also permits the insurance company to release the information you are submitting to it on the form to any credit-reporting services it pleases!

Here, for example, is an example of the release statement you are asked to sign for one large US company:

You are authorized to provide (company name) any benefit plan administrators, consumer reporting agencies, attorneys and independent claim administrators acting on (company)'s behalf, with information concerning medical care, advice, treatment of supplies provided the Patient, and any employment-related information regarding the Patient.

Here's another example:

I authorize any physician or other medical professional, hospital or other medical care institution, insurer, medical or hospital service or prepaid health plan, employer or group policyholder, contract holder or benefit plan administrator to disclose to (company name) or any benefit plan administrator, consumer reporting agency, or attorney acting on

(company)'s behalf, any medical information and any employment-related information regarding the patient.

These releases authorize the company to release your personal information (and that of your spouse and dependents) to consumer-reporting agencies! This includes release of personal information that has nothing to do with your medical problem (such as employment information) to credit-reporting services or any attorneys that your insurance company or self-insured employer may retain. These conditions are outrageous infringements on personal privacy, coerced under threat of denial of health-care-insurance benefits.

In plain language, medical insurers and paying agents of self-insured employers "trick" you into giving permission to release personal, private, and confidential information to data services, when you are led to believe that you are permitting just the opposite. For this reason, these data services are able to keep their files up-to-date, with no reimbursement to you for the release, future use, and sale of your private information. Most medical insurance companies will require you to sign a release authorization every time you make a claim, will request your SSN to be entered on the form, and will release your SSN to the medical-data services. Of course, you are not required to provide your SSN, but the insurance company will threaten that if you do not cooperate fully with their request for information and fill out the form completely, they *may* have grounds for denying payment of your claim. In fact, a friend of mine, who recently refused to reveal his SSN, received the following notice from his medical insurance company: "No future charges can be considered without (employee's) Social Security Number."

Coordination of Benefits -- a Very Effective Tool for Privacy Intrusion

Some of the most aggressive and intrusive of today's privacy intruders are health-care companies and "self-insured" corporations. Self-insured corporations are very large corporations, with annual sales in the billions of dollars, which have so many employees that they can safely play the role of the insurance company. With a large number of employees, it is possible to accurately predict what the total employee medical cost will be and to charge premiums or set aside fringe benefit amounts that are virtually certain to cover that cost. There is essentially no chance that the firm will be "wiped out" by an unexpectedly large number of catastrophic cases. Generally, self-insured corporations hire large insurance companies to act as claims administrators, or paying agents, for their employee's claims.

Perhaps the most obnoxious weapon in the privacy-invasion arsenal of health insurers and large self-insured corporations is "coordination of benefits." Under a coordination-of-benefits provision, if you and your spouse are both employed and have separate medical insurance plans, the two plans "coordinate" their insurance payments to you so that the total insurance payment does not exceed the total medical cost, that is, you can't collect from both companies for the same medical expense. The companies praise this device, noting how it can reduce medical insurance costs. While this is true, it is a deceptive practice. In order for coordination of benefits to work, there is a severe cost that you must pay in terms of your privacy.

Consider what your employer will force you to do under coordination of benefits. Suppose that you submit a claim for your dependent. Reasonably, on your health-claim form, you should be expected to identify yourself as an employee of the company and to provide particulars about the health-care expense (dependent's name, health-care provider, nature of the problem, and treatment cost). Under coordination of benefits, however, the insurance company or your employer will demand that you provide your spouse's and dependent's names, addresses, birth dates, marital statuses, student status (of dependent), names of employers, whether your

dependent has received any insurance payment from any other source (such as automobile accident insurance), or whether your dependent is covered by any other insurance (such as your ex-spouse's current employee group medical plan). What business is it of your employer if you have a spouse, or, if you do, whether she is employed, or who her employer is, or what her name and age are, or where she lives, or if you are legally married to her, or whether you have an ex-spouse, or who she is, or who her employer is? Absolutely none! The demand for this information is a presumptuous, arrogant intrusion into your personal life. If the claim is for your dependent, it is not even any business of your employer whether you are married at all.

Fine, you may say, that's none of their business, so you won't tell them. What happens? They will refuse to honor your claim. Even if you are not married and there is no other insurance at all, if you refuse to disclose this personal information to the insurance company or to your employer, you will be denied insurance coverage. In today's society, medical cost for some illnesses can run up to a million dollars or more. It is not practical or prudent to be without insurance coverage. Medical insurance coverage is costly. If you refuse coordination of benefits, you may have to spend thousands of dollars a year in premiums to obtain individual coverage outside of your company. Few people will resist this pressure to release their personal information.

Coercion and Harassment Await Those Who Resist Submission of Their SSNs

If you refuse to provide your SSN on the form, you will probably be informed that it is required; that processing of your claim will be deliberately delayed; and that your claim may even be returned. Your claim may even be rejected. Since the numerical value of your SSN is not germane to the medical basis or eligibility basis for your claim, however, there is no reasonable basis for the requirement to submit it; you are justified in refusing to provide it on the grounds of unwarranted invasion of privacy. Remember, when it initiated the SSN identification system, the Social Security Administration explicitly specified that SSNs were "NOT FOR IDENTIFICATION."

The fact that knowledge of your SSN makes it easier for the insurance company to investigate you or enables them to augment a data service's dossier on you with up-to-date information, does not override your right to privacy. Most people are intimidated by the insurance company's demand, however, and are led to believe that their claim will be justifiably denied if they do not cooperate with this request. At the very least, the insurance company will delay payment of the claim, while it harasses the insured individual for his SSN. In the case of my friend who recently refused to submit his SSN, the claim was for hospital expenses. After waiting several months for payment, the hospital finally forwarded the bill to a collection agency. While the insurance company will no doubt eventually have to yield on the issue of demanding the SSN, it will cause, through its delays, a considerable amount of inconvenience before doing so. For large bills, payment delays may entail collection fees, attorneys' fees, and even the ruin of your credit rating. Few people can afford to resist this pressure.

Most people either do not realize that the insurance company may compromise the privacy of their medical information, or they do not perceive that the indiscriminant access to their SSN compromises their privacy, or they are unwilling to resist the insurance company (or pressure from their employer) on the matter; they simply capitulate. Moreover, some companies hold the privacy of their employees in such low regard that they will release their employees' SSNs to medical insurance companies or paying agents, without even asking the employees' permissions.

Credit-checking companies operate in much the same way. You can be reasonably certain that there are a number of credit-reporting services that contain information about your past in their files and regularly sell your personal information to a variety of curious organizations or individuals.

In addition to insurance companies and credit-checking companies, a variety of other companies, such as direct-mail marketing companies, retain information on you in their databases. Your state government may well contribute to these bases by selling information about your automobile, plus other personal information, to various organizations.

The Growing Use of Computers Increases the Demand for a Permanent, Unique, Universal Identifier

Thirty years ago, most organizations maintained information on individuals in "manual" data files. Because the records were reviewed often by human beings, it was a relatively easy matter to maintain them using the name/address/DOB identifier. Furthermore, since it was prohibitively expensive to merge data files from different organizations by manual means, there was little demand for a universal identifier.

The situation has changed radically since the 1950s, when the digital computer first "went commercial." Today, most personal information is stored in digital computers, in computer databases. To better understand the important role of the SSN in assisting the operation of these databases, it is helpful to know a little about how the data are stored in computer data files.

The information that is stored about you in these various databases is almost always stored in a "record" that is contained in a computer database "file." A "record" is simply the collection of information about an individual. A "file" is a set of records, for example, all of the individuals in a state. A "data base" is a collection of files. In order to access data in these files, it is necessary to have a "key" or "identifier" or "index" on each record. The identifier could be your name, but, as discussed earlier, there are several problems with this.

The dependence of computer merging on the availability of a reliable, universal identifier is increasing dramatically. Previously, most computer data processing was done by programmers, who could develop and modify the "match/merge" computer programs. If no reliable identifier existed, similar records could be printed out and matched manually. In the past several years, however, there has been a move to the use of "data base management systems (DBMSs)," which can be used by nonprogrammers.

Modern DBMSs Need Keys Such as the SSN

The most powerful of these packages are called relational data base management systems (RDBMSs). These systems include an easy-to-use "query language" capability, which enables the data base user to retrieve information without programming. The query language is a "fourth generation" language, which enables the user to extract information simply by specifying what information he wants. It is no longer necessary to develop a computer program that specifies the procedures for extracting the information and presenting it in the form of a report; that is, the new languages are "nonprocedural." A variety of RDBMSs has been developed and can be purchased for use on both large ("mainframe") and small ("mini" and "micro") computers.

In order to use an RDBM, however, it is necessary to specify a key, or unique identifier, for each record in the data files of the database. The RDBMs cannot perform its data manipulations and retrievals without it. The days in which a programmer could "work around" imperfectly identified records are fast disappearing. The new DBMSs demand reliable keys, and many of the personnel using these new systems do not have the programming skills to process data without them. The sociological impact of this technological development is that the federal government, state governments, local governments, credit-checking firms, insurance firms, direct-mail firms, and any

other organizations interested in maintaining files on individuals have a substantially increased vested interest in having available a universal identifier, such as the SSN. Their new data base systems will, quite simply, not work without one.

Concern Over the Loss of Privacy in the US Is Mounting

The availability of data files containing information about you -- both true and false -- is increasing dramatically. Many "horror" stories have been reported about people who have tried to correct false credit files. Several books have been written on the subject of invasion of privacy by data base services (for example, Professor Arthur R. Miller's book, *The Assault on Privacy*). The greatest single facilitator of the merging of data files is the availability of a unique, universal identifier. The SSN is a nearly unique identifier that has been assigned to almost all adults (that is, it is nearly universal, with respect to the adult population). Furthermore, it doesn't change, even if a person changes his name; it is permanent (for all practical purposes).

The Pressure on You to Release Your SSN Is Intense

By requiring each working adult to have an SSN, the federal government has created a universal, unique, permanent identifier that is used very much by private organizations to intrude on the privacy of individuals. It may be argued, however, that no one *has to* release his SSN to anyone, except perhaps (as required by law or regulation) to his employer for use in collection of payroll taxes and to the IRS when filing his personal income tax. From a practical viewpoint, unfortunately, that is definitely not the situation. For example, if you apply for a driver's license in Virginia, you are required to release your SSN to the state, or you will not be issued a driver's license. The Privacy Act of 1974 allows this, under a "grandfather" clause. Obviously, in today's mobile society, one cannot afford to be without a driver's license, so from a practical viewpoint it is not feasible to refuse.

Submit to Release of Your SSN or Face Disfranchisement

A few years ago a friend of mine moved to Tucson, Arizona, and promptly proceeded to register to vote. He was asked for his SSN (and some other personal information), and he respectfully refused. He was told that the SSN was required in order to identify him. He agreed to reveal his full name, address, and date of birth. Because it was extremely unlikely that more than one person had all three of these characteristics identical to his, he contended that that information was quite sufficient to identify him for voting purposes. He also indicated that his Social Security card bore the legend, "NOT FOR IDENTIFICATION." He was then told that his voter registration would be refused. He had been disfranchised and has not been allowed to participate since that date in any election -- federal, state or local.

Submit to Release of Your Tax Return -- or Lose Your Passport

The US Government is embarked on a full-scale assault on your privacy. The new tax law requires that any US citizen applying for a passport or any resident alien applying for a "green card" must file an IRS information return with the passport application. Fine, some may say -- if you've nothing to hide, there's no problem. That may be, except for the fact that the IRS can ruin your reputation without due process. The security of the individual from government control is enhanced if information is "compartmentalized"; that is, different agencies do not share personal information. This practice controls the dispersion of personal information, avoids the proliferation of copies of individual records, and reduces the damage to individuals in the event that erroneous

information is transmitted. This practice is used by the Department of Defense to reduce the risk of compromise of classified information.

The US Government is clearly bent on total exposure of its citizens. In the long run, that policy will work to the detriment of free individuals.

Release Your SSN to the Government -- or Go Without a Job

Scientific consultants often work with highly classified data and require special security clearances, such as a "top secret" clearance, a "Q" clearance, or an "SI/TK" clearance. A few years ago, a friend of mine became engaged in nondefense consulting, and his clearance "lapsed," or became inactive. Recently, when he reapplied for clearance, he was informed that he had to submit his SSN to the Defense Industrial Security Clearance Office. He refused. He was then told that if he did not release the SSN, he would be denied the clearance -- he would lose his job. He has a wife and children to support. He is not independently wealthy and needed the work if he wished to remain in Tucson, where the opportunities for highly technical work are limited. He was in no position to refuse and was therefore forced to submit the SSN.

Release Your SSN to Your Bank -- or Go Without a Bank Account

If you apply to a bank to open an account -- of any kind, not just an interest-bearing account -- you will be asked for your SSN. The Treasury Department sponsored a law that requires a taxpayer's identification number on every account. With respect to interest-bearing accounts, the rationale for this requirement is that it enables the bank to report interest income to the IRS. For noninterest-bearing accounts, identification of assets by taxpayer ID number facilitates IRS attachment of your assets in the event that they claim, correctly or incorrectly, that you owe the money.

You have, of course, the privilege of refusing to release the SSN to the bank, but if you do, your request for an account will be denied. Once again, in a modern economy it is very inconvenient not to have a checking account, just as it is not to have a driver's license. □ Since you must supply the SSN even for a noninterest-bearing (checking) account, the requirement in this case has nothing to do with taxation of income. It is simply an attempt on the part of the government to identify and catalog your property to facilitate monitoring and possible confiscation.

In some cases, it is feasible to deny a request for an SSN. For example, if someone insists on it as identification to cash a check for you and you refuse, he will probably refuse to cash your check. That is certainly his privilege: he wants to know as much as he can about you before taking a chance, is free to ask you for whatever personal information he pleases, and can refuse to cash your check for whatever reason he pleases. This presents no serious problem, however, since you can probably readily find another source, such as a bank, to cash the check for you, without requiring your SSN.

As mentioned earlier, your employer's medical insurance company or claims paying agent will no doubt ask you to reveal your SSN on your medical expense reimbursement claims. You may refuse, in which case they will complain, but will probably not persist in refusing to pay your claim, since it would no doubt be viewed by the court as an inadmissible basis for denying the claim.

Protect Your Privacy at Your Peril

Recently, a friend of mine applied to a large mortgage company for a mortgage loan to purchase a home for his family. The mortgage company asked him for information on his earnings, assets,

and liabilities. In addition, they asked for permission to make a credit check through a national credit-reporting company. As part of this request, they also asked for permission to release his SSN and all of the private financial data he had just provided to the credit-reporting firm. He refused, indicating that while he had no objection to the mortgage company's obtaining and reviewing a report from the credit-reporting firm, he saw no need for them to release his current private financial information to the credit-reporting firm. He stated that he had no objection to release of his name, address, and age to the credit-reporting firm, since these items uniquely identify him in the credit-reporting firm's files.

The mortgage company terminated his mortgage application, indicating that the conditions he imposed were too restrictive. It stated that it was able to receive a credit report using his name, address, and age, but would not request one unless he would permit release of all of his current financial data to the credit-reporting firm. Having been defamed by a credit-reporting service in the past, my friend replied that he had no intention of ever releasing any information to any credit-reporting service.

The situation was clear -- either allow release of his private information to credit-reporting companies or he would never receive a mortgage loan. A conspiracy between the mortgage company and the credit-reporting service? Who knows? The fact remains that today, unless you submit to release of your private information to credit-reporting services, you may never be able to purchase another home on credit. Submission of all of your financial or other personal data to the mortgage company is evidently no longer accepted as a basis for the mortgage company's review of your qualification for a mortgage loan. You must agree to provide the credit-reporting services with up-to-date personal data for them to sell to others without compensation to you, or the mortgage company will deny your loan.

Modern Computer Technology Can Link Together Distributed Data

With modern data base technology, it has become an easy matter to combine data on an individual from many sources. In technical terms, the data structure is called a distributed database. Previously, when data on individuals were maintained manually by a large number of independent and "unlinked" organizations, it was not feasible to assemble, maintain, and distribute reasonably complete and current dossiers on a large segment of the population. That is now done as a matter of course. Moreover, from a practical viewpoint, the individual is coerced by financial, insurance, and governmental organizations to provide -- without reimbursement -- both the universal identifier needed to operate these systems and the up-to-date private information needed to fill the files.

Use of the SSN Identifier Is Increasing Dramatically

The government will not let go of the SSN without a fight. The SSN is used by a wide variety of agencies to monitor and control the activities of individuals. The most widely recognized use of the SSN is, of course, to track income. Employers, banks, and investment firms are all required to report information about your earnings to the IRS, using the SSN for identification. The Office of Child Support Enforcement uses the SSN to track parents who make child support payments. The Office of Education uses the SSN to track college graduates who made education loans. The Department of Defense uses the SSN to identify soldiers and individuals having access to classified information.

Many states use the SSN to monitor and track motor vehicle drivers. A friend of mine told me that she was stopped for speeding in Ohio recently and was requested to provide her SSN to the patrol

officer in order for him to run a "check" on her identity. To an increasing extent, police cars are being equipped with computer terminals that link the car directly to local, state, and national computer systems. Unless positive steps are taken soon, the day will arrive when a police officer may routinely demand a person's SSN for entry into such systems for a search of his records. It would not be surprising if, someday, laws are passed that require an individual to release his SSN on demand, or his driver's license will be revoked. Such a procedure is already used in some states in the case of sobriety tests. If a person refuses the test, he is arrested on the spot, and his driver's license is revoked. The issuance of the driver's license is viewed as "presumptive" permission to administer the test.

In spite of the restrictions placed on the use of the SSN by the Privacy Act of 1974, the use and abuse of the SSN as an identifier is growing. Some colleges and universities use the SSN to identify students. This use appears to be illegal, since the Privacy Act prohibits any federal grantee from setting up a system of records based on the SSN, and most colleges and universities receive federal grant funds that benefit students.

The Move to SSNs for Children

Under the new tax reform legislation, all citizens over the age of four will be required to be issued SSNs, in order to be claimed as dependents. If you do not submit an SSN for each dependent over the age of four on your tax return, you will be fined. The rationale for this move is that it makes it easy for the IRS to check to see whether separate filers have claimed the same dependent. With no personal income tax, this rationale would evaporate. Although the government has a greater interest in having a universal identifier than it has in maintaining personal deductions, it is politically very difficult to argue that it needs a universal identifier to monitor and track its citizens. It is much more palatable to say that personal deductions are necessary in order for taxes to be "fair," and that the SSN is necessary to make certain that everyone claims no more deductions than he is entitled to. For this reason, the US Government will be extremely resistant to the idea of dropping the income tax, even though a lower-cost, higher-equity, less-intrusive alternative is available.

Individuals Have Suffered a Tremendous Loss of Privacy in the US

In summary, a substantial loss of privacy has occurred with the advent of the electronic digital computer and its use in monitoring you. Low-cost storage and retrieval of personal data is now possible, and the merging of files from different sources is greatly facilitated by the availability of a near-unique, near-universal, near-permanent identifier, such as the SSN. Unfortunately, these practices have contributed to a tremendous erosion of privacy in the US. Careless maintenance of these files has severely damaged the reputations of many people, and will harm many more. These practices would be substantially curtailed if no universal identifier were available.

It may be argued that the preceding loss of privacy would occur even if the SSN were not available. That is not at all clear. It is not obvious that it is hopeless for a person to retain a substantial measure of privacy in a modern world, even though the federal government is making achievement of that goal very difficult in the present-day US. In any event, should the US Government, with its purported concern for privacy of the individual, be in the position of facilitating privacy loss through its promotion of the SSN?

On May 6, 1987, *New York Times* columnist Anthony Lewis published an editorial entitled "American Journalism," decrying the *Miami Herald's* tracking of Senator Gary Hart for the purpose of exposing his personal life. In that editorial, Mr. Lewis stated, "Loss of regard for privacy has

exacted a terrible price in American politics." Given that the citizens are, in effect, placing their lives and futures in the hands of the President, it may be understandable that they wish to conduct a detailed examination of his life, both public and private. For the private citizen who wishes simply to lead an unharassed existence, however, that exposure is unwarranted. The loss of privacy has exacted a terrible price in America, period. If someone asks you an impertinent question, you should be able to deny his access to that information simply by saying, "That's none of your business," without jeopardizing your right to a job, to health-care benefits, or to vote. With the massive trafficking in third-party sale of personal information, however, the private citizen has little control over the dissemination of information about him and his family and little chance of maintaining his privacy.

A major aspect and component of human dignity is privacy. Rampant disregard for personal privacy diminishes our dignity and depreciates the quality of life in the US.

Institutional Defamation of Character

Some people argue that if you have done nothing wrong, you should have no objection to allowing storage, sale and distribution of information about you by government agencies and private-information procurers/peddlers. That argument is specious from several points of view. First, it denies our cultural desire for privacy, the same desire that drives us to wear clothes and place window shades and interior doors in our houses. Second, because of the strong potential for misuse of credit data, it is unwise to allow third parties to maintain and distribute personal information about you. Third, information about your personal characteristics or past may be used as a basis for unwarranted discrimination against you. Fourth, many US citizens routinely break laws they consider unreasonable or immoral, or may refuse payment for an improperly rendered bill without wishing to go to court over the matter. It does not serve the best interests of our imperfect system of government and justice to support systems of records that permit the destruction of a person's credit rating or the documentation of his protest of certain laws. Fifth, our culture has a heritage of "forgive and forget"; there is no strong rationale for permanent documentation and distribution of your past. The preceding points are discussed in detail in the following paragraphs.

The Desire for Privacy

Most people desire and enjoy privacy. The extent to which they enjoy it varies, from the nudist who desires exposure to Howard Hughes, for whom privacy became a consuming obsession. Most people don't want everything about them known to the public, and many people don't want much about them known.

The Argument for Personal Control of Distribution of Personal Information

In addition to wanting to retain a measure of privacy, some people want to retain control over distribution of personal information about them. The concept of control is far more important than many people realize. In many instances, erroneous information is entered into credit-reporting-service data files. Many times, you do not know that false information about you is being distributed by the credit-reporting service. Correction of these files may be difficult; tracking down and correcting all of the false reports that have been distributed may not be possible. Furthermore, it may be impossible to undo the damage that has been done by a false report.

Because of errors made by credit-reporting firms, severe damage has been caused to people's reputations. It is extremely difficult to undo this damage. Most of us cannot afford the cost of a

lawsuit to recover compensation for the damage to our reputations. Because of this situation, a strong argument can be made that all third-party information trafficking -- the general collecting, buying, and selling of personal information by firms such as credit-reporting services and medical-information-reporting services -- should be made illegal. The current system, under which we ostensibly have the right to deny these firms access to their personal data or are free to sue for damages if defamed, has simply failed. We are almost powerless to deny them access to our personal data and to deny them permission to sell that information.

"Revealing Well-Kept Secrets"

As an example of damage suffered because of loss of privacy, consider the case of the epileptic. Richard Pollack published an interesting article in the September 8, 1986, issue of the *Arizona Daily Star*. The article, "Revealing Well-Kept Secrets," discusses the dilemma of an epileptic who may be subjected to a drug-screening test. He, along with hundreds of thousands of others who have epilepsy, takes anticonvulsant drugs to control seizures. These drugs are detected in urine tests, such as those proposed recently for drug abuse detection.

One fear is that people who take legitimate drugs -- for epilepsy, hypertension, diabetes, or depression -- could be refused hiring, or even fired, if drug tests became mandatory conditions of employment. Even routine foods, such as poppy seeds on bread rolls, can cause positive drug test results. Suppose that such a positive result is entered into an information system and that the individual is later determined only to have eaten dinner rolls? Will he ever be able to make sure that his records have been corrected?

Another fear is that many people discriminate against epileptics, and Pollack does not consider that fair. He would prefer that people be able to keep their epilepsy or other health conditions to themselves, as protection from what they consider unwarranted prejudice. With the current rampant development of medical-information systems, recording personal information about millions and distributing this information around the world at the touch of a keyboard, the freedom to preserve one's privacy and protect oneself from unwarranted discrimination and prejudice is in serious jeopardy.

Forgive and Forget

We all make mistakes and have shortcomings. Until a few decades ago, most of these mistakes and shortcomings, except for major crimes, were not documented in data files. As we grew older, it was a delightful aspect of human existence that a person could, in essence, "wipe the slate clean" and start over again. That privilege is no longer allowed us.

Trafficking in personal information is big business. Our credit problems, employment problems, medical problems, marital problems, driving problems, psychiatric problems, and substance abuse problems are documented and maintained, usually in computer data bases, along with a variety of other personal information. Your personal information is distributed nationwide. If you've had some problems in the past, they're "cast in concrete" and are going to haunt you the rest of your life.

Human beings aren't perfect, and they don't respond well to documentation of their past and constant reminding of it. In our culture, a 40-year-old does not expect to be held perpetually accountable for the peccadilloes of his youth, and is not, unless they are extreme.

Many people have difficulties, weaknesses, shortcomings, personal characteristics, or experiences that they do not wish to share with the public. These may include a small income, a heart problem, epilepsy, occasional use of alcohol, consultation with a psychologist, a lost job, divorce, and marital problems. Having such facts reside in the memories of a friend, associate, or family member is one thing. Having such facts reside in the memory of a computer, owned and operated for someone else's profit, is quite another matter. The existence of such documentation constitutes, in effect, an institutional defamation of character. Because of the SSN, such information is easy to store, retrieve, merge, transfer, and sell.

Some may argue that a person should be held fully accountable for his current status and past actions. This point of view, however, fails to recognize that a person grows, matures, and changes. A 40-year-old is virtually a different person from the 20-year-old he once was. Furthermore, it is not a defense of defamation to prove the truth of the defamatory statements. The storage and release of information about an individual's past that defames his reputation or limits his ability to qualify for future benefits on the basis of the assertion that it is true is insufficient justification, and does not enhance the quality of life in our society.

"If You've Done Nothing Wrong, You've Nothing to Hide"

The growing use of the SSN to track individuals is a significant invasion of privacy. Some would argue that this practice is socially beneficial. Mothers forced to raise children without assistance from fathers endorse tracking fathers down and garnishing their wages. In April 1987, a bill (SB 1031) was introduced in the Arizona legislature to require that all child-support payments be automatically deducted from a parent's paycheck -- whether the parent is behind in the payments or not. This bill is in violation of a person's right to both privacy and due process.

In our society, use of the law to track down fathers and force them to support their children can be carried just so far. A very effective way of forcing fathers to support children is to outlaw divorce. Although this is the policy in some countries, few in the US would endorse this use of the law to force parental support.

The Move Toward a National Identification Number

One of the most controversial potential uses of the SSN is to track "illegal" aliens. While citizens of some Western European nations have acquiesced on the matter of work permits, national identity cards, and police "good conduct" documentation, such control is not consistent with our heritage of freedom of the individual.

Privacy of the Individual Represents Protection of Imperfect Human Beings From Imperfect Laws

Some would argue that all of these activities are legal. The term "legal" does not necessarily mean morally justified, or even generally desired by the citizenry. Many laws are enforced for years and then judged to be unconstitutional. The basis for "civil disobedience" is that the breaking of minor laws may be justified as a means to righting greater wrongs. The institution of detailed information systems that enable close government monitoring of individuals can stifle the ability of US citizens to force the government to be responsive to their needs. Privacy of the individual is an important protection against governmental tyranny.

The following examples are just a sample of the many laws that are unwanted or ignored by a large segment of the population, and are often inconsistently enforced.

Prohibition of alcohol was once the law of the land, even though a majority of citizens apparently did not want it. Blacks and women were denied the vote at one time. For many years, the national speed limit was 55 miles per hour, although a majority of the population routinely exceeded this limit. Gambling is legal in some states, illegal in some states, and legal if operated by the state (such as lotteries) in others. Private poker games in one's own house are illegal. Office football gambling "pools" are illegal. Bingo games operated by the local fire department fraternal organization are not.

Cigarette smoking is legal, although it has been designated as a leading public health hazard and secondary (involuntary or "passive") smoking has been identified as a cause of thousands of cancer deaths each year. Alcohol consumption is a legal form of recreational drug use, although it is widely recognized as very damaging and a severe and widespread drug abuse problem. Marijuana smoking is not legal.

"Sanctuary" movement church members believe that they should be permitted to save human beings from death, regardless of whether by accident of birth they happen to bear the label of citizens of a particular country. Many people opposed the Vietnam War. Alcohol consumption on the beach at Ocean City, Maryland, is illegal, but the law appears to be enforced against teenagers, and not against middle-aged individuals. Sexual relations between an unmarried 18-year-old male and a 17-year-old female is a crime in some states -- statutory rape. Oral sex is illegal in the US, although many engage in this practice. Many people are outraged at the rounding up and incarceration of Americans of Japanese descent and the subsequent loss of their income and properties during World War II.

Many laws (such as, exceeding the 55-miles-per-hour limit, private poker parties, drinking on the beach, adultery, sex between a 17-year-old and an 18-year-old) are routinely broken by a large number of US citizens, and many "law-abiding" US citizens do not intend for the offenders to be apprehended or punished. The law in these cases is evidently regarded merely as a statement of an "ideal" standard of conduct, for which most people are prepared to overlook nonoutrageous infractions by their fellow citizens. The penalties for such laws are often set very low. For example, when the national speed limit was 55 miles per hour everywhere, if a person was stopped by the Arizona police for driving 60 miles per hour, he was fined a small amount and cited for failure to conserve natural resources.

Most Citizens Don't View Changing the Law as Practicable; Privacy Is a Buffer Against Unreasonable Laws

In general, many generally law-abiding US citizens recognize that the law is an arbitrary collection of regulations, some of which are "right" and some of which are "wrong," depending on a person's set of moral values. Based on our own personal system of values, we decide which laws we will obey and which we will not. If a law is morally unjust, or unreasonably intrusive, and we feel strongly about it or believe that the affected domain is none of the government's business, we will not obey it. The US civil rights movement proceeded on the basis of violation of laws considered unjust.

In addition to the fact that many laws are viewed simply as standards of conduct, another factor underlying this point of view is that many people do not feel that they have much control over which laws are passed and which are not. They may be convinced that a law or government regulation is wrong, but feel helpless to change it. The bureaucracy has become so large and powerful that the ordinary citizen feels a strong sense of helplessness. People who have dealt with the IRS know the feeling -- essentially, you *cannot* deal with it. Its notices are threatening and

intimidating, and its reputation for confiscation of personal property without due process is widely known. People who opposed the war in Vietnam saw 50,000 young citizens die, billions of dollars squandered, and a decade pass before the war was finally terminated by President Richard Nixon.

The effort to change the system, even when the change is generally supported by public opinion, may be Herculean, and could require a lifetime commitment. From a practical viewpoint, quietly ignoring stupid or immoral laws is a more reasonable approach. Our system of representative government vests power in the hands of a select few who are able to make the two-party system work for them. Most people do not possess the time, resources, and charisma required to change the law, or the desire to devote themselves to becoming lawmakers or political appointees. Most citizens have their own lives to live and do not have time to campaign for changes in laws.

The Road to Participatory Democracy Is Rocky

In his book *Megatrends*, John Naisbitt sees a trend away from representative democracy toward participatory democracy, through the increased use of initiatives and referenda. Although this trend may give citizens a stronger voice in the setting of laws, recent experience has revealed some serious drawbacks in this approach. While it may work in very small local areas, evidence is mounting that it is proving to be a very ineffective means of dealing with regional problems, compared to representative government.

For example, in spite of the fact that the transportation-planning department in Tucson, Arizona, has over the past several years produced many fine plans to speed the flow of traffic through the city, local residents have consistently voted all such plans down -- "no freeway in *my* neighborhood!" The participatory democracy system has failed to solve the transportation problem. Today, traffic flow in the city is paralyzed. The use of referenda to implement urban policy by the citizenry has failed miserably. Participatory democracy has prevented the implementation of proven solutions to the problem and nullified the attempt to plan and implement a high quality urban environment. If egregious examples of the failure of participatory democracy to solve regional problems continue to surface, the trend to participatory democracy will reverse, and a return to representative democracy and central control will occur. Given recent experience, the trend to participatory democracy probably will slow and reverse itself. In this case, the sense of hopelessness of individuals to affect their laws will continue.

In a society of imperfect laws, privacy of the individual serves as a buffer that prevents suffocating governmental control. This is especially true in a large nation, in which the infinitesimal size of an individual's vote effectively denies him a significant voice in government or control of his nation's character. As a practical matter, an individual must accept the culture into which he is born. As unique individuals, however, their personalities, characters, and interests may not coincide with society's norms. America's tolerance of individual differences and heritage of nurturing the independent, entrepreneurial spirit has been a major factor in its greatness. Privacy is a major safeguard of the right of an individual to express his individuality, to achieve his full potential as a unique human being, and to enjoy a rich, full life, unfettered by the shackles of uniformity, conformity, and control which our increasingly restrictive government forges, year by year.

Privacy is the nemesis of tyranny, the strength and shield of the free man. A strong right to privacy is a hallmark of freedom. Preservation of a strong right to individual privacy is an effective defense against the evolution of a police state. □ With a silver tongue appealing to the duty of the US citizen to pay his rightful share of the tax burden under an income tax system devoted to equity and based on ability to pay, the beguiling IRS would strip the US citizen of his right to privacy, brand him with the SSN as a thrall of the state, and subject him to a lifetime of monitoring and control.

It Is Demeaning for Human Beings to Be Registered and Monitored

If a local government decides that dogs should be controlled, it usually requires that each dog be issued an identification number. The ID numbers are registered with the local government and cataloged. The dog is monitored throughout its lifetime: the status of the dog's registration, ownership, and rabies vaccination is repeatedly reviewed. Use of ID numbers to systematically identify all of the members of a group is the first step in an effective control program. For about a century-and-a-half -- until the beginning of the Social Security and personal income tax programs - - US citizens were not individually identified and registered.

Upon incarceration, convicted criminals are assigned numbers. In the concentration camps of Hitler's Germany, identification numbers were tattooed on inmates. In primitive societies, slaves were branded. We are not dogs. We are not criminals. We are not slaves. It is demeaning and degrading to be issued an identification number and registered by a government. Individual anonymity is a strong component of freedom from governmental tyranny. The concept of a government-issued ID number is not consistent with the US tradition of independence and a high degree of freedom for the individual.

Why the SSN Survives

One of the reasons why the US Government has gotten by with requiring the SSN for so long is cultural. As young people grew up in this country, they were told that they had to apply for an SSN before they could get a job. It was just one of the many things that you had to do in our culture. To some, receiving an SSN was one of the evidences of emerging into adult society. The fact that it, in effect, represents a "work permit" and increases the potential for infringement on a person's privacy and liberty is rarely discussed with the young person.

Another reason why the SSN has lasted as long as it has is that the considerable economic value of a universal identifier such as the SSN was not realized until recently, with the commercialization of the digital computer, the subsequent development of a large number of data bases containing personal information, and the ability to merge data files based on the same identifier at low cost. The demand for personal information has always been strong, but never before was it available so inexpensively and on so grand a scale. The government placed minimal restrictions on the sale of private information -- in fact, it was one of the greatest consumers of such information -- and the market for personal information grew to the multibillion-dollar industry and public sector component we have today.

The Shift to an Information Economy Has Increased Demand for Information System Identifiers

Another factor contributing to the use of the SSN is the gradual shift the US economy has undergone, from an industrial economy to an "information" economy. In today's US economy, many people's jobs are concerned with processing information about individuals. With the single exception of agriculture, the economic activities of a country are largely discretionary. Once the country's food demands are taken care of (and in this country they are taken care of by just 3 percent of the population) the remainder of the population can become engaged in any economic activities it (or its government) chooses: manufacturing cars, personal computers, video cassette recorders and antitank missiles; going to the moon; gambling in the commodity and stock markets; fighting "political" wars; building ski slopes; foreign travel.

This country has opted to invest a large portion of its discretionary productive capacity in data processing. Once the choice of economic activity is made, however, a degree of economic inertia sets in. People tend to want to continue doing the same type of work they have been doing, whether it is copper mining, shoe manufacturing -- or dealing in private information. The immediate elimination of the availability of a universal identifier would cause a temporary economic dislocation: the price of producing personal information would rise, and the demand would fall. Some people would be out of work, until the economy (or the government) decided what other type of productive (or nonproductive) work would be substituted for the decrease in the level of personal-information data processing.

Government Intrusion on Privacy May Be Warranted in Some Situations -- But the Income Tax Isn't One of Them

I am not arguing that all intrusion of privacy by a government is unwarranted. Some intrusions may very well be warranted, even necessary. Search warrants provide government a basis for search in the event that a crime is suspected. Other good examples occur in the area of public health. In order to protect the US population from decimation by AIDS, governmental identification and monitoring of infected individuals may turn out to be the only effective means of control of a serious threat to the well-being of the population.

In the case of the income tax, however, the government has set up an arbitrary system of rates and regulations that is totally unnecessary from an economic, health, or other general-welfare viewpoint, and monitors all citizens to enforce compliance with these rules. The income tax system is a contrived one that serves no purpose other than to rationalize government monitoring of individuals. Monitoring of individuals may be justified in public health issues such as in the case of smallpox, tuberculosis, or AIDS; it is not, in the case of the income tax.

The Potential for Abuse of the SSN Is Profound

To many people, the concern over the SSN may appear to be a "tempest in a teapot." They are culturally accustomed to the current low level of privacy, unconcerned with the sale of personal information, desensitized to the defamation of character that has been associated with personal-information reporting, and do not perceive that their personal freedom is in imminent danger -- at least not on account of the SSN. It is an axiom of human sociology, however, that governmental systems do not endure. All empires and nations rise and fall. The US will not exist forever as it exists today. Our system of government may change, either gradually or precipitously, or we may be conquered by a foreign power. When that change occurs, the availability of a universal identifier could facilitate the immediate and effective control of the population by a new power.

With our history of having never been conquered, this nation is not sensitive to this concern. Other nations are. For example, it is the law in Sweden that all adult men possess a rifle and a number of rounds of ammunition. While a rifle-armed citizen-army may be no match for a powerful external threat, that government nevertheless recognizes that, in the final analysis, national security depends on the willingness and ability of individuals to take a stand. Anonymity is a valuable resource in the fight against a governmental tyrant. The leaders of any revolutionary movement will be quick to confirm this fact. The US population has allowed the anonymity of the individual to slip through their hands. In the interest of the long-term survival of our heritage of freedom and independence, it is essential to regain this important asset.

Although the danger associated with the loss of anonymity may not be widely perceived, it is real. A government that knows who its citizens are, where they live, what they own, and where their

incomes are derived from, is in a strong position to control its people -- for good or ill. Although the US Government to date has promoted the general welfare of its citizens, the situation may not always be so pleasant. The time to take steps to preserve and strengthen our liberty is now, while we still possess it.

5. The American Gestapo?

Guilty Until Proved Innocent

One of the most objectionable aspects of the US tax system is that you are considered guilty until you prove your innocence. If the government believes, rightly or wrongly, that you owe a tax, it will take the money from you, and it is up to you to prove that you do not owe it. This concept is quite different from the fundamental premise of US law that a person is considered innocent until proved guilty. □If the US Internal Revenue Service, the tax collection agency of the US Federal Government, believes that you owe a tax, it will send you a dunning notice, which includes the warning, "We have enclosed a copy of publication 586A, which provides information about our collection procedures and your rights in relation to them. Your attention is specifically directed to our Enforced Collection Policy" The publication goes on to state, "Enforced collection action includes the filing of a Notice of Federal Tax Lien, the serving of a Notice of Levy and/or the seizure and sale of your property (personal and/or business). Once a Notice of Federal Tax Lien is filed, it becomes a matter of public record and may adversely affect your business transactions or other financial interests."

Even though you respond with an explanation or hire a tax accountant to represent you, the notices may continue. The next one threatens that the IRS "must now consider filing a Notice of Federal Tax Lien and seizing your property, wages, or other assets to satisfy your unpaid tax. The amount due includes additional interest and penalties which will continue to increase until the balance is paid in full." All of this, before you have ever had a day in court. The process represents nothing less than conviction and confiscation without due process of law.

The important thing to realize -- which many people do not -- is that the IRS can take these actions whether or not it has been proved that you actually owe the tax: they can destroy your home and business before you have ever had a day in court!

US tax law is so complicated and so confusing that it is impossible for a layperson to know all of the correct tax procedures. Some tax rules defy logic. The IRS nevertheless employs the doctrine that ignorance of the law is no excuse, and may ruin you for a reasonable and honest mistake -- or totally because of its own error!

In tax matters, the burden of proof lies with the individual -- you are guilty until proved innocent. One hundred million Americans are placed in this terrible position because of the personal income tax. No other way has been found for implementing a high-rate personal income tax. Only with the elimination of the personal income tax will the US be able to claim, sincerely, that an individual is innocent until proved guilty. The cost of placing 100 million Americans in jeopardy would be a heavy burden for a worthy cause. To pay this price for a costly, inefficient, inequitable, and intrusive tax is folly. The personal income tax is a tax structure irreconcilable with the ideal of personal freedom and is unworthy of a role in our system.

Because of the concept in tax law that the burden of proof lies with the taxpayer, that is, he is guilty until he establishes his innocence, all US citizens are at risk of punishment at the discretion of the government. Although this ploy has not been used on a grand scale to date, the situation offers a tremendous potential for abuse. The federal government has set up an incredibly thorough information system for monitoring all US citizens and has established the legal

machinery to arrest and jail US citizens at will. This system poses a potentially serious threat to freedom. It stands ready and waiting for the first truly tyrannical leader of the US as a means to enslave us.

The Income Tax System Has Spawned a Big-Brother Watchdog Agency

Before the implementation of the personal income tax in 1913, the federal government relied on indirect business taxes, such as tariffs, to raise revenue. Upon implementation of the personal income tax, the government required citizens to file annual tax returns, revealing their income and other personal information. As mentioned, the tax originally applied to only a small proportion of the population. The massive revenue requirements of World War II converted this tax to a mass tax, including essentially the entire population.

Today, the income tax process is a massive intrusion on the privacy of the entire population. Each year, the citizen is required to provide a detailed accounting of the amount and sources of his income, how he spends it, his dependents, and a variety of other information, such as the names of his creditors, physicians, churches, and charities.

The IRS is the government agency that enforces the tax system. As discussed previously, it operates under the assumption that you are guilty until proved innocent and has broad powers to search and seize your property and to fine you. The IRS is an organization, 85,000 strong, that is engaged in the monitoring of the activities of US citizens. This type of organization has no place in a nation such as the US, with a heritage of independence and freedom of the individual.

The IRS is a bureaucracy committed to and involved in the investigation of the financial affairs of private individuals, and in their cross-examination. This bureaucracy is a cancer in the tissue of a strong citizen-government relationship. It wastes productive resources and instills anger, fear, resentment, and hatred in the citizens. The concept of independence and freedom of the individual from government tyranny is incompatible with the personal income tax system. Even if a dictator realized sufficient wealth from natural resources (oil, minerals, forests), wealthy landowners, or businesses, he would do well to implement an income tax, just for the firm control it enables over the citizens.

The Income Tax System Has Been Converted from a Tax on the Rich to a Tax on the General Population

Given their cultural heritage, many US citizens do not want a "big brother" watching them, yet that is exactly what has evolved in this country, as a byproduct of the income tax. The legislators who implemented the personal income tax in this country evidently did not intend that it turn out this way. When started in 1913, less than one half of one percent of the population was required to file. Now, the vast majority of the population is taxed in this manner. The social movements of the late nineteenth and early twentieth centuries were oriented toward taxing the rich, not the development of a system to monitor all citizens.

If the personal income tax were eliminated, the government would have no reason to identify, monitor, investigate, and cross-examine millions of US citizens, as it now does in its tax enforcement program. Not only is the personal income tax unnecessary, but it is extremely costly in terms of the disgust it engenders in the citizen for the government. No other tax is discussed

and vilified to the extent and degree that the income tax is. In general, US citizens do not reject the concept of paying taxes; they object very much, however, to being subjected to the unnecessary control and harassment associated with the personal income tax.

To summarize, a major problem with the income tax is that it is an intrusive tax, generally perceived as inequitable, and applied to the general population. Originally, it was conceived as a low-rate tax applied to a very small proportion of the population. Today, the government considers it necessary to verify the income of virtually everyone. Citizens are encouraged by offers of rewards from the government to inform on their friends suspected of tax evasion.

There is a total lack of trust on the part of the government. It requires employers to inform them of wages paid to individuals, and banks to notify of payments of interest. To facilitate verification, the government requires all income earners to possess taxpayer identification numbers -- an SSN, in the case of the individual. The income tax -- like other bad taxes -- is creating a widespread contempt for the government. Just as slavery and prohibition were abolished, it is time to replace this odious system with a more efficient and equitable one.

A hallmark of the communist form of government is the centralized planning and control of the economy. In addition, communist governments exercise substantial economic and social control over the lives of the individual members of society. Through the intrusiveness of the personal income tax, the US Government has established a citizen-monitoring system that rivals those of the communist nations. The US citizen should be able to come and go as he pleases, without having to "check in" with the IRS every April 15.

Close government monitoring of individuals is inconsistent with the American heritage of freedom of the individual. For over 100 years, this country maintained the tradition of personal liberty. That freedom has been considerably eroded since the imposition of the income tax. In the tradition of the framers of the Constitution, it is time to reclaim that individual liberty, and reject continued government monitoring of individuals.

Many People Regard the IRS as an American Gestapo

For years, reports of IRS outrages against US citizens have surfaced. In the past year, for example, we have read the newspaper accounts of the little fourth grade girl whose life's savings were seized by the IRS to pay for her father's back taxes. Alarmed that its excesses might expose it as a large, uncaring, insensitive agency, the IRS moved to correct the perception that it confiscates children's savings. Earlier this year, an incident was reported in which a Catholic church in Yuma, Arizona, underpaid its employers' withholding tax by one cent (\$15,662.54 versus \$15,662.55), and was fined \$453.60. Last winter, a Tucson, Arizona, businesswoman was fined \$315.48, also for underpaying her August federal deposit tax by one cent.

Unfortunately, many encounters with the IRS do not end with a reasonable resolution, but in personal tragedy. Such occurrences are not mere isolated incidents in which an overzealous agent makes a mistake. They represent but a few cases in a systematic program of fear waged by the IRS against US citizens. This book will not dwell on the subject of IRS abuses -- many books have already been written on the subject. Instead, I will simply summarize two recent books on the subject: *Tax Revolt*, by Martin A. Larson, and *To Harass Our People*, by George V. Hansen. Both books are recommended reading for anyone who is unaware of IRS excesses committed in the name of the income tax system.

An excellent book describing the excesses of the IRS is *Tax Revolt*, by Dr. Martin A. Larson. He 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
- 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)

Larson's Case Studies

In his book, Larson describes numerous cases of IRS atrocities against US citizens. One such case is that of a Colorado couple who were notified in June of 1974, without explanation, that they owed \$4,451. A letter soon followed indicating that they owed \$4,206. A few months later, they were notified that they owed \$13,700, then \$15,000, then \$16,000 -- all with no explanation! The IRS then moved into action against this couple, in their sixties. It seized their savings accounts and other assets, valued at \$13,000. It seized their home, worth \$100,000, and sold it for \$16,000. They were evicted -- the wife in a wheelchair. The man who bought their home threw their personal belongings into the street. The news media contacted the IRS for an explanation, but were told that the Privacy Act prevented the IRS from making any statement.

The Case of Congressman George Hansen

Another, more famous, case described by Larson is that of Congressman George Hansen, author of the 1980 book, *To Harass Our People*, and the 1981 book, *How the IRS Seizes Your Dollars and How to Fight Back*, coauthored with Larrey Anderson, Jr.

The title of Hansen's book has an interesting derivation, which indicates the parallel of the relationship of the King of Great Britain to the American colonists and the relationship of the IRS to the American people. The US Declaration of Independence includes the statement, "He has

erected a multitude of New Offices, and sent hither swarms of Officers to harass our people, and eat out their substance," from which the title is derived.

Hansen characterizes the IRS as the American Gestapo. He writes of the American people's fear of the -- "a runaway arm of government" -- and cites the following excesses:

- 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
- 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

The income tax is a costly tax, indeed!

With the advent and incredible growth of the income tax, the principal function of the IRS has become one of monitoring, intimidating, and prosecuting private US citizens. All of this machinery has been established to enforce a tax that the framers of the US Constitution declared specifically to be illegal.

Gestapo-like Tactics of the IRS □□ In their book, *How the IRS Seizes Your Dollars*, Hansen and Anderson document many of the Gestapo-like tactics of the IRS in its enforcement efforts. Hansen and Anderson provide several chilling accounts of cases in which US citizens have been brutalized by the IRS. In one instance, for example, in 1977 an Alaska couple was told, without explanation, that they owed the IRS \$3,300. When the couple asked for an explanation, they were dunned for \$4,700, once again, without explanation. Next, the IRS informed them that they owed \$4,200 and placed a levy on the husband's wages, which reduced the couple to below the poverty level. The IRS then informed the couple that they owed \$9,600 in back taxes. When the couple went to the Fairbanks federal building, the IRS attempted to tow their car away. The couple entered the car, at which time the IRS surrounded their car with other vehicles. After a seven-hour standoff, the IRS obtained a search warrant, at which time they began smashing the windows with billy clubs, hurled the husband from the car, dragged the wife through broken glass from the car, and slammed her to the pavement, bruised and bleeding. They confiscated the car. The next day the IRS informed the couple that they now owed only \$4,010. The IRS then proceeded to sell the couple's car for \$500.

In another instance, Hansen and Anderson describe the case of a Maryland couple. The IRS alleged that the husband had not paid his taxes in 1971 and 1972. Without benefit of a trial, or even a search warrant, on February 20, 1981, IRS agents burst into the couple's home with automatic rifles aimed and ready to fire. Outside, IRS agents armed with M16 rifles surrounded the couple's property. Ten IRS "storm troopers" then took possession of the couple's home until late afternoon, when an IRS van confiscated the couple's household goods, workshop equipment, vehicle, and tractor. The IRS proceeded to sell the confiscated property at public auction.

All of these actions were committed without a search warrant and without benefit of due process. Hansen and Anderson point out that the husband had committed no crime, and that the IRS would not accuse him of a crime because this would afford him the opportunity of a trial by jury. Since no crime was committed, a search warrant could not be issued. Instead, the IRS used a writ of entry. Along with Section 6331 of the IRS Code, this order of entry allows the IRS to forcibly seize a citizen's property without due process of law. This is an absolute violation of the Fifth Amendment.

A third episode narrated by Hansen and Anderson is the case of a Minnesota farmer and crop duster. He claimed that he did not owe the IRS \$39.65. He asked for an explanation, but received no response. He contacted his bank to put them on notice not to honor any IRS demands on his account, except by his consent or by court order. The IRS nevertheless proceeded to confiscate \$39.65 from his account, with the bank's acquiescence. The farmer was furious over the bank's cooperation with the IRS. The incident escalated. On July 29, 1980, in an encounter with the local sheriff stemming from the incident, the farmer, in the presence of his wife and son, was shot in the head with a shotgun and died one week later from extensive brain damage.

As a result of his book exposing the IRS' tactics, Hansen is convinced that the IRS began a concerted campaign to defame him. He cites several examples of instances in which the IRS went to extraordinary lengths to discredit prominent persons who speak out against it. Hansen describes the IRS' approach in dealing with prominent citizens. A powerful weapon is simply the act of launching an investigation against someone. It doesn't matter whether the individual is innocent or not, and the IRS does not have to prove anything. After visiting a few friends or leaking word of the investigation to the press, the individual's reputation is suspect, and the damage is done.

Through the IRS, the US Has Established a Police State

Hansen and Anderson describe the elaborate police-state system that has been developed by the IRS for monitoring individuals and maintaining lists of citizens suspected of giving them trouble. They describe how the Tax Court has been set up to dispossess citizens of their property in lieu of a proper constitutional trial by jury in a legitimate court (a court *inferior* to the Supreme Court and bound by the Constitution). They noted that in 1981 (the time of writing of their book), ten of the 16 Tax Court "judges" were former employees of the IRS. Refusal to obey the orders of the Tax Court is considered a felony. If the citizen refuses to obey the orders of the Tax Court, he is charged with a felony and can get a jury trial -- not relative to the disputed income taxes, but for refusal to pay taxes assessed by the Tax Court!

Under Article I, Section 8, Paragraph 9 of the Constitution, the Congress has the power "to constitute tribunals *inferior* to the Supreme Court." The Tax Court is not inferior to the Supreme Court. It is not even in the Judicial Branch of the federal government at all, but rather in the Executive Branch, within the Treasury Department. This is a clear violation of the Constitution.

Hansen and Anderson 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.
- 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.

Hansen's book characterizes the IRS as an American Gestapo that uses terrorist tactics in committing atrocities against US citizens. Some people view this characterization as too strong -- that the IRS simply ruins people financially, but does not kill them. On the other hand, the IRS does operate outside the Constitution, has set up an illegal court outside the Judicial Branch, confiscates property without due process, and engages in many police-state-like activities, such as threats, intimidation, and spying.

With respect to the preceding examples of IRS actions against US citizens, some may respond, "The government *has to* collect taxes; that need takes precedence over individual rights." That may be so, but there are taxes available that are far less intrusive than the income tax and do not create the need for extreme enforcement procedures against individual citizens. Business taxes such as the VAT do not require individual citizens to reveal their incomes, expenditures, or wealth to the government. The income tax creates an intrusive, confrontational, and adversarial relationship between the citizen and government. This is totally unnecessary and undesirable.

The IRS Needs Resistors

Mr. Hansen's characterization of the IRS as the American Gestapo is severe. As might be expected, however, few win a fight with the IRS. Recently, Mr. Hansen was imprisoned. Congressman Hansen was found guilty in 1984 of ethics violations for failing to report more than \$300,000 in personal loans on financial disclosure documents required by the House of Representatives ethics rules. He had been assured that he did not need to report his wife's financial affairs, and did not. He was sentenced to 15 months in prison. He served six months of the sentence, but was imprisoned again in April 1987 on a parole violation.

Hansen became a target. Other members of Congress were allowed to amend their ethics documents, but he was not. He was arrested in Omaha, Nebraska, where he was to speak against the federal government.

As Hansen himself noted in his book, the IRS needs resisters. It needs them to justify its existence and expansion, and to create well-publicized examples that periodically reveal its awesome power to destroy persons without due process, thereby creating an atmosphere of fear and intimidation that cows the majority of US citizens into compliance. The use of confrontation, of escalation to violence, is an established IRS tactic.

The Case of Woody Herman

The IRS goes after its targets with a vengeance. If it can prove that the taxpayer erred in any way, it persecutes him endlessly, with the tenacity of a pit bulldog. Consider, for example, the case of bandleader Woody Herman, which was recently in the news. His band faltered in its indentured-servant role of collecting payroll taxes for the federal government. His business manager failed to submit some of the band's payroll taxes in the 1960s and gambled the money away. Twenty years later, the IRS was still persecuting Herman, up to his death on October 29, 1987.

Woody Herman labored for over 20 years to repay the taxes squandered by another, plus severe penalties and interest. Most of the money he earned since the sixties went to pay for tax liens. Even this year -- his 74th -- he was on tour, earning to repay the never-ending penalties relentlessly imposed by the IRS. In March, he fell ill with a heart ailment contracted after taking medication for high-altitude sickness during a tour through Colorado and Utah. He suffered a series of heart attacks in the past six months, and declined steadily until his death. With Herman in his seventies, after 20 years of paying for another's wrongdoing, one might expect that the IRS had surely extracted its pound of flesh -- no? No way!

Bedridden, requiring oxygen and 24-hour nursing care, no longer able to work, Herman was now easy prey. The IRS sold his house of 41 years at a tax auction. His earning ability gone, he was unable to pay the rent to the new owner of his home. The new owner moved to evict him. Hearing of his plight, his friends and supporters rallied to his side. Los Angeles radio station KKGQ offered to pay the back rent.

Since the 1960s, the IRS collected \$1.6 million in fines, penalties, and taxes from Herman. The IRS went after Herman personally, even though it was Herman's business that owed the money. Money alone is not enough, however, for the IRS. The IRS enforcement system thrives on spine-chilling examples of its power to destroy.

The Efficiency and Dedication of the IRS Are Misdirected

What is wrong? Why is the American public so frightened of the IRS? Why has the IRS mission to achieve a high level of voluntary compliance resulted in a massive citizen-monitoring bureaucracy that engenders fear and contempt by the citizen for the US government and led to a massive underground economy? The answer is simple: the US has adopted a *personal* income tax system as its major source of revenue. With high rates, voluntary compliance does not occur and the IRS hence must force compliance through fear and intimidation.

The 85,000 employees of the IRS are not traitors, nor are they Gestapo agents. In many cases, however, they have been forced to engage in Gestapo tactics to enforce an inhumane tax. The employees of the IRS are not an evil, malicious group of people; they are American citizens who have accepted the necessary job of tax collection. The problem is that the personal-income-tax-based system is a corrupting one; it corrupts not only the taxpaying citizens through its intolerable incentives to evade, but it forces other citizens -- IRS employees -- to violate the personal rights of their fellow citizens to collect an unreasonable tax. Through the personal income tax, the government has set up a complicated, unfair system with intolerable room for error and incentives to evade; consequently it has set up an elaborate, tyrannical bureaucracy to enforce the tax.

The solution to this problem is easy -- replace the US *personal* tax system with a *business* tax system. Impose taxes on businesses, not on individuals. Apply the IRS conscientiousness, diligence and efficiency toward the collection of taxes from *businesses* rather than from *individuals*, and the problem will be resolved. No one disputes the necessity of a government's collection of taxes. In a modern economy, however, collection of those taxes at the personal level is not only inefficient and ineffective, but also extremely damaging to the citizen / government relationship.

The alienation of the US citizen from his government is a symptom of an intrusive, oppressive tax system. The rampant tax evasion and alienation are symptoms of a bad system. It is time to stop treating the symptoms (through more intrusion and oppression) and address the cause of these problems. The personal-income-tax-based US tax system needs to be scrapped and replaced by a humane one.

The 85,000 employees of the IRS are loyal, hardworking Americans who in some cases are being forced to violate their fellow citizens' constitutionally endowed personal rights to collect a bad tax. Recently, the IRS published a document entitled *The Internal Revenue Service Strategic Plan* (May, 1984). This document is a frightening plan to further destroy the personal rights of the US citizen in the name of voluntary compliance and to advance the development of a society with a high degree of governmental monitoring and control of the citizen. The zeal of the IRS in collecting taxes should be oriented toward businesses, not toward the private citizen.

The IRS Attack on Churches

Hansen and Anderson describe how the IRS uses the guilty-until-proved-innocent device not only to harass individual taxpayers, but organizations as well. He cites the case of a private religious school claiming church exemption from taxation. The IRS regulations for Revenue Procedure 75-50, *Federal Register*, Vol. 43, No. 163, states that ". . . the Service will consider these schools to be racially discriminatory unless the schools can show that they now have a significant minority enrollment or that they are in good faith operated on a nondiscriminatory basis. If the schools

cannot make such showing, the Service will consider the schools to be racially discriminatory, and tax exemption will be revoked or denied." Note that the burden of proof, as in all tax matters, is placed on the taxpayer, not on the government.

The US Government touts the US income tax system as a "voluntary" system. That is one of the finest examples of "doublespeak" in use today. It is not voluntary. It is a compulsory system based on rigorous enforcement by means of threats, intimidation, force, violence, defamation, invasion of privacy, spying, confiscation of property, and tribunals that are outside the framework of constitutional law and in flagrant violation of the Bill of Rights.

The Personal Income Tax Forces Businesses to Act as Tax Collectors

A particularly grating aspect of the personal income tax is the impressment of firms by the IRS to collect the personal income tax, under threat of severe penalties. In this country, most personal income taxes are collected by businesses, in the form of withholdings. The estimated tax is deducted from each paycheck and forwarded to the government by the employer. The business is forced to conduct all of the accounting necessary to accomplish this tax collection. Businesses are not reimbursed by the government for their tax collection services. While expecting a firm to be responsible for its own taxes is reasonable, forcing it to be responsible for the collection of another's taxes is offensive. Moreover, it is unconstitutional. □ It should be recalled that one of the particularly galling acts of England against the new US republic was impressment of seamen. □ It might be argued by some that forced tax collection by firms is nothing more than a "tax in kind" -- the "tax" is exacted in the form of labor required to assess, collect, and forward the individual's tax. While this is a nice theory, one should take note of Amendment 13, Section 1 of the US Constitution, which reads:

Neither slavery nor involuntary servitude, except as punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.

Originally conceived as a tax on the rich, the income tax did not pose serious collection problems. When it was extended to a mass tax in the Second World War, however, it was no longer feasible to collect the tax -- the administrative costs were too great and the "leakage" and nonpayment too likely. Congress should have recognized this as a clear warning that something was terribly wrong with the concept of the individual income tax as a mass tax. Instead, refusing to acknowledge error and repeal the tax, it pressed blindly, stubbornly, and brutally on, and passed the Current Tax Payment Act of 1943, which imposed withholding on wages and salaries on the middle class. It was recognized that few middle-class Americans would save sufficient money for payment of a high-rate income tax, and so the US Government would simply make these savings for them. Firms were impressed into servitude as tax collectors, in patent violation of the Thirteenth Amendment.

Some might argue that the term "involuntary servitude" in the Thirteenth Amendment refers to forced labor of natural persons, not firms. That argument is specious. Firms don't work, people do. Forcing a firm to engage in labor is tantamount to forcing the people in the firm to engage in labor.

The Constitution empowers the Congress to levy taxes on firms. It does not empower the Congress to impress firms into service as tax collectors; in fact, by Amendment 13, it explicitly

forbids this activity. The personal income tax is a bad idea that just keeps spawning problems, additional legislation, and further regimentation of citizens and firms. The income tax is perhaps the worst of all taxes, from a humanistic point of view.

How long will Congress persist in forcing this system on the US population? How long will Congress resist the cry to free the American people from this bondage?

The US Income Tax System Is in Reality a Payroll Tax System

The bulk of all income taxes is not collected directly from the 100 million taxed individuals. Instead, they are collected by the seven million businesses that employ most of those individuals. These collections are made by means of "withholding" the estimated tax from the employees' pay and forwarding it to the government.

The current system is, in essence, a payroll tax system in which the individual simply verifies his income every April 15 and makes a minor adjustment to his tax payment.

Given that the current tax system is essentially a wage tax system rather than an income tax system, it is reasonable to ask why 100 million citizens must be subject to government monitoring, to enable income verification, rather than the actual collection of taxes. Also, it is reasonable to ask why US businesses are burdened with the job of determining income tax payments for 100 million workers, when the use of a different form of taxation, such as the VAT, would obviate this burden.

Businessmen frequently complain about the burden of being forced to collect individual income taxes and execute all of the corresponding paperwork. If this work were necessary in order to determine the *firm's* tax liability, this burden would set much better. The fact is, however, that the burden represents forced labor, caused by the use of a ridiculous method of taxation.

Most taxes are paid by businesses. Personal income taxes are levied on individuals, but are paid mainly by businesses (through withholding). The percentage of the personal income tax that is collected directly from individuals is small. The personal income tax was in essence converted to a business tax with the passage of the Current Tax Payment Act of 1943. Since these taxes are already mainly collected and paid by businesses, why not acknowledge this fact and replace the personal income tax by a business tax (such as the VAT), and accomplish the significant goal of eliminating the needless monitoring of 100 million Americans and the impressment of firms to collect taxes from them?

The only defense you have against a police state is privacy. By passing the Sixteenth Amendment, the Congress has in effect abolished the right of privacy; the Supreme Court has given precedence to the Sixteenth Amendment over all the personal-liberty guarantees of the Bill of Rights, and the Executive Branch has implemented a police state, through the IRS. If you want to take back your freedom, you are going to have to start by accomplishing the repeal of the income tax.

6. The Constitution Has Failed

The Personal Income Tax System Has Weakened the Constitution

The Constitution of the United States denied the federal government the power of imposing direct taxes that were not apportioned, or allocated, to the states in direct proportion to population. (Recall that a direct tax is one for which the burden of the tax falls on the taxpayer.) The federal income tax is a direct tax. When the federal government attempted to adopt a personal income tax in 1895, it was declared unconstitutional.

Congress accomplished passage of the income tax by first accomplishing passage of the Sixteenth Amendment to the Constitution. This amendment allowed the federal government to collect personal income taxes without allocating the revenue to the states.

The founding fathers of the US and the framers of the Constitution had sound reasons for limiting the power of the federal government to levy direct taxes. The power to levy such taxes severely weakens the position of the citizen with respect to the government. Direct personal taxes are severely intrusive of privacy, and pose a substantial threat to individual liberty. They are appropriate in a small society, in which the individuals share directly in government; they are not in a large one, in which individuals vest significant power in a central government.

The strong intent of the framers of the Constitution was severely undermined by the adoption of the Sixteenth Amendment. The passage of the Sixteenth Amendment, legalizing the personal income tax and the establishment of the IRS to collect personal income taxes, has led to the virtual destruction of the Bill of Rights. As noted by Larson in his book *Tax Revolt*, the IRS has arrogated vast legislative, judicial, and executive powers -- powers far beyond those to which an agency of the Executive Branch of the government is entitled. These powers nullify the personal freedom guarantees of the Bill of Rights. US citizens have lost their right to protection from unreasonable searches and seizures of their persons, houses, papers, and effects (Amendment 4); they have lost protection from being arrested and tried for a serious crime unless indicted by a grand jury (Amendment 5); they have lost 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), and to the right of privacy (implied in most of the amendments comprising the Bill of Rights, especially the tenth).

In their book *How the IRS Seizes Your Dollars*, Hansen and Anderson note that the extreme complexity of the US Tax Code, in effect, violates the principle of equality before the law because the wealthy can afford to hire tax accountants and lawyers to interpret the code and protect their client from its assessments and penalties, whereas the poor lack the wherewithal to appreciate the code or protect themselves from its provisions. No area of law is so fraught with unneeded complexity and so removed from common sense as the tax code. Whereas the average citizen may be confident that his general knowledge of the law and common sense can keep him out of trouble, ignorance of the complex tax code is common, and the fear of tax prosecution is widespread.

The Constitution has failed. It has failed to protect the citizen from a strong central government. The framers of the Constitution created three branches of government -- the Legislative, Executive and Judicial -- and delegated powers among them in a system of "checks and balances" that was intended to check the power of the government and prevent any one branch from becoming too powerful. Powers not explicitly delegated to the federal government were reserved to the states and to the people (Amendment 10). And that's where the Constitution failed!

While the system of checks and balances to some extent preserved the relative powers of the three branches of government, a dramatic shift in power gradually occurred, from the states and people to the federal government. The federal government has grown in size, from a handful of senators and representatives to a massive bureaucracy with three million employees. The federal government budget now represents 20 percent of GNP.

The sheer size of the federal government perhaps is not alarming in and of itself, were it not for the Sixteenth Amendment, which legalized the personal income tax. That single amendment has, in essence, led to the demise of the Bill of Rights and to the establishment of a national police force, the IRS. The Sixteenth Amendment has subverted the intent of the framers of the Constitution. At the time of its passage, the income tax was not viewed as a mass tax and its insidious role in indenturing the US population to the government was not envisaged. As demands for revenue grew, this tax was extended to the point where it forms the major basis of the relationship between the US citizen and the government. The government is now so heavily dependent on the income tax that it ruthlessly crushes any attempt to resist the tax.

Had the original Constitution remained in force and the Sixteenth Amendment not been passed, the evolution of a police state based on the personal income tax would have been avoided. In their wisdom, the framers outlawed direct federal taxes, but they could not prevent the passage of the Sixteenth Amendment over 100 years later.

The US citizen will not regain his freedom until the Sixteenth Amendment is repealed. Until then, he will not be let alone. The IRS will force his registration and that of his children, monitor his activity in detail, demand annual revelation of his private affairs, and perpetuate its ever-increasing registration of the population. It will continue its tribunals in which the citizen, without benefit of a jury trial, is guilty until he satisfies IRS "judges" of his innocence. It will continue to confiscate property without due process. It will continue to maintain files on virtually all US citizens and to destroy the reputations and careers of any who resist or attempt to bring it under control or within the framework of the Constitution.

Concerning the shift of power from the people and the states to the federal government, the states have raised no voice in slowing this trend, especially since the defeat of the South in the War Between the States. States now act mainly as "rubber stamps" for the federal government, vehicles for administering federal law and dispensing federally funded services. Contrary to the intent of the framers (Amendment 10), the takeover of state functions by the federal government has been essentially complete. The federal government has been able to do so as the result of collusion between the Legislative, Executive, and Judicial branches of government. Article I, Section 8 gives Congress the power to "provide for the common Defense and general Welfare of the United States." The Supreme Court has interpreted this statement in an "expansive" manner, which in essence transfers all power to the federal government and none to the states, contrary to the intent of the framers. Congress steadfastly has refused to overrule the Supreme Court's rulings, even though it has the power to do so (Article III, Section 2, Paragraph 2). The Executive Branch of government has grown to extreme size and power, on the basis of Congressional actions.

Originally, the states acted as buffers, protecting the citizen from the power of a strong federal government. By having, in essence, two governments, the citizen had some protection from abuses from either one. That buffer has now been destroyed, reduced to a vestigial role of little more consequence than the Electoral College. With the states out of the way, the citizen has little defense against the federal government, and it is free to continue its program of regimentation and control.

The passage of the Sixteenth Amendment was an attempt to introduce social legislation aimed at improving the lot of the common citizen. Inadvertently, this single amendment has subverted the entire Bill of Rights and resulted in the creation of a police state which some refer to as an American Gestapo. It was a nice try, but it failed, and created a Frankenstein monster. The experiment failed. It is time to take back our freedom by repealing the Sixteenth Amendment and eliminating the personal income tax.

7. The Income Tax Is Unfair

The income tax is unfair, for a number of reasons. It penalizes individuals who increase their incomes by working longer hours or taking a second job. It penalizes those who increase their income by going to school. It severely penalizes the earnings of a spouse who goes to work to help increase the family's income. It places a very heavy burden on older Americans by imposing taxes on their lifetime savings that may exceed 100 percent of the earnings of their investments. The US tax reform system imposes a heavy "marriage tax" on low-income families with children; for such families it is a cruel antifamily tax. This chapter explores the many inequities of the US income tax system.

Tax Terms: Marginal Rate, Average Rate, Graduated, Progressive

In order to appreciate why the income tax is so unfair, it is necessary to understand the basic structure of the income tax and the definition of certain terms. Two very important terms are the "average tax rate" (or "effective tax rate") and the "marginal tax rate." The average tax rate is simply the proportion of a person's income that he pays in taxes. The marginal tax rate refers to the tax rate imposed on the next dollar of income that a person earns, at a specified level of income. The marginal tax rate is often referred to as the "tax bracket."

For example, suppose that a married person with no dependents other than his wife earns \$50,000 per year and files a "joint" federal tax return. Under the tax reform law, this person is entitled to a "standard deduction" of \$5,000 and "personal exemptions" of \$2,000 for himself and \$2,000 for his wife -- a total "tax deduction" of \$9,000. His taxable income is hence \$43,000. He pays 15 percent tax on his taxable income between zero and \$29,750 (a tax of \$4462.50), and 28 percent on taxable income above \$29,750 (a tax of $.28(\$41,000 - \$29,750) = \$3,150$). His total federal tax is hence \$7,612.50. The proportion of his income that he pays in tax is $7,612.50/50,000 = .15$, or 15 percent. Hence his average tax rate is 15 percent. At an income level of \$50,000, he is taxed at the federal rate of 28 percent on each additional dollar he earns. His marginal federal income-tax-rate, or federal "tax bracket," is hence 28 percent.

It is important to realize the distinction between the average tax rate and the marginal tax rate. Most economic decisions depend on the marginal tax rate, not on the average tax rate. For example, a person in the 28 percent tax bracket saves 28 cents on every dollar he is able to shelter from taxation. It is that 28 percent saving that represents an incentive to obtain the tax shelter; the level of the taxpayer's average tax rate (for example, 15 percent) is not a factor in this decision.

A tax for which the marginal tax rates change as the income level increases is called a graduated tax. A tax for which the average tax rate is higher for higher incomes is called a progressive tax. A flat-rate tax is a progressive tax if personal exemptions are allowed. Both the previous personal-income-tax scheme and the current personal-income-tax scheme are graduated and progressive.

Tax Rates Under Tax Reform

Under tax reform, there are five income tax brackets for individuals or families. For families (more specifically, for married taxpayers filing joint returns), the rates are: 0 percent on tax-exempt income (personal exemptions, standard deduction, itemized deductions); 15 percent on taxable

income between zero and \$29,750; 28 percent on taxable income between \$29,750 and \$71,900, 33 percent on taxable income between \$71,900 and \$149,250, and 28 percent on taxable income over \$149,250. The top marginal tax rate is hence 33 percent. This figure -- the maximum marginal tax rate for individuals -- will be referred to later, since it plays a role in many of the undesirable incentives of the personal income tax.

If you do not "itemize" your deductions, the "basic standard deduction" is \$5,000. The personal exemption is \$2,000 for the individual, spouse, and each eligible dependent.

The 33 percent tax on income between \$71,900 and \$149,250 is represented as a 5 percent "surcharge" imposed in addition to the 28 percent rate. The purpose of this surtax is to remove the benefit of the personal exemptions and the 15 percent tax rate on income up to \$29,750, so that the tax rate on families earning over \$149,250 is a flat 28 percent of all income.

For businesses, as for individuals, there are also five tax brackets. The tax is placed on a measure of corporate profit -- "taxable income," as defined by the IRS. The tax rates are: 15 percent on taxable income between zero and \$50,000; 25 percent on taxable income between \$50,000 and \$75,000; 34 percent on taxable income between \$75,000 and \$100,000; 39 percent of taxable income between \$100,000 and \$335,000; and 34 percent on taxable income above \$335,000. The top marginal tax rate for business is hence 39 percent of taxable income. This figure will also be referred to later.

Why a Progressive Income Tax?

The US income tax system is progressive: as your income goes up, the government taxes a greater and greater proportion of it. A progressive income tax system is adopted if one accepts the principle that citizens having a greater ability to pay should bear a heavier burden of the tax, *and* that current income is a good measure of a citizen's ability to pay. Even if you accept the ability-to-pay principle, and accept current income as a good measure of ability to pay, there is no theoretical basis for setting the degree of progressivity. Economic theory provides no answer to the problem of determining the number of tax brackets and the bracket rates.

Under tax reform, there are five tax brackets, as described above. These tax brackets are completely arbitrary. They can no more be justified than the previous system with its 14 brackets, or a one-bracket (flat-rate tax) system. Why, for example, should a person earning only \$9,000 pay no tax? Does he not have *any* responsibility to help pay for schools, social services, highways, and defense? It could be argued that it would be better to tax him at the same rate as everyone else and give him a strong sense of participation and pride, than to give him a sense of being a freeloader, unable to carry a proportional share of the burden, with someone else paying his share. With a flat-rate tax, he could at least claim that he was paying the same share of his income as anyone else, even though that share may be small for him and large for someone else. Or, some argue that the poor have *no* ability to pay taxes. From this point of view, a "negative income tax" may have appeal -- the government should not only impose no tax on the poor, but should send them cash supplements. (The apparent dilemma posed by these arguments results from considering the income tax independently of other government social and economic programs. The inadequacy of this approach is addressed later.)

The point is that the number of brackets (extent of graduation) and the degree of progression is arbitrary and a subject for mutual discussion and agreement. There is no right or wrong answer to

the problem of determining these items. While there are no economic arguments that support a particular progressive rate structure, there are numerous economic arguments both for and against progressive taxation. The paragraphs that follow summarize these arguments. On balance, despite the academic appeal of the principle of ability to pay, empirical evidence suggests that progressive taxes are generally regarded as unfair.

The Utility of Income

One rationale for increasing the tax rate for high-income earners, that is, for a progressive tax, is that it may be argued that the "utility" of money grows less as the amount of money that the person earns increases. In other words, the first \$25,000 that a person earns means more to him, in terms of the pleasure or satisfaction or happiness that it buys, than the next \$25,000. Said another way, he doesn't "need" the second \$25,000 as much as the first \$25,000. Because of this, he should not mind giving more of the second \$25,000 to the government, than he gives of the first. Under the concept of taxing according to ability to pay, the government is tempted to take a greater and greater percentage of the additional dollars that he earns. The maximum marginal-federal-tax rate in this country, set at 50 percent just prior to tax reform and 33 percent under tax reform, has been as high as 94 percent.

All People Do Not Have the Same Utility Functions

From another point of view, because of the diminishing return of utility per additional dollar earned, a high-income earner must be taxed at a higher average percentage in order to suffer the same loss of utility, or realize the same burden, as a low-income earner. This point of view assumes that both persons have the same "utility function"; in other words, that money means the same to both of them with respect to the satisfaction it brings.

It also assumes that additional dollars earned have the same utility to the individual. For persons who increase their earnings by taking on additional jobs, this is definitely not a reasonable assumption. For example, a person who already works 40 hours per week may double his income by taking on a second 40-hour-per-week job at the same rate of pay. Because he is bone-weary on the second job, because he will never see his family or friends, and because it may cost him his marriage, the value of the second 40 hours is undoubtedly significantly greater to him than the first 40 hours.

In other words, each additional dollar earned in the second 40 hours "costs" him much more of his health, family, and social life than each dollar earned in the first 40 hours. Because the second-job dollars are earned with far greater "blood, sweat, and tears" than the first-job dollars, the utility of the second-job dollars is far greater than the utility of the first-job dollars. For each second-job dollar that he relinquishes (to spend more time with his family and friends), he receives a much greater return of "pleasure" than he would from relinquishing a first-job dollar. It is very difficult to see why a government ostensibly "for the people" would wish to tax the second-job dollars at a higher rate than the first-job dollars, but that is exactly what it does under a progressive tax system.

Most people would agree that the utility of earned and unearned income is different -- that "clipping coupons" is intrinsically different from managing a store every day of one's life, or teaching school.

Notwithstanding this important distinction, for most taxpayers' earned and unearned income are taxed at the same rates. And yet the income tax system is proclaimed to be equitable!

The Progressive Income Tax Discriminates against Hard Work, Long Hours, and Self-Improvement

A progressive tax is often touted as a socially desirable means for extracting more tax income from individuals who earn at a high rate, and therefore have a greater ability to pay. No provision is made, however, for those who increase their income by working longer or harder (for example, through lower rates or deductions for "overtime" hours). The progressive income tax, in fact, constitutes a penalty for being successful, for investing long hours in additional work, for furthering one's training and education, for taking entrepreneurial risks, or for taking any actions that lead to increased income.

A drawback of the personal income tax is that it introduces a disincentive to work. Previously, when marginal income tax rates were relatively low (10-20 percent), there was a strong economic incentive to earn more income; the family could keep a large proportion of additional income earned by working longer hours or by entry of a spouse into the labor market. With marginal tax rates currently totaling 50 percent or more (federal income, state income, and payroll taxes) for many individuals and families, the incentive to earn more is reduced. Instead, people have an incentive to invest time and effort in less productive areas where high taxes may be avoided, such as taking more time off, vacationing longer at lower-cost times or places, operating a "gentleman-farmer" ranch, or investing in risky ventures with high tax reduction (write-off) advantages.

Some economists argue that a progressive income tax system incorporates the concept of ability to pay very well by forcing large-income earners to pay heavy taxes. Others argue that wealth and purchases are better indicators of ability to pay than personal income and profit. On the basis of the rationale that ability to pay should be related to how rich one is, a heavier burden should be placed on wealth, not income or profits. A millionaire who has no income in a given year undoubtedly has a greater ability to pay than a person with zero net worth who earns \$30,000. Yet our tax system will tax the zero-net-worth individual heavily, and may not tax the wealthy individual at all. Clearly, the income tax system is a very imperfect means of taxing on the basis of ability to pay. Contrary to the assertions of many economists, income is not a good measure of ability to pay.

A problem with taxing wealth, of course, is that it is more difficult to locate and measure than income. An old argument against taxes on wealth is that they destroy capital, which is the basis of economic productivity.

The Progressive Income Tax Weighs Heavily on Working Wives and Mothers

Another example of the inequity imposed by the progressive income tax system arises in the case of working mothers. Many families strongly prefer that the mother stay at home to care personally for their children, rather than to go to work in the competitive (paid) labor market. In the past few decades, taxes have increased dramatically for middle-income earners, such as skilled workers and professional people. Because of this burden, many families now have to send the mother out to work in the paid labor market, just to make ends meet. As a worker, the mother incurs extraordinary work-related expenses: childcare expenses, different clothing for herself, paid meals

for herself, transportation costs. In addition, there are substantial psychic costs: the loss of her children to another primary caretaker, and less energy to give to her family. The husband and the children incur the cost of loss of attention and care when the mother is forced to go to work. Also, many working mothers still have to do most of the housework, cooking and cleaning, or pay for housekeeper services.

In spite of the high social cost of the mother's working, the government, under the progressive income tax system, will tax her income at a heavier rate than her husband's income if she gets a job to supplement the family income. If her working moves the family from the 15 percent tax bracket to the 28 percent tax bracket, her earnings are, in effect, taxed at approximately twice the rate of her husband's.

In summary, the mother and the family may pay dearly when the mother goes to work in the paid labor market, both in terms of attention and care, but also in terms of extraordinary work-related expenses. Because of this, the mother's earnings are particularly hard-earned dollars. Yet, under the progressive tax system, the government sees fit to tax these dollars at a higher marginal rate than it did the husband's income when he was the sole income earner. Not a very pretty picture.

The issue being addressed here is not whether mothers should or should not work -- that decision is up to the woman and family. The issue is whether it is defensible for the government to encourage or discourage this activity through tax policy. Some women prefer to stay at home in a traditional family situation. Some women prefer to work in the paid labor market. Under current tax policy, with high rates and high progressivity, both are discriminated against.

The woman who wishes to work in the paid labor market faces a very high marginal tax rate on the additional income she brings home: a marginal rate of 50 percent for many families of modest incomes. Since wives are often the secondary earners in a family, it is generally their income that is taxed more heavily by the progressive tax system, and her working that is discriminated against. This is not an equitable situation.

The woman who wishes to stay at home faces strong pressure to enter the paid labor market because the high personal-income-tax rates in force under the current progressive tax system have made it difficult for many families to make ends meet on a single income. This is particularly true for families that work hard to earn the extra income to purchase a home, because of the government's severely progressive income tax system. If the personal income tax were terminated, the government tax policy would be essentially neutral on the issue of working mothers.

Tax Reform Imposes a Heavy "Marriage Tax" on Many Families

A recent study conducted by Princeton economist Harry S. Rosen and published by the National Bureau of Economic Research analyzed the perverse antifamily incentives of the Tax Reform Act of 1986. Under tax reform about 40% of US families will pay a "marriage tax" averaging \$1,000. The term marriage tax refers to situations in which a married couple pays more in taxes than they would if they were unmarried with the same incomes. The marriage tax occurs because there are different tax rate schedules for single persons and families.

The new law can provide either a marriage tax or a marriage subsidy, depending on the incomes of the man and wife and the number of dependents. Partners with quite different incomes would

receive a subsidy (since, because of the progressive tax scheme, tax on the combined income is less than the combined tax on the separate incomes).

The marriage tax falls particularly heavily on low-income families. For example, in a family with two children with one spouse earning \$10,000 and one earning \$7,500, the marriage tax amounts to \$1,500; that is, the family pays \$1,500 more in taxes than two single persons having the same incomes. The marriage tax under the Tax Reform Act is substantially greater than under the old law. Under the old law, in this example the marriage tax would have been less than \$500. What is the point in having an antifamily tax system?

On the other hand, the tax reform laws can provide hefty marriage subsidies. For example, a family having two children, with one spouse earning \$50,000 and the other nothing, would receive a \$3,000 marriage subsidy; that is, the family pays \$3,000 less in taxes than two single persons with the same incomes.

This situation, of marriage taxes and subsidies, is but one more example of the gross unfairness and illogical nature of an income tax. Other taxes, such as the VAT, are available that do not possess this perverse property; the amount of the VAT would depend only on the amount consumed by the family, regardless of its marital status.

Eventually, in response to cries of unfairness, the Congress will likely introduce further complexities into the tax code in an attempt to undo the complication it introduced by having separate tax rates for families and single persons. This has, in fact, been done before; under the tax law prior to tax reform, working married couples were allowed a small deduction.

The income tax approach to taxation is an absurd approach. An income tax system inevitably possesses inequities, and the inequities lead to modifications that further complicate the law. This process never ends. A fair, uncomplicated income tax cannot be devised. Tax reform is a laugh. The US tax system is complicated and unfair, and will remain so until the income-tax-approach to taxation is abandoned.

The Verdict: The Progressive Income Tax Is Unfair

A problem with concepts such as utility, equity, and ability to pay is that they are very abstract. It is very difficult to determine a person's utility function or the average utility function for all taxpayers, so determination of a "good" or "appropriate" or "best" progressive tax schedule is not possible. It is not even a "given" that a tax schedule *should* be progressive -- recall the arguments about the second job. The point of view that it should be is an arbitrary value judgment.

Over the past two decades, a concerted effort was made to achieve social and economic goals and equity by means of the imposition of a vast array of exemptions, deductions, incentives, disincentives, and progressive rates. The net effect of this approach was the creation of a tax system that was generally perceived to be highly inequitable and to favor the rich or tax-wise. Although the concepts of equity and ability to pay have theoretical value in discussing alternative tax methods, the attempt to set up specific tax rules and structures to implement, or "operationalize," these concepts failed miserably. Workers have, in fact, objected the least to the payroll tax and retail sales taxes; taxes that are regressive, but are applied at low, uniform rates.

Two decades of trying to develop an equitable tax system based on the income tax, special deductions, and progressive rates have met with dismal failure. The concepts have seductive appeal and charm, but they fail in practice. In spite of theoretical arguments asserting its equity, decades of experience have resulted in the empirical realization that the progressive income tax is perceived as inequitable, pure and simple. Based on this experience, attempts to implement it should be abandoned.

The Politics of Envy

The progressive income tax is one manifestation of the "politics of envy." The politics of envy has been distinguished from the "politics of greed." The politics of greed refers to the tendency of individuals to use political power to increase their own wealth. The politics of envy refers to the tendency of poor individuals to want everyone to be poor, if they have to be poor. Under the politics of envy, the nonrich want the rich to be taxed simply to deprive them of their riches, regardless of whether that action will improve their own situation. It is a basis for the appeal of the communist viewpoint, "From each according to his ability, to each according to his need," to the wretchedly poor in many developing countries.

The rich can be deprived of their riches by means of confiscatory income taxes and confiscatory wealth taxes. Whether this is desirable is a value judgment. If some individuals become extremely wealthy, they may represent a concentration of power that threatens the security of nonwealthy individuals. Extreme concentrations of wealth not only generate envy and social discontent, but also are considered to contribute to recessions and to amplify the severity of depressions. If all wealth is confiscated, however, the economic means of production will be so weakened as to lower the standard of living for everyone. The centrally planned economies of the various communist systems of government provide unequivocal and ample evidence of this. The cost of an egalitarian society is universal poverty. Some concentration of wealth is a prerequisite for the accomplishment of great works: of art, of architecture, of technology, of economics, of humanity. Until recent times, for example, great works of art and architecture were sponsored primarily by the church or the state.

Most of the individuals who are involved in the tax legislation process are economists. Many economists are not wealthy and are therefore susceptible to the politics of envy. They generally are in favor of a progressive income tax. The use of a progressive income tax is a sign of the workings of the politics of envy.

The politics of envy is a strong force and it has had an influence in areas other than taxation. An excellent example of the politics of envy is legislation prohibiting a retired military officer from representing his employer to his former service branch. After a lifetime of serving his country at a modest salary, the Congress would deny him the privilege of capitalizing on his skills and contacts. Note that congressmen do not require of themselves the restrictions they place on the retired military. With far less stringent restrictions, an ex-senator, ex-representative, or ex-cabinet member can go to work for a Wall Street law firm or accounting firm at a quarter-million dollars a year and capitalize heavily on his knowledge and contacts. The politics of envy is a strong force.

Taxing the rich or productive members of society by means of a severely progressive mass income tax may realize the objective of confiscating their income or wealth, but it carries with it a high cost: the loss of privacy of all of the nonwealthy who must relinquish their privacy in order to implement the income tax. Since the wealthy are few in number and relatively easy to identify, it is

feasible for the government to confiscate their wealth without invading the privacy of the masses of nonwealthy through the mechanism of a mass personal income tax.

The Personal Income Tax Is Not Well Suited to Tax Capital Gains

The personal income tax is suited to taxing earnings from salary, wages, rents, and interest, but it is not well suited to taxation of profits from the purchase and sale of property, that is, from capital gains. Two major problems arise in using the income tax to tax capital gains. First, the verification of what constitutes the profit from the sale requires the government to have access to details on when the purchase and sale was made and to a description of the property. This requirement is highly intrusive of the privacy of millions of citizens.

Second, in many cases capital gains do not reflect profit in any sense, but solely increases from inflation. The "profits" are apparent, not real. Inflation in the US is mainly government caused. Relatively little US inflation is caused by external price increases, such as the oil price increase in the early 1970s. Most US inflation is caused by inadequate US Government fiscal policies (in particular, an inadequate US tax system), under which the US spends more than it collects in tax revenue. Since US inflation is mainly government-caused, it represents a "hidden tax." The fact that, in many instances, capital gains are manifestations of inflation results in a gross inequity.

Capital Gains May Be More Apparent Than Real

An example will illustrate this problem. Suppose that you purchase a house for \$50,000 and sell it for \$100,000. The profit from the sale of the house is a "capital gain." Under tax reform, capital gains are taxed at the same rate as ordinary personal income: up to 33 percent (federal rate) for a family filing a joint return.

Suppose that, in this example, you purchased the house in 1970 and that you sold it in 1982. During that time, the price of housing inflated by approximately 8 percent per year, or 150 percent over the 12-year period. This means that, on the average, the price of a house in 1982 was 2.5 times that of a comparable house in 1970. Or, a 1970 dollar spent on housing was worth, or equivalent to, 2.5 1982 dollars spent on housing. Stated in terms of "1982" dollars, the value of your house at the time of purchase was $\$50,000 \times 2.5 = \$125,000$. Or, stated in terms of "1970" dollars, the value of your house at the time of sale was only $\$100,000 / 2.5 = \$40,000$. From either point of view, taking into account the effect of inflation, your house actually lost real value -- either \$10,000 1970 dollars or \$25,000 1982 dollars. Nevertheless, the government will assess you a tax of 33 percent on the apparent "profit," or $.33 \times \$50,000 = \$16,500$.

Suppose that your next-door neighbor bought a house in 1982 for \$50,000 and sold it later in the same year for \$100,000. The tax on his \$50,000 profit was exactly the same as in your case, \$14,000. In other words, you suffered a real loss (measured in 1982 dollars) of \$25,000 on your house, and your neighbor realized a real gain (in 1982 dollars) of \$50,000. Yet you both pay the same capital gains tax, \$16,500. Because the government causes most inflation (essentially, by printing too much money), it has, in effect ripped you off. It has charged you a tax on an apparent "inflation-caused" profit, when you actually suffered a real loss. The profit was illusory: nothing more than an artifact of inflation. The tax is on the "nominal," or apparent, capital gain, not on the real capital gain. This is not fair because, as in the example presented above, two people realizing

quite different real profits are treated very differently. From a basic equity point of view, people who realize the same *real* profit should pay approximately the same tax.

"Tax Reform Adjusts for Inflation" -- a Myth

The statement has been made that under tax reform inflation will not result in tax increases. That statement is not true. While that may be true for labor earnings, it is certainly not true for earnings from sales of property. Inflation will continue to produce apparent profits, which will be taxed at standard rates and result in effective tax rates far beyond those that would apply to real profits (adjusted for inflation). It not only causes inequities but it also represents a cruel way in which the government confiscates a substantial portion of the value of a person's home at the time of sale. In view of the fact that for many people their home is their principal means of saving throughout their lifetime, and may represent their life's savings, this is a shameful practice. As a deception, it is comparable to bracket creep, which was practiced for over half a century by the IRS. Income tax zealots may argue that a solution to the problem of capital gains on inflation-caused "profits" would be to provide an inflation adjustment on capital gains -- thereby making the tax code even more complex.

Capital gains are, in essence, business transactions (purchase and sale of goods and services). There are tax types that are much better suited to taxing business transactions than the personal income tax. Capital gains taxes on income should be eliminated and replaced by a tax designed for business transactions, such as a property transfer tax, a sales tax, or a VAT. Occasional sales of property by individuals should be exempted from taxation; attempts to tax them lead to privacy-invasive monitoring by the government.

Under Tax Reform, Older Americans Can Get Socked With a 38 Percent Tax on Lifetime Earnings -- Or More!

The US Government's treatment of inflation-caused capital gains as the same as ordinary labor earnings works particularly heavy on older Americans, and can represent a nominal tax of up to 38 percent on lifetime savings. Consider the following example.

It's 1990. The provisions of the Tax Reform Act of 1986 are in full force. Consider the case of John and Mary Smith, a middle-income couple who have worked all of their lives and raised three children. Now, at age 50, they have just paid off a 30-year mortgage on their home in Wisconsin and, with the last child gone from home, are moving to Yuma, Arizona. They bought their home for \$25,000, but, because of inflation, just sold it for \$160,000.

John and Mary sell their home and move to Yuma, where they buy a mobile home for \$15,000. Their home represented their savings of a lifetime. With it, they can live out their retirement years on these savings. Right? Wrong! Under tax reform, the increase in the value of the home is considered "income." John and Mary's combined labor earnings in 1990 are \$39,000. With the "profit" on their home, the government considers their income in 1990 to be their labor earnings (\$39,000) plus the increase in value of their home ($\$160,000 - \$25,000 = \$135,000$), less the cost of their new home (\$15,000), for a total of \$159,000. Under tax reform, the federal tax on \$159,000 is a flat 28 percent. Let's say that the state tax rate in 1990 is 10 percent. The total "income" tax is hence 38 percent times \$159,000, or \$60,420. The tax on their \$39,000 income would have been computed as follows. Taxable income = \$39,000 less standard deduction

$(\$5,000)$ less personal exemptions $(2 \times \$2,000) = \$30,000$. Tax = $.15 \times \$29,750 + .28 \times (\$30,000 - \$29,750) = \$4,742.50$. The tax on the home is hence $\$60,420 - \$4,742.50 = \$55,677.50$.

In simple terms, the US Government, under the guise of an "income tax," is levying a property tax of \$55,677.50 on John and Mary's home -- 35 percent of its value. This is an incredible action. The increase in the value of their home was not the result of 30 years of buying and selling houses: it represented the increase in the price due to government-caused inflation. The real value of their home is essentially unchanged since they bought it. The \$135,000 increase in the value is an artifact of inflation, not a real profit. To tax this in the same way as earned income is grossly inequitable. Not even the most socialistic countries of Europe impose property taxes of 35 percent. The inheritance and estate taxes on \$135,000 would be zero.

Many older couples have larger homes than they need after their children leave, and so it is a common desire to move to a smaller home. Furthermore, many older couples enjoy relocating to warmer climates in their retirement years. Under tax reform, they'd better sit tight in their large homes in Wisconsin, unless they want to be socked with an effective property tax of up to 38 percent. For many older Americans, their home represents their lifetime savings. They need to have the option of moving to a smaller one, without having the government descend like a vulture and devour almost half their lifetime savings, if ever they have to sell it. Alas, through the income tax, the eagle has become a vulture.

The citizens of California rebelled at a 2.5 percent property tax when they passed Proposition 13 in 1976. Why do they not protest a 38 percent property tax?

The increase in the value of John and Mary's home was not earned income, and it should not have been taxed as such. It represented savings -- the savings of a lifetime. Under tax reform, the income tax on these savings can range up to 38 percent (assuming a 28 percent federal income tax and a 10 percent state tax).

This incredibly inequitable treatment of lifetime savings illustrates the type of inequity that arises with an income tax. Under a VAT, John and Mary would be able to keep every penny from the sale of their home. Their tax in 1990 would be proportional to their purchases, which would be about the same as usual, plus the VAT on their mobile home.

The Real Tax on Your Home's Appreciation May Exceed 100 Percent!

The example given above is, in fact, extremely conservative. Because capital gains realized on the sale of a home that has been owned many years may represent mainly appreciation due to inflation, the *real* tax is in most cases much greater than the nominal rate (up to 38 percent). Because of inflation, the real tax rate on the capital gain may easily exceed 100 percent! This happens, for example, when the real, uninflated value of the home is less at the time of the sale than when the owner bought it, but, because of inflation, the house sells for more than the marginal purchase price. (The "real" tax rate is the tax expressed in uninflated, constant dollars, as a proportion of the original value of the house.)

Under tax reform, older Americans get a "kick in the teeth": the government will strip them of half their lifetime savings, if their home represents the bulk of their savings and they must sell it to live off those savings. Because of inflation, the tax may actually exceed 100 percent. The government

touts tax reform as an equitable system. This is a total misrepresentation, a cruel deception, a subterfuge. The progressive income tax is a pernicious tax and it should be abolished.

Is stripping our older citizens of their lifetime savings any way to treat people who have paid a lifetime of taxes? Some primitive societies put their old out to die when they are no longer productive. Under tax reform, the IRS would confiscate the savings and security of our older citizens. Some economists have proclaimed the income tax as one of the best taxes ever devised. That assertion can be made only from the government's point of view; from the citizen's viewpoint, it is one of the worst taxes ever devised.

The government will no doubt criticize the above example as unfair, pointing out that under certain conditions, the couple may be entitled to a tax break on the sale of their home (for example, by somehow holding out until age 55). But why should ridiculous tax incentives control the timing of the sale of their home? Why should couples that can't wait until age 55 be discriminated against so severely? In fact, under tax reform, the law contains a perverse incentive to break up marriages. It has been noted that if a couple obtains a divorce, after three years *each* of them may qualify for a \$125,000 one-time tax exclusion of capital gains from the sale of their homes, whereas if they remain married, they qualify for only a single \$125,000 tax deduction. If they wait for three years before remarrying, the statute of limitations will prevent the IRS from nullifying the deduction on the basis of an "insincere" divorce. Why should the tax system motivate couples to divorce? This is but one more example of the insanity of the income tax.

Moreover, since this incentive is illogical, it engenders contempt for the law and a strong motivation to evade it. With its economic distortions and illogical incentives, the income tax is corrupt and is corrupting America. This topic is addressed in detail in the chapter that follows.

8. The Income Tax Is Corrupting America

There are several ways in which American citizens are purposely and needlessly being corrupted by a tax system that offers incredible temptations to evade. A major factor underlying the evasion incentives of the US income tax system is that income taxes are simply too high. This factor is the principal one that has led to the development of an underground economy -- a "tax-free zone" where citizens engage in barter and cash transactions to avoid payment of an oppressive, illogical tax.

Another factor that creates an incentive for tax evasion is the complexity of the tax code. Many rules are not only complicated, but also vague. This complexity and ambiguity creates an undesirable atmosphere in which businessmen are motivated to push deductions to the limit; they are unnecessarily tempted to make tax-related decisions that may be challenged by the IRS as attempts at evasion.

Some of the factors that create a strong incentive to evade taxes are structural. One of them is "double taxation" of dividends. The other is the strong incentive to make purchases through one's business, caused jointly by the tax deductibility of business purchases to the firm and taxation of income to the individual.

This chapter explores the many ways in which the income tax, through its perverse, malicious incentives, is corrupting America.

The Income Tax System Contains Strong Incentives for Tax Avoidance and Tax Evasion

People pay sales taxes without much objection. Few people will drive hundreds of miles to buy a car where the sales tax is less. People pay Social Security taxes without wasting much time trying to avoid paying them. People pay unemployment taxes, luxury taxes, cigarette taxes, alcohol taxes, gasoline taxes, and airplane ticket taxes -- all without much objection. Many people object to the personal income tax, however, and invest considerable effort in trying to avoid paying income taxes.

The reasons for this behavior are several. A principal one is, of course, that the income tax is the only tax that one can reasonably avoid. That the income tax by its intrinsic nature unduly tempts avoidance activity is one of its worst features. If a person refuses to pay a consumption tax (such as an alcohol, or telephone, or airplane ticket tax), he must (from a practical viewpoint) do without the product or service. Aside from this reason, however, there are several other reasons why many people spend a lot of time and effort engaged in the practice of income tax avoidance.

First, income-tax rates are extremely high. The government has, through high income-tax rates, created a strong incentive to avoid them. Next, the complicated tax system and the oppressive burden of the personal income tax *demand*s that a prudent individual spend time determining how to structure his income and investments to minimize the tax burden -- he owes it to himself and his family to pay no more tax than necessary. If he does not engage in tax avoidance, the taxes on his next-door neighbor, having the same income, could be significantly less than his own.

Note that tax *avoidance* is perfectly legal: it is just the practice of attempting to find out -- in the face of the incredibly complex and changing tax code -- what is the minimum tax a person is legally required to pay. It is distinguished from tax *evasion*, which is the practice of paying less tax than the law requires. The income tax motivates both avoidance and evasion.

The use of a high-rate income tax, when lower-rate nonincome-type taxes are available, is unreasonable. Instituting a "voluntary" tax system that had rates on the order of one percent was one matter; use of a "voluntary" tax system when the rates are 50 percent is ridiculous. At these high rates, the "voluntary" tax system is nothing more than an elaborate entrapment scheme. Imposing high income tax rates on 100 million Americans when the same taxes could be levied on and collected from a few million business establishments is as ridiculous, for example as collecting a one-cent tax on Popsicles directly from every child who eats a Popsicle, when he eats the Popsicle, rather than collecting the tax from the businessmen who deal in Popsicles in quantity -- the manufacturer, the wholesalers, the distributors, and the retail merchants.

Income taxes are too high!

The Overall Tax Burden in the US Is High, But No Higher Than in Many Other Countries

Some people believe that the overall tax burden (from all types of taxes, not just the income tax) in the US is too high. Compared to other developed countries, however, the overall tax burden is not very heavy. The Organisation for Economic Co-operation and Development (OECD) publication *Revenue Statistics of OECD Member Countries*, presents a list of all member countries, showing the size of their overall tax burden (total tax revenue) as a percentage of gross domestic product (GDP). (Gross domestic product, or GDP, is the same as the more familiar gross national product, except that the value of foreign goods used in production has been removed. Gross national product, or GNP, is the total value of all goods and services produced by the nation in a year.) The US has one of the lowest overall burdens -- 29.03 percent of GDP in 1983. Of the list of 21 countries, only Japan and Turkey are lower: Japan at 27.71 percent of GDP and Turkey at 18.78 percent of GDP. All 19 other member countries have higher overall tax burdens, ranging up to Sweden, at 50.50 percent of GDP.

This book does not address the issue of whether the *overall* tax burden is too high. It objects to the attempt to extract this revenue from the imposition of a *personal income tax* on individuals.

The total income tax burden is the sum of the federal income tax, the state income tax, and the payroll tax (both the "employer" and "employee" contributions, since the incidence of the payroll tax burden is generally considered to fall mainly on the employee). The personal income tax as a percentage of GDP is 8.03 percent; the US ranks fourth highest of all OECD countries. The payroll tax represents 4.32 percent of GDP; the US ranks 12th. The US places its tax burden more heavily on individuals than most other nations in the world. While the *overall* tax burden (from all tax sources) on US citizens may not be very high compared to other industrialized nations, US *income taxes* are too high!

Tax Rates Under Tax Reform

Under tax reform, as discussed in the preceding chapter, there are five tax brackets. For convenience, those brackets are repeated here. For married taxpayers filing a joint return, the rates are 0 percent on all nontaxable income (deductions and personal exemptions); 15 percent on "taxable" income from zero to \$29,750; 28 percent on taxable income from \$29,750 to \$71,900; 33 percent on taxable income from \$71,900 to \$149,250, and 28 percent on taxable income over \$149,250.

The 28 percent rate applies to a large proportion of families -- approximately 20 percent of all families have incomes over \$29,750. When the 28 percent rate is added to other taxes, the total rate is extremely high. For example, the employee's Social Security tax is 7.15 percent of income up to \$43,800 (not even counting another 7.15 percent Social Security tax on earnings, which is euphemistically called the "employers" tax); a state income tax might be 10 percent; a property tax might be the equivalent of 5 percent of income; a sales tax might be 7 percent of expenditures, or about 3 percent of total income. When combined with the 28 percent federal income tax, these amounts represent 52 percent, or over half of a person's income, for a large proportion of the population. Many people assert that a government should not take half a person's income, that taxing 50 percent of a person's income is confiscatory, and that 20-30 percent is quite high enough. Tax reform, with a 28 percent federal tax, when combined with other taxes, will represent a total personal income tax of approximately 50 percent for a large segment of the population. That is too high.

Income tax rates are now so high that a large proportion of the population now actively evades taxes. Tax reform will exacerbate the problem because, for many people, tax rates are even higher than before.

High Income Tax Rates Have Given Rise to an Underground Economy

In response to a burdensome, unjust, and hassling personal income tax system, an underground economy has arisen, involving millions of US citizens. These are professional people and independent businessmen who fail to report some of their income, or who engage in barter (that is, trade their goods or services), without declaring the dollar value of the trade as income.

There are several factors that have led to the growth of the underground economy, in addition to the oppressive tax burden. Americans are reacting to the extreme regulation of our current society, to the regimented social welfare system, and to being unnecessarily hassled by government. Many Americans do not want government involved in their private affairs. They do not want government looking over their shoulders when they make small private sales. They object to being taxed at swap meets. They resent government's immediate confiscation of gambling earnings. They are fed up with being hassled on a personal level. They want, quite simply, to be left alone.

The problem of suppressing the underground economy is a difficult one to address by enforcement, because the number of taxpayers is very large -- 100 million. Having similar rates on businesses would not represent nearly so great a problem, because the number of businesses is much smaller (3 million corporations, 11 million proprietorships, and 1.5 million partnerships) and they are more easily monitored.

The size of the underground economy has been estimated to be several hundred billions of dollars. The growth of the underground economy has been fueled by a tax system that is widely perceived as heavy, unjust, and intrusive.

The government learned in the alcohol prohibition era that it is unwise to promote laws that result in the turning of large numbers of citizens into lawbreakers. Such laws don't generally last, but while they are in effect they cause the bad side effects of creating a resentment and dislike of the government and a general lack of respect for the law. The government has created a monster in the personal income tax system -- a very costly system that requires close monitoring of the citizens by the government, the needless expenditure of much effort on the part of the individual, and the creation of a strong adversarial relationship between the government and the citizen.

A principal cause of the underground economy is the very heavy burden of the income tax. Another cause is the hassle factor -- many Americans do not want to be continuously hassled by government. Envy contributes to the problem, but it would not be a significant factor if income tax rates were low. The Tax Reform Act addressed the issue of envy to some extent, but it did not address the issue of the heavy burden of the income tax, nor did it address the hassle factor -- in fact, both were made worse! Under tax reform, the overall tax burden is greater, and the tax burden for a large proportion of the population will be significantly heavier.

Instead of addressing the issue of the heavy personal income tax burden or the hassle factor, the Tax Reform Act concentrated on the problem of envy. Before tax reform, people in similar economic situations often paid vastly different amounts of tax. Also, people with similar incomes also often paid vastly different amounts of tax. This happened because some were able for various reasons (high incomes to retain tax experts and to take advantage of tax shelters, a superior knowledge of tax law) to take full advantage of the complex tax system to pay little or no tax. The existence of this perceived inequity caused strong and widespread resentment. According to a 1984 IRS survey, four out of five believed that the tax system was unfair to the average citizen and that favored the rich.

By removing most tax shelters, the income tax paid by people having similar incomes will vary much less than before, and it will be very difficult for wealthy people to avoid paying income taxes altogether. Unfortunately, the new tax system is, overall, more burdensome than the system that preceded it. The 1984 IRS survey reported that three of four taxpayers considered their income taxes much too high. That problem has not been addressed by tax reform; in fact, for a large segment of the population, income taxes will increase.

The IRS survey reported that the public believes that a large percentage of the public cheated on their taxes; one in five admitted to cheating on his own taxes.

Income taxes are too high!

Tax Reform Will Not Dismantle the Underground Economy

The underground economy will not disappear because of the Tax Reform Act. The hope that it will is unfounded. The underground economy is caused more by the oppressive burden of high tax rates as it is by envy. The overall income tax burden has not been reduced by the Tax Reform Act; on the contrary, it has been increased. Moreover, the burden has been increased most for the very people who can profit most from the underground economy -- moderate-income earners.

With the passage of the Tax Reform Act, the federal government would have the US population believe that the US tax system is now fair, and therefore, that people should and will pay. On the one hand, this is a subterfuge; on the other, it is folly. The income tax is not the correct vehicle for producing the massive revenue required by the modern US Government. The tax base is too narrow, and the burden on individuals and families is too great. The Tax Reform Act has not addressed this problem, and it does not represent a solution.

If the income tax is continued to be used to raise a major portion of the required revenue, the IRS not only will have to continue the operation of a police-state organization, but also will have to expand its powers. In this regard it is interesting to note that the monitoring of individuals will increase significantly under tax reform (for example, the mandatory SSN registration of all dependents over the age of four, the reporting of tax-exempt income), and the penalties for noncompliance have been increased.

The US people have called out to be freed of the oppressive yoke of the personal income tax. Like George III, the US Government has hardened its heart, and refuses to listen. The cause is just, however, and like George III, the US Government will yield, or it will not endure.

The US Government, through its enforcement of an inhumane tax system, has corrupted the moral fiber of the US population. A large proportion of the population now believes that they are quite justified in evading taxes. To many, it no longer matters what the law says, because the law is wrong. The government has opened a Pandora's box, and has ruined its ability to depend on voluntary collections as a means of administering the income tax system. It had best look to another method of taxation. Trying to force citizens to once again do voluntarily what government incentives, inequities, and intolerable burdens motivated them to reject is unrealistic, if one wishes to avoid a police state.

The Complexity and Vagueness of the Tax Code Contribute to Tax Evasion

One of the reasons why tax evasion is on the increase is that the line between tax avoidance and tax evasion is not always very clear. The tax code is so complex that it is impossible for a layperson to invest the time required to understand the tax code and know the tax status of his activities and how to structure them to legally reduce his tax burden. News reports have occurred describing how famous individuals (actors, politicians, industrialists) have participated in tax shelter schemes that have been declared invalid. When highly successful and intelligent people cannot determine the tax base or cannot afford the time necessary to determine it, it is clearly too complicated.

The problem is even worse for the businessman. To determine the tax base (profit), he must make numerous judgments, such as whether a payment to himself should be represented as a labor cost or as a dividend; how fast to depreciate an asset; whether an automobile represents a business or personal expense; whether a business open-house represents a tax-deductible effort to advertise or establish goodwill, or a simple party; whether a visit to a tropical island to visit the US Agency for International Development is all business or part business and part pleasure, and if the latter, how the costs should be allocated between business and pleasure.

These problems have no place in business. They arise because of a nonsensical business tax system. The tax base should be simply defined, such as sales receipts, or sales receipts less

easily defined expenses. A businessman should not have to worry over whether a particular purchase is tax deductible; that should be clear from the definition of the tax base. Because US income tax rates are so high, the current system produces an intolerable incentive to evade taxes.

Because the rules of the game are not known, it is easy to understand how businessmen are not only frustrated, but on occasion led astray by the insidious system. The current system not only includes high incentives for tax evasion, but in many cases it is not clear whether a decision represents (illegal) tax evasion or (legal) tax avoidance. The tax system should not be a "guessing game"! The tax code is so complicated that the determination of what is taxable in many cases must be arbitrarily decided in the Tax Court.

Knowing that the government created this monstrous game, believing that the rules of the tax game have been set up in favor of the wealthy, it is little wonder that, in the frustration of record retention, tax pamphlet reading, and the attempt to avoid the cost of a tax adviser or tax preparer, many individuals cross the line from tax avoidance to tax evasion. The dramatic rise of the underground economy in the past decade is a reflection of the strong objection of a large segment of our country to the personal income tax.

The Irrational, Inequitable, Heavy-Burden Income Tax Creates a Lack of Respect for the Law

In 1984, the IRS conducted a public opinion survey in which it was reported that four out of five taxpayers consider the tax system unfair, that three out of four consider income taxes too high, and one in five admitted to cheating on his own taxes. The US income tax system is turning ordinarily law-abiding citizens into criminals. The incentives for tax avoidance and tax evasion are intolerably high. The high proportion of the nation's tax burden that is placed on individuals encourages tax avoidance and evasion. It is an inhumane system, not well suited for human society.

The irrational, burdensome, envy-causing, evasion-tempting income tax system not only tempts citizens to cheat, but it creates tremendous resentment against the government. The system is ridiculous, and it invites ridicule and contempt for the government. It has created a schism between citizens and their government, an adversarial relationship that contributes to a general lack of respect for the country and its ideals.

Americans are basically honest. The Puritan tradition is strong. When one in five Americans admits to cheating on his income taxes, something is terribly wrong with the tax system. This type of general disrespect for the law by a basically honest society -- especially the flaunted violation of the law -- occurs when laws are perceived as improper or unjust. The income tax system is a bad one; it has undermined the respect that Americans had for the law and their government.

When a law -- such as alcohol prohibition, the 55 miles-per-hour speed limit, or the personal income tax -- is so unacceptable that many people break it or spend much time and money trying to avoid its consequences, it is time to reconsider its merits.

The Income Tax Generates Citizen Resentment of the Government

The US public does not like the income tax. It tolerates other forms of taxation (such as the sales tax), but cannot abide the income tax. There are two principal reasons for this reaction. First, income tax rates are too high. Second, it is perceived as complicated and inequitable. The tax code has become so complicated, and the personal income tax burden is so high, that many people have become not only frustrated, but also angry at the absurd level of complexity and inequity of the current system.

One reason why some people object to the personal income tax is that it is unnecessary. This nation operated quite well for over 100 years without an income tax, that is, with business taxes rather than personal taxes. The argument that US citizens now demand a higher level of government-funded services, and therefore the government needs an additional source of revenue, is specious. The same level of revenue that is currently collected by personal income taxation can be collected more simply, efficiently, and equitably from businesses.

How much revenue the country can afford to take out of the economy depends on the size of the economy. The government can remove this revenue in a variety of ways; it does not have to extract any of this revenue by income taxation of individuals. Why waste 100 million individuals' time (in learning the tax code, in reading instructions, in collecting and maintaining records, in completing tax forms, in submitting to audits) and intrude in their privacy to collect revenue that could be collected more equitably and with less cost at a different point in the economy -- from 15 million businesses rather than from 100 million individuals?

In the final analysis, human beings are the source of economic productivity, and they are therefore the ultimate source for all tax revenue. It is not at all necessary, however, to collect the tax directly from every family. This is particularly true in a highly developed economy consisting of business organizations. In the US economy, most production is channeled through economic units (businesses) at a higher level of aggregation than the family. The individual family is *not* the basic unit of production in the US, and it is not at all necessary to collect taxes at the family-unit level. Moreover, it does not even make sense to collect the revenue from individuals rather than businesses. Businesses, by their very nature, deal in money and keep records; they are the natural point in the economy from which to extract tax revenue. Families should not be burdened with the hassle of keeping records for tax collection purposes.

US citizens are not stupid. They can understand the concept that the basic economic issue regarding taxation is what the total tax burden on the economy is. They can perceive that this burden can be distributed in an infinite variety of ways -- between businesses and individuals, between rich and poor individuals -- and that the decision on how to distribute the burden is arbitrary. The current system of distributing the burden, as embodied in the tax code, is extremely complicated and unfair. The current tax system could be replaced by a simple, uniformly applied, equitable tax system. Collection of taxes at the family-unit level is absurd in an advanced economy such as the US. Why should US citizens go along with an inefficient, costly, intrusive, and unnecessary system for extracting tax revenue from the economy?

Double Taxation

Under the US income tax system, corporation earnings are taxed twice -- once as corporate income, and again as personal income after distribution (of what remains after corporate taxes) to shareholders in the form of dividends. This procedure is called double taxation. A book on this topic is *Must Corporate Income Be Taxed Twice?* by Charles E. McLure, Jr. Under double

taxation, a businessman who makes a profit in his business must first pay a business profit tax (say 49 percent: 39 percent federal income tax and 10 percent state income tax) on his profit, and then pay a personal income tax (say 43 percent: 33 percent federal income tax, 10 percent state income tax) on the remainder, which is paid to him as a dividend: a combined tax of 71 percent ($1 - (1-.49)(1-.43) = .71$).

Double taxation represents a strong incentive for a business owner to convert profit to income, to avoid paying the profit tax (since labor costs are tax-deductible to the firm). Because the line between what is a reasonable income for the owner and what should be paid as a dividend is a fuzzy one, this feature of the business profit tax system not only generates an incentive to evade taxes, but the evasion is defined on the basis of a subjective assessment on the part of the IRS or the tax court as to what constitutes a reasonable income for the owner. In other words, the tax base is not well defined. This is an absurd situation. It places the firm's owner in an awkward position of not knowing what is right and what is wrong, relative to his tax responsibility.

The "reasonableness" of a businessman's salary should never have been an issue for government consideration in the first place. Determination of the legitimacy of his salary would not be a problem if the government had not structured the business tax as a profit tax, with the concomitant problem of determining what constitutes profit (taxable income).

The government really has no business trying to tell a business what expenses are "legitimate" and therefore tax deductible. The government can't make those decisions as well as the free market, and the attempt to do so either hassles the owner, or creates incentives to evade or avoid taxes, or distorts the economy and produces a lower standard of living for all. A tax structure that requires the government to make such decisions is a bad tax structure, from both economic and social points of view. The government evidently prefers, however, to have an excuse for monitoring the affairs of business, just as it does for individuals, and so it is naturally drawn to methods of taxation that require such monitoring. Without the business income tax, tax audits would be tremendously simplified, and this intrusion of the government on the private affairs of business would be unwarranted. Collecting an unobtrusive, economically neutral business tax is one matter; telling business how to run business is bad business.

The business profit tax and the personal income tax are ill-conceived ideas, and they should be eliminated. The US set an example for the rest of the world in establishing the income tax; the US should set an example by abolishing it.

The Personal Income Tax and the Business Income Tax Work Together to Create a Strong Incentive to Evade Taxes

In spite of the expressed intent of the Tax Reform Act to reduce the impression that the tax system is unfair, it barely touched one of the most perverse aspects of the system: the strong incentive for business owners to avoid or evade taxes by keeping their income in their firms and making personal purchases (such as an automobile or computer) through their firms. The incentives for this are in many cases about the same as before tax reform, and in some cases greater than before.

The incentive for a business owner to make purchases through his firm arises in two ways. First, by keeping some of his salary in the firm to make purchases, he avoids paying personal income taxes on the salary. Second, if, as is usually the case, the purchased item is tax deductible to the

firm, the firm saves the corporate income tax on the extra profit that would have resulted had the purchase not been made. Since the owner owns the firm, the owner saves this amount. Together, these two factors result in a discount of up to 71 percent on the cost of items purchased through the firm.

Before tax reform, the combined discount represented by making purchases through one's firm was about 82 percent, for items that were tax-deductible to the firm but not to the individual. Under tax reform, that discount has been reduced to about 71 percent. The discount was very large before, and it remains very large. Under tax reform it has been reduced hardly at all.

The paragraphs that follow describe in detail how the tax law creates incentives for businessmen to make purchases through their businesses.

"I Bought It Through My Business"

Under both previous tax law and the new tax reform law, there is a very strong incentive for individuals to use their businesses to make purchases of a personal nature. This is easy for the owner of a business to do because many "big ticket" items, such as health and disability insurance, cars, computers, trips and buildings, can legitimately be characterized as business related expenses. Such expenditures are generally not tax deductible to the individual, but are tax deductible to the business. For this reason, the individual has to earn substantially more than the price of such an item in order to purchase it.

The amount of the saving realized by buying an item through one's business depends on whether the firm buys the item (say, a car) out of funds that would otherwise have been used for some other tax-deductible purpose, or out of funds that would otherwise represent profit. Suppose, for example, that on the one hand the firm buys the car out of funds that would otherwise be paid to the owner in the form of salary. In this case, the owner saves his personal taxes and the firm's payroll tax on the salary, by purchasing the car through the firm. On the other hand, suppose that the firm buys the car out of profit from which he would otherwise pay himself a dividend. In this case, the owner saves his personal taxes and the corporate profit tax.

The extent to which a business owner pays himself by salary or by dividends depends on how much money he wishes to take out of the business and what salary is reasonable, in the eyes of the IRS, for his services. As mentioned before, he may pay himself at most a "reasonable" salary; payments beyond a "reasonable" salary are regarded by the IRS as dividends. The owner is motivated to pay himself in the form of salary rather than dividends, since salary is income-tax-deductible to the firm, whereas dividends are not. The only tax on salary is the payroll tax, and that drops to zero after \$43,800.

The tax saving is greater if the owner buys the car "out of profits" rather than "out of salary." Let's consider first the case in which the owner buys the car through the firm using funds that would otherwise be paid to himself in the form of salary. Suppose, for example, that an individual's marginal tax rate (federal, state, and local) is 50 percent: 33 percent federal, say 10 percent state, up to 7 percent Social Security. In order to purchase a \$10,000 automobile, he must earn \$20,000, because the government will take half of the \$20,000 salary in the form of taxes. Furthermore, the firm may have to pay up to an additional 7 percent payroll tax on the salary (if the salary is less than the payroll tax ceiling of \$43,800), so that the total labor cost to the firm may be as high as \$21,505. The car is a 100 percent tax-deductible expense for the business. If the

businessman purchases the car through his business, it costs him only \$10,000 -- a saving of between \$10,000 and \$11,505, depending on whether his salary is over or under \$43,800. In summary, because the marginal tax rate on the employee's income is approximately 50 percent, every purchase that can be made by the business costs approximately one half as much for the business as for the employee.

Let's consider now the case in which the owner buys the car using funds that would otherwise be paid to himself in the form of dividends out of the firm's profit. This situation could occur, for example, if the owner's salary was already high and any additional payment would be considered a dividend by the IRS, rather than salary. Since the car is tax deductible to the business, the owner also saves (through his firm) the income tax that would have been paid on the profit with which the car was purchased. Under tax reform, the business profit tax is up to 49 percent (39 percent federal tax plus, say, 10 percent state tax). Let's assume that the individual's tax on dividends is 43 percent (33 percent federal income tax, 10 percent state income tax, but no payroll tax). Combining the 43 percent saving from his own personal taxes with the 49 percent saving on the corporate profit, the total saving amounts to 71 percent. (The formula for the amount of the discount is: $1 - (1 - \text{personal marginal-income-tax rate}) \times (1 - \text{business marginal-income-tax rate}) = 1 - (1 - .43)(1 - .49) = .71$. Alternatively: Cost of car to owner if purchased by firm = \$10,000. Cost of car to owner if purchased through earnings = $\$10,000 / (.57)(.51) = \$34,400$. Discount = $\$24,400 / \$34,400 = 71$ percent.)

Hence we see that the owner of a firm may realize a discount of on the order of 50-70 percent, depending on whether he buys the item out of salary or out of profit. The opportunity to receive a 50-70 percent discount on a car is quite a temptation.

Before tax reform, the marginal individual-tax rate was about 60 percent (50 percent federal plus 10 percent state), and the marginal rate for the firm was about 56 percent (46 percent federal plus 10 percent state). In that case, the discount was $1 - (1 - .60)(1 - .56) = 82$ percent. In other words, tax reform has hardly reduced the discount at all. It was very great before, and it is still very great. What is the reason for adopting a tax system that contains unnecessarily and extremely high incentives to evade for certain individuals? With respect to this evasion incentive, the US income tax has a very low "vertical equity": individuals with high incomes are subjected to high incentives to evade, whereas individuals with low incomes are not. Other tax systems (such as the VAT) are available in which these incentives are far lower than for the current income tax. The imposition of a tax system having high incentives to evade is a highly corrupting influence that should be ended.

Cars Are Not the Only Thing a Businessman Can Buy Through His Business

Cars are not the only things that the business owner may buy at half-price because of the income tax laws. Complementing the car, the business may also buy the gas (say, \$2,400 per year if purchased by the business, but \$4,800 per year in pretax earnings if purchased by the owner as an individual), the car insurance (say, \$3,000 per year for the business, but \$6,000 for the employee), parking (say, \$1,000 per year for the business, \$2,000 per year for the employee), and repairs and maintenance (oil changes, car washes, tires, and repairs -- say \$500 per year for the business, but \$1,000 for the employee).

A business owner may buy medical, dental, and disability insurance through the business. For these fringe benefits, there is not even a question of their tax deductibility. Fringe benefits are tax deductible to the firm, but not to the individual; that is, the individual must pay for them in after-tax

dollars. This arrangement may generate envy in persons who do not own their own firms (or have employer-paid fringe benefits), but, because it is perfectly legal to make such purchases through one's firm, it does not constitute an incentive to evade taxes. Why should employee fringe benefits be tax deductible to a firm but not to an employee? Who knows? This is just another example of the illogical, arbitrary income tax rules.

For items other than fringe benefits, the item is tax deductible only if it is reasonably needed by the business for the production of income. In many cases, it is not clear whether an item is reasonably necessary. The problem that arises is that, under a very high income tax, there is a tremendous incentive for a business owner to purchase such items through his firm to realize the tax saving. This incentive would be much less under alternative tax systems. The very high income tax creates a strong incentive to evade taxes; that unnecessary incentive is a corrupting influence on US business.

The following paragraphs describe some of the many items that a business owner may be tempted to purchase through his firm, whether they are truly necessary for the production of income.

Suppose that the business owner wants to treat several of his friends to an all-expense-paid resort visit every year. He can arrange to have the board of directors' meeting at Lake Tahoe each year -- a several-day visit to the finest hotels, in beautiful surroundings, with all meals, lodging and salaries paid for by the business.

Suppose that he enjoys brief trips to foreign vacation spots. He can set up a real-estate investment firm, make his wife and several of his associates officers, directors, or partners, and visit luxury resorts around the world to investigate their investment potential. For example, a week in Costa Rica may be required to investigate the "time-sharing" vacation condominium resorts in that country.

Whatever your interests, you can readily identify enjoyable activities that can be justified as business activities. Suppose, for example, that your business is data processing and that you would like to visit Las Vegas or other resort city for a few days. There are, in any given year, thousands of seminars and professional meetings presented in very nice settings: Las Vegas, San Francisco, Miami, New Orleans, Honolulu. A visit to any of these meetings to attend a technical seminar or to present a technical paper qualifies the visit as a business activity. The cost of visiting these places -- the air fare, your labor cost, meals, lodging, local transportation -- all are legitimate business expenses. No matter who your clients are, the visit to Las Vegas can cost you half, if you take it when the next data processing seminar is located there.

Suppose that you are in the construction business, and you like to give large parties. The next time you open a new business-office complex, throw a large open-house party, introducing your new complex to the public. The entire cost of the party can be "written off" as a business expense. The cost to you -- because you pay for it in pretax dollars -- is half the cost of the same party, given by you as a private individual, to the same guests, at the same place, at the same time.

Suppose that you want to buy a powerful personal computer. Buy it through your business. Cost: half what it would cost if you bought it as an individual.

The above examples illustrate some of the many items that may or may not be legitimate business expenses. In those cases in which they are not, or are questionable, the current high-rate income tax is a pernicious incentive to represent them as business expenses to avoid the high taxes. This incentive, which can be dramatically reduced by other methods of taxation, is harmful for society in

several ways: it encourages the wasteful activity of tax avoidance and the illegal activity of tax evasion. It generates envy in those non-business-owners to whom the advantage is not available and resentment against a government that promotes a tax system that contains such strong corrupting incentives. Finally, because the government has instituted a tax system with such high incentives to evade, the leakage resulting from this evasion might be considerable, and the government is hence highly motivated to monitor firms closely to minimize the practice. Having established an income tax system with strong incentives to evade, the government is consequently highly motivated to implement strong administrative procedures to control this problem (that it created in the first place!). These administrative procedures further boost the cost of the income tax system.

The IRS Can Eliminate Personal Tax Evasion by Eliminating Personal Privacy, or by Eliminating the Personal Income Tax System

The IRS is already seriously intrusive of the privacy of firms and owners of firms, yet the practice of an owner's making personal purchases through his firm continues. If the IRS wishes to eliminate this practice under the current income tax system, it may begin by totally destroying the privacy of all US citizens, and by making business decisions for all business owners. To the IRS, this may seem to be an appropriate solution, and a low price to pay, in spite of the fact that the practice of making purchases through one's firm is an opportunity available only to a relatively small proportion of the population.

Destroying the hearth to kill the cricket makes little sense.

The Income Tax System Creates Crimes That Waste Law Enforcement Resources

There are several types of laws. On the one hand, there are laws that prohibit intrinsically offensive behavior, such as stealing, assault, and murder. Such crimes may be called intrinsic, or inherent, or essential crimes; the crime is offensive by its very nature. Another type of law relates to the regulation of activity that may be considered objectionable on moral grounds; laws prohibiting gambling, prostitution, indecent exposure, or pornography are examples. In a third category, some laws are implemented to enforce citizen compliance with government-established rules and regulations that do not relate directly to intrinsically objectionable activities, or to morally disapproved activities. Laws against income tax evasion fall in this third category. Such laws serve to preserve the income tax system.

The worth of such laws depends on the worth of the system they support. The value of the law in this situation derives from the value of the income tax system. In this book, we will refer to the crime of income tax evasion as an "artifactual" crime. The crime is an artifact of a synthesized tax system.

While it may be argued that all laws should be enforced and all crimes (including artifactual ones) should be punished, this situation should be examined more closely. It costs money to enforce the law and punish crimes. In the case of artifactual crimes, it is necessary to ask whether this cost is justified by the value of the system that the laws support.

Since the collection of *some* type of tax is necessary, tax evasion is necessarily a crime. Because the investigation, prosecution, and punishment of crimes costs a lot of money, however, the cost of

punishing the artifactual crime of tax evasion must be examined, as part of a rational analysis to determine whether a particular tax system is reasonable.

In general, the income tax system scores very poorly relative to the matter of the artifactual crime of tax evasion. The system creates 100 million taxpayers, and sets up strong incentives for tax evasion. The system not only generates much artifactual crime, but also requires the expenditure of massive resources to examine and audit tax returns, and investigate possible tax law violations.

Personal income tax evasion is an artifactual crime. It exists only because the income tax system exists. It occurs frequently because the government has created a system that has very strong incentives for tax evasion.

Society's synthesis of some artifactual crimes is justified. For example, a value-added business tax is an efficient, equitable, and low-cost method of collecting tax revenue. The artifactual crime of business tax evasion is justified on the basis of the worth of the system it enforces. The artifactual crime of personal income tax evasion has no such justification.

With other types of tax methods, the cost of artifactual crimes would be far lower. With a VAT, for example, the system generates only a few million taxpayers (that is, 15 million businesses), and the incentives and opportunities for evasion are far less.

If the personal income tax system were efficient and equitable, the creation of the artifactual crime of personal income tax evasion would be justified. The system is, however, costly, inefficient, and inequitable. The social and economic cost of prosecuting these artifactual crimes derives no justification from a useful end, namely, the maintenance of a system that is beneficial to us. The millions of dollars that are allocated to tax auditing, enforcement, and tax crime punishment are not invested to maintain a beneficial system, but are invested in the preservation of a costly, inefficient, inequitable and intrusive one.

The Investigation, Prosecution, and Punishment of Artifactual Crimes Costs Money: Is That Money Well Spent?

The drawback of artifactual crimes is that they consume law enforcement and judicial resources. Instead of using these limited resources to pursue intrinsically real crimes, resources are shifted to the investigation and prosecution of synthetic crimes. If the amount of revenue produced by the tax system is low, or if the system generates an unreasonable level of artifactual crime (for example, by reason of high incentives for tax evasion or very high numbers of taxpayers), these resources are wasted.

The crime of fraud against a ridiculous Rube Goldberg tax system that is woefully inadequate on economic and sociological grounds is different in its essential character from the crime of fraud in which a person steals directly from other people. This difference arises because the economy would be far better off without the income tax system -- better alternatives are available. If this income tax system were superior to others, there would be a rationale for investing massive law enforcement resources in its perpetuation. This is, however, not the case. It is an inadequate, costly system that does not stand on its own merits. Wasting law enforcement resources to perpetuate it accomplishes nothing more than the diversion of law enforcement and judicial resources from investigation and prosecution of real crimes.

The US Government invests billions of dollars every year in monitoring its citizens relative to the artifactual crime of personal income tax evasion. That money could be spent going after real criminals for real crimes. It could even be spent building schools, factories, and resort hotels in Honduras.

From one viewpoint, laws should be obeyed, regardless of how poorly conceived they may be. From time to time some very poor laws are created. The personal income tax is an example of a law that does not serve us well; it should be eliminated.

If tax laws were reasonable, creating the artifactual crime of tax evasion would be justified, and punishment for it would be warranted. Unfortunately, that is not at all the case with the personal income tax. Few people object to penalizing individuals who break the law. The rules for which infractions are punished should, however, serve some good purpose. There is little point to the elaborate, costly, and totally unnecessary game of the income tax system.

Tax evasion is a crime, and citizens who break this law should be punished. The tax, however, should be a reasonable one. The imposition of a costly, complicated, inequitable, economically inefficient, privacy-intrusive burdensome tax is absurd. (This is especially true when a low-cost, low-rate, economically efficient, and non-privacy-intrusive alternative exists for raising the same revenue.) The use of such a tax, with the inevitable temptation it presents for tax evasion, is not reasonable. Tax evasion is an artifactual crime that has been synthesized by a freedom-threatening tax that the Constitution framers in fact prohibited.

It may be asserted that the argument that the crime of personal income tax evasion need not exist is equivalent to the argument that the crime of smuggling need not exist -- but we have decided as a society to impose import restrictions, and those who violate them are breaking the law. The difference is that many laws proscribe activity that is inherently offensive, such as property theft or assault. In the case of income tax evasion, however, the government has created a totally unneeded system of procedures (because the same tax revenue can be collected with far less cost in other ways) and the legal machinery to severely punish anyone who refuses to participate. If laws against assault were repealed, assaults would continue to occur and would go unpunished; it is not possible to eliminate the assaults. On the contrary, it is quite possible to eliminate the activity of personal income tax evasion, simply by eliminating the personal income tax. Not only would the country then have an improved tax system, but also it would save billions of dollars in collection and enforcement costs in doing so.

The Income Tax System Encourages Surrogate Punishment

Despite its high cost of collection, intrusive nature, and inequity, the government has a strong incentive to continue the income tax; its collection and enforcement provide a basis for the state to monitor individuals, and to investigate, interrogate, and punish, in a highly discriminatory manner, individuals whom they view as "troublemakers" or "protestors," or suspect of other crimes. Investigation for income tax evasion is an effective weapon against tax protestors. Prosecution for tax evasion may be used as a surrogate for prosecution for crimes, which the government suspects but cannot, prove.

Personal income tax evasion is easy to prove in a technical society in which every person's income is subject to monitoring by the government. Individuals have been singled out for intensive investigation and prosecution under tax laws, based on issues that have nothing to do with their

taxes. The very process of an IRS investigation of a person's taxes is an inquisition that may cause serious damage to his reputation and financial status, regardless of whether he is guilty of evasion. In view of the damage it inflicts, the IRS investigation can be a punishment, inflicted on the individual unlucky enough to come to the attention of the IRS. In his book *To Harass Our People*, George Hansen presents several graphic examples of how the IRS has used this tactic against individuals who spoke out against it.

Although this method has been used since the time of Al Capone, the prosecution of persons for income tax evasion as a surrogate for prosecution for other suspected crimes has a serious drawback: it denies US citizens the right to equal treatment under the law. When any of us is denied equal treatment, our constitutional rights are weakened, and we all lose.

Under our concept of justice, citizens should not be subjected to intensive investigation and punished because they are considered to be "bad." They are to be punished, supposedly under a uniform code of justice, for specific crimes. To intensively investigate someone for tax evasion because the government cannot prove its case in some other area or because the individual has spoken out against the IRS constitutes discriminatory treatment under the law, and becomes unreasonable search and seizure.

The government has little to lose if it investigates someone for tax evasion and cannot prove the case. The individual may lose his reputation, income, and business, but IRS agents (under IRS regulations) are immune from prosecution. The individual may be tried, convicted, and punished merely by the process of an IRS investigation, even if no charges are ever brought.

With its inquisitorial powers, the IRS can cause great damage to individuals. That power has been abused.

The Income Tax System Is an Unnecessary Incentive for Crime

If the personal income tax were eliminated, personal income tax evasion would cease to exist as a crime. Personal income tax avoidance would cease to exist as a waste of economic productivity. The adversarial relationship between the US citizen and his government that is caused by the income-tax-audit process would cease to exist. The underground economy -- to the extent that it exists to avoid income taxes -- would shrink.

The current personal income tax system is unjust; it is so absurdly complex, and places such a heavy burden on individuals, that it understandably creates a desire to avoid payment. "It's the law" does not constitute sufficient justification for this unjust tax system any more than it did for slavery, persecution of Jews in Hitler's Germany, or denial of the vote to women. Even at its best - - a low, flat-rate, no-deduction system -- it still invites government monitoring of individuals (to verify income) and undermines the good relationship between the citizen and the government. Thomas Jefferson's maxim, "That government governs best that governs least," is not possible to promote in the context of a personal income tax (or a wealth tax, either), where government monitoring and control is implemented at the level of the individual citizen.

9. The Income Tax Is Too Complicated

This chapter discusses the complexity of the income tax. It explains why an income tax is typically a complex tax and describes the nature of this complexity. It describes what happened with another complex tax, the turnover tax.

The effects of complexity are explored. The hopelessness of the citizen in the attempt to determine his income tax liability is described. The complexity of the tax places you at a terrible disadvantage -- in an audit, the IRS is almost certain to find errors in your return. The detrimental effect of this situation on the government-citizen relationship is discussed.

The Income Tax Is Out of Control

The income tax system is terribly complicated. The tax base for the tax is defined in thousands of tax code and IRS regulations. In many cases, the rules and regulations are arbitrary and irrational. They reflect well the primitive, illogical process that designed the system -- a lack of theme, of methodology; a myriad of rules to favor special-interest groups; the lack of a systematic systems-engineering approach to system design.

The system has evolved over seven decades into a complete monstrosity. The tax base is now, in fact, unknown -- it is 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.

The personal income tax requires filing of tax returns by over 90 million individuals. The form is complicated. In 1986, for example, the basic form contains 16 pages of schedules and 52 pages of instructions, with 54 additional schedules and instructions referenced. The system is so complex that many individuals -- even those having low-wage incomes and few deductions -- consider it necessary to pay professional income-tax preparers to complete their returns. The Internal Revenue Tax Code of 1954 contains thousands of pages of tax rules and regulations. The so-called Tax Reform Act of 1986 simply adds more pages to these regulations. The regulations on income tax, with which every filer must comply, comprise eight volumes, consisting of over 5,000 pages.

Books on Tax Advice Sell Well

The US income tax system is an incredible, labyrinthine system of rules and regulations. The goal of finding a correct, minimum-tax return is an almost hopeless goal, certainly without employing a specialist. The complexity of the system has spawned an industry that feeds on this hopelessness and offers the promise of aid. In recent years, there has been a proliferation of books on tax advice. Every year near tax-return filing time, bookstores realize large sales of books on advice on how to save money on taxes and how to complete income tax forms.

A recent example is the book *Audit-Proofing Your Return*, by Jack Warren Wade, Jr., a former IRS Revenue Officer. This 482-page book offers advice on "how to reduce your chances of an IRS audit," and "how to fight and survive a tax audit." The book points out that the number of IRS auditors will soon grow by 40 percent, and that over two million returns will be examined every

year. Neither the "fear and loathing" generated by the income tax system nor the storm-trooper tactics of the IRS has any place in a society ostensibly dedicated to freedom of the individual. The current situation constitutes an indictment of a disgraceful income tax system that has no place in a democratic society.

Because of the complexity of the personal income tax code, there is a good chance of making an error in your return. You may overpay and waste money, or underpay and risk penalties. Many people believe that they need professional help in completing their tax forms. The complexity of the income tax returns has given rise to a large industry of lawyers and tax accountants, who advise on income tax matters, and tax preparers. The fact that many average US citizens retain tax-preparation services testifies to the fact that US tax laws and regulations are too complicated.

A Rash of Books on the New Tax Law Attests to Its Complexity

Since passage of the Tax Reform Act, a spate of books has been released, describing the new tax law. Under tax reform, the US tax system is a complicated Byzantine mess, just like the system that preceded it.

It may be argued that only those with unusual sources of income, or desiring to take full advantage of available deductions, must be aware of and refer to many of the tax regulations. The fact stands, however, that tax laws and regulations are viewed with consternation by so many US citizens that a large number retain professional tax preparers, even though there is nothing unusual about their income and they qualify for no special deductions. The complexity of the income tax is beyond the comprehension of many taxpayers.

A major flaw in the US income tax system is that the tax base is not simple in concept (such as sales or income); rather, it is an incredibly complicated base defined in terms of thousands of pages of IRS regulations. A tax base that is so complex leads to high administrative costs, favoritism, suspicion, distrust, and anger.

One of the factors leading to the complexity of the income tax is its progressivity. Under tax reform, there are five tax brackets. The tax is highly progressive, with rates jumping from zero to 15 percent to 28 percent to 33 percent as income increases. Progressive rate structures are themselves complicated. They are impossible to justify, and inevitably lead to "adjustments," such as itemized deductions and inflation adjustments. Special provisions are instituted, for example, in the case of income from capital gains from the sale of a home.

The income tax base is both elusive and ridiculous. When the personal income tax and business profit tax were initially established, at low rates, income was simply defined. As rates grew higher, however, the inequity of the income tax became apparent, and special deductions were introduced. While favoring some, these deductions invariably hurt others, so that more deductions or exceptions to deductions were added. Creative individuals were able to use this complexity of deductions to an advantage not anticipated or intended by the federal government, so additional rules and restrictions were added. As the complexity of the code grew, new inequities, disincentives, and irrationalities were revealed, leading to still more regulations. The inequities, irrationalities, ambiguities, and complexities led to court cases, with more rulings. The tax code grew like a cancer.

Under Current Law, the Tax Assessment Is Not Known for a Year

Under the previous and current (tax reform) systems, the individual does not know the magnitude of his tax liability until the end of each calendar year. In a number of cases, the individual finds that he owes a substantial amount and has difficulty paying. The IRS moves into action in such cases, threatening the individual with enforced collection, with fines for late payment, and a fine (\$500) for not estimating his tax liability sufficiently well.

With a simple business tax (such as a sales tax), the amount of the tax can be determined immediately, with certainty.

In many cases, because of the incredible complexity of the tax code, the individual may reasonably believe that he is not liable for taxes, and therefore may claim exemption from withholding. If the IRS later decides that he is liable for taxation, he may be fined \$500 or more for failure to withhold.

In an attempt to withhold at rates that will keep tax over- or under-withholding at low levels, the government has designed, this year, a new W-4 form, which is quite complicated. Strong objections to this form have been raised.

These difficulties would be eliminated if the personal income tax were abolished.

The Income Tax System Has Caused Citizen Resentment, Suspicion and Fear, and a Contempt for the Government

Because of the complexity of the tax code, many individuals make errors on their tax returns. In response to this, the IRS has established a billion-dollar investigation and audit service. This year, about two million US citizens will be audited -- cross-examined on their returns. The audit process creates an adversarial relationship between the US citizen and the government that need not exist. It is humiliating for a person's word to be questioned and for him to be forced to prove his innocence; that is one reason why the framers of the Constitution specified that a US citizen be considered innocent until proved guilty. Tragically, the IRS has succeeded in abrogating that right for tax cases.

Because of the absurd complexity of the tax code and the practical impossibility of taxpayers to know this code, however, there is a very high likelihood that errors will be found in your return. The US taxpayer has, in a sense, been "set up"; the tax system has been made so complex that he is doomed to failure. Ralph Nader's Tax Reform Research Group sent a sample tax return to 22 IRS offices for review -- every office calculated a different tax liability! Why should US citizens be put in the uncomfortable position of having to explain errors they made in attempting to comply with a tax system that has needlessly been created, and is so complicated that even the IRS cannot complete the forms correctly? The government has fabricated a ridiculous and unnecessary income tax game whose compulsory play accomplishes nothing but the needless alienation of large numbers of US citizens.

The IRS audit process is the principal means by which a US citizen will interact with a US Government official, and it is not a wholesome relationship. The audit process at best annoys, but at worst needlessly frightens and antagonizes US citizens. It is a destructive mechanism that serves no useful purpose. Taxes can be collected in ways that do not promote distrust and dislike

between the government and the citizens. A friend of mine was recently audited by the IRS. He had two telephones in his home: a personal phone and a business phone. He brought all of the telephone bills -- business and personal -- to the audit. By mistake, he had interchanged two of the bills, and recorded a business bill as a personal bill, and vice versa. My friend noticed this error in going through each of the bills with the auditor. Upon noticing this error, he immediately called it to the attention of the auditor, at which point the auditor arrogantly sneered, "How many other 'mistakes' like this are there in here!" He was clearly insinuating that my friend had deliberately attempted to cheat on his taxes. My friend does not cheat on his taxes.

Why Is the Income Tax So Complicated?

Why is the income tax so complicated? What is it about an income tax that causes the income tax system to become more complex each year? The principal factor underlying this characteristic of the income tax is that economists have been unable to agree on a definition of income. Some economists, in fact, argue that it is impossible to develop a practical, measurable definition of income.

It Is Not Possible to Measure Income

Many economists consider the income tax a desirable type of tax because use of it theoretically enables the government to tax on the basis of ability to pay. This viewpoint is adopted on the theory that a person's income is a good indicator of his ability to pay. That theory is accepted by many, but by no means all, economists.

To implement an income tax, it is necessary to have available an acceptable conceptual, or theoretical, definition of income and a practical means of measuring income relative to that definition. And there's the rub! While a consensus exists on a conceptual definition of income, it has proven totally impossible to achieve a consensus on a practical means of measuring income relative to that definition. Some economists claim that it is impossible to specify a practical, measurable, definition of income. Because of this difficulty, the goal of taxing on the basis of income is impossible to achieve. This impossibility has not, however, stopped the government from trying. Every year, the government decides that the definition used last year isn't quite right, and makes changes to the definition. Since no consensual measure of income exists, this process never ends. The tax code grows more and more complicated.

Many economists accept, as a general conceptual definition of income, the Davidson-Schanz-Haig-Simons (DSHS) concept of income (Joseph Pechman's book *Comprehensive Income Taxation* presents a detailed discussion of the definition of income). Haig's definition is that income is the increase, or "accretion" in one's power to satisfy his wants in a given period, insofar as that power consists of money or anything susceptible to valuation in terms of money. Alternatively, Simon's definition is that personal income is the sum of consumption plus change in net wealth. This definition of income has existed and been accepted for a long time (Davidson, 1889; Schanz, 1896; Haig, 1921; Simons, 1938) as a general conceptual statement. To date, however, a massive academic literature has been developed in an attempt to operationalize this theoretical definition; that is, to determine a rigorous conceptual definition, to obtain an objective measure of income relative to this definition, and to determine a practical means of collecting data to numerically evaluate the measure. One of the problems deals with taxation of income from

unrealized capital gains, the increase in value of an item that has not yet been sold. No method has been devised for dealing with this problem -- only realized capital gains are taxed.

The problems that arise in measuring income are several. Problems exist both with respect to measuring personal consumption and measuring net worth. With respect to consumption, it is not clear, for example, how to allocate the purchase of an automobile used partially for business and partially for pleasure to personal consumption versus a business expense. With respect to net worth, it is not possible to take into account all changes in the value of assets and liabilities because of price level and interest rate fluctuations. For example, it is difficult to assess the monetary value of capital assets until the asset is sold. Furthermore, even when the asset is sold, the gain may be more apparent (due to inflation) than real. The monetary (present) value of an income-yielding asset fluctuates as the current interest rate and expectations of future interest rates fluctuate.

The difficulty in measuring consumption prompted economist Henry C. Simons to admit that measurement of consumption presents as insuperable difficulties as a rigorous conceptual definition of personal income. Similarly, with respect to difficulties in measuring changes in net worth, economist Nicholas Kaldor asserted that the problem of defining individual income, quite apart from the problem of practical measurement, appears in principle insoluble (for additional discussion and citations, see Richard Goode, *The Individual Income Tax*).

In summary, economists are in disagreement on a rigorous definition of income. While some (for example, Simons) have asserted that income can be measured "well enough for tax purposes," others (for example, Kaldor) advocate the use of other types of tax (such as an expenditures tax) that avoid the measurement problem. The fact that, year after year, the government is unable to settle on a fixed definition of income is clear evidence that income *cannot* be defined well enough for tax purposes. The difficulty in measuring income was a primary factor leading to the complexity of the income tax law. These difficulties showed up in the wide array of depreciation schedules, income and loss averaging, and alternative methods for treating capital gains. The use of income as a basis for taxation is incompatible with the goal of simplicity. The failure of the past seven decades to develop an income tax that is both fair and simple pays testimony to this fact.

In view of the impossibility of defining and measuring income, it is reasonable to question to what extent the income tax reflects taxation on the basis of ability to pay, when economists cannot produce an acceptable definition of income and there is therefore no way of knowing how valid a measure of income the IRS definition of income is.

Some economists justify the terrible social and economic costs of the income tax on the basis that it enables taxation on the basis of ability to pay. In view of the inability of economists to produce a satisfactory operational definition of income and, moreover, in view of the inability of economists to produce a satisfactory operational definition of ability to pay, the belief that the individual income tax is a fair tax is difficult or impossible to justify.

The attempt to tax on the basis of a concept of ability to pay that is related to income has not proved practical. It leads to a tax base that cannot produce the revenue needed by today's economy at reasonable rates. In his book *The Economics of VAT*, Professor Richard W. Lindholm discusses the efforts of German economists to address the problem of defining income, earlier in this century. Some of the questions that must be resolved under a satisfactory definition of income include whether a beggar earns income, or whether there is a difference between a waiter's tip and a child's allowance. The German economists maintained that the return to capital or income required to maintain capital, including human capital, could not be considered income, under a

"preservation of source" principle. The problem that arises is that these considerations lead to the elimination of much of the income tax base, which is associated with preservation of human capital. These concepts basically eliminate income for tax purposes for the majority of US families. Elimination of a large portion of the tax base leads to a narrow base, and with today's large revenue requirements, to high taxes. The conclusion is reached that in an economy with large revenue requirements, it is not possible to have a tax system based on the income tax. The attempt to do so leads to high rates, budget deficits, or both, as is the case in the US today.

It is interesting to note that when the income tax was first introduced in the US, exemptions were so high that the tax in fact *did* allow for exclusion of almost all of a family's income -- and, in fact, *all* income for most families. As the US leaned more heavily on the income tax to provide large amounts of revenue, the point was reached where, on the one hand, the exemptions and deductions no longer exempted sufficient income to reasonably support a family, and, on the other hand, the tax base became too narrow to provide the needed revenue at reasonable rates. □ Because of the impossibility of defining income, the goal of developing a fair, simple tax based on income has eluded Congress, and it will continue to do so. Nevertheless, the quest continues. Economists delight in conducting research on how to measure income and how to tax on the basis of some abstract, ill-defined concepts of income and ability to pay. The problem is an academician's delight, because it has no solution.

The relentless, seven-decade attempt to develop a tax system based on taxation of income has produced nothing more than a system that is both complicated and unfair. A simple alternative, such as the use of a sales tax, has far less "publication" potential than discussion of a tax system based on an undefinable construct. In the interest of both simplicity and fairness, it is time to abandon the futile search for a fair and simple income tax. It simply doesn't exist.

Complexity Destroyed the Turnover Tax, and Will Destroy the Income Tax

The same sort of experience -- increasing complexity -- occurred with the turnover tax, which was used in Europe before its replacement by the VAT. A turnover tax is a tax imposed at several stages of production: manufacturing, wholesaling, and retailing levels. The problem that occurs with a turnover tax is that the tax "pyramids," or "cascades." Each time the item "turns over," the tax builds up. If a large number of stages is involved in the production and distribution of the product, the tax becomes intolerably high. Producers are motivated to absorb their suppliers. To avoid these incentives, governments attempt to introduce rate modifications. These modifications lead to other inequities, and further modifications. Eventually, the tax evolves to an inequitable administrative nightmare. For these reasons, the turnover tax has gone out of use.

What happened to the turnover tax is happening to the income tax: the income tax has evolved to a complicated, unfair tax. The only difference is that Congress has yet to throw in the towel on the income tax. Tax reform was promoted to try to clean it up. Unfortunately, tax reform did not scrap the income tax system and implement a new, improved tax system in its place. The cosmetic "fixes" of tax reform only delay the inevitable, and sentence the US public to a few more years under an unbearable system. It may not be possible to achieve complete equity with a simple tax system; recent US tax experience would indicate, however, that it is impossible to achieve equity with a complicated one.

The income tax system is now out of control. Today, no one knows what the tax base is. The definition of the base has switched from a simple definition to a definition not only in terms of a

myriad of rules and regulations, but in thousands of court cases as well, and in thousands of court cases yet to come. To know whether an item should be included in or excluded from taxation, it is necessary to review decades of Tax Court case rulings and anticipate future Tax Court rulings. The tax base is now defined in terms of legal precedence. The situation is similar to the contrast between the English Common Law and the Napoleonic Code approaches to law: one defined in terms of general rules, precedence, and judgment, the other defined in terms of specific rules. While the precedent-based English Common Law is a humane approach to law, it is a disastrous approach to defining the tax base. No one knows what the tax base is any more. It is a continually changing, amorphous, daedalian enigma.

While the subject of tax policy analysis may be somewhat arcane, the definition of the tax base need not and should not be. It does not have to be income -- a complex and impossible-to-measure concept. It can be as simple as sales, with no measurement problem whatever. Use of a complicated, essentially unknown, tax base leads to frustration, resentment, and anger on the part of the citizen, and subjects the government to ridicule and contempt. Several decades of experimentation with the income tax have proved it to be unworkable. It is time to give up on this intrusive system.

10. The Income Tax Is Economically Deficient

This chapter explains the many ways in which the income tax is deficient, from an economic viewpoint. These deficiencies do not arise simply because the US income tax is a poorly designed income tax. They arise because an income tax has intrinsic economic deficiencies. By its very nature, it causes economic distortions, inefficiencies, and undesirable incentives.

The economic inadequacy of the income tax has been appreciated for a long time. Many economic textbooks have been written describing the economic inadequacies of the income tax. The American economy and people pay a high economic cost because of the US Government's clinging to the income tax. The tax discourages saving, investment, productivity, creates an incentive for businesses to go into debt, subsidizes inefficient firms, and stifles economic growth (employment and production). The paragraphs that follow show how.

The Income Tax Discourages Saving and Investment

The business profit tax discourages saving and investment. The reason for this is that a very high tax is imposed on the return on investment -- approximately 43 percent for individuals (33 percent federal plus 10 percent state) and 50 percent for businesses (39 percent federal plus 10 percent state). Because of the high tax on investment returns, an investment must provide very high returns in order for it to be justifiable and desirable.

The personal income tax does not encourage saving. Consumption taxes do. A consumption tax is a tax on the sale of goods and services, such as a sales tax or a VAT. The consumption tax encourages saving because no tax is imposed on saving; it is imposed on spending. The tax encourages saving because the less the consumer spends, the lower his tax. With the income tax, the only way he can cut his tax bill is by reducing his earnings.

Many other countries (in particular, Japan) have much higher savings rates than the US. A low savings rate means that little money is available for investment; this contributes to economic stagnation. An income tax discourages saving, by placing a heavy tax on the return to investment. We can ill afford a tax system that discourages saving. Consumption taxes such as the VAT, on the other hand, encourage saving. If you spend less, your taxes are less. The structure of the tax creates a definite incentive to save.

Under tax reform, interest paid on home mortgages is tax deductible, but interest on other types of consumer loans is not. This means that home mortgage loans are, in effect, much cheaper than other types of loans -- half as expensive, for a person whose marginal tax rate is 50 percent. Already, before a year has passed under tax reform, bankers are predicting a massive increase in the amount of "home equity" loans, from \$25 billion in 1985 and \$35 billion in 1986 to perhaps \$100 billion eventually, out of a total second-mortgage market of approximately \$200 billion. The availability of government-subsidized credit represents a disincentive to save and an incentive for families to go deeper in debt. Moreover, this trend makes it less likely that many Americans will ever own their homes. The economic incentives of an income tax structure may seem academic or insignificant, but they can cause massive economic distortions.

In Japan, the gross private saving rate is about 30 percent of GDP, and personal saving is about 20 percent of disposable personal income. In the US, the gross private saving rate is about 17

percent of GDP, and the personal saving rate is about 5 percent of disposable personal income (1985 data). The saving rate in the US is, in fact, one of the lowest of the industrialized nations. With inadequate saving, investment is crippled, and the US dooms itself to a second rate position in the world economic community.

Gross private saving includes personal saving, undistributed corporate profits, and capital consumption allowances (depreciation). Gross saving is gross private saving plus government surplus or less the government deficit. Annual US Government deficits are now massive: 5 percent of GDP for the past several years. If we subtract the government deficit from gross private saving, US gross saving is seen to be about 12 percent of GDP.

By promoting a tax system that cannot produce the needed revenue, the US Government cripples the US saving effort in two ways -- it introduces tax incentives that discourage private saving, and it creates massive deficits that reduce the country's saving rate even more. If, for example, the 5 percent government deficit were a 5 percent surplus, the US gross saving rate would be 22 percent of GDP instead of 12 percent.

The US Government, through its adoption of an insane tax system, is selling the country short. It is thwarting the efforts of responsible US businessmen and private citizens to prepare for tomorrow by saving, exposing US citizens to a future of penury, and dooming the US to a position as a second-class citizen in the world economy of nations.

Through its large deficits, the federal government is placing a millstone around the neck of responsible citizens who do save. It irresponsibly jeopardizes our future, while prudent citizens attempt to prepare for it. Worse, its fiscally irresponsible policies are depleting the private credit market; these policies threaten to kill US economic growth, and have the potential to cause both a national and worldwide economic collapse.

As a direct result of the inadequate income tax system and the resulting massive US Government deficits, the US finally reached the point where the nation's debt exceeded the capacity of the US domestic credit sources. In 1985, we became a debtor nation; counting both public and private debt, we owed more to foreign nations than they did to us. As one of the world's wealthiest nations, this is a morally bankrupt position. The world's developing nations depend upon the wealthy nations for capital. As a debtor nation, the US is using capital that is desperately needed by poorer nations. Through its irresponsible tax policy, the US Government is squandering not only our own economic potential, but that of developing nations as well.

The federal government is acting like an immature couple with a new credit card. Faced with a choice between increasing income and reducing spending to balance the budget, the government has chosen to do neither. It has refused to cut programs; it stubbornly refuses to abandon a defunct tax system that not only cannot produce the needed public revenue, but discourages private saving as well. This crazy tax policy could not continue forever. The day of reckoning has arrived; the nation is now bankrupt; it is time to face reality and discard the income tax system.

The Income Tax Discourages Productivity

As our society becomes more productive because of the industrial revolution, a larger and larger proportion of the population may engage in activities that are not directly related to the basic "sustenance-related" tasks of providing food and shelter. As noted earlier, we currently waste

approximately \$35 billion per year in unnecessary personal income tax collection and avoidance activities. We currently spend over \$200 billion in national defense.

The more productive we become, the more we can channel into nonsustenance activities. An issue that needs to be addressed is do we really want to spend our "discretionary" productive resources on activities such as income tax avoidance, rather than on more pleasurable activities such as earlier retirement, travel, or construction of homes.

Many of the 85,000 IRS workers are performing nonproductive activities -- activities that are totally unnecessary, since the income tax is unnecessary. The government has decided to waste their labor in playing an elaborate tax game whose rules are the tax code. Do US citizens really want to spend their discretionary economic productive capacity in this way? Why not use their \$3 billion in wages to repair roads, bridges, and dams; to renovate cities, reduce pollution, and clean up rivers; to repair roofs and mow lawns; to provide some free health care services to the elderly; or maybe even to fund free vacations on a lottery basis? Do we really want to support an agency of 85,000 to monitor our personal activities?

One of the greatest wastes associated with the complexity of the income tax system is the tremendous waste of skilled accounting and legal personnel in the business of tax advice, analysis, and return preparation. The demand for these skills is created by the labyrinthine tax system, which requires a massive amount of effort to learn. Since the income tax system is completely unnecessary, all of this skilled labor is wasted. This contributes to a great loss in productivity. These resources could be used productively in accounting oriented toward real business decisions and operations, instead of wasted on analysis of a fantastic, synthesized tax system.

The Income Tax Encourages Debt Financing

Under current tax law, interest charges are tax deductible to a business. For this reason, there is an incentive to make loans to acquire capital equipment (such as issue bonds), rather than to use equity financing (float stock issues).

This incentive is not a good one. It raises the rate of return needed to justify an investment. If interest rates are high, the return needed to justify an investment may be so high as to cause the elimination of many investments, and the rate of investment may decline. By creating an incentive to borrow, it tends to drive interest rates up. The increased use of debt financing by firms raises the risk of bankruptcy. This perverse incentive serves to introduce an unnecessary source of instability in business. It is an example of how tax laws distort economic decisions. Such distortions reduce the economic efficiency of the allocation of resources.

The Business Profit Tax Subsidizes Inefficient Firms

By its very nature, the business profit tax is a tax that falls more heavily on firms that, by reason of their efficiency, show a profit. Firms that show no profit pay no tax. Firms that show a loss may carry the loss forward to future years in which they show a profit.

The net effect of the business profit tax is that firms that are profitable are penalized, and firms that are not profitable are subsidized. In general, profitable firms are employing resources more

efficiently; that skill should be rewarded, not penalized. The business profit tax subsidizes inefficiency over efficiency. It is undesirable from an economic point of view.

Use of the Income Tax Places the US at a Disadvantage in International Trade

Countries that use the VAT have an advantage over the US, with respect to international trade. As discussed earlier, under the GATT a country that uses a VAT may subsidize its exports by the amount of the VAT, and may impose a border tax on imports also equal to the VAT rate. The US does not use a VAT, and cannot impose such subsidies and penalties under the GATT. The income tax does not qualify for preferential treatment under the GATT; US firms cannot subsidize exports by the amount of the income tax. To the extent that income taxes raise prices, US firms are placed at a competitive disadvantage in international trade.

Almost 40 countries have adopted the VAT. It is not only a tax method that can generate massive resources at low rates, but it offers significant advantages in international trade. As more and more countries turn to the VAT, the US will find itself at a greater and greater disadvantage.

The US Income Tax Distorts the Economy

Under the income tax, firms receive a tax deduction each year for the wear and tear on capital assets, buildings and equipment. This tax deduction is computed as a depreciation allowance that represents the "using up," or consumption, of the capital. If the depreciation allowance in a year bore a close relationship to the reduction in value of the asset during that year, the depreciation of capital assets would not cause serious economic problems. It would be simply a needless burden on firms and a waste of the firm's accounting resources.

A problem that arises with depreciation of assets is that, under US tax law, firms are allowed to depreciate assets at rates that are significantly higher than the actual consumption of the capital. This depreciation method, enacted in 1981 and maintained with little change under the Tax Reform Act of 1986, is called the Accelerated Cost Recovery System (ACRS). It enables "fast write-offs" of business assets. The economic problem that accelerated depreciation of capital causes is that it places capital-intensive industries at an advantage relative to labor-intensive industries. Capital-intensive industries receive, in effect, a tax subsidy through the preferential manner in which capital consumption is treated.

This situation represents an incentive for people to invest in capital-intensive industries. Whenever a government, through its tax laws, creates incentives for consumers to alter their preferences, economic inefficiencies result. The efficient allocation of economic resources, in response to consumer preferences, is perturbed. The result is that society obtains a lower return in terms of consumer satisfaction on its investment of economic resources than would otherwise be the case. The tax law has introduced a distortion in the economy. The government, through its tax policy, has interfered with the efficient allocation of society's economic resources, thereby reducing the benefit realized by society from the use of its resources.

Note that the economic distortion caused by the preferential tax treatment of capital in the US derives from the conscious and substantial effort to extend tax advantages to capital consumption. The magnitude of distortion caused by this preferential treatment of capital would be less if depreciation were closely linked to fair estimates of useful lifetimes, without accelerated

depreciation rates. In other words, an income tax does not have to distort the allocation of economic resources as much as it does in the US. There will always be some distortion, however, because of the impossibility of estimating the actual decline in value of all of a company's assets in a particular year.

Because of the tax preferences that invariably exist with an income tax, the income tax is in general not neutral with respect to tax preferential treatment of capital versus labor. The US income tax system makes no attempt to achieve neutrality. It strongly favors capital-intensive industries, and distorts the economy because of this preferential treatment.

The preferential treatment of capital assets points out a key defect of the income tax. Its mind-boggling complexity camouflages the undesirable effects of the tax. Special-interest groups can work to incorporate rules and regulations (such as accelerated depreciation) that may appear to be nothing more than arbitrary, mindless complications, when in fact they have serious deleterious effects on the economy.

The US does not have to put up with a seriously distortive tax system. A single-rate, universally applied VAT, for example, is economically neutral. It contains no incentive to change the mix of capital and labor from that that would exist in the absence of the tax.

The income tax distorts the economy in other ways. Because profits are taxed, the income tax penalizes efficient, profit-making firms and subsidizes inefficient firms. Because of the double taxation of dividends, it discriminates against the corporate form of business. Because fringe benefits are untaxed, it provides an incentive to reimburse employees through fringe benefit payments-in-kind. A VAT, on the other hand, contains no incentives regarding business structure, and taxes fringe benefits in the same manner as labor costs and other factors of production. The VAT encourages efficiency, since a firm that reduces the costs of its inputs pays a lower tax.

The preceding discussion has centered on the business income tax. The personal income tax also contains tax shelters that distort the economy. For example, individuals may deduct the interest cost of up to two homes. This preferential treatment of housing benefits the US construction industry, at the expense of the taxpayer. The US citizen would be better off overall if the government did not distort the economy by introducing tax preferences that favor certain special-interest groups.

The Personal Income Tax and the Corporation Income Tax Are Not Well Integrated

One of the complaints that is voiced about the personal income tax and the business profit tax system is the fact that it forces double taxation, in the form of a heavy tax burden on dividend earnings. As was briefly mentioned in Chapter 8, this happens as follows. A business pays a tax on its profit, and then pays a dividend to the owner or a stockholder. The owner or stockholder then pays a personal income tax on the dividend income. Let's say that the total marginal tax rate is up to 49 percent (39 percent federal, 10 percent state) on the business and 43 percent (33 percent federal, 10 percent state) on the individual -- a combined tax rate of $1 - (1-.49)(1-.43) = 71$ percent. Economists generally believe that the tax on dividends falls on the stockholders. In this case, the corporate profit tax is an additional burden on the dividend earnings that is not imposed on other types of earnings. Before tax reform, the double-tax rate was $1 - (1-.46-.1)(1-.5-.1) = 82$ percent. Under tax reform, the level of double taxation, that is, the additional burden on dividends, has not changed significantly.

What's wrong with double taxation? From the viewpoints of economic impact and equity, there is plenty wrong. From an equity viewpoint, the double tax is a very heavy tax imposed on the earnings of individuals who depend on stock dividends for their earnings, for example, a retired person. The additional tax burden associated with double taxation is actually heaviest for those in the lowest income classes. For example, a person in the zero-rate income-tax bracket suffers an additional tax burden of 49 percent -- the tax on the business profit (39 percent federal and 10 percent state). A person in the 43 percent tax bracket (33 percent federal, 10 percent state), however, suffers an additional tax burden of only $(1-.43)(.49) = 28$ percent. The burden is reduced because he would in any event pay a 43 percent tax on the earnings. With the addition of the corporation profit tax, the tax burden is 49 percent and 43 percent, or $1 - (1-.49)(1-.43) = 71$ percent. The additional tax burden caused by the corporation profit tax is 71 percent - 43 percent = 28 percent. In other words, a retired person living on dividend income realizes a heavier additional tax burden from the double taxation of the personal income tax and the business profit tax than the high income earner in the highest tax bracket (49 percent versus 28 percent additional burden).

From an economic-impact viewpoint, the double tax represents a very heavy tax on the earnings of an investment; the practice hence discourages investment. In addition, it illogically discourages investment in corporations, rather than unincorporated business structures that are not subject to double taxation. What is the purpose of this deliberate economic distortion?

The personal income tax and the business profit tax are not well integrated; just one more example of America's hodge-podge tax system. They work together to impose a heavy tax burden on low-income earners who are dependent on dividend earnings, and represent a disincentive to invest (because the earnings from the investment are so heavily taxed). The additional tax burden represented by the combination of the personal income tax and the business profit tax is much greater for low-income earners than for high-income earners.

11. The Income Tax Is Too Costly

The Administrative Cost of Collecting the Personal Income Tax is High

The cost of collecting income tax from over 90 million individuals is staggering. The total cost includes the cost of return preparation, the cost of tax advice and preparation services, the cost of maintaining tax-related records, and the cost of the IRS to collect, process, and audit tax returns and prosecute income tax cases.

The personal income tax is a very costly tax, both in terms of the cost to the government in collecting the tax and the cost to citizens in complying with the tax. These two types of cost are referred to as the administrative cost and the compliance cost.

The administrative cost of the tax includes the cost of processing tax returns and making audits. The compliance cost includes the direct cost of tax lawyers, tax accountants, and tax-preparation services. The indirect cost of compliance includes all of the effort that is expended by the individual in preparing his return.

The US income tax is sometimes touted as a low-cost tax, by citing the fact that the cost of administering the tax is only one half of one percent of the tax collected. This figure is, however, grossly misleading. First, since the income tax is the country's primary source of tax revenue, .5 percent of the total income tax is a very large amount. Second, the administrative cost of the income tax is a small portion of the total cost of the tax; the compliance cost of the US income tax is extremely high.

The IRS budget is approximately \$3 billion per year, with much of this amount going toward the collection of personal income tax -- the printing and distribution of millions of tax return forms, instructions and pamphlets, the cost of processing the returns, the cost of auditing selected returns, and tax court costs. If the tax revenue that is collected as income tax were collected in other ways (for example, as a VAT tax on business), much of this cost could be eliminated.

The use of a personal income tax imposes a heavy administrative burden of monitoring the incomes of the population. In order for a near-universal income tax to be feasible, a high level of compliance and effective administration are required. The personal income tax is not widely used in countries where compliance is not high and administration is not effective. Compliance was high in the US when rates were low, but sentiment against the income tax has increased considerably in recent times, as rates have moved to high levels for a large portion of the population.

The Cost of Compliance With the Personal Income Tax Is Very High

The tax collection cost is, however, just part of the cost associated with the personal income tax. From an economic point of view, all of the labor associated with preparation of the returns is an economic cost of collecting the tax.

Many people do not feel capable of completing the tax forms themselves. The imposition of a personal income tax has given rise to an entire industry of tax accountants, tax lawyers, and

preparers. All of the time that these organizations spend on tax analysis, advice, and return preparation is an economic cost of the personal income tax. The direct cost of professional assistance (lawyers and accountants) has been estimated by various sources to be about \$3 billion per year. While people seek professional help for a variety of reasons -- medicine, accounting, architecture, employment search -- the need for tax preparation assistance for individuals is a need that is totally unnecessary. It is a synthetic need that derives solely from the government's imposition of an unnecessary and complicated form of taxation on individuals.

The cost of lawyers, accountants, and tax preparers is, however, just part of the tax compliance cost. From an economic viewpoint, the total compliance cost of the income tax includes the dollar value of the time that the individual taxpayer spends in analyzing tax matters, assembling information, and filling out tax forms. The estimates of this cost vary considerably, from about \$10 billion to \$35 billion, depending on the assumptions that are made. (Detailed, comprehensive sample survey data are not available on compliance cost.)

For example, suppose that it is assumed that it takes 100 million filers approximately six hours each to prepare their returns. Assuming an average labor cost of \$8.00 per hour, this totals \$5 billion of wasted productivity per year. This amount is a very conservative estimate of the cost of tax compliance. If the cost of collecting tax-related data (that is, saving receipts throughout the year, determining mortgage interest amounts, reading tax-form instructions, reading tax articles and books, researching tax law) is included, the total economic cost of income tax compliance is many times greater than the return-completion cost. A total compliance-cost estimate of \$35 billion (corresponding to a loss of 42 hours, or approximately a week of time, during the year) is not unreasonable. □ In addition to the preceding compliance cost, US businesses expend considerable resources on accounting activities related to collection of the personal income tax.

The Income Tax System Causes the Waste of Much Productive Effort in Tax Avoidance

Much of the cost of tax compliance is associated with time spent in tax avoidance. Tax avoidance is the (perfectly legal) practice of structuring one's income to minimize tax payments. Because income tax rates are so high, there is a strong incentive to engage in tax avoidance. Because of the tremendous complexity of income tax law, however, the practice of tax avoidance requires the investment of substantial time and resources. This investment not only includes the time of the individual taxpayer, but the productive effort of tax lawyers, tax accountants, and tax preparers. Their effort, wasted in the practice of tax avoidance for an unnecessarily complicated tax, could be used to increase the productivity of the US economy. The lost productivity caused by the income tax system's high incentives for tax avoidance is massive. All of this economic productivity is wasted, since it is unnecessary, and could be better spent.

Many US citizens do not want to bother with the hassle of having to keep track of all of their bills and receipts, as is required to comply with our perverted tax system. They resent this imposition. They may sense that this is somehow unnecessary, that the income tax is a silly, hassling way to collect tax revenue.

The Income Tax System Causes the Waste of Productive Skills

The incentive for tax avoidance is costly from two points of view. First, it wastes the individual's time and money. Second, it deprives society of the product of the labor of educated, skilled workers. Tax attorneys and accountants are college-trained individuals, many of whom have post-college training (such as Certified Public Accountant certification). In recent years, the growth in productivity in the US has tapered off to the point where we are now in an unfavorable position relative to other nations. In some areas (for example, protection of the environment, concern for workers' health) the benefits of decreased productivity due to government regulations are desirable and real, and the costs are justified.

In the case of the income tax, however, the effort invested in tax avoidance is totally wasted -- millions of hours of skilled labor poured down the drain in the analysis and interpretation of a complicated, arbitrary, totally unnecessary set of rules. The US cannot afford to waste the talent and time of its educated citizens. This skilled labor can be put to much better use, either in support of a humane tax such as the VAT or applied directly to non-tax-related economic production.

For many types of taxes, the number of tax collection points (taxpayers) is small (for example, natural resource severance taxes) or the tax is sufficiently simple (such as a sales tax), that its collection is relatively easy, inexpensive, and unintrusive. This is not the case for the personal income tax. It requires a massive investment of time and resources on the part of the taxed individuals, and on the part of the government. It is a costly, inefficient form of taxation.

The Inevitable Leakage in Wage or Income Taxes Drives Collection Costs Sky High, Creates Citizen Resentment, and Narrows the Tax Base

One of the worst features of an income tax system is that it is extremely costly to develop a system that ensures that all individuals pay their intended share of the tax. As we have seen with the tax system before tax reform, it is easy enough to tax individuals who work for companies, but self-employed individuals such as physicians, consultants, house painters, and waitresses can easily avoid being taxed on at least some of their income. Moreover, the marginal tax rates are high, creating a strong incentive to do so.

In the guise of being "fair," the government expends considerable funds in setting up systems to attempt to reduce this problem. Without assuming total control of employment, the government cannot hope to eliminate this problem. The resentment and leakage in the current system have demonstrated unequivocally that, with a budget of \$3 billion and a work force of 85,000 employees, the IRS has failed completely in eliminating leakage, and has succeeded, instead, in instilling anger and resentment in the US population toward its government.

The problem of attempting to tax the income of 100 million individuals in an equitable fashion, given the diversity of our economy and the private ownership of the means of production, is impossible. The attempt to do so incurs astronomical costs, instills suspicion on the part of the population, and results in failure. Experience has shown that the income tax simply cannot be implemented fairly -- or at reasonable social or economic cost -- in a free-enterprise economy.

There are 15 million businesses versus 100 million individual taxpayers. Extracting the federal tax revenue from 15 million points in the economy is much simpler than extracting revenue from 100 million points. It is much easier to monitor businesses than individuals. Intrusion of privacy is not the issue for business that it is for individuals.

A major problem with the current tax system is that, because it is so burdensome, and because to date it has not been practicable to enforce total compliance on 100 million citizens, a large portion of the taxpayers successfully evades taxes. The IRS has estimated that, in 1986, the tax gap (the difference between what taxpayers should pay and what they do pay) is \$103 billion, compared to \$39 billion ten years ago.

The success of the underground economy has narrowed an already-narrow tax base to the point where the rates are very high, and yet the revenue is still not sufficient to cover the national budget without deficits.

In summary, the income tax is an extremely costly, inefficient tax. This chapter has identified some of the costs of the income tax and estimated their magnitude. The estimates presented here are very conservative. Other writers present even higher estimates. For example, in their book *The Flat Tax*, Hall and Rabushka present the following estimates: lost output associated with tax-advantaged investments -- \$100 billion; compliance cost (filing and buying expert advice) -- \$35 billion; tax evasion -- \$120 billion. Comparing this cost -- \$255 billion -- to the total income tax revenue (\$350 billion in 1984), the income tax system is seen to be an extremely costly and inefficient means of taxation.

Given the reaction of taxpayers to the system, and the inability of the IRS to halt the growth of the underground economy, it is time to consider an alternative tax system. The motivation of the Tax Reform Act was the assumption that taxpayer dissatisfaction derives mainly from the inequity of the previous income tax system. That assumption is wrong. Taxpayers are responding more to an intolerable burden than to envy caused by tax shelters. The leakage will continue; the tax gap will persist. These are symptoms of an inhumane income tax system. They will not disappear until that system is dismantled and replaced by a humane one.

12. The Income Tax Is Contributing to Economic Collapse

The US income tax system is contributing to an economic collapse both in the US and worldwide, in two ways. First, the system cannot produce the level of revenue needed to cover the government budget, and massive budget deficits have resulted. Second, the system has not prevented the development of extreme concentrations of wealth.

Both of these conditions threaten to result in economic collapse. Massive US government debt results either in massive borrowing by the government or in the printing of large amounts of money. The result is either very high interest rates, or inflation rates, or both. Either of these conditions is not conducive to economic stability and growth.

Extreme concentrations of wealth are considered to contribute to economic depressions for two main reasons. First, there is high demand for loans by the large nonwealthy portion of the population; because of the extreme concentration of wealth, these many borrowers do not have substantial assets and the loans tend to be risky. Second, wealth concentrations lead to speculation and risky investments by the very wealthy. Extreme concentrations of wealth hence contribute to unstable economic conditions. The natural economic fluctuations (expansions and contractions) of a free-enterprise capitalist economy are amplified, heightening the likelihood of extreme economic booms and depressions.

This chapter discusses the ways in which the US income tax system is contributing to an economic collapse.

The Income Tax Causes Government Budget Deficits

The US income tax system causes budget deficits in two ways. First, the tax cannot produce the level resources needed by a modern economy. The income tax base is so narrow that Congress is reluctant to impose the high tax rates that would be required to produce the desired level of revenue. Second, the system causes deficits because it produces volatile (highly fluctuating) levels of revenue from year to year. A government deficit in a few recession years is not cause for concern. The important thing is that government deficits be covered when economic conditions improve. If, over the course of the business cycle of economic expansions and contractions, the government uses surpluses in boom years to offset deficits in recession years, no serious economic problems arise because of the government debt. Under the inadequate US income tax system, however, the government debt is not being retired in good economic times. In fact, even in boom years, massive deficits are being run up! The national debt is steadily increasing, even in the good years of the business cycle.

The Income Tax Base Is Too Narrow

The US Government adopted the business profit tax in 1909 and the personal income tax in 1913. When it adopted these taxes, the rates were very low -- one percent on profits and not over one percent for most individuals. The government chose the personal income tax as an alternative to higher or varied indirect business taxes (such as a national retail sales tax) in an attempt to promote social equity through the redistribution of income. When introduced in 1909 and 1913, the personal income tax and the corporation income tax were comparable in burden to other taxes.

During the first half of this century, the demand for tax revenue grew dramatically, especially as the result of World War II. Because the bases for these taxes are narrow, however, they cannot produce the massive revenue now needed, at low rates. As the need for revenue grew, the business- and personal-income-tax rates grew to very high levels. The tax burden in the US is approximately one third of GDP, and most of the revenue comes from the personal income tax, the business profit tax, and the payroll tax. The personal-income-tax and business-profit-tax rates are now (even under tax reform) very high.

The government has not faced up to the issue that the personal-income-tax and business-profit-tax bases are too narrow to provide the revenue it requires at reasonable rates. Instead of dropping these taxes in favor of a tax with a wide economic base and low rates (such as the VAT), it has, under tax reform, simply eliminated some deductions and tax brackets. Tax reform did not address the fundamental issue that the income tax base is simply too narrow to provide the needed revenue at reasonable tax rates. The government passed the Tax Reform Act of 1986 in the face of mounting opposition to high income tax rates. It has not solved the problem; income tax rates are still high. The Tax Reform Act is a sham; it pretends to be a solution to the income tax problem, but it is not. The reform that is needed is to scrap the personal income tax and the business profit tax. They are too narrow for today's needs.

To understand the nature of the problem of a narrow tax base, it is helpful to know something about national income accounting. Table 1 shows a breakdown of the GNP into its major components. The GNP is simply the total value of all goods and services produced in the US in a given year. Total GNP for 1983 was \$3,305 billion. The tax base for the personal income tax in that year was only \$1,300 billion, or 39 percent of GNP. For corporate taxes, the tax base (corporate profit) was only \$219 billion, or seven percent of GNP. Together, these two tax bases total \$1,519 billion, or less than half of GNP. These bases comprise too small a part of GNP to produce needed government revenue at reasonable rates. On the other hand, the potential VAT tax base is approximately total national income -- \$2,647 billion, or 80 percent of GNP. This income base is much larger, and can produce the desired revenue at much lower rates.

Table 1. Relationship of Gross National Product, National Income, and Personal Income, 1983

	<i>Item</i>	<i>Billions of Dollars</i>	<i>Percent</i>
	Gross National Product	3,304.8	100.0
Less:	Capital Consumption Allowance	377.1	11.4
Equals:	Net National Product	2,927.7	88.6
Plus:	Subsidies	15.6	.5
Less:	Indirect business tax and nontax liability	280.4	8.5
Equals:	National Income	2,646.7	80.1a
Less:	Corporate profits	225.2	6.8b
	Net interest	256.6	7.8
	Contributions for social insurance	272.2	8.2
Plus:	Government transfer payments to persons	389.3	11.8
	Personal interest income	376.3	11.4
	Personal dividend income	70.3	2.1
	Business transfers	15.6	.5
Equals:	Personal Income	2,744.2	83.0

Less:	Personal tax and nontax payments	404.2	12.2
Equals:	Disposable personal income	2,340.1	70.8c
Less:	Personal outlays	2,222.0	67.2
Equals:	Personal saving	118.1	3.6

Source: US Bureau of the Census, *Statistical Abstract of the United States: 1985 (105th edition)*, Table No. 717, p. 433, US Government Printing Office, Washington, DC, 1984.

a. The VAT tax base is National Income, which is 80 percent of GNP.

b. The corporate income tax base (that is, corporate taxable income) is \$219 billion, which is 7 percent of GNP (Source: Statistics of Income, 1983, Corporation Income Tax Returns, Department of the Treasury, IRS, Statistics of Income Division, Publication 16 [Rev. 8-86], p. 2, US Government Printing Office, Washington, DC, 1986).

c. The personal income tax base (that is, taxable income less zero-bracket amount) is \$1,300 billion, which is 39 percent of GNP (Source: Individual Income Tax Returns, 1983: Tables Emphasizing Returns Filed, Sources of Income, Exemptions, Itemized Deductions, and Tax Computations, Statistics of Income Division, IRS, Publication 1304 [Rev. 4-86], Table A, US Government Printing Office, Washington, DC, November 1985).

Both the Personal Income Tax and the Business Profit Tax Have Small Tax Bases

As can be seen from Table 1, both the corporate-profit-tax and the personal-income-tax base are relatively small proportions of the total national production, as measured by GNP. If the US Government revenue requirements were small, the needed revenue could be raised using these tax bases. Since the US revenue requirements are so large, however, it is necessary to use a larger tax base in order to keep tax rates low. An alternative that uses a large proportion of GNP as a tax base is the VAT. With a VAT, the tax base is sufficiently broad that the needed revenue can be produced at low tax rates.

Imposing heavier taxes on the personal-income-tax base and the corporate-profit-tax base is not practical. A basic motivation for the Tax Reform Act of 1986 was the fact that the taxes on those bases were already so high that people were voicing strong objections. The Tax Reform Act accomplished little more than a shuffling of this heavy tax burden over the taxable income base. The US population already objects to the current high levels of the personal income tax and the business profit tax, and will not accept a heavier income tax burden.

Under tax reform, the relative size of the tax bases for the personal income tax and the business profit tax are not expected to change very much. The reason for this is that the major effect of the Tax Reform Act is to eliminate tax shelters for a relatively small proportion of the population.

The Volatility of the Business Profit Tax Base Contributes to Government Budget Deficits

Another problem with the business-profit-tax base is that it is so volatile that the revenues provided from it are unstable, that is, they fluctuate widely from year to year. Total national corporate profits can fluctuate 20 percent a year. Unstable tax revenues make government budget planning difficult, and contribute to a growing national deficit because tax revenue surpluses in boom years are generally not used to reduce deficits in recession years. The temptation to reduce taxes or expand spending programs has proved irresistible.

Because of the progressivity of the personal income tax and the business income tax, the revenue from these taxes is unstable. Fluctuations in the business cycle are amplified in tax revenues, under the current system. Furthermore, the success of the "built-in flexibility" feature of the income tax (that is, the reduction in taxes when business activity is in recession) in moderating recessions has been questioned (see, for example, Lindholm's book *A New Federal Tax System*).

The massive deficits that the US Government has been piling up will continue until it scraps the current inadequate tax system and adopts one that can produce the needed revenue. The massive US deficit has the potential not only to destroy the US economy, but also to trigger a world economic collapse. Congress has been "fiddling while Rome burns," relative to the issue of the US Government deficit. Its impotence on this matter is a planetary disgrace; the danger that this represents to all nations is an outrage. The time for a new tax system is long past. A means must be found for prodding Congress to responsible action on this critical matter.

The Income Tax Contributes to Extreme Concentrations of Wealth

One of the objectives of a tax system in a democratic system is to prevent extreme concentrations of wealth. Extreme concentrations of wealth are considered undesirable for several reasons. The wide disparity in wealth causes envy in the nonwealthy, contributing to social unrest and instability. Private concentrations of wealth provide considerable power to the wealthy; this power may threaten the personal security of the nonwealthy. Finally, concentrations of wealth are considered to contribute to recessions, and extreme concentrations may contribute to severe economic depressions.

The US tax system is not effective in reducing concentrations of wealth. In the US, taxes are imposed primarily on income, not on wealth. Even though income taxes are high, they have not prevented massive accumulations of wealth. This situation is due partly to the fact that in recent years US tax laws have greatly favored the wealthy. A second factor is that US inheritance taxes are not high and have little effect in preventing an intergenerational transfer of wealth.

Dr. Ravi Batra discusses the relationship between concentrations of wealth and depressions in his book, *The Great Depression of 1990*. He draws many parallels between economic conditions in the 1920s (just before the Great Depression of the 1930s) and the 1980s. Based on the similarities, he predicted a stock market crash in 1989 followed by a great depression starting in 1990 and lasting for at least seven years. It is interesting to note that in October 1987, the stock market indeed crashed.

Dr. Batra promotes the opinion, shared by many economists, that an uneven distribution of income contributes to recessions; further, he asserts that extreme concentrations of wealth cause great depressions. He notes that in 1929 (the year of the Great Crash of the stock market) and in 1986, the richest one percent of the population owned more than one third of all of the wealth. (The richest one percent in the US generally possess on the order of one fourth of the wealth.)

As mentioned at the beginning of this chapter, extreme concentrations of wealth are considered to contribute to depressions basically for two reasons. First, because of wealth concentrations a large proportion of the population has few or no assets. This means that a large proportion of bank loans are risky. Second, the extremely wealthy tend to make speculative or risky investments. The result is an unstable economic situation.

The US economic system is a capitalist, free-enterprise system. A capitalist system is one that allows private ownership of the means of production. A free-enterprise system is one in which businessmen are free to maximize their profits. In a capitalist, free-enterprise system, economic fluctuations are natural and inevitable; economic conditions continually change in an unending sequence of recessions and booms. The random fluctuations of the business cycle occur because of the many uncontrolled actions of the large number of individuals and firms in the economy. Although government actions do not eliminate these fluctuations, it appears that government actions can dampen or amplify their magnitudes. Batra asserts that if the government were to take steps to reduce the massive budget deficit and decrease the concentration of wealth, the severity of the next economic contraction could be lessened.

The US tax system is contributing to massive, persistent government deficits, and is enabling the extreme concentration of wealth. These conditions can result in an economic collapse. The US income tax system *must* be replaced!

13. How to Design a New Tax System

This chapter describes a methodology for developing a modern, adequate tax system. The "tax engineering" methodology presented here represents the application of the disciplines of systems analysis and systems engineering to the problem of analyzing, designing, and implementing a new tax system.

Before describing the recommended methodology for designing a new tax system, the chapter begins with a discussion of the goals of tax policy analysis and the legislative process currently used to develop the US tax system.

Tax Policy Goals

Tax systems are the result of an evolutionary process, in which the specification of the tax sources and rates evolves in response to changes in the governmental, economic, and social environment. Changes in the tax system may be minor or substantive. For many years, minor changes may be made in a basic tax system -- rules and regulations are introduced, modified, or eliminated. At some point, however, the social or economic environment will have changed so much that the basic structure of the system may no longer be appropriate, and a major change may be legislated.

Such major changes occurred in the US at the time of the Revolution, the Civil War (temporary income tax), 1909 (corporate income tax), 1913 (personal income tax), and the Great Depression of the 1930s (states move to retail sales tax). Since World War II, there have been about two dozen major tax bills, including three "Tax Reform Acts": the Tax Reform Act of 1969, the Tax Reform Act of 1976, and the Tax Reform Act of 1986. None of the tax law changes since World War II have been substantive, fundamental changes in the tax system. The most recent legislation, the Tax Reform Act of 1986, does not represent a major structural change in our tax system; it is simply a large number of modifications (changes in deductions) to the personal-income- and business-profit-tax system introduced early in this century.

When tax legislation is considered, the opportunity arises to analyze the current system and to develop alternative systems that are better suited to the economic, political, and social environment. The process of developing a new tax system involves the synthesis of alternative systems, the analysis of those alternatives, and the selection of a preferred alternative. Under the current legislative process, the alternative systems that are considered are those proposed by politicians and economists who are actively interested in tax policy. The approach is an unsystematic, hit-or-miss one that produces a hodge-podge set of alternatives for consideration. The process excludes most of America's finest intellectual resources, and it is ineffective in taking public preferences into account. The present process is an unstructured, primitive, archaic one, a "pork-barrel politics" approach that is more oriented to catering to special interests than to addressing a central theme or serving the public well. Being primitive and archaic would not be bad in itself, if the system worked. It doesn't work, however.

There are three basic goals in the development of a tax system: (1) the system must produce the required level of revenue, and the revenue levels should be stable; (2) the system should have desirable economic impacts (that is, it should promote economic growth, the effective use of economic resources, and stability of the economy); and (3) the system should not have

undesirable sociopolitical impacts (for example, it should not contain unnecessary incentives for tax evasion, it should not be unnecessarily invasive of individual privacy, it should be equitable and be perceived as equitable).

The Current System Rates Poorly in Accomplishing Tax Policy Goals

The current US tax system clearly has serious disadvantages relative to the preceding goals and relative to criteria associated with these goals. As evidenced by recent federal budget deficits, the system has not produced the level of revenue required to fund desired programs. Because the volatility of the business tax base and the progressivity of the personal income tax amplify the fluctuations of the business cycle, federal tax revenues are not stable. They are less stable than the general economy.

As the discussion of the previous chapters has indicated, the current income tax system has a number of undesirable economic incentives, both for individuals and for businesses. The only strong theoretical argument in favor of the progressive personal income tax is the argument that its built-in stabilization should tend to moderate economic recessions and expansions. Whatever effects may be realized in this area appear to offset the fact that the revenue fluctuations necessary to accomplish it make government planning difficult and appear to contribute to the growth of the national deficit. In summary, the income tax has many drawbacks with respect to economic efficiency and growth.

With regard to equity, the arguments against the income tax are strong. The theoretical argument set forth in favor of an income tax is that a progressive income tax recognizes differences in ability to pay (with respect to individual differences in income). Several decades of experience with the progressive income tax have, however, convinced taxpayers of its unfairness. The progressive income tax system places a very heavy burden on overtime earnings, and on the earnings of a secondary earner in a family (for example, a wife who goes to work to supplement her husband's earnings). A progressive system places a heavy burden on those who increase their incomes by self-improvement, such as additional training or education. The income tax rates are so high that the incentive to avoid and evade taxes is extremely strong (for example, the incentive for a businessman to purchase personal goods through his firm). While tax reform has eliminated many of the tax shelters available to the wealthy, the incentive to make purchases through one's firm has hardly changed.

The Tax Legislative Process Is Inadequate

Why does the current tax system rate so poorly in achieving the basic goals of tax policy? A fundamental reason for this is the process by which the tax system is developed. In his book *Federal Tax Policy*, Joseph A. Pechman gives a detailed description of the legislative procedures by which tax legislation is accomplished. The process is an unsystematic one, subject to influence by special-interest groups, and vulnerable by its very nature to the development of a complicated tax code.

The process is so bad, and produces such bad tax legislation, that numerous experts and citizens' organizations have recommended that the tax code should remain in force for only a few years, say five years, and then automatically expire. Although this arrangement would not guarantee that a good tax system would result, it would at least force a periodic reanalysis. It would not, however,

produce a stable tax system and a stable environment in which business could conduct rational long-term planning.

The Current Legislative Process Does Not Take Advantage of America's Talent

One of the problems is that the government tries to do much of the analysis "in-house"; in the process, it excludes the participation of many of America's leading scientists and systems engineers. The following are the major groups involved in the process of developing a tax bill (see Pechman's book *Federal Tax Policy*, for a detailed description of this process).

In the Treasury Department, the Office of Tax Analysis (35 economists and statisticians); the Office of the Tax Legislative Counsel (20 tax attorneys and an expert in accounting); Office of International Tax Counsel (six attorneys); the Committee on Ways and Means of the House of Representatives (35 members); the Senate Finance Committee (20 members); the Congressional Budget Office (12 economists). There are other resources, such as the Treasury Department's Office of Management and Budget, IRS staff, and members of other government organizations.

□ In all, a few hundred technical specialists, primarily economists and lawyers, determine the tax laws of the US. The US has thousands of skilled, talented systems scientists, who have little input to the process. The country does not take advantage of its tremendous analytical resources in the development of its tax policy. This lack of a systematic approach is evident in the inadequate response of the Tax Reform Act of 1986 to a serious tax problem.

The point to be made by listing the major "players" in the development of the tax system is that they are all government employees. To be sure, the committees may and do call "expert witnesses" and solicit testimony from the public. But they do not fund major surveys to determine the desires of the public, nor do they award major systems-engineering contracts to design and analyze tax system alternatives.

If a major toothpaste manufacturer desired to introduce a new toothpaste, you can rest assured that it would spend millions of dollars in market research studies and analysis. This sort of approach is noticeably absent from the tax legislative process, in spite of the fact that it profoundly affects every US citizen and his relationship to his government. Science has developed tremendously powerful tools for systems design, but the government is not using those methodologies effectively in the design of the tax system.

On the one hand, Congress demonstrates a commendable sense of concern in its detail-oriented approach to tax law. In other areas of human endeavor (such as health, education, defense), the government passes laws that indicate general Congressional intent, and leaves the writing of detailed regulations up to the appropriate government agency. In tax law, Congress takes it upon itself to specify the tax law, in complete and excruciating detail. This approach would be the equivalent, in the area of defense, for example, of Congress' specification of the engine displacement size of a jeep.

On the one hand, Congress' attention to detail in tax matters reflects the profound importance of this area. On the other, it has resulted in the production of an incredibly complicated system that is not only inadequate to produce the needed revenue, but is driving our people to distraction.

The Income Tax System Is an Unstable System

One of the serious problems with the US income tax system is that, as revenue requirements change, the definition of income must be modified. Simply leaving the structure the same and raising the rates to produce more revenue does not work because the income tax rates are already too high. This not only leads to a complicated tax system but it also leads to an ever-changing one. The US tax system is not stable. It changes every year, with major changes every few years -- 23 major tax bills, including three major tax reforms since 1948 alone. Business doesn't know what is coming next. The US tax system creates an unstable environment in which business operates, particularly since a profit tax seriously affects business decisions. A VAT, on the other hand, does not suffer from these problems. The tax is on a large economic base, and is economically neutral. Adjustments can be made in the rate without distorting the economy. The tax is neutral, so these changes do not introduce economic distortions. Because the base is large, the tax can accommodate rate changes without driving the rates too high.

The Current Tax Legislative Process Is Unsystematic

The use of a systematic approach to tax policy analysis and the development of an improved new system is noticeably absent from documentation of the legislative process leading to the Tax Reform Act of 1986. *The Conference Report to Accompany H. R. 3838* describes this process. Volume I, consisting of 925 pages, describes the Tax Reform Act itself. Volume II, consisting of 886 pages, describes the legislative process. This report constitutes a veritable indictment of the US tax legislative process. For each of the hundreds of sections of the Act, this document presents four sections: Present Law, the House Bill, the Senate Amendment, and the Conference Agreement. The document is mind numbing, virtually devoid of intellectual content; it is a monument to obfuscation. It does not present a cohesive theme or basic underlying concept or goal; the legislative intent is not explicit -- it is embodied in a myriad collection of details. The document is a complicated, detailed description of definitions, rates, rules, and exceptions to rules -- an Alice-in-Wonderland house of cards. The legislative process concerns itself with a myopic attention to detail, while ignoring the achievement of multifaceted tax policy goals. The process ignores the forest for the trees. The US public deserves better from its elected representatives.

Systems Engineering Is the Discipline for Developing Systems

A country's tax system is a *system*, and the methodologies of the fields of systems analysis and systems engineering should be applied to develop an improved system. Systems analysis is 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 low cost.

The methodologies of systems analysis and systems engineering have been successfully applied to place a man on the moon, and to develop major systems in transportation, communications, defense, industry, and commerce. Under the name of software engineering, it is the basis for the development of modern, large-scale computer program systems. In spite of the many and long-standing successes of these disciplines, these systematic procedures have not been applied to the task of developing an improved tax system.

Systems engineering is a highly structured approach to systems design and implementation. It includes formalized steps such as needs assessment, technology assessment, requirements analysis, functional analysis, top-level design, synthesis of alternative candidate systems, cost-effectiveness analysis of proposed alternatives, selection of a preferred alternative, detailed design, optimization, test, and implementation. Systems analysis is concerned with the development of measures of performance, measures of effectiveness, performance models, effectiveness models, cost models, and tradeoff analysis. These disciplines comprise a set of systematic procedures for developing a tax system that can achieve the goals of tax policy analysis, at reasonable cost.

Systems Engineering Has Achieved Success in Developing Modern Social and Economic Systems

Systems engineering has succeeded not only in industrial and military applications, but in financial and social areas as well. The reservations systems used by America's airlines were developed as a result of modern systems engineering. The stock market could not support today's massive trading volumes without a high-powered software system, developed using software-engineering concepts. Modern financial systems, such as on-line credit-card verification systems, were developed and maintained by applying these procedures. Bank processing of financial instruments is highly automated and efficient, the result of application of modern systems engineering methodology.

The point is, systems engineering works! It has put a man on the moon, and has produced the automated systems of today's modern world across the full spectrum of applications areas.

Systems Engineering Can Accommodate Social Institutions and Cultural Values

Systems engineering is only a tool, but a sterile technical methodology. By itself, it cannot produce a new tax system any more than a hammer, by itself, can produce a house. In skilled hands, however, the tool can be of invaluable assistance in facilitating the development of systems that perform desired functions or possess desired characteristics. Applied in the context of a cultural value system (where the cultural values are reflected in the requirements imposed on the design), systems engineering can achieve impressive results. Our culture provides the normative (value) input to the system design; the systems engineering methodology accepts this normative input and efficiently prescribes a system that takes it into account.

In his book *Methodology for Large-Scale Systems*, Andrew P. Sage describes the relevance of systems engineering to solving the complex problems facing modern societies. He points out that the problems facing modern societies -- for example, food and energy resources, health care, environmental pollution, inflation and recession -- are very complex problems whose solutions require a high level of technology that recognizes the systems aspects of the problems (feedbacks, dynamics, uncertainty, complex interrelationships, resource constraints, institutional constraints, conflicting goals, values, multiple disciplines). In order to solve these problems, a methodology is required that not only recognizes the symptoms of a problem, but takes into account social institutions and cultural values as well.

Dr. Sage describes the characteristics and capabilities of systems engineering that make it a successful tool in addressing complex, large-scale social problems:

- Systems engineering can handle problems involving many considerations and interrelations
- Systems engineering can work in areas having far-reaching and controversial value judgments
- Systems engineering can incorporate knowledge from multiple disciplines
- Systems engineering can deal with uncertainty
- Systems engineering can give full consideration to the structural and institutional elements of a problem

Systems engineering can solve complex social problems. It is not a narrow technological tool from a single discipline; it is a methodological framework that can take into account human needs and values.

In their column "Simulation in the Service of Society," (*Simulation*, October, 1987, pp. 189-191), John and Suzette McLeod discuss the relevance of ancient oriental philosophy (*I Ching*) to modern global modeling. They review a draft of a paper by Richard W. Chadwick of the University of Hawaii Political Science Department ("The *I Ching* and Global Modeling"). Dr. Chadwick emphasizes the importance of integrating traditional political, economic, ethnic, religious, and social thought into modern management methods. He asserts that peaceful evolution of civilization is not possible if philosophy and culture are not taken into account. If the cultural aspects are ignored, alienation and destructive leadership will follow.

The fall of the Shah of Iran illustrates dramatically what may happen if a government attempts to impose systems that are not in harmony with the social, cultural, religious, or philosophical preferences of a population. The result is ultimate rejection by the people. If peaceful, evolutionary change is not accommodated, the potential for violent, destructive, revolutionary change increases.

To date, our tax system has been designed by a sterile, nonhumanistic process that has not accommodated important social and cultural values such as the American tradition for individual rights and values such as privacy and freedom from governmental oppression. The tax-design process centers on narrow economic concerns and pork-barrel politics. Our fundamental cultural, social, and political values have been ignored and the result has been understandably tragic: a system that has alienated the American citizen. If continued, the frustration of the US population to an oppressive tax system that ignores its cultural values may grow and eventually lead to convulsive change through violent rejection of the system.

The Government Uses the Systems Approach with Demonstrated Success

In developing important weapon systems, billions of dollars are spent on concept development, test, and evaluation before development and implementation of the system. Having an inadequate tax system imposes a heavy burden on citizens. Failure to address the deficit problem caused by an inadequate tax system could lead to economic collapse. Yet the process for developing the tax system is a primitive one, implemented by a handful of politicians and economists, responding more to the complaints of a few special-interest groups than to the desires of the full population.

The contrast between how the US Government addresses the problem of developing a tax system and problems in other areas is striking. For example, in the early 1970s, the US Navy wished to

develop better "correlation/tracking" algorithms for its ocean surveillance system. After reviewing proposals from America's leading aerospace firms, it decided to award *three* parallel multimillion-dollar contracts to three firms with somewhat different approaches. In recognition of the importance of this problem, the Navy allocated significant funds to its solution.

In general, the US military uses a highly sophisticated approach to solving its defense problems. One of the aspects of this approach is test and evaluation. The US Army is in the process of evaluating a "cellular telephone" system for battlefield communications, the Mobile Subscriber Equipment system. In the process of developing this system, it will spend millions of dollars examining alternative concepts, in the development of prototypes, in the development and application of computer-simulation models to assess system performance, and in field-testing -- all before it ever goes into production.

In passing the Tax Reform Act of 1986, the government did nothing more than make a few patchwork changes to a Neanderthal system that has unequivocally proved its inadequacy and unworthiness. The stakes are very high, but where are the parallel multimillion-dollar systems studies of alternatives? The government has not applied modern methodology to the tax problem, and it has not succeeded in developing a satisfactory tax system.

One of the fundamental problems with the US tax-system-development process is that it confuses objectives with constraints and criteria. The primary objective of a tax system is singular -- to raise revenue. Other desires for the system (equity, political acceptance) are secondary. They should be treated as limitations, constraints, or evaluation criteria, not as the primary objective. The US tax process has not had the objective of raising adequate revenue as its primary objective, and it has miserably failed to do so. The situation will not improve until Congress scraps the current archaic tax-development process and adopts a modern tax-engineering methodology based on proven systems engineering concepts.

The current process for developing the tax system not only fails to achieve the primary objective, but it unwittingly imposes conditions on the system in one area that cause severe problems in other areas. Such problems could be avoided with the adoption of a comprehensive systems-analysis approach that analyzed the tax system as a system. One of the reasons cited for our current progressive income tax system is that it redistributes income, that is, takes from the rich and gives to the poor. As noted by William E. Simon in his book *Reforming the Income Tax System*, our system is not very effective in redistributing income, but the attempt to do so places a terrible economic burden on our economy.

Another inadequacy of the current tax-system-development process is its failure to adequately take into account the fact that the tax system is part of a larger system -- the entire government social and economic system. Under a "systems" approach to tax system development, the relationship of the tax system to other systems is taken into account. One way in which the lack of a systems approach manifests itself is in the requirement for progressivity of the tax system. Some economists impose the requirement for progressivity, asserting that the poor should be insulated from tax. Taken in isolation -- if the tax system were the *only* economic program -- such a principle might have merit. The fact is, however, that the tax system is just one component of the government's social and economic system. The real issue is that the poor be helped -- *overall*. It does not matter whether the tax system (viewed as just one component, or subsystem, of the total socioeconomic system) is slightly regressive, if the government's total mix of social and economic support systems is adequate, overall. Imposing the additional constraint that the tax system must be progressive leads to a "suboptimal" system design: a "local" optimum, instead of a "global" optimum, in systems terminology.

The lack of a systems approach is further evidenced in the lack of integration among federal, state, and local tax systems; between the business and individual income taxes; and among the various other taxes that comprise the current system (such as property taxes, inheritance taxes, sales taxes, excise taxes). Another area in which the lack of a systems approach is evident is the complete failure of the current tax system to take into account cultural values that lie strong in American society. The current system ignores the high value that the American citizen places on individual rights and the right of privacy. By ignoring these cultural values the US income tax system has indeed caused the alienation of which Dr. Chadwick wrote.

In view of the tremendous impact of the tax system, a heavy investment should be made in the development of a good system. The task is not an easy one, because of the nature of economic analysis. Because of the inability to control conditions and impose randomization, it is impossible to determine unequivocal estimates of economic impact from empirical studies. Some conclusions are available, but the bulk of economic analysis regarding tax alternatives consists of qualitative speculation on the probable impact.

In spite of the difficulties, however, use of a systems approach could develop a system that would satisfy revenue requirements, exhibit desirable economic incentives, and possess desirable sociopolitical characteristics. In view of the great importance of having a good tax system, the neglect of this important area is unconscionable.

Much could be done, in spite of the difficulty in assessing the economic impact of alternatives. Sample surveys could be conducted, for example, to assess public response to tax alternatives. Television programs could explain the features of alternative systems, and solicit citizen opinion. The current practice of conducting public hearings for the extremely small proportion of the population who know about the hearings, have the time and wherewithal to visit Washington, or have sufficient knowledge of tax policy to participate effectively, is a totally inadequate method of involving the public in the determination of the system that affects their lives so profoundly. Under the present system, you are informed of major developments on tax bills, but you have no effective voice in the choice of the system. While the danger of crippling the tax-system-development process by participatory democracy should be avoided, your views should be better accounted for by the tax legislation process.

This book proposes an alternative tax system for the US. This alternative was selected after synthesis and analysis of numerous alternatives. The system proposed here will produce the required revenue, and have desirable economic impacts; it is equitable, and respects your privacy. It is not, however, the result of a multimillion-dollar systems-engineering study. It addresses general tax concepts, not fine details. Such a study, sorely needed, has yet to be conducted in this country.

To date, the science of economics has centered on tax analysis, but it has not formalized the process of what could be called tax engineering -- the application of the principles of systems analysis and systems engineering to the development of tax systems. Many economists *analyze* particular tax systems (for example, assess the economic impact of the system). A much greater challenge, however, is the *design* of a good tax system. The country would be better served if the massive effort that goes into analysis of the current system were channeled into the application of a systematic methodology to design a better one. A design effort is, however, much more difficult and demanding than an analysis effort. It involves an active, creative process, rather than a passive, contemplative one. Modern economic education is oriented toward analysis, not design.

As is the case with any scientific discipline, although systems engineering is a powerful methodology, it is not a magic panacea. Application of the systems-engineering process enabled the US to get to the moon within a decade. At the same time, there are certainly examples of modern system-design failures, such as the Sgt. York Division Air Defense gun. While the systems-engineering process is not fail-safe, it has proved itself, properly applied, as a powerful method for developing systems that work. It is time to apply this methodology to the tax problem.

Examination of Existing Alternatives

With respect to the synthesis of alternative tax systems, it is helpful to examine the wide variety of tax methods used by other nations. An excellent resource for this information is the annual publication, *Revenue Statistics of OECD Member Countries*, published by the Organisation for Economic Co-operation and Development. This publication describes the major types of taxes and presents data showing the overall tax levels (as a proportion of GDP) and the distribution of taxes over the tax types. The data are very revealing. They show large differences from country to country, both with respect to overall tax level and distribution over different types of tax. □ In 1983, tax levels varied from 19 percent of GDP (Turkey) to 51 percent of GDP (Sweden). The lowest countries were Turkey (19 percent), Spain (27 percent), Japan (28 percent), the US (29 percent), and Australia (30 percent). Compared to other developed nations, the US has a low overall tax level. Since this is so, it is interesting to ponder why US citizens are so upset over their tax system. In view of the fact that US citizens are proud and patriotic, one is led to the conclusion that the fault lies with the system, not with the citizen.

The distribution of taxes among the major categories of taxes (income and profit, social security and payroll, property, goods and services, and other) varies tremendously. Expressed as a percentage of total tax revenue, income and profit taxes vary from 16 percent (Greece) to 67 percent (New Zealand). Taxes on goods and services (which includes the VAT) vary from 15 percent (Japan) and 18 percent (US) to 46 percent (Ireland), and average 30 percent over all OECD nations.

Criteria Associated With Tax Policy Goals

In developing the tax system proposed in this book (Chapter 18), tax methods were selected that scored high on the following criteria, or measures of performance.

Revenue-Producing-Ability Criteria:

1. Produces adequate revenue (no deficits)
2. Produces stable revenue

Sociopolitical Criteria:

3. Not invasive of privacy of individuals
4. Low incentive to engage in tax avoidance
5. Low incentive to engage in tax evasion
6. High degree of simplicity
7. High perception of fairness
8. High likelihood of acceptance by public

9. High likelihood of acceptance by states and local governments
10. Low tax rates
11. Reduces concentrations of wealth
12. High visibility of taxes to the citizen
13. No "marriage tax" or "marriage subsidy"
14. Constitutional: the tax does not itself violate the Constitution, and its implementation does not lead to violations of the Constitution

Economic Criteria:

15. High incentive to save
16. High incentive to produce
17. High incentive to be efficient
18. Low administrative cost
19. Low compliance cost
20. Promotes tax harmony in international trade
21. Promotes tax harmony among the federal, state, and local governments
22. High incentive to use equity financing over debt financing
23. High economic efficiency
24. Contributes to economic growth and stability
25. Does not destroy capital accumulation
26. Robustness; ability to accommodate rate changes without introducing complications or economic distortions, or necessitating changes in the structure or complexity of the tax system

The objective in designing a new tax system is embodied in Criterion 1: the system must produce adequate revenue. Tax revenue must be sufficient to eliminate deficits. The US must cease to be a debtor nation. The continued accumulation of massive deficits will desiccate the credit market and strangle US economic growth; it has the potential to lead to an economic collapse, both in the US and worldwide.

All of the other criteria are "secondary objectives." They represent limitations, constraints, restrictions, and evaluation criteria that will be examined or taken into account, for any system that can produce adequate revenue.

Note that some of the criteria are at cross-purposes. For example, reducing concentrations of wealth promotes the security of democracy, but contains a danger of destroying capital and thereby slowing economic growth.

Tax-Engineering Methodology

The tax engineering methodology for developing a new tax system includes the following major steps:

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.

In the course of developing the proposed new tax system presented in Chapter 18, a large number of alternative tax systems were considered, and the "best" one selected. The many alternatives that were considered are not described in this book. Instead, the next four chapters summarize the alternative tax methods that were considered, and describe their principal characteristics. Then, in Chapter 18, a recommended tax system is presented. The performance of that system relative to the various criteria listed above is described.

A serious problem that arises in the design of a tax system is that there are a large number of performance criteria to take into account. The design of the system would be relatively simple, for example, if the objective were simply to design a system that could produce revenue equal to 33 percent of GNP, at minimal administrative cost, ignoring all other factors. The problem is, however, that there are over 20 other factors that *cannot* be ignored.

The significant problem that arises, then, is how to select a preferred system, based on comparison of alternative tax systems relative to a multidimensional set of performance criteria. That is not an easy task, and there is no automatic formula or procedure for doing so. It is based on a subjective assessment of what system is best, taking into account the performance of each candidate alternative system relative to the performance evaluation criteria. The proposed system presented in Chapter 18 reflects my personal preference, taking all the criteria into account, and my personal views concerning their relative importance. In making that subjective selection, no attempt was made to quantify each of the performance criteria, or to rank them in order of importance. Because of resource limitations, no attempt was made to apply econometric models to produce quantitative assessments of the economic impact of alternative systems. Alternatives were simply rated high or low on each criterion, and compared to each other relative to one criterion at a time.

With regard to requirements analysis, the following single requirement was placed on the tax system:

Ability to raise revenue equal to 33 percent of GNP

Except for this single requirement, all other factors were considered to be "flexible" -- that is, no firm constraints were placed on any of them.

The remainder of this chapter discusses some of the subjective considerations that arise in comparing alternative tax methods relative to political factors, such as acceptance by the public and by state and local governments.

What Rates Are Correct?; What Tax "Mix" Is Appropriate?

One of the problems with any tax is determining what tax rate is, in some sense, best. There are just two basic decisions that need to be made regarding tax rates. First, what is the total amount of revenue that is desired for the government budget? Second, how will this revenue be extracted from the economy, in the form of taxes; in other words, what different types of taxes will be used.

The answer to the first question depends on what size budget the US Government and the public want: how much money shall be spent on national defense, social services, roads, and civil servants' salaries. In the US today, that total amount is approximately one third of GNP.

The decision about how much money is needed for the government budget is determined by taking into account how much tax burden the population is willing to bear, how much revenue is "needed" by the government to execute its mission, and what its mission should be (for example, should we put a man on the moon, engage in the Vietnam war, fund various social welfare programs, clean up the environment, develop nuclear fusion energy sources). Many people believe that the US Government should continue its current programs (social, economic, and defense) or even do more. Others believe that imposing a tax burden of one third of GNP is far too heavy -- that a 25-percent burden is quite heavy enough for any government, and that people should be held basically responsible for their own welfare.

The answer to the second question depends on how the government wishes to distribute the tax burden, and to what extent it wishes to disguise it from the public, and how it wishes to address the economic impact and sociopolitical consequences of the tax (such as equity, invasion of privacy).

In this book, we do not address the issue of how large the government budget should be, or how the money should be spent. That issue depends on what programs the government wishes to fund and how heavy a tax burden the government decides to place on the private, productive sector of the economy. We are concerned in this book only with how the money is collected. This decision is a value judgment. There are several considerations that enter into the decision. What economic incentives or disincentives or dislocations or redistributions are caused by the tax? What are the sociological and political ramifications of the tax? What is the cost of the tax? What are the international trade implications of the tax?

All governments face these issues. For example, in Haiti, coffee, the principal agricultural commodity, is taxed at a heavier rate than is the case in any other country in the world. It is taxed so heavily that small farmers cannot afford to make investments (tools, equipment, replanting, fertilizer) to improve productivity or the quality of the crop. In the US, the Rube Goldberg income tax code has diverted much labor from productive uses to the unproductive activity of attempting to determine how to structure one's business or one's investments to reduce taxes, rather than to increase production.

Many questions arise in determining the distribution of tax burden. Is the tax fair? Is it generally perceived that able-bodied citizens carry an equal tax burden? Or, are the rich allowed exemption from the tax because they can afford to invest in tax shelters that the average citizen cannot afford? Sales taxes are not costly to implement; income taxes are very costly to implement (in terms of enforcement costs, lost production due to tax accounting and tax avoidance, and loss of privacy).

Economists Generally Prefer Taxes That Do Not Distort the Economy

Economists have spent much time analyzing the different types of taxation. The Advisory Committee on Intergovernmental Relations publishes reports on the variety of different methods of taxation used by the states. Generally, free-market economists prefer taxes that do not cause economic dislocations, that is, taxes that do not create strong incentives to change economic behavior. Examples of taxes that do not introduce distortions are taxes on alcohol, cigarettes, and food, because it is believed that an individual will purchase about the same amount of these commodities regardless of the size of the tax. In technical terms, demand for such commodities is said to be *inelastic* with respect to price changes, or that the price elasticity of demand is said to be low. A high tax on a discretionary good, such as restaurant meals, however, will probably cause some people to eat in less expensive restaurants or to eat out less often. Levying a high tax on restaurant meals, hence, changes the structure of the economy -- makes it less efficient in terms of maximizing the utility of people -- and so would be generally viewed as economically undesirable.

How to Allocate Taxes Is a Value Judgment

How the government allocates the tax burden among the various tax sources, and what the total tax burden is, represents a value judgment. The allocation should take into account all aspects of the three goals of tax policy analysis. Governments "balance" taxes among various tax sources so that no single tax "stands out" in the public's eye as being very high. A government may (or may not) consider the various "costs" of each type of tax (in terms of collection costs, economic incentives, equity, ability to pay, willingness to pay, popular acceptance) and sets the rates accordingly.

The Government Must Set the Overall Tax Rate and Decide on Progressivity

If a government makes the decision to adopt an income tax, two principal decisions are required. What should the average tax rate be, and should a progressive tax rate structure be adopted? The income tax burden (average tax rate overall) should be determined in concert with all of the other tax sources, so that the burden associated with each type of tax is kept to a low level. With regard to tax progressivity, an important consideration is how high the maximum marginal tax rate is.

Let's consider a few examples, in the case of an income tax system such as we currently have. Should it be, for example, 94 percent, 50 percent, 28 percent, or 15 percent? At extreme levels, such as 94 percent, deductions must be allowed for other taxes (for example, state taxes, property taxes) in order to ensure that the individual will have some income left for basic living expenses, will be left with at least some incentive to be productive, will not have a strong incentive to

overthrow the government, and will remain in this country. With an income tax of 50 percent, the total tax -- when combined with state taxes, property taxes, Social Security taxes, and sales taxes -- could be as high as 80 percent, and would generally be considered oppressive. At 28 percent, the total tax rate would be about 50 percent, and would still probably be viewed as too high. At 15 percent, the total tax rate could be about 35 percent, and would probably be judged acceptable.

Clearly, the problem of deciding on the rate structure for a progressive income tax is a difficult one. There is no right answer; it may be the case that there is not even a good one.

Public Opinion Can Be a Major Factor in Tax Policy

Public opinion can have a lot to do with what maximum income tax rate is acceptable. In the year (1913) in which the personal income tax was introduced, the personal exemption was so high that most people were exempt from tax; the tax rate was only one percent for most taxpayers (that is, up to \$20,000 in income), with a maximum of 7 percent for incomes of over \$500,000 per year. Imposing income tax rates of 15-28 percent (as under tax reform) in 1913 would have probably caused riots and a revolution. Today it might be viewed as a reasonable tax rate.

It is not in the best interest of a government to set maximum income tax rates too high, because at some point the productive members of society will see that they are working more for others than for themselves and their families, and feel oppressed. With a federal income tax rate of 28 percent, this is almost surely the case because, when the federal tax is combined with other taxes the total income tax rate, including wage taxes collected by the employer before to paying the employee his wages, is over 50 percent, or half the individual's income. (These other taxes could be: 10-percent state tax, 14-percent Social Security tax, 3 percent unemployment insurance tax, a property tax equivalent to 1 percent of total income, and a sales tax of 7 percent, equivalent to 3 percent of total income. The 14-percent Social Security tax is represented as a 7-percent wage tax "on the employer" and a 7-percent wage tax "on the employee." These are semantic distinctions. From an economic viewpoint, the burden of a near-universal payroll tax is considered to fall on the employee. In reality, the payroll tax is an income tax, at a 14-percent rate.)

The Acceptability of a Tax Burden Depends on Political Philosophy

Many people believe that, if an income or payroll tax approach to taxation is used, the individual should be left with the lion's share of the fruits of his labor. This is a value judgment. Some, communists, for example, may argue that all of his productive labor should be turned over to the state for redistribution as the elite see fit. Most US citizens do not subscribe to that point of view. There is no rightness or wrongness, however, associated with their point of view -- it's just a matter of preference. The communist may argue that his system can eliminate poverty if the state keeps 100 percent of an individual's production. The capitalist may argue that the incentive to keep a share of one's production results in a greater overall level of production. The environmentalist may argue that increased production is not desirable. In summary, the choice of tax type and burden is an arbitrary one, derived from the way that people feel about things at the present time - - a matter of taste, a question of philosophy.

The US Tax System Allows for Collections at Several Levels of Government

In the US, taxes are collected at several levels of government: federal, state, and local. Decisions are required concerning the type and burden at each level and the sharing of the revenue collected. In recent times, local governments have made heavy use of the property tax, states have made heavy use of the retail sales tax and income taxes, and the federal government has made heavy use of income taxes. The federal, state, and local governments may decide among themselves -- by "revenue sharing" -- how to split the revenue.

A fast-growing community that needs to build roads, sewers, and schools, or a deteriorating city that needs to rebuild, can legitimately argue for a greater share. A state having no natural resources (such as oil) or other sources of state tax revenue can also argue for a greater share of federally collected revenue. The rationale for varying the split of revenue among the states is that most US citizens demand a comparable level of public support (schools, highways), and states vary considerably with respect to their abilities to raise revenue (that is, some states are poor, others are rich).

With respect to a tax system, the split of programmatic responsibilities between the federal government and the states is relevant because it determines the relative sizes of the federal and state budgets. This book does not address the issue of what that split should be. The revenue-raising objective for the proposed tax system is simply taken to be 33 percent total (federal and state). Regardless of what the split is, it is very important to coordinate the tax system used by the federal government with that used by the states and local governments, that is, to achieve integration or tax harmonization between these different levels of government. The tax system proposed in Chapter 18 is an integrated, harmonized tax system.

The issue of splitting the revenue between the federal government and the state and local governments can be resolved only when a determination is made concerning which activities fall in the realm of the federal government and which fall to the states. The remainder of this chapter discusses that issue. By harmonizing the tax system between the federal government and the state and local governments, the issue of designing a national tax system has been separated from the issue of allocating rights and responsibilities between the federal government and the states.

Powers Reserved to the States

For many years, there has been a growing controversy over the appropriate level (state versus federal) of operation of health, education, and welfare programs. The issues are both constitutional and practical, but the arguments are mainly constitutional. Article I, Section 8 of the Constitution enumerates the powers of the federal government: "The Congress shall have Power To lay and collect Taxes, Duties, Imports and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States" In the twentieth century, the Supreme Court has taken a liberal interpretation of this clause, citing it to justify that the federal government has implied powers to engage in a wide variety of health, education, and social services activities, and to effect a massive transfer of income from the rich to the poor to pay for them. Many people object to this interpretation as exceeding the intent of the framers. If the federal government can do whatever it wishes to promote the defense and welfare of the United States, what rights, referred to in Amendment 10, are left to be reserved to the states?

On the one hand, some people view the current level of provided human services as excessive. On the other hand, some have the view that, under a "strict," or "narrow," interpretation of the

Constitution, the federal government has no business in these activities, since they were not explicitly mentioned in the Constitution. Instead, they regard such activities as the exclusive purview of the states, under Amendment 10. ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.") They view active federal involvement in health, education, and welfare and other service programs as a clear violation of the Constitution, and call for an immediate transfer of the responsibility for these activities to the states. On the other hand, many people think that the important social progress of the twentieth century (such as civil rights, welfare programs) would not have taken place without federal involvement, and they see a transfer of responsibility for these activities to the states as jeopardizing significant social gains.

Those who believe that the Constitution implies that states are responsible for social programs take issue with the contemporary Supreme Court's expansive interpretation of the Constitution. Since the Supreme Court is the body responsible for rendering the current interpretation of the Constitution, a transfer of social programs to the states is unlikely to occur unless and until a constitutional amendment is passed that explicitly identifies these programs as falling in the bailiwick of the federal government or of the state governments. Amendments were required, for example, to abolish slavery, establish women's suffrage, and to levy income taxes because the founders' intent clearly proscribed those rights, either implicitly (because slavery existed and women were denied the vote at the time of writing of the Constitution) or explicitly (because unapportioned direct taxes were prohibited). Furthermore, it was clearly the intent of the founders to limit the powers of the strong central government they were creating. It is for this very reason that they explicitly defined the powers of that government (Article I, Section 8) and reserved all other unnamed powers to the states and the people (Amendment 10). Given this clear intent, and the current heavy involvement of the federal government in a wide variety of areas (that could certainly have been identified in the Constitution, but were not, for example, health, education, charity), it is difficult to see how this heavy involvement can be viewed as constitutional. Given that such activities -- which existed at the time of the writing of the Constitution -- were in fact not listed as federal responsibilities, it would appear that amendments are required to empower the federal government to legally engage in them.

In many cases, activities (such as chemical birth control) exist that did not exist at the time of the writing of the Constitution. Supreme Court pronouncements or Congressional action relative to such activities are necessary, because they were not and could not be explicitly mentioned. (Attempting to divine the "intent" of the framers relative to these new concepts is a ridiculous approach, but it is nevertheless our approach.) This is not the case, however, for the general social functions of health, education, and charity, which clearly did exist at the framers' time, and were not identified as federal powers.

The issues of whether responsibility for health, education, welfare, and other programs should best be vested at the federal level or the state level will not be addressed in this book. Apart from constitutional interpretations, from a practical viewpoint, there are arguments pro and con. On the one hand, programs such as education are so essential to the well being of the nation and its defense and competitive position worldwide, that it can be argued that it is too important to leave responsibility for it to the states. If this position is accepted, a constitutional amendment should be passed authorizing the federal government to run education. On the other hand, the delivery of services for many programs occurs at the local level, suggesting that responsibility for such programs should occur at the local level (that is, at the state level).

In any event, the tax system proposed here allows for payment of a strong social insurance program, regardless of which level of government (state or federal) bears responsibility for it.

Federal involvement in income taxation and in the provision of a wide array of social services has been severely intrusive of individual privacy. Many citizens are upset over the federal control of health, education, and social services. In view of this controversy, and in view of the fact that the founders could have listed but did not list responsibility for health and education as federal responsibilities, it would be desirable to pass amendments explicitly identifying these activities as federal responsibilities, if the federal government is to continue to assume responsibility for them. Otherwise, because it is clear that the framers did not intend these activities for the federal government, the controversy is likely to continue, and this avoidable waste of time and effort is unnecessarily divisive for the country.

The choice is clear: accept the interpretation of the Supreme Court, or amend the Constitution, or override the Supreme Court's decision by Congressional action (as allowed by the Constitution). Continuing to waste time in contention about whether the current Supreme Court has correctly or appropriately or desirably interpreted how the values of the framers apply to today's situation serves little good purpose. It is counterproductive and divisive. The framers outlawed a federal income tax, but the people wanted one in 1913, so they passed the Sixteenth Amendment. If the people want health, education, and social services to be provided by the federal government, an amendment should be passed empowering the federal government to do so. To continue to vest these powers in the federal government when the framers could have explicitly done so but did not, weakens the value of the document in its role as a standard. The framers set up a mechanism (the amendment process) for changing the Constitution. By this means, it can continue to be a strong standard. Otherwise, it serves little purpose other than an historical artifact.

The nation has entered a phase in which the wording of the Constitution is not taken at face value, in which divination of what the founders' desires might have been in today's context has replaced acceptance of literal statements of fact. In the twentieth century, the US Supreme Court has assumed an Alice-in-Wonderland posture in which the words in the Constitution mean exactly what it intends for them to mean, nothing more and nothing less. If the Constitution is to be ignored, the nation may as well abandon the constitutional form of government, and adopt a parliamentary form, in which laws can be passed at will by Congress without reference to a Constitution. We would then be governed by our representatives, rather than a handful of political appointees on the Supreme Court.

14. Tax Alternatives

Descriptions of Alternative Taxes

This chapter describes the major types of taxes and cites a number of advantages and disadvantages associated with each type of tax. The chapter also describes several "principles" of taxation. Taxation principles are criteria that are used to justify certain types of taxes.

Some of the points presented in the following paragraphs have been discussed previously; they are summarized here to enhance the continuity and completeness of the description of the various tax methods.

Criteria, or Principles, for Choosing a Tax

Economists compare and evaluate tax alternatives primarily in economic and sociological terms. The economic comparisons are concerned with the impact of taxes on economic activity (for example, administrative and compliance costs, incentives, disincentives, efficient allocation of productive resources, effect on employment and economic growth). The sociological comparisons are concerned with issues such as the equity, or fairness, of a tax system; the social discontent caused by the system; and its intrusiveness. Equity is usually measured in terms of the concept of ability to pay. The idea is that poor people, whose ability to pay is less, should bear a tax burden that is in some sense lighter than the burden imposed on rich people. On the basis of the ability-to-pay concept, progressive taxes are generally favored over nonprogressive or regressive taxes. Although the concept of ability to pay is discussed a great deal by economists, no satisfactory means have ever been developed for measuring ability to pay.

Some argue that progressive taxes are a poor means of attempting to help the poor -- that they can be better helped by direct expenditures on social programs rather than by a complicated, take-from-the-rich-give-to-the-poor progressive income tax system. In view of the tremendous loss of privacy that all taxpayers suffer in order to enable the government to avoid taxing the poor, this viewpoint is supportable. Recent tax legislation has in fact moved away from the attempted use of tax policy to cure social ills to the use of spending policy. There are much more effective, efficient, and less privacy-intrusive means of providing for the poor than a progressive income tax.

Horizontal equity refers to the principle of equal taxation of individuals having equal abilities to pay. "Vertical equity" refers to the principle of taxing individuals with greater ability to pay more heavily than those with less ability to pay. Before the Tax Reform Act of 1986, the US tax system scored very poorly with respect to both horizontal equity and vertical equity, using annual income as a measure of ability to pay. The previous system evidenced a low level of horizontal equity because, with a wide array of complicated tax shelters available, individuals with similar incomes could have widely different tax liabilities. The old system exhibited a low level of vertical equity, since rich persons with large incomes could, through tax shelters, pay no or very little tax, whereas assetless moderate-income individuals could not avoid taxes. Under tax reform, the horizontal and vertical equity of the US income tax system has been improved, to the extent that one accepts the premise that current annual income reflects ability to pay. It is essentially because of this improvement that proponents of the Tax Reform Act hailed it as a "revolutionary" breakthrough in

tax reform legislation. These proponents gloss over the fact that it fails miserably in almost every other area of concern.

Another economic criterion on which taxes are measured is the benefit principle -- that it is appropriate to levy a tax in a way that places the tax burden primarily on the recipients of the benefit of the tax. The principal example of a tax that may be justified on the benefit principle is the payroll tax, which is ostensibly used to underwrite the cost of social welfare insurance and retirement. Other examples include the gasoline tax (used to improve highways) and the airplane ticket tax (used to improve airports). Some argue that big businesses receive much more help from the government than do small businesses, as evidenced by the large loans to Chrysler and Lockheed. On the basis that big businesses receive more benefits, they view a progressive corporate income tax structure as justified.

Some taxes are levied to help cover the social and economic costs associated with certain activities or products, such as alcohol or cigarette taxes.

With regard to international trade, two important principles are the destination principle and the origin principle. Under the destination principle, taxes that raise the price of goods (such as general sales taxes, or the VAT) may be exempted from a nation's exports and applied to imports. The destination principle is not applied to income taxes, since it is not considered practical to determine the portion of the price of a good that is associated with income tax. The basis for the destination principle is the concept that the burden of taxation within the nation of production (that is, how heavily a nation taxes its own citizens) is not relevant to international trade. Instead, whether a nation imposes a heavy or light tax on its own citizens should not affect its trade position; it should be able to sell its goods tax free to other nations if it so desires.

In contrast to the destination principle is the origin principle. If the origin principle is accepted, tax payments are made where the production occurs. Under the origin principle, exports are not exempted from tax, whereas imports are. The basis for the origin principle is the point of view that the nation whose economic activity produced the goods has a right to taxes derived from that economic activity. No tax is refunded if the goods are exported, and no import tax of the same amount is levied on imports.

Whether a nation adopts the origin principle or the destination principle is less important than the adoption of the *same* principle by all nations. Such agreement is referred to as tax harmonization. If some nations adopt the origin principle and some the destination principle, some products will be very heavily taxed, and some will be untaxed, leading to economic distortions in the international marketplace. The GATT is based on the destination principle.

Some argue that an individual should be taxed relative to what he takes out of the economic pool (as measured by consumption), instead of what he contributes to it (as measured by income). This principle will be called the consumption-tax principle.

There are numerous other principles of taxation. A rationale for property or wealth taxes is to prevent or reduce large private concentrations of wealth. Taxes on alcohol and tobacco can be justified as a means of collecting reimbursement for the economic cost of these products (lost productivity from sickness and premature death). Taxes on these products may also be justified as a means of discouraging their consumption. Some justify a corporation profit tax from the view that the ability of a firm to make a profit is a privilege granted by the state, and that profit represents monopoly income.

We see, then, that there are a number of economic principles of taxation: the ability-to-pay principle, the benefit principle, the origin principle, the destination principle, the consumption-tax principle, the reduce-private-concentrations-of-wealth principle, the reparations-for-socially-costly-habits principle, the penalize-socially-disapproved-habits principle, the profit-represents-monopoly-income principle. Adherence to different principles leads to different tax systems. Furthermore, within each principle are concepts that lead to different taxes. For example, there is disagreement on how to measure ability to pay. Some argue that wealth is a better indicator of ability to pay than income; on the basis of ability to pay, they would favor wealth and property taxes over income taxes.

Taxes may also be compared in terms of their political acceptability. For example, a simple, flat-rate sales tax appears to be more acceptable to the public than a complex income tax that attempts to redistribute income or achieve other social goals. The remark is often made that a federal sales tax is politically unacceptable in the US, because state governments have used this form of taxation for several decades, and may now consider that they have some sort of exclusive right to that tax by virtue of their having used it before the federal government did, or because they have used it for so long.

How Tax Level and Distribution Are Measured

There is a large variety of ways that a nation may tax its citizens. The principal features of a tax system are the total amount of all tax revenues collected and the distribution of the tax sources. A simple way to characterize the total amount of the tax is to express it as a proportion of gross domestic product (GDP). As mentioned earlier, GDP is the total value of all goods and services produced in the country in a given year. GDP differs from the more familiar gross national product (GNP) in that GDP excludes the value of foreign goods used in production. In the US, GNP and GDP do not differ by very much -- on the order of one percent.

Gross national product is essentially national income plus indirect business taxes (sales and property taxes), less capital consumption (depreciation) allowances. Expressing overall tax burden as a proportion of GDP is recommended over the use of GNP as a base, because it is considered more meaningful to express a nation's tax burden relative to its own productivity rather than relative to a base that includes foreign production. Since GNP and GDP differ very little in the US, either base would be satisfactory for US statistics. For comparisons across nations, however, expressing tax burden as a percentage of GNP is not recommended, because in many countries GDP is much smaller than GNP.

Table 2 shows the tax revenue as a percentage of GDP and the distribution of tax revenue by source for a number of economically developed countries. In the US, total tax revenue equals 31.3 percent of GDP (1981). About two thirds of this amount represents federal taxes, and one third represents state and local taxes. At 31.3 percent of GDP, the US tax burden, expressed as a percentage of GDP, is one of the lowest of the developed nations.

Table 2 breaks taxes into six major categories: individual income, corporate income, payroll, goods and services, property (which includes inheritances and gifts), and other. As may be seen from Table 2, the US depends very heavily on personal income taxes for its tax revenue. The proportion of total taxes that is extracted from individuals is the sum of the personal income tax (37.7 percent) and the payroll tax (26.5 percent), or 64.2 percent. By contrast, the US taxes goods and services at one of the lowest levels of all developed countries, or 17.6 percent.

Table 2. Distribution of Tax Revenues by Source, Selected Countries, 1983

Tax Source	Percentage of Gross Domestic Product					
	US	Canada	Japan	UK	France	Germany
Pers. Income	10.77	11.97	7.09	10.47	5.98	10.56
Corp. Income	1.60	2.46	5.44	4.1	1.91	1.92
Payroll	8.33	4.34	8.30	7.19	20.64	13.33
Property	3.08	3.01	2.60	4.79	1.66	1.26
Goods & Serv.	5.23	10.79	4.21	11.25	12.91	10.28
Other	0.00	0.45	0.07	0.01	1.43	0.01
Total	29.03	33.02	27.71	37.81	44.57	37.37
Tax Source	Percentage of Total Tax Revenue					
	US	Canada	Japan	UK	France	Germany
Pers. Income	37.12	36.25	25.57	27.70	13.50	28.26
Corp. Income	5.52	7.46	19.62	10.84	4.29	5.14
Payroll	28.71	13.14	29.95	19.02	46.31	35.69
Property	10.62	9.12	9.39	12.66	3.73	3.38
Goods & Serv.	18.02	32.67	15.20	29.75	28.96	27.52
Other	0.00	1.36	0.26	0.03	3.21	0.02
Total	100.00	100.00	100.00	100.00	100.00	100.00

Source: *Revenue Statistics of OECD Member Countries, 1965-1984*, Organisation for Economic Co-operation and Development, Paris, 1985.

"Property Taxes" include taxes on immovable property, net wealth taxes, estate, inheritance, and gift taxes.

"Goods and Services Taxes" are taxes on production, sale, transfer, leasing, and delivery of goods and rendering of services. Included are sales taxes, value-added taxes, transfer taxes, excise taxes, import/export taxes, production taxes, and other transaction taxes.

The US Constitution Distinguishes Between Direct and Indirect Taxes

There are numerous ways in which taxes may be classified, to assist an understanding of their nature. These classifications generally relate to the economic and social impact of the tax. A major classification is whether the tax is direct or indirect (these terms will be described later). Another major classification relates to the tax base -- national income or national wealth. Another classification relates to whether the tax is imposed on national income in the form of an income tax or in the form of a consumption tax.

Before presenting a description of alternative taxes, the terms "direct" and "indirect" will be defined as they relate to taxes. The other classifications of taxes will be described after the various individual types of taxes are defined.

A classification of taxes that has important constitutional and international trade ramifications is that of "directness." As discussed previously, the US Constitution specifies that direct federal taxes shall be apportioned among the states according to their populations. The interpretation of this requirement is that the total revenue of a direct tax is specified by Congress, divided among the states in proportion to population, and levied by the states. As noted before, the Constitution does not provide a definition of a direct tax. There is still controversy over the definition, but the Supreme Court has decided that a direct tax is a capitation or property tax, or a tax that produces essentially the same results as these taxes. In general, direct taxes are income and property taxes; indirect taxes are tariffs and transaction taxes (such as sales taxes and the VAT, export taxes, and consumption taxes).

The effect of the constitutional pronouncement on direct taxation is that direct taxes must be apportioned to the states in proportion to population; otherwise, they are unconstitutional. Since income taxes are considered direct taxes, they would, under the original Constitution, have to be apportioned to the states. To avoid this restriction, the Sixteenth Amendment was adopted (1913), empowering Congress to levy income taxes without regard to source, without apportionment to the states, and without regard to population.

Indirect Taxes Raise Prices; Direct Taxes Reduce Income

From an economic viewpoint, the burden of direct taxes is not shifted, or passed along; the burden of indirect taxes is shifted, or passed along, to someone other than the taxpayer. From an economic viewpoint, direct taxes do not raise the price of goods, but instead reduce income. As discussed earlier, determining where the burden of a tax falls is difficult, and it depends on the response of consumers and producers to price changes. Moreover, the burden is often distributed. For these reasons, it may be difficult to say whether a particular tax is a direct tax or an indirect tax.

Indirect Taxes Receive Preferential Treatment Under the GATT

The distinction regarding the effect of taxes on prices is an important one in international trade. According to the General Agreement on Tariffs and Trade (GATT) -- the basic international trade agreement, to which the US is a signatory -- a nation may exempt its exports from its indirect taxes (which raise the price of goods), and may impose a border import tax of the same amount on imports. (The border tax is imposed to compensate for lost domestic taxes on similar goods and to compensate for taxes refunded on imports.) On the other hand, exemption of exports from direct taxes is considered unsanctioned subsidization.

Because of the GATT, the classification of a tax as indirect or direct may have important trade consequences. For example, a VAT is considered an indirect tax; a nation's exports may be exempted from it (in effect, subsidized at the VAT rate), and imports may be taxed at the VAT rate.

A flat-rate income tax (FRIT), on the other hand, is considered a direct tax. A nation, therefore, may not subsidize its exports and tax imports at the FRIT rate without violating the GATT. Hence,

although a nation may collect the same amount of revenue from a FRIT as from a VAT, the use of a FRIT puts it at a serious disadvantage in international trade, to the extent that the tax is not absorbed by the taxpayer, but passed along in the form of higher prices.

The preferential treatment of VAT taxes is a result of acceptance of the destination principle, that the tax burden imposed on a good in the nation of origin is not relevant to tariff considerations. The European Economic Community (Common Market) applies the destination principle in dealing with non-EEC nations, and is adopting the origin principle in dealing with member nations. This, in effect, results in a tariff being imposed around the Common Market (since a border tax is not levied on goods from member nations, but is levied on goods from nonmember nations).

The Individual Income Tax

The individual income tax, or personal income tax, is a tax on a portion of an individual's money income. The personal income tax was used temporarily in the US at the time of the Civil War and was permanently adopted in 1913, after passage of the Sixteenth Amendment. At that time, this tax applied only to a small proportion of the population having high-income earnings, and the rates were low. Over the years this tax has been extended to include most of the population, and the tax rates have been raised to high levels.

With the personal income tax, not all income is taxed. Certain types of income are exempted, such as unemployment compensation benefits, welfare payments, and employee fringe benefits. In addition, each individual is granted allowances, such as the "personal exemption" for family members, and deductions for certain types of expenditures, such as charitable contributions, certain interest payments, and medical expenses above a certain level. The amount of income after subtraction of the allowances is called the taxable income. A tax rate is applied to taxable income. The tax rate depends on the size of the taxable income. The tax rate is higher for higher taxable incomes; that is, the personal income tax is *progressive*.

The Personal Income Tax Attempts to Address Ability to Pay and to Moderate Recessions

While the VAT is the major tax-revenue producer in many developed countries, the personal income tax is also currently used. Arguments in favor of the personal income tax are that it taxes generally on the basis of ability to pay, and that it tends to reduce the concentration of economic power and control by taking larger amounts from higher-income earners. Because the allowances are in fixed amounts and the tax rate is progressive, the proportional change that occurs in an individual's income tax when his income changes is greater than the proportional change in his income. Many economists believe that this built-in flexibility feature of the income tax promotes economic stability by mitigating economic recessions and expansions. Other economists point to the fact that the intensity of business cycles does not appear to have moderated, even as the nation has leaned more heavily on the income tax.

Notwithstanding its intellectual or theoretical appeal, the concept of ability to pay is impossible to measure satisfactorily, and there is no consensus on how sharply progressive the tax rate should be to reflect perceived differences in ability to pay. Some argue that the poor have no ability to pay; that the personal exemption and the standard deductions are not adequate and, if it is desired that income levels reflect ability to pay, the poor should in fact receive a payment -- a "negative"

income tax. Others reject the concept of giving the poor money directly rather than retaining control over what specific goods or services they receive free.

In the past, the marginal federal personal-income-tax rate for high-income earners has been as high as 94 percent. Just before tax reform (1986), the maximum rate was 50 percent; under tax reform, it is 33 percent. There is no agreement on just how high the tax rate should go to reflect perceived differences in ability to pay. In short, although the concept of ability to pay is attractive, it is not possible to implement in a consensual fashion.

The Personal Income Tax Has Many Undesirable Properties

In summary, the personal income tax is touted because it is thought to lend itself well to consideration of ability to pay (because of personal exemptions and progressive rates). As discussed in previous chapters, however, the personal income tax has many serious economic drawbacks. It is costly to administer. As a direct tax, it does not qualify for GATT preferential treatment in international trade. Some argue that it militates against saving and represents a work disincentive. The personal income tax base is narrow, so that this tax cannot raise the massive amount of revenue that is needed for today's government without the imposition of very high tax rates. At high rates, the tax is oppressive and, because of the complexity of the tax base, there is an incentive to engage in the productivity-wasting activity of tax avoidance. Its built-in flexibility represents both an advantage and disadvantage; this feature may moderate recessions, but year-to-year fluctuations in tax revenue appear to have contributed to increases in the national deficit.

The Corporation Income Tax

The corporation income tax (or corporate income tax) was enacted in 1909. Before World War II, it often produced more income than the personal income tax. Corporate-income-tax revenue has been smaller than personal-income-tax revenue since 1941, and has been smaller than payroll tax revenue since 1968.

The Corporate Income Tax Is a Tax on Profit

The US corporate income tax is a tax on corporate profit, as defined by the IRS. The IRS definition of profit is very complicated and does not correspond either to standard accounting practice or economic theory. Deductions are allowed for the costs of doing business, including allowances for depreciation expense of capital equipment. A graduated, progressive tax rate is applied to the profit.

As mentioned before, the name corporate *income* tax is a misnomer; it implies that the tax is a tax on the income, or gross revenue, of the business. It is, in fact, a tax on a very small portion of income, namely, that portion defined by the IRS as profit. More descriptively, the corporate income tax in the US should be called a business profit tax.

From a classical economic point of view, profits arise because of a lack of competition, that is, monopolistic conditions exist, and profit represents monopoly income. It is advocated that in a free-enterprise society, the government has a right to confiscate, or tax, this monopoly income.

As discussed earlier, a drawback to the concept of taxing corporate profit is that it is difficult to define profit and to determine what portion of profit is due to monopoly control. Many "profits" are not real -- they are capital gains caused by inflation.

The Corporate Income Tax Has Many Economic Disadvantages

The economic shortcomings of the corporate income tax were described in detail in previous chapters. A major disadvantage of the corporate profit tax is that it causes businesses to invest considerable effort in tax avoidance, rather than in productive activity.

Although many economists assert that the burden of the corporate profit tax falls on the stockholders, economists are not unanimous concerning where the burden of the corporate profit tax falls. The issue here is who really pays the tax: the stockholders, the consumers, or the workers. Because of this disagreement, there is no unanimity concerning the economic effects of the corporate profit tax. Because of this, the theoretical basis for the corporate income tax is weak.

The many other shortcomings of the corporate income tax were described in detail earlier. The tax is not well integrated with the personal income tax, so corporate profits are subjected to double taxation. The corporate income tax encourages debt financing, which increases the risk of bankruptcy and drives up the cost of money. The income tax penalizes efficient firms and subsidizes less-efficient firms.

The Corporate Income Tax Produces Unstable Revenues

The US corporate income tax is based on a very narrow base -- corporate profit. It is highly volatile, since total corporate profit may vary substantially from year to year. It is an unstable source of government tax revenue.

Although the volatility of the corporate income tax results in fluctuations in tax revenue as a result of the business cycle of economic recessions and expansions, this tax is not considered to constitute a built-in stabilizer. The reason for this is that the variations in the tax revenue do not reduce fluctuations in consumer disposable income or investment. Many firms continue dividends even if profits decline, so that the contribution of profit to consumer income is maintained.

Overall, the corporate income tax has many shortcomings, including numerous undesirable economic incentives and instability caused by a narrow and volatile tax base (profit).

Payroll Taxes

Payroll taxes are taxes applied to a firm's labor payroll. Payroll taxes are used by many countries to finance social security programs. In the US, these taxes fund two social insurance programs: the Social Security program (also called the Old Age, Survivors, Disability and Health Insurance, or OASDHI), and the state-federal Unemployment Compensation program. The Social Security tax rate is applied equally to the employee and the employer; the rate is currently 7.15 percent of the employee's first \$43,800 of earnings. The Unemployment Compensation tax is levied on

employers in all states, and also on employees in some states; the rate is 6.2 percent of the employee's first \$7,000 of earnings.

Most countries levy payroll taxes to finance social security programs. When the US passed the Social Security Act in 1935, 28 countries already possessed national retirement systems. □ Social Security contributions are placed in a trust fund that can (normally) be used only to provide program benefits. Although the Social Security payroll tax program has been likened to private insurance, it is not. The payroll taxes paid by current workers are paid out as current benefits to eligible program participants (such as retirees). The benefits are not based on the actuarial value of the taxes paid, but on the worker's earnings history.

Social Security Contributions Are Not Contributions, and the Social Security Trust Fund Is Not a Trust Fund

The practice of referring to Social Security tax payments as "contributions" is misleading, and the practice of calling the Social Security collections a "trust fund" is a deception. This terminology implies that a person's contribution is placed in trust for him, to generate his retirement income. This is not so. Current contributions are immediately used to pay benefits for current beneficiaries. The Social Security "contribution" is a tax, pure and simple -- not a contribution to a retirement fund.

In spite of the fact that the government refers to the Social Security revenue as a trust fund, it has dipped into this trust fund to continue operation of the government, when Congress failed to pass legislation authorizing the new budget. The employee has no property rights in the trust fund; Congress may reduce or withdraw benefits at will.

The Social Security tax is said to be earmarked for use in social welfare. Since money is in essence a pooled commodity, it is misleading to say which dollar of tax revenue pays for a particular government purchase. All that the term "earmarking" really means is that current social service benefits will be at least as large as the money collected by the tax.

In Spite of Its Nonprogressive Character, Workers Do Not Voice Strong Objection to the Social Security Tax

Because the Social Security tax rate drops to zero after \$43,800 in wages, it is a regressive tax. That is, because of the \$43,800 ceiling, people earning less than \$43,800 pay a smaller proportion of their income in Social Security taxes than people earning over that amount. It is the lowest-paid workers, however, that receive the largest benefits relative to their contributions. Proposals have been made to remove the regressivity by eliminating the maximum taxable earnings ceiling or to make the tax progressive by also instituting personal exemptions and a standard deduction.

Because almost all workers are included in the Social Security program, it has been proposed to simply integrate it with the income tax program, or to eliminate it and use general revenue receipts to fund social insurance programs.

The funds collected as Social Security taxes are "earmarked" for the Social Security program to provide workers with a psychological feeling that they have a "right" to the benefits they receive, and that the program is permanent. Because of this "packaging" of the program, and because

many (lower-wage) beneficiaries have received greater benefits than their contributions would have earned them from a private insurance program, workers evidently do not object to the regressive character of the Social Security tax.

Consumption Taxes (Taxes on Goods and Services)

Consumption taxes are taxes on goods and services. Consumption taxes include sales taxes, VATs, excise taxes, import and export taxes, property transfer taxes, and other transaction taxes paid by enterprises. Although the total amount of consumption taxes is considerable (17.6 percent of GNP in 1981), consumption taxes reflect a smaller component of total tax revenue in the US than in most other countries (see Table 2).

There are many types of consumption taxes. An *expenditure* tax is a tax levied on an individual's consumption expenditures. It may be proportional or progressive. A *sales* tax is a tax levied on the sale of goods or services. A sales tax can be imposed at the manufacturing level (for example, Canada), the wholesale level (Australia, New Zealand), or the retail level (US). Because there are many more retail firms than manufacturing and wholesaling firms, countries having limited administrative resources may prefer manufacturing and wholesaling taxes to retail taxes.

A *turnover* tax is a transaction tax (sales tax) that is levied every time that a commodity is sold, or turned over from one firm to another. A *value-added* tax is a tax levied on the difference between a firm's sales and its purchases, that is, on the net value added to the product by the firm. It may be assessed at a uniform rate for all commodities, or at varying rates for different types of commodities. *Excise* taxes are taxes on the sale of a particular product or service, such as tobacco, alcohol, gasoline, and telephone service.

Consumption Taxes Encourage Saving

Consumption taxes are criticized by some economists on the basis of equity. They argue that the poor consume a greater proportion of their income than the rich, and so the burden of the tax is greater on the poor. Studies show, however, that over a lifetime most people, rich or poor, consume about the same proportion of income, so that this argument against consumption taxes is not well founded. An advantage of consumption taxes compared to the income tax is that they encourage saving. With a consumption tax, a person may decrease his tax bill by spending less. The income tax includes incentives to spend (for example, tax deductions for home mortgage interest payments).

An advantage of consumption taxes is that they are stable. They do not exhibit the large fluctuations that the income tax exhibits because of its sensitivity to economic expansions and contractions.

With regard to excise taxes, economists argue that because they are not levied at the same rate on all goods and services, sales and excise taxes may introduce inefficiencies in the allocation of resources.

In the US, the most popular consumption tax is the sales tax, which is used by state and local governments, but not by the federal government. In foreign countries, a very popular consumption tax is the VAT.

The following paragraphs provide additional discussion of three major consumption taxes: the sales tax, the VAT, and the expenditure tax.

The Sales Tax

A sales tax is a consumption tax imposed on the sale of an item. A general sales tax is one imposed at the same rate over a large geographic area (a state or the entire nation). Sales taxes may be imposed at various stages of production, such as a manufacturers' sales tax, a wholesalers' sales tax, and a retail sales tax. A multistage, or turnover, sales tax is a sales tax imposed at several stages of production, for example, at the manufacturing, wholesaling, and retailing levels.

A single-stage sales tax is preferred to a multistage, or turnover, sales tax. The problem with the turnover tax is pyramiding, or cascading. Even though the turnover tax may be levied at a uniform rate, the total tax rate may differ widely for different products, depending on the number of steps in their production and distribution. Pyramiding occurs when many firms are involved in the production or distribution of a product. The tax is imposed on gross sales at each stage, so that the total tax imposed on the product by the time it reaches the retail stage is very high -- the tax is said to have pyramided. This heavy tax on such products causes economic distortions (since it discriminates against products having many stages of production or distribution), and also introduces a strong incentive for firms to merge with their suppliers, thereby causing economic concentrations in industry and trade.

A problem with a wholesalers' sales tax is the determination of wholesale values when manufacturers sell directly to retailers.

A retail sales tax is a single-stage tax that avoids the pyramiding of turnover taxes. Since the tax applies only to the final price, retail sales taxes usually have broad bases, and rate high from the point of view of economic efficiency and equity. Because of the broad base, the retail sales tax can be low and yet produce a large amount of revenue.

From an administrative viewpoint, the retail sales tax is more burdensome than the wholesalers' or manufacturers' tax (because of the much larger number of retailers), but the problem of determining the basis of the tax is simpler.

The VAT -- "Born In the USA"

The value-added tax, or VAT, has its theoretical origins in the US. The concept was evidently first proposed by Professor T. S. Adams, who discussed the concept in papers published during the period 1911-21. It was promoted in 1918 by the German industrialist Wilhem von Siemens. It was considered for several decades until it was implemented in Michigan in 1953. France adopted the VAT in 1954, and since then most European countries and a number of other countries have adopted it.

In France, the VAT is called the *taxe sur la valeur ajout e*, or TVA. In Mexico, the tax is called the IVA -- *impuesto de valor agregado*. The acronym TVA could have been adopted in English -- tax

on value added -- but was not. Economist Alan Tait suggested that this reversal of the acronym in English is perhaps indicative of British attitudes toward things European.

The VAT is a consumption tax on the value added by the firm to the products it produces. The value added is the difference between sales receipts and amounts paid for goods and services purchased from other firms. Value added is hence equal to total wages, salaries, net rents, net interest, and profit.

The VAT advocated in this book is a very special kind of multistage sales tax. (There is a type of VAT that resembles the corporate income tax; it will be described in the next chapter.) It is applied at all stages of production, including manufacturing, wholesaling, and retailing (some countries exclude agriculture from the VAT). The VAT is recommended over a retail sales tax if a government has large revenue requirements, and wishes to extract the tax revenue by means of transaction taxes. By spreading the tax over all stages of the production process, tax rates may be kept low (thereby reducing the incentives to evade taxes). The retail sector represents only a small part of the total economy, so that a very high retail sales tax would be required to produce the substantial revenue needed by today's modern economies, if the preretail sector were not taxed.

How does the VAT differ from an ordinary multistage sales tax (that is, from a turnover tax)? In a very simple but important way. At each stage, a firm is taxed (by means of a sales tax on its products) only on the economic value added to the products by the firm. The value added to the firm's products is represented by the firm's total revenue (sales) less the cost of supplies and services purchased from other firms (purchases). In other words, value added is the cost of labor, net interest, net rents, and profit.

The VAT is generally considered a consumption tax, and, indeed, it is most frequently implemented in the form of a sales tax, not only on retail sales, but on preretail sales as well. Economist Richard Lindholm objects to the characterization of the VAT as a consumption tax. In his book *A New Federal Tax System*, he argues, first, that referring to the VAT as a consumption tax wrongly implies that the VAT is simply a national retail sales tax (rather than a tax on all sales, both retail and preretail). Second, he argues that a broad-based tax such as the VAT is just as much a tax on production as a tax on consumption -- that the production and consumption, or sale and purchase, of a good go hand in hand. Imposed on all sales, the VAT applies just as much to raw materials and capital goods as it does to goods and services intended for consumption.

Lindholm notes that the widespread characterization of the VAT as a consumption tax stems from France's desire to adopt the VAT in 1954, and have it eligible for preferential treatment under the GATT. In order to qualify for preferential treatment under the destination-principle-based GATT, the VAT had to be a tax on consumption. Since, as a broad-based tax it could be represented either as a tax on consumption or production, the obvious choice in that context was to represent it as a consumption tax.

The point is that a broad-based tax is a tax on economic activity, overall; the amount of the tax (represented as a proportion of GDP) is the portion of a nation's economic activity that is to be funneled into government expenditures, that is, brought under direct government control. It confuses the issue to characterize such a tax simply as a consumption tax. Calling a broad-based tax such as a VAT a consumption tax as opposed to a production tax is equivalent to calling a half-filled glass of water half empty as opposed to half full. The distinction is semantic, not real.

Two Ways to Administer the VAT: the Tax-Credit Method and the Calculation Method

With a VAT, there are two methods used for computing the tax, so that the tax is on the net value added by the firm and no pyramiding occurs. These two methods are the "tax-credit method" and the "calculation method"; both methods produce the same tax on the firm, but they are administered differently.

With the calculation method, the VAT is not explicitly shown on each transaction. The firm simply computes the difference between its total sales and total purchases (that is, the value added) and applies the VAT rate to this difference. The customer is unaware of the tax -- it is a hidden tax, like an income tax or a payroll tax. This situation is advantageous from the government viewpoint, because citizens are not continually reminded of the tax. The tax-credit method represents a greater computational burden for the firm, since the tax must be shown on each invoice or cash receipt. Government tracking of tax-exempt items for compliance verification is facilitated with this method.

The calculation method is appropriate when there is a single VAT rate applied to all products. Under this method, the firm calculates the total value added by subtracting its purchases from its sales. The VAT is then determined simply by multiplying the VAT rate times the value added. The firm would perform this computation periodically, for example, once a month, and forward the tax to the government.

The tax-credit method is appropriate when there are multiple VAT rates: most products have a standard rate, but some (for example, luxuries, harmful products) may have a higher rate and some (for example, necessities, such as medicines) may have a lower rate, possibly zero (in which case the product is said to be zero-rated). In this case, the amount of the VAT charged on each item is shown on the sales invoice. To determine the VAT, the firm first determines the total VAT charged on all of its sales by adding up all of the VAT amounts charged by it on invoices or sales receipts to its customers. Call this amount the gross tax. Then, the firm determines the total VAT that is included in all its purchases, by adding up all of the VAT amounts on invoices for its purchases from other firms. This amount is called the tax credit. Subtract the tax credit from the gross VAT to obtain the net VAT, which is the VAT due the government.

Because the tax-credit method is applied when the VAT is shown on all invoices, it is often called the invoice method. If the same VAT rate is applied to all products, the tax-credit method and the calculation method produce exactly the same VAT revenue for the government.

While the calculation method is much less costly to implement, a country using multiple VAT rates must use the invoice method if it wishes to take advantage of the GATT. The reason for this is that under the GATT, a country may deduct the amount of the VAT that has been charged on a product before it exports the product; in order to deduct the correct amount, it must be possible to accurately determine the amount of VAT that has been charged on each exported item. If the calculation method is used with multiple rates, it is not feasible to accurately determine the VAT that has been charged on each item as it passed through the production chain.

In his book *A New Federal Tax System*, Richard Lindholm discusses the destination principle. He cites a serious drawback associated with the acceptance of that principle in international trade, namely, the favoring of countries having large public sectors and utilizing the least amount of private resources. With respect to international trade, under the destination principle the inefficient

nation with a large public sector becomes a large supplier, leading to inefficient use of resources, worldwide. Such countries have large VATs, and receive large border tax adjustments (large refunds on exports and large taxes on imports). Lindholm calls for the US to demand elimination of the destination principle in international trade. If this were to occur, and the origin principle were adopted, it would not be necessary to use the tax-credit (invoice) method to determine border tax adjustments if a multiple-rate VAT were adopted. Instead, the VAT could be implemented using the calculation method, with a tremendous saving in administrative cost. The cost of implementing the current corporation income tax would cover the cost of implementing the VAT.

Only two nations use single-rate VATs, and therefore may use the calculation method to correctly determine border tax adjustments. In view of the tremendous amount of resources applied worldwide in implementing the invoice method, a worldwide switch to the origin principle certainly deserves consideration. Implementation of such a fundamental change in the GATT may not be achievable. Until and unless such a change occurs, the US is essentially locked in to the acceptance of the destination principle. In view of the near-inevitability of multiple rates, this suggests that an invoice-method VAT would be necessary in the US if we wanted to take advantage of GATT preferences.

Lindholm argues that the refund of any domestic tax on exported goods or services should be viewed as a trade subsidy prohibited by the GATT, that border-tax adjustments on imports should be regarded simply as tariffs. If such a change is not possible, however, he recommends that the US reform its tax system to enable the destination principle to be applied to its treatment of taxes on its exports.

Examples of a VAT

Table 3 presents an example of how a VAT works. In this example, we assume that the production of a product involves four stages, with a separate firm at each stage. Suppose that the finished product is canvas cloth. Suppose that the four stages are agriculture, manufacturing, wholesaling, and retailing. Suppose that the manufacturer pays \$50 for the cotton, sells the finished canvas at \$100/unit, that the wholesaler sells the item at \$200/unit, and that the retailer sells the item at \$400/unit. Suppose that the VAT rate is 20 percent.

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

For simplicity, let us assume that the farmer had no inputs (such as fertilizer, pesticides). In this case, the value added is sales revenue (\$50) less cost of purchased services and supplies (\$0), or \$50. The VAT on the cotton is hence $.2 \times \$50$, or \$10. The farmer collects this \$10 tax at the time of the sale to the manufacturer, and remits it to the government. The manufacturer's value added

is his sales revenue (\$100), less the cost of the cotton (\$50), or \$50. The VAT on the manufactured canvas cloth is hence $.2 \times \$50$, or \$10. The wholesaler's value added is his sales revenue (\$200), less the cost to the manufacturer (\$100), or \$100. The VAT on the wholesale cloth is hence $.2 \times \$100$, or \$20. Finally, the retailer's value added is his sales revenue (\$400), less the cost of the wholesale cloth (\$200), or \$200. The VAT to the ultimate consumer is hence $.2 \times \$200$, or \$40.

The total VAT, over all stages of the production chain, is $\$10 + \$10 + \$20 + \$40 = \$80$. The tax revenue raised by the 20-percent VAT and a 20-percent retail sales tax is the same. In the case of the VAT, however, the tax is paid all along the production chain, whereas in the case of the retail sales tax it is all collected at the retail stage.

Table 3 actually exemplifies a subtractive calculation-type VAT (the term "subtractive" will be defined later). In this case, each firm determines value added (by subtracting the cost of purchased supplies and services from sales revenue) and applies the VAT rate to determine the VAT. The amount of the VAT would be submitted to the government periodically, say, once a month.

In Table 4, we illustrate the case of a subtractive tax-credit-type, or invoice-type, VAT. In this example, the tax at each stage is the same, but the manner in which it is computed is different. In this case, the firm charges his customer the full VAT rate on the product, and obtains a credit from the government on the VAT already paid by his suppliers. The amount of tax charged by each firm to a customer is shown on an invoice.

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

In this example, the farmer charges the manufacturer a VAT of $.2 \times \$50$ on the \$50 sale of cotton, or \$10. This tax is shown on the farmer's invoice to the manufacturer. The manufacturer charges the wholesaler a VAT of $.2 \times \$100$ on the \$100 sale of the cloth, or \$20. When the manufacturer submits his collected VAT to the government, he subtracts a tax credit of \$10 for the VAT he paid to the farmer. His net VAT paid to the government is hence $\$20 - \$10 = \$10$. The wholesaler charges the retailer a VAT of $.2 \times \$200$ on the \$200 sale of cloth, or \$40. When the wholesaler submits his VAT return to the government, he subtracts a tax credit of \$20 for the VAT he paid to the manufacturer. His net VAT paid to the government is hence $\$40 - \$20 = \$20$. Finally, the retailer charges a VAT of $.2 \times \$400$ to the consumer on the \$400 sale of cloth, or \$80. When the retailer submits his VAT return to the government, he subtracts a tax credit of \$40 for the VAT he paid to the wholesaler. The net VAT paid to the government is hence $\$80 - \$40 = \$40$. The consumer, of course, receives no tax credit at all. The total amount of VAT collected by the government is $\$40 + \$20 + \$10 + \10 , or \$80, just as in the case of the calculation method.

Three Major Types of VAT: the Subtractive (Consumption-Type) VAT, the Additive (Income-Type) VAT, and the Gross-National-Product-Type VAT

There are three major types of VATs: the additive VAT (used in Michigan), the subtractive VAT (used by most VAT-using nations), and a gross-national-product-type VAT (which is rarely used). With the subtractive type, firms subtract purchases of capital goods in computing the tax base, so that the total value added is equal to total retail sales of all final consumer goods. This type of VAT is a general consumption tax. With the additive VAT, firms do not subtract capital goods purchases, but instead subtract a depreciation allowance over the useful life of the capital good; total value added in this case is equivalent to national income.

Both the additive and subtractive VATs allow a tax deduction for the cost of capital goods: the subtractive method at the time of purchase and the additive method according to a depreciation schedule over a projected useful life of the good. The gross-national-product type VAT does not allow any deduction, either immediate or deferred, for capital goods purchases. This feature discriminates heavily against the use of capital goods. Most countries prefer to encourage (or at least not discriminate against) the use of capital goods. Only three nations (Finland, Morocco, and Senegal) out of the 39 countries currently using the VAT use a gross-national-product type of VAT. The gross-national-product type VAT is so-called because the tax base approximates GNP; this type of VAT can have lower tax rates than the other types of VAT since the tax base is larger.

The subtractive approach avoids the problem faced by an income tax system of deciding what depreciation rates to use. It is usually administered, using the tax-credit method of administration, as a transaction tax in which the tax is explicitly indicated on sales invoices or receipts. The additive tax is similar to the business profit tax; it is usually administered, using the calculation method of administration, as a hidden tax on business, so that the purchaser does not know how much tax is included in the price.

Synonyms: Additive VAT = Income-Type VAT; Subtractive VAT = Consumption-Type VAT

The additive VAT is also called an income-type VAT, because the tax is paid on capital goods at the time of purchase and recovered as they are depreciated. The subtractive VAT is also called a consumption-type VAT, because the purchases of capital goods are free of tax. Economists are in disagreement about the relative advantages and effects of the two types of VAT. □Recently, some confusion has arisen concerning VAT terminology. In his book *The Value-Added Tax: Key to Deficit Reduction?* (1987), Charles E. McLure, Jr., uses the term "naive subtraction-method VAT" to refer to the calculation-method subtractive VAT; the term "credit-method VAT" to refer to the credit-method subtractive VAT; and the term "sophisticated subtraction-method VAT" to refer to a calculation-method subtractive VAT in which the firm keeps track of purchases and eliminates untaxed purchases in computing its tax base. Professor Carl Shoup, in his paper "Criteria for Choice among Types of Value-Added Tax" (presented at the World Bank Conference on Value-Added Taxation in Developing Countries, Washington, DC, April 21-23, 1986), uses the term "subtraction method" to refer to the calculation-method subtractive VAT; the terms "tax-credit method" or "invoice method" to refer to the tax-credit subtractive VAT. This new terminology is very confusing because it implies that the credit method is not a subtractive type of VAT, which it is.

Since the original terminology of subtractive tax-credit (or invoice) method and subtractive calculation method was unambiguous and descriptive, it is not clear why the new terminology was introduced. The original terminology was not only patently clear, but was widely used by writers on the VAT (for example, Pechman, Lindholm) for a long time.

Single-Rate Versus Multiple-Rate VATs

Most countries that have adopted the VAT have adopted multiple-rate VATs. Only Denmark and Norway have single-rate VATs. Furthermore, many countries exclude items from taxation by exemption or zero rating. (Exemption and zero rating are tax preferences that are described in the next chapter.) Multiple-rate VATs are regarded as economically less desirable than single-rate VATs because they forego the economic neutrality of a single-rate VAT, and introduce economic distortions (that is, preferential treatment for exempt, low-rate, or zero-rated items). Multiple rates occur when some items are assigned higher or lower VAT rates, or are exempted from VAT taxation altogether, in order to accomplish some sort of social or political purpose. For example, medical services may be excluded because many people consider it "unfair" to tax an item as necessary as medical treatment; from a political point of view, it may make sense to exclude such items in order to achieve the goal of implementing a VAT, even though it may not be "best" from an economic viewpoint, or have substantially greater administrative complexity. In terms of theoretical arguments, some favor the VAT because it is a consumption tax; they may be in favor of exclusion of medical services from taxation on the basis that medical care is not a discretionary consumption item, and should not be included in a consumption tax.

As noted earlier, the calculation-method VAT is best suited for a single-rate VAT. The principal reason for this preference is the fact that, if multiple rates are used but the calculation method is not used, then the amount of the VAT on a particular item is not known. This makes it impractical or impossible to determine the amount of border-tax adjustment to make, to be in compliance with the GATT, as long as the GATT operates on the destination principle. (It is not necessary to use the invoice method with the single-rate VAT, since the amount of tax on all items is the same, that is, equal to the VAT rate.) In addition, the presence of multiple rates creates incentives to reorganize the production/distribution system (that is, merge firms) in order to minimize the total tax. Another disadvantage of a multiple-rate VAT is that special-interest groups bring pressure for preferential treatment. Each time an exclusion is granted, the tax becomes more complicated, more costly, and more susceptible to further modification and complexity.

The calculation method requires substantially less accounting effort than the tax-credit method. Under the calculation method, the tax is determined simply by applying the tax rate to the difference between the firm's sales and already-taxed purchases. This procedure is equivalent to an extremely simple income tax. Under the tax-credit method, it is necessary to keep track of the tax on each business transaction (invoice or sales receipt). The Treasury Department has estimated that administration of a tax-credit (or invoice-type) VAT would require an additional 20,000 employees and an annual expenditure of \$700 million. This requirement would be offset by the reduction realized by elimination of the personal income tax. Implementation of a calculation-type VAT would not require additional IRS staff because it is equivalent in administration to the current corporation income tax.

With a calculation-type of VAT, there is no need to keep track of the VAT on each invoice, so that the consumer is unaware of the effect of the tax on the product's price, just as he is unaware of the

effect of the firm's income or payroll taxes. This feature is desirable from the government's viewpoint, since the citizen is unaware of the tax. It is a disadvantage to you if you wish to be reminded of what taxes you are paying.

In summary, the calculation method is much less costly to implement and administer. As long as the GATT is based on the destination principle, it is necessary to be able to compute the amount of VAT on a product for export, and this is feasible to do under the calculation method only if a single-rate VAT is used. The chances of introducing a single-rate VAT are slim, however, since most countries cannot resist the political pressure to introduce multiple rates and exclusions. As noted, only Denmark and Norway have single-rate VATs. For this reason, unless the US can persuade other countries to change the GATT to the origin principle, it is probably necessary from a practical viewpoint to use the tax-credit method, so that the correct border-tax adjustments may be made.

It is noted that the tax-credit method has a self-policing feature, namely, in order to prove that it was entitled to its claimed tax credits, a firm must keep records of its purchases, showing the amount of the VAT is paid to each supplier. A firm will hence insist on invoices from suppliers that show the amount of tax paid. Since the invoice represents a record of the supplier's sale, the supplier cannot therefore safely avoid paying the VAT indicated on the invoice. This pressure for compliance extends throughout the production/distribution chain. Moreover, if a retail firm chooses (illegally) to operate in the underground economy and not to pay the VAT, he forgoes credit for all taxes paid on his purchases (since he cannot receive a credit unless he pays his tax). Because he is at the end of the production/distribution chain, the amount of tax already paid is generally substantial; the saving that he realizes by not paying the VAT is generally considerably less than the total amount of the VAT.

A businessman at the preretail stage may even be placed at a *disadvantage* by not registering as a VAT payer. This situation may occur because, by being outside the VAT system, he receives no tax credits and his customers receive no tax credits. His customers hence have to pay the full VAT, without any credit. The total tax on the product actually increases by the amount of his foregone tax credits. The pressure to comply with the VAT builds as a product passes through the preretail stages of the production/distribution chain, since the amount of VAT in the product increases. This situation, in which a firm may in fact be placed at an economic disadvantage by not paying its taxes, is a truly remarkable feature of the VAT.

Because the VAT has been used around the world for over 30 years, there is a wealth of experience in its use, and ample experience is available to guide the design of a VAT for the US.

Two Final VAT Terms: Tax Inclusive Versus Tax Exclusive

In most countries, when a VAT rate is quoted, it means the amount of tax computed as a proportion of the pretax price, that is, the price exclusive of the tax. In other words, the base used to compute the tax rate is the price exclusive of the tax. In this case, the VAT rate is said to be tax exclusive. France, however, uses a tax-inclusive base. Under this convention, when the tax rate is quoted, it represents the proportion of the total price -- including the tax -- that is tax. In other words, the base used to compute the tax rate is the price inclusive of tax. The tax base and the tax rate are said to be tax inclusive.

Whichever method is used for determining the VAT rate, the resulting rate is called the nominal rate. The effective rate is the rate computed using the tax-exclusive price as the base. If a country uses a tax-exclusive base for computing its VAT, the nominal rate and the effective rate are the same. If a country uses a tax-inclusive base, the effective rate is higher than the nominal rate. In this case, the relationship between the effective rate and the nominal rate is: $\text{Effective Rate} = \text{Nominal Rate} / (1 - \text{Nominal Rate})$.

The use of a tax-exclusive base is generally considered to be a clearer, less-complicated method of quoting tax rates, and is the preferred method worldwide. The only advantage associated with the tax-inclusive method is that it indicates what proportion of a country's total sales is tax, if the tax is universally applied at a uniform rate. In any case, it is necessary to know the meaning of these terms in comparing VAT rates for different nations.

There Are Many Types of VAT

By now, it should be very clear that a VAT is not a single, uniquely defined tax. There are many varieties of VAT. In "Criteria for Choice Among Types of Value-Added Tax", Professor Carl S. Shoup notes that there are hundreds of different types of VAT. These different VATs correspond to different combinations of choices among eight different VAT characteristics:

- The type of VAT: consumption type, income type, and gross-national-product type
- The regime for international trade: the origin principle (exports taxable, imports exempt) versus the destination principle (exports exempt, imports taxable)
- The administrative method of computing the tax liability: the tax-credit (invoice) method versus the calculation (accounts) method
- The products, firms, or sectors to be excluded from the VAT
- The method of VAT exclusion: exemption versus zero rating
- The sectors and firms that, although taxed, are considered to require special rules or regimes
- A single-rate versus a multirate VAT (in addition to zero rating)
- Tax-inclusive versus tax-exclusive specification of the VAT rate.

The "Personal-Exemption-Type VAT" Is *Not* a VAT

A few years ago, economists Robert Hall and Alvin Rabushka promoted an income tax which they called a flat tax. This proposed tax was to be levied on individuals at a flat rate after personal exemptions, and on firms at a flat rate on income less the cost of labor and purchases of goods and services purchases from other firms (including capital equipment). Recently, the Hall-Rabushka flat tax has been referred to as a "personal-exemption-type VAT." Under the Hall-Rabushka proposal, firms receive a tax deduction for labor costs, and individuals pay an income tax. Labor is hence taxed only once, as with the VAT. Because individuals may receive personal exemptions, however, it is in fact *not* a VAT, since some of the labor (the principal component of value added) is exempted from taxation (through the personal exemption).

The Hall-Rabushka proposal is nothing more than an income tax. As an income tax, the Hall-Rabushka tax is suited for international tax harmonization based on the origin principle. Since the GATT has adopted the destination principle, the Hall-Rabushka tax would not be in harmony with the taxes of GATT nations.

The Hall-Rabushka tax is an income tax, plain and simple. It is not even a flat-rate income tax (as it is purported to be), because of the presence of a personal exemption; that is, it has two rates -- zero and 19 percent). It is in fact a highly progressive income tax. It is not a VAT. It is not a consumption tax. It generates no incentive to save; the only way a person can legally reduce his taxes under the Hall-Rabushka proposal is to lower his income. Because labor is tax deductible to the business and taxable to the individual, the tax includes a strong incentive for tax evasion, and the need for a national police enforcement agency. To include it in the same discussion as a VAT confuses the issues and does the VAT a considerable disservice, because of the very different character of the VAT and the Hall-Rabushka income tax.

Referring to the Hall-Rabushka proposal as a VAT is misleading and deceptive. In view of the severe drawbacks of the Hall-Rabushka income tax, a disservice is rendered by referring to it as a type of VAT. A "personal-exemption-type VAT" is not a VAT!

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.

The Expenditure Tax

An expenditure tax is a consumption tax levied on the consumer rather than the seller of goods and services. It is administered in the same way that an income tax is administered -- the individual reports on expenditures rather than on income. As with the income tax, there may be deductions, and the tax rate may be flat or graduated.

The expenditure tax is favored over the income tax because an income tax reduces savings and therefore has a negative impact on investment.

Some argue in favor of the expenditure tax as a replacement for the income tax and as an alternative to a VAT. As consumption taxes, both the expenditure tax and the VAT have advantages over the income tax. The severe disadvantage of the expenditure tax, of course, is that it is a tax on individuals. Just as the personal income tax requires returns from each

individual, so does the personal expenditure tax. The expenditure tax hence shares all of the sociological drawbacks of the income tax -- the invasion of privacy and the necessity of a national police force to enforce the tax.

Excise Taxes

Excise taxes are consumption taxes on the sales of particular commodities or services, such as gasoline, alcohol, tobacco, or long distance telephone calls. Excise taxes that are applied as a fixed amount on a product are called specific taxes; those that are applied as a percentage of the price of the product are called *ad valorem* taxes.

Excise taxes are generally used because the government, for one reason or another, wishes to place a heavier tax burden on the producers, distributors, or consumers of particular commodities than on the general public. If demand for the commodity is inelastic (not sensitive to price changes), the burden of the tax falls on the consumer. Economists often criticize excise taxes on the ground that in many cases they may decrease the efficiency of the allocation of resources. This inefficiency has the effect of placing some of the burden of the excise tax on everyone in the economy. This burden is referred to as the excess consumer burden of the excise tax.

Excise taxes are often used to fund special programs. Examples are the gasoline tax, used to support development of the nation's interstate highway system, and the airline ticket tax, used to support development of the nation's airports.

Excise taxes may constitute a form of use charge. An example is the excise tax on heavy trucks; this tax represents a way of forcing users of heavy trucks to reimburse society for the heavy wear that these trucks cause to the nation's highways.

Excise taxes may be placed on scarce resources, especially in wartime, as a method of reducing demand for these resources. The "gas guzzler" tax placed on cars that get low-gasoline mileage is an example of an excise tax intended to reduce consumption of a scarce resource.

Excise taxes that are placed on commodities or services that are viewed as socially undesirable (for example, tobacco, alcohol) are called *sumptuary* taxes. The objective of the tax is to charge the consumers of these products for some of the societal costs of these products (lost time from work, automobile accidents, unnecessary use of health care resources, deaths from lung cancer). It may be argued that this type of excise tax actually improves economic efficiency, since the price of the goods does not reflect their true cost. Other examples of sumptuary taxes are taxes on lotteries and other types of gambling.

Property and Wealth Taxes

In the US, property taxes are used heavily by local (city and county) governments. A property tax may be levied against the value of land, buildings, or personal property, depending on the preferences of the local government. The term "wealth tax" or "net wealth tax" refers to a tax on a person's total wealth (assets minus liabilities). Wealth taxes are used to reduce private concentrations of wealth. They are used in many industrialized countries.

Annual property and wealth tax rates are low, for example, a maximum of 2.5 percent. The reason they are low is that they represent a large fraction of the income value of the property. For example, a wealth tax of 2.5 percent on an asset that earns 10 percent return per year represents a tax of 25 percent on the asset earnings. When property taxes in California reached the 2.5 percent level, taxpayers became so angry that in 1978 they passed Proposition 13, limiting the property tax to one percent of 1975 market value.

The US Federal Government has not levied wealth taxes for two principal reasons. First, property taxes have been reserved by custom since the 1930s as a revenue source for local governments. Second, the Constitution would require apportionment of them to the states in proportion to population.

Inheritance, Estate, and Gift Taxes

Inheritance, estate, and gift taxes are special types of property taxes. An *estate* tax is a tax on property transferred at death; it is levied by the federal government. The *inheritance* tax is a tax levied on inherited property received; most states have inheritance taxes. A *gift* tax is a tax imposed on the donor of a gift.

The estate and gift taxes are promoted for various social and economic reasons. A major objective is to equalize the distribution of wealth. As discussed earlier, concentrations of wealth are considered undesirable because they threaten the security of nonwealthy individuals, they cause envy and social discontent, and they are considered to contribute to recessions and depressions.

Inheritance and estate taxes represent a very small proportion of total tax revenue -- on the order of one percent. It might be asked, in view of the trauma they cause (the tax collector showing up upon the death of a loved one), why they not be eliminated.

It has been argued that wealth taxes are undesirable since they destroy capital, and that their one-time levy complicates orderly planning. As applied in the US, they are not very effective in reducing concentrations of wealth.

Inheritance, estate, and gift taxes are privacy intrusive to the heirs of a decedent. Upon the death of an individual, protection of his privacy is no longer a real issue.

Classification of Taxes; Income and Consumption Taxes Versus Wealth Taxes

Taxes may generally be classified into three categories: taxes on income, taxes on consumption, and taxes on wealth. The potential tax base of income and consumption taxes is similar: national income or sales. Wealth taxes are levied on the property holdings of individuals or businesses: real estate, buildings, equipment, and other assets. Income and consumption taxes are levied on the product, or result, of the economic activity of the nation -- the output of goods and services valued at market prices.

The potential tax bases of income and consumption taxes are similar. The potential tax base for income taxes is national income, which is GNP minus allowances for depreciation and business indirect taxes (sales taxes and property taxes); national income is about 80 percent of GNP. The

potential tax base for consumption taxes is generally total retail sales. Total sales differs from national income in that the latter subtracts the depreciation on capital equipment that occurred during the year. Note that there are two versions of the VAT, the income-type VAT, which uses national income as the base, and the consumption-type VAT, which uses sales as the base.

Income taxes are generally levied on an annual basis, although five-year income averaging was allowed in recent years, and businesses are allowed to transfer losses to future years. □ Income taxes are currently the federal government's primary source of revenue; states depend on consumption taxes (such as the retail sales tax); and local governments rely heavily on wealth taxes (such as the property tax).

Taxes are placed on income or consumption versus wealth for different reasons. Taxes are imposed on income or consumption primarily to produce income for the government. Taxes are imposed on wealth primarily to reduce the private concentration of wealth, and thereby enhance the survival of democracy.

Taxes on wealth do not represent a very large proportion of tax revenue; capitalistic governments have little desire to destroy capital -- the "goose that laid the golden egg" of a high economic standard of living. The allocation of tax burden between income and wealth represents a value judgment, tempered by the knowledge that a too-severe tax on wealth may erode a country's capital base. In addition, a point is reached at which citizens perceive a wealth tax as too heavy a burden, at which point they rebel (for example, California's Proposition 13).

Classification of Income and Consumption Taxes

Income and consumption taxes may be classified in many ways: with respect to how they are distributed over the factors of production, the national income base, type of product, sectors of the economy, stages of production, consumption versus income, and business versus individuals.

Regarding factors of production (land, capital, labor and their returns, rent, interest, salary and wages), economists prefer a neutral tax -- one that does not change the preference for one factor over another. Tax neutrality promotes the efficient use of economic resources.

Regarding the national income base, it is desirable to spread taxes over the entire base, so that tax rates are low. A universally applied VAT uses all of national income for the base. The personal income tax and the business profit tax use taxable personal income and taxable business income as bases; together, these represent only 40 percent of national income. In order to keep the tax base broad, it is desirable to avoid exemptions for certain types of product (goods, services, structures), industry, or sector (agriculture, manufacturing).

Regarding stages of production, it is desirable to spread the taxes over the stages, that is, to tax manufacturers and wholesalers, not just retailers. This keeps the tax rates lower than if the entire tax is collected from just one stage. The VAT spreads the burden over all of these stages; the retail sales tax, in contrast, collects the full tax from the retailer. Although the retail sales tax is similar to the VAT with respect to neutrality, it places the full burden of the tax on the final stage of production -- the retail level. The VAT distributes the tax burden over all stages of production, and therefore results in a lower tax at the retail level. As discussed earlier, there is an advantage in keeping tax rates low: to reduce the perceived burden, and to reduce the incentive for tax evasion.

Comparison of Consumption Taxes to Income Taxes

Because the tax bases for income and consumption taxes are similar, it is reasonable to examine the differences between these two taxes. There are differences in two areas: equity (how "fairly" the tax burden is distributed over the population) and economic impact (growth, efficiency, and stability). The income tax is generally viewed as superior to the consumption tax with respect to tailoring the tax burden to ability to pay. The income tax can address ability to pay relative to the income class of an individual, but it does not address ability to pay relative to the wealth class of an individual.

Regarding economic impact, consumption taxes are generally viewed as superior to income taxes. Income taxes have a number of economic drawbacks: they represent a disincentive to save, to invest, and to produce; they produce an incentive to use debt financing over equity financing; they reward inefficient firms; by introducing incentives to change the mix of the factors of production, they distort economic activity and lower the efficiency of the allocation of resources; the lower stability of revenue is considered to contribute to the growing government deficit. With a smaller tax base (taxable income is about 40 percent of GNP; national income is about 80 percent of GNP), income taxes must overall have higher rates than consumption taxes to produce the same revenue. The tax base of income taxes is very complicated, and is open to political manipulation to accomplish preferred treatment of special-interest groups.

In spite of economic theory in support of the increased equity of income taxes, citizens have complained bitterly about the inequity of the income tax, but have not complained about the nonprogressive feature of flat-rate taxes (such as retail sales taxes, payroll taxes). To address ability to pay by means of the income tax, a large number of exemptions, deductions, and rate brackets are introduced. While these may appear reasonable overall, they invariably cause an increased and unfair burden on some individuals, contributing to the perception that the tax is irrational and unfair.

The complexity of the income tax (even under tax reform) invites individuals to turn this complexity to their advantage and create the impression in their fellow citizens that the tax is unfair. Consumption taxes are generally flat-rate, have a simple base (sales), have few exemptions or deductions, and offer few opportunities for taxpayers to take advantage of the complexity of the system. As a result, consumption taxes are generally perceived by the public as evenhanded. Income taxes, on the other hand, are viewed as favoring particular individuals and discriminating against others. In general, income taxes have been viewed as inequitable, and consumption taxes as equitable.

The point has been made that if only we could make income taxes truly comprehensive, we could achieve an economically neutral tax. This goal is not only impossible, it is unnecessary. With a VAT, an economically neutral tax is already available, through a simple, fair tax.

In summary, the income tax is promoted by social economists as a better instrument for achieving equity than the consumption tax. A low, flat-rate consumption tax is generally viewed as superior from an economic-impact viewpoint; this type of tax promotes economic stability, efficiency, and growth. Experience over several decades has demonstrated convincingly that, in spite of the attempt to tailor the income tax to achieve equity, the very "tailoring" of the tax invariably leads to special treatment for certain individuals or groups and causes it to be perceived as an inequitable tax, compared to flat-rate consumption taxes.

Social economists have oversold the income tax as an instrument of achieving social goals. After several decades of experimentation with this approach, it has been demonstrated to be a failure. Perhaps the single significant achievement of the Tax Reform Act of 1986 was that it stands as a statement of the futility of this approach, and a turn to the use of spending policy rather than tax policy as a means of achieving social goals.

There is a philosophical argument that has been used to recommend the consumption tax over the income tax as a general method of taxation. In his book *Leviathan*, Thomas Hobbes asserted that it is just for a person to be taxed on what he takes out of the common pool rather than on what he contributes to it. A person's income is a measure of what he contributes to society ("the pool"). A person's consumption is a measure of what he takes out. From this philosophical viewpoint, it is preferable to tax consumption rather than income (to encourage contributions to the pool rather than withdrawals from it). Thomas Hobbes' assertion was popularized by Nicholas Kaldor in his book, *An Expenditure Tax*.

A person's ability to consume is affected by both his income and his wealth, and by his perception of the stability of his income. By taking all of these factors into account, consumption is a better indicator of ability to pay than income.

Advantages of Business Taxes over Taxes on Individuals

With respect to dividing taxes between business and individuals, a major advantage in using business taxes rather than individual taxes is that, by their very nature, businesses are set up to collect tax revenue and transfer it to the government. The major source of tax revenue is economic activity, and businesses are the seat of this activity (in all countries, wealth-tax revenue is small compared to revenue from taxes on economic activity). There is a relatively small number of businesses: 3 million corporations, 1.5 million partnerships, 10.7 million sole proprietorships (including 5.9 million employers and 9.3 million self-employed individuals), compared to total individuals, approximately 100 million (including the 9 million self-employed). It is administratively costly to collect the revenue from 100 million individuals. The attempt to do so (in the interest of establishing the equity of the system) is severely intrusive of privacy and lays the foundation for a police state. Much wealth is in private hands, and the use of a wealth tax leads naturally to invasion of privacy; a tax on national income can be collected more efficiently from businesses, and without the intrusion of privacy of individuals.

The Problem of Determining the Tax Mix

One of the tremendous advantages of a VAT (or retail sales tax) is that it is a straightforward matter to apply the tax uniformly on all factors of production. (The VAT has the additional advantage over the retail sales tax of having lower rates to achieve the same level of tax revenue.) This is impossible to accomplish with the income tax. To minimize the economic distortions caused by the income tax, many exemptions, deductions, rules and regulations are introduced. A major complexity is introduced, for example, in the task of deciding what depreciation rates should be used on assets to impute an "expense" to these items. In the absence of a VAT or other uniform business tax, a question arises concerning how to allocate the tax amounts over the major tax categories: corporation income, individual income, goods and services, payroll, property. What is the "best" allocation, or even a "good" allocation, over these categories?

The allocation between taxes on national income versus taxes on national wealth is fairly easy to address. The issue is a tradeoff between reducing private concentrations of wealth versus protecting capital. If the former is favored over the latter, high property taxes (for example, about 5 percent in the UK) are indicated; otherwise, low taxes (for example, .5 percent in Belgium) are indicated.

Systems Engineering Can Help Develop a Good Tax System

From this point on, the allocation of taxes among the major income- or consumption-tax types (individual income, corporate income, payroll, and goods and services) is highly arbitrary. A scientific discipline -- systems engineering -- is available for solving this type of problem, but the legislative process that develops the US tax system does not embrace this methodology. Instead, it uses a primitive, nonsystematic political process to develop a tax system. No systematic process is used to identify alternatives, and a "squeaking-wheel" approach is used to evaluate the suggested alternatives. The advantages of a systems engineering approach to tax system development are described in Chapter 13.

The percentage allocation over the major tax-type categories varies tremendously in countries around the world, much more than the percentage of total tax burden expressed as a percentage of GDP. The US tax system is a hodge-podge agglomeration of taxes, developed without using modern systems-engineering methodology. With such a system, the issue of assessing the impact of alternative allocations over the various tax categories, and achieving an allocation that minimizes distortions, is a real and difficult problem. This problem is obviated with the VAT, which is a neutral tax. Given that the task of determining an economically desirable allocation of taxes is very difficult, there is a tremendous advantage in using a tax form (such as the VAT) that by its very nature avoids economic distortions.

One of the additional problems that must be addressed with a hodge-podge tax system is, apart from consideration of economic impact, what is the perceived burden of the tax. This is a political problem as much as an equity problem. An advantage of imposing many taxes (for example, using both income and consumption taxes) is that tax rates are lower and the perceived burden is less. The experience of the past several decades is, however, that income taxes are perceived as unfair and burdensome. Psychologically, the use of uniform, low-rate business taxes evidently appears to strike citizens as imposing less of a burden, and a fairer burden, than the use of a direct income or property tax on the individual, especially a tax whose base is complicated (thereby leading to charges of special treatment, unfair treatment, or inconsistent treatment of particular individuals, businesses, or groups). From a political viewpoint, the use of individual income taxes creates problems.

Another problem to be addressed (if taxes other than a uniform indirect business tax are used) is the effect of the payroll tax. How large should it be relative to other taxes? To what extent does it lower economic efficiency by distorting the efficient allocation of labor versus capital? To what extent does it place the US at a disadvantage to other countries having lower payroll taxes?

The use of a simple, uniform, indirect business tax such as the VAT eliminates many of these problems. The use of a complex array of taxes introduces a serious problem of balancing the rates to minimize economic distortions and maximize equity. The use of a wide variety of taxes may appear to reduce individual tax rates, reduce the perceived tax burden, and reduce citizen

objection. It in fact opens a Pandora's box, leading to severe difficulties in determining what are the correct rates to use to minimize undesirable economic and sociopolitical impact.

15. The Value-Added Tax, or VAT

What About Income Taxes for Business?

The value-added tax, or VAT, was defined in the preceding chapter. This chapter describes the VAT in further detail, presents examples, and describes types of tax preferences under the VAT. It shows why the VAT is preferable to any of the other types of taxes that were described in Chapter 14, as the major source of revenue for the US.

The chapter begins with a general discussion of business taxes, and reasons why the VAT is preferable to the current business profit tax.

My principal concern in proposing the abolition of the personal income tax is to promote and protect the privacy, and in the long run the freedom, of the individual. The argument against the invasion of privacy of the individual is not extended to business. No objection is raised to the government's monitoring of nonpersonal units of production, that is, incorporated businesses. In order for a government to function, it must have some knowledge of economic activity within its borders.

From a personal-freedom viewpoint, then, taxes on business are acceptable. The question that arises is: What type of business tax is best? While a number of business taxes have undesirable features, the business profit tax is perhaps the worst. The corporation income tax, through its incentives to discourage saving and investment, its incentive for debt financing, its penalization of efficient firms, and its incentive to favor certain factors of production and business structures over others, disturbs the efficient allocation of economic resources. Government imposition of taxes on business is one matter; government interference with business by means of a complex tax system that wastes resources in tax analysis and tax avoidance, and that creates incentives for poor business decisions that distort the economy, is quite another.

The Free-Enterprise System Has Accomplished Impressive Economic Growth

The success of a mildly regulated free-enterprise capitalist system to provide a high standard of living for many is impressive. The alternative systems of heavy socialism and communism have simply not been able to achieve the productivity or creativity levels that have been achieved by a profit-motivated free-enterprise system. There are, of course, serious problems that the free-enterprise system has failed to solve, such as extinction of other species from the planet because of overpopulation by the human species; destruction of the ozone layer; pollution of land, air, and water; acid-rain destruction of lakes and forests; nuclear waste; overcrowding; unemployment; poverty and hunger. On the other hand, other major socioeconomic systems have not succeeded in solving these problems, either.

In his book *Small is Beautiful: Economics as if People Mattered*, E. F. Schumacher proposed a solution to these problems, based on the restructuring of economic society into small, stable, totally self-sufficient economic units that recycle all of their waste, such as some Chinese villages. Until the environment of the planet is substantially ruined, however, and the quality of life begins to degrade even for the wealthy and politically powerful, it is unlikely that proposals such as those of Schumacher will be considered seriously, or that serious efforts will be made to solve these

problems. Until then, or until a large-scale nuclear war occurs, the primary goal of most nations will be to attempt to increase the standard of living of the human species, at the cost of extermination of all wild animal life forms on the planet, and our own species' ultimate destruction. To that end, the regulated free-enterprise system appears to be the system of choice for promoting the material welfare of human beings. The VAT, as a tax that promotes economic growth and stability, is well matched to the goals of the free-enterprise system.

The Business Profit Tax Has Economic Disadvantages, but It Does Not Severely Compromise the Privacy of the Individual

Accepting the concept of a regulated free-enterprise system, the question then arises concerning the role of government in monitoring and regulating business. With respect to invasion of privacy, government monitoring of business for tax revenue collection is a necessary alternative to monitoring of individuals. Taxes have to be collected from somewhere, either from individuals or businesses (or both), and the enforcement of the tax-collection process is going to require some invasion of privacy of the taxed entity. Since the needed government revenue may be more easily and efficiently collected from business, the personal income tax is unnecessary, and government invasion of individual privacy is unwarranted. Since the collection from business is less costly, more economically efficient, and less detrimental to the freedom of the individual, all of the required tax revenue (that is collected from national income, not wealth) should be collected from business. Incorporated businesses are not natural persons; they simply represent economic structures set up to serve man. The invasion of their privacy does not strike at the heart of individual liberty. Government monitoring of businesses to assist tax collection does not constitute the pernicious threat to liberty that government monitoring of individuals does. While the invasion of a business's privacy may be annoying, it represents a minimal-level intrusion -- and an acceptable one, considering the alternative.

From an economic perspective, the current business income tax -- a profit tax -- has some of the same problems that are present in the current individual-income-tax system. For example, the tax code is unnecessarily complicated, and business spends a great deal of legal and accounting effort in tax avoidance rather than in productive activities. Businesses are required to conduct substantial accounting to determine taxable income, for example, by applying IRS depreciation schedules, by reviewing expense items to determine their tax-deductible status.

A Low-Rate VAT Reduces the Incentives for Tax Evasion

From the discussion of the problems associated with the personal income tax, we saw that one of the problems, the incentive to keep income in the business and pay for items through the business, was jointly motivated by the structure of the personal income tax and the business profit tax. This incentive occurs because many items are tax deductible to the business but not to the individual (that is, they must be paid for by the individual in after-tax dollars. This chapter discusses a type of business tax -- the VAT -- that dramatically reduces this incentive.

Under the income tax, the honest taxpayer is at a distinct disadvantage relative to the dishonest taxpayer, who cheats on his taxes. Under the VAT, as discussed in the last chapter, the dishonest taxpayer may even be at a competitive disadvantage! A nonretail businessman who evades the VAT places himself at a competitive disadvantage. If he does not pay the VAT, he is in no position

to give invoices to his customers showing that he did (or he will surely be caught). Because his customers receive no tax credit on purchases made from him, they will turn to other suppliers.

The VAT Is a Good Tax on Which to Base Spending Policy

One of the changes brought about by the Tax Reform Act of 1986 was the abandonment of the policy of using tax incentives to assist the attainment of particular social or economic goals. In view of the low level of economic and social control that tax policy enabled, and the tremendous dissatisfaction that was engendered in people who saw the wealthy make extensive (and creative) use of tax deductions that the nonwealthy could not afford, this is a good move. This shift away from the use of tax policy to achieve such goals will see a corresponding shift to the use of "spending" policy to achieve national goals. One of the requirements for sound spending policy is stable revenue. The VAT can produce this stable revenue; the income tax does not.

The VAT

How should a business be taxed if it is not taxed on profits? There are many alternatives. First, it could be taxed on total income, that is, on gross receipts. This would be analogous to taxing an individual on his total income.

As discussed in the preceding chapter, the problem with a gross-receipts tax is that the tax pyramids, or cascades -- the tax is heavy on products that have many separate firms involved in their manufacture and distribution. If uncorrected, this feature either introduces severe economic distortions (by raising the prices of such products) or encourages the merging of firms (that is, for firms to acquire their suppliers). If the government attempts to correct this problem by setting differential rates, the tax schedule becomes impossibly complicated.

To avoid this problem, many governments have adopted the VAT. The VAT is imposed only on the additional economic value (mainly labor and profit) added to materials by each firm in the production process. This procedure removes the incentive for the firms to merge (since the total tax over all stages of production will be approximately the same whether the firms are separate or merged), and thereby promotes competition and economic efficiency.

In order to use a VAT, of course, the government must set up rules for determining the value added to materials by a firm. Estimation of value added is less difficult than estimation of profit, since value added is defined very simply (as total revenue less cost of goods and services purchased from other firms); whereas, profit is more difficult to define.

A definite advantage of the VAT over the profit tax is that two firms that produce the same product from the same materials will pay approximately the same tax. This feature removes the major undesirable features of the profit tax: penalization of firms that are more efficient and realize a greater profit, and creation of an incentive to waste legal and accounting resources by attempting to hide profits and avoid taxes.

The VAT is a desirable tax from an economic viewpoint because it is economically neutral. All of the factors of production are taxed at the same rate, so that the decision to use a particular mix of inputs (such as labor versus capital) is not affected by the tax.

The VAT is preferred to a single retail-sales tax (on domestic trade and services) when the revenue required by the government is very large. If the total revenue requirement is small, a retail sales tax (or other business tax, such as a manufacturers tax) can provide all the needed revenue at a low sales-tax rate. When the revenue requirements is heavy, however, as is the case in the US today, a very high retail-sales-tax rate would be required to raise the needed revenue, since retail sales in the distributive trade and service industries amount to only about 8 percent of national income. The VAT imposes a tax at all stages of production, and on all industries, so that a lower tax rate is possible.

Taxable Items Are More Simply Defined Under the VAT Than Under the Income Tax

Government verification of value added requires monitoring of the firm's revenues and expenses. This is intrusive, but it does not impose additional cost because firms must monitor revenues and expenses in any event. Every country needs some kind of tax, and some type of government verification is inevitably required. The VAT keeps the requirement for government verification of the tax base and tax computation to a tolerable level. Furthermore, unlike the case for profit, the definitions of revenue and expense are standard accounting definitions, so that no accounting resources are wasted in the determination of profit defined according to a very complicated set of IRS regulations.

Under a VAT, the Incentive to Make Purchases Through One's Firm Can Be Dramatically Reduced

Even under a VAT, there is still some incentive for an owner of the firm to purchase personal goods through his firm, that is, to pay for goods and services out of the firm, rather than to pay himself an income and then buy these goods and services. This incentive exists because goods and services purchased by the firm are tax deductible under the VAT concept. For example, by purchasing a car through the firm, he avoids having to pay himself an equivalent amount of income. The car is tax deductible under the VAT, but labor payments are not (unless purchased from another firm that has already paid the VAT on the labor services). For this reason, the firm's tax bill is reduced by the amount of tax on the car (since the nondeductible labor expense of the business is converted to a deductible expense for the car). The firm's expenses are increased by the cost of the car, but since the owner owns the firm, that would not matter to him as long as the firm is showing a profit.

Although some incentive still exists under a VAT to make personal purchases through one's firm, the incentive is dramatically reduced from the current system, for two reasons. First, because of the broad tax base, the VAT rate would be much lower than the current corporate income tax rate. Second, dividends and labor earnings are not taxable to the individual (under the VAT-based system proposed in this book, there is no individual income tax). There is no double taxation of dividends, with its corresponding creation of an extreme incentive to make personal purchases through one's firm.

The problem of owners' making purchases through their firms is a worldwide one, and exists to some extent even under a VAT. For example, in France (the first nation to adopt a national VAT), firms are simply not allowed to include any automobiles or gasoline as VAT-deductible items because of the practical impossibility of verification of the business status of these items.

You may wonder why so much attention centers on the incentive of a tax system to motivate owners to make purchases through their firms. The number of individuals who are in a position to do so is not very large, and the tax loss associated with this practice is not great. Also, many people view the ability to make a few purchases through one's firm as an acceptable perquisite for the hard work and long hours that generally are the business owner's lot. Despite these observations, there are several reasons why the practice draws attention. First, in spite of its limited extent, the practice generates a certain amount of envy, and the perception that the tax system is unfair and the government duped. Second, the incentive, if strong, corrupts our citizens by encouraging them to engage in an activity that may be illegal. This corrupting incentive can and should be kept at low levels. An unnecessarily high incentive exists in our present system, and it should be reduced. Third, the government recognizes that the system contains a high incentive to evade, and therefore expends considerable resources in attempting to suppress the evasion.

Use of a Low-Rate VAT Would Dramatically Reduce the Incentive to Shelter Income in One's Firm

The question arises: If there is still an incentive for the owner of a firm to make personal purchases through the firm, to what extent is the VAT preferable to the personal income tax and the business profit tax? The issue turns on the level of the tax rates. Under the personal income tax system, the owner's tax rates are up to 33-percent federal personal income tax, up to 10 percent state income tax, and up to 7-percent payroll tax. In addition, the firm's marginal tax rate is up to 39-percent federal income tax, up to 10-percent state income tax, and up to 7-percent payroll tax. As described in Chapter 8, these high taxes combine to produce an effective discount of up to 71 percent on goods purchased by the owner through his firm, the exact rate depending on the owner's and the firm's tax brackets and whether the owner buys the goods out of funds that would otherwise represent profit or salary.

The incentive to make purchases through the firm also exists in a tax system in which there is a VAT and no income tax, but for different reasons. Labor costs are taxed in the firm, but the individual pays no tax on his income. The car is tax deductible to the firm. If the firm pays salary to the owner to buy the car, it pays tax on that salary (both the VAT and payroll taxes). If the firm buys the car, it saves the tax on the car because it has substituted a tax-deductible item (the car) for a non-tax-deductible item (labor).

Under a VAT system, then, the incentive to purchase goods or services through the firm is represented by the sum of the VAT tax rate and the payroll tax rate. Assuming a VAT tax rate of 20 percent and a payroll tax rate of 20 percent, this amount is 40 percent. In other words, the owner of a firm receives a 40-percent discount by making purchases through the firm. Although this is still an incentive, it is considerably reduced from the incentive that exists under the current system, with its very high income-tax rates and business-profit-tax rates. The advantage arises because the VAT is a low-rate tax on a broad tax base, whereas the personal income and business profit taxes are high-rate taxes on narrow tax bases.

The incentive to purchase goods through one's business appears to be most widely exercised through the purchase of automobiles and gasoline. In recognition of the corrupting influence of high business tax rates and the administrative impossibility of monitoring businesses sufficiently closely to determine the extent to which an automobile is used for business versus pleasure,

France has adopted the position that no automobile or gasoline may be classed as business expenses. This position eliminates the single greatest incentive for purchasing goods through one's firm and significantly reduces the corrupting influence of the tax. That approach -- the elimination of a strong incentive -- is a far more humane approach than the US approach of raising the incentive to intolerable levels (up to a 70 percent discount) and then attempting to correct the problem by means of heavy administrative monitoring and punishment. The absurdly high incentive to evade embodied in the US income tax system represents nothing less than a perverse entrapment scheme.

From the point of view of reducing the incentive to make purchases through one's firm, then, there is a strong case for replacing the personal income tax and the business profit tax by a VAT. With regard to elimination of the personal income tax and the business profit tax, this would be equivalent to returning to the situation that existed before the imposition of the personal income tax in 1913 and business profit tax in 1909. The difference, of course, is that the revenue produced by these taxes would be replaced by the VAT.

Is There Any Tax System That Completely Removes the Incentive to Make Purchases Through One's Business?

Even under a low-rate VAT, then, there exists some incentive to make purchases through one's business. An issue to be addressed is whether the VAT provides an *unacceptable* incentive for individuals to keep their salaries within the firm, and to use the firm for pay for personal items, such as cars, trips, and parties.

Under the current tax system, there is a very strong incentive for people to buy things through their businesses. This incentive is not only highly corrupting, but it promotes a practice that is particularly galling to individuals who do not own their own businesses, and draw all of their income as wages or salaries. With a VAT and no additional labor income tax, the incentive to continue this practice is considerably reduced from what it is with our current system. With the elimination of automobiles as deductible business expenses, the incentive is further significantly reduced.

A question that arises is: Is there any tax system in which the incentive for an owner to make purchases through his firm is totally eliminated? The answer is yes. If a turnover tax is used, and there is no personal income tax or payroll taxes, the incentive is removed. The reason for this is as follows. Recall that a turnover tax is a transaction (sales) tax that is imposed at each stage of production each time a commodity turns over. For example, the tax is imposed on the manufacturer, the wholesaler, and the retailer. The difference between the turnover tax and the VAT is that the turnover tax does not adjust for taxes that may have been paid at earlier production stages.

Under the turnover tax, labor is not taxed in the firm, nor is the car tax deductible. The tax is on sales, period. The tax to the firm is the same, whether it buys the car or not. The tax to the individual is the same (zero), whether the car is purchased in the firm or whether he is paid income with which to purchase the car.

Why not eliminate the personal income tax and payroll taxes and adopt a turnover tax in their places? The answer is that the turnover tax is such a bad tax that the disadvantages of this solution far outweigh the advantages of removing the incentive to make purchases through one's

firm. Because the turnover tax pyramids, it creates severe tax burdens on products whose manufacture or distribution involves numerous stages. This situation creates a strong incentive for vertical integration, for example, for manufacturers to purchase their suppliers.

In an attempt to moderate the burden or reduce the integration incentive, the government faces strong pressure to introduce varying tax rates. The problem that arises with this approach is that an economy is so complex that the tax rate structure eventually becomes extremely complicated and administratively burdensome. Moreover, it is simply not possible to address every situation, and the tax becomes inconsistent and inequitable. For these reasons the turnover tax is a very poor tax.

The situation we face then, is that it is not practical to totally remove the incentive for owners to make purchases through their firms. The incentive is dramatically reduced, however, by replacing the personal income tax and the business profit tax by the VAT. It is of interest to examine the costs of this incentive, given that there is no practical way of avoiding it entirely. Under a 20-percent VAT and a 20-percent payroll tax, the owner receives a 40-percent discount by making purchases through his firm. The practice of making purchases through one's firm is undoubtedly more common in small firms than in large ones, since the owner has direct control over purchase decisions in a small firm.

Furthermore, the procedure works only if the firm has sufficient profits to cover the cost of the desired item. The practice encourages consumption, since it represents an incentive for the owner to make purchases rather than to save the money in the firm or to purchase somewhat less with the reduced income he would receive after the firm pays taxes on it. With a VAT system, the savings accrue to the owner only if the firm has profits that will cover the cost of the item to be purchased.

Under the VAT, the resentment caused by owners making purchases through their firms should be considerably less than it is under our current system. First, because the incentive is less, the practice should be reduced. Second, because the discount is significantly reduced, the envy of nonowners to whom this privilege is not available should be considerably less. Knowing that someone -- for example, the 60-hour-a-week owner of a small business -- was able to save 40 percent on his car by taking advantage of the tax system is not as irksome as knowing that he was able to save 71 percent by doing so. Finally, the resentment and corrupting influence can be significantly reduced by the elimination of automobiles and gasoline as tax-deductible items for business.

Elimination of the Personal Income Tax and Business Profit Tax Probably Will Face Government Opposition

In spite of the fact that the revenue lost by eliminating the personal income tax and the business profit tax could easily be replaced by the VAT, the government is unlikely to want to do this, since, having succeeded in persuading the population to accept the concept of an income tax, it would see no reason to give up what appears to be an additional source of tax revenue. The fact is, however, that from an economic (rather than sociological) viewpoint, the issue of deciding how much *total* tax revenue is extracted from the economy is generally more important than the issue of deciding *at what points* in the economy the tax revenue shall be extracted. Ignoring noneconomic costs such as equity and intrusiveness, from an economic point of view it doesn't matter a great deal whether the government extracts the tax revenue from the economy by taking

the money from individuals or from businesses. The fundamental issue is what percentage of national income is being funneled into government expenditures.

Changing the allocation of tax burden between individuals and business may produce economic dislocations, but probably not as substantial as changing the total tax burden. The point is that it is the total productivity of the country that determines how easily we can afford a specified total tax burden. If the personal income tax is eliminated and the associated revenue replaced by a VAT, individuals will pay more for goods. The money they save by not having to pay income taxes will be generally offset by the money they spend in higher prices to enable firms to pay for the VAT.

Replacing the Personal Income Tax and the Business Profit Tax by a VAT Would Reestablish the Privacy of Individuals

From the point of view of intrusiveness, the VAT is about as intrusive -- to businesses -- as the income tax, since verification of the value added requires monitoring of the firm's accounts. Less resources are wasted in accounting and legal fees, however, because no Rube Goldberg encyclopedia (the income tax code) is necessary to specify what is taxable and what is not, that is, what constitutes profit under IRS regulations and what does not. All the government really needs to know is what the firm's goods and services expenses are and what its revenues are. These items are simply defined and easily identified; the IRS definition of profit is not.

The VAT Includes a Tax on Labor

It may appear, with the VAT, that if there is not an additional earnings (payroll or income) tax, then labor has not been taxed at all. This is not so. Since value added includes labor cost, labor is taxed, at the VAT rate.

With a VAT and no additional labor income tax, labor income is not exempted from tax nor is it double taxed. It is taxed only once, when the firm pays the VAT. There is no tax discrimination for or against labor.

There is a rationale for total elimination of the personal income tax when a VAT is used. Once labor has been taxed, by applying the VAT to Revenues minus Materials, Supplies and Services Expense, it is undesirable to tax it a second time, through an additional earnings tax. Just as the imposition of successive profit taxes on firms that add value to products provides an additional incentive for vertical integration (through merging) of firms, a second taxation of income provides an increased incentive for the individual to "merge" with the firm, that is, to keep his income in the firm, and to use the firm for personal expenditures. With a 20-percent VAT and a 20-percent payroll tax, the discount that an owner receives in making purchases through his firm is already 40 percent. The addition of even a low personal income tax -- for example, 15 percent -- would increase this incentive substantially.

Effect on Wages

If the US replaces the personal income tax and business profit tax by a VAT, wage rates will change over time. If the VAT rate is such that it replaces the revenue lost by eliminating the

personal income tax and business profit tax, wages received with a VAT (assuming no personal income tax) will eventually be about the same as current after-tax wages.

Alternative Ways of Administering a VAT: The Tax Credit Method Versus the Calculation Method

Recall that there are two different ways of administering a VAT. Under the tax-credit method, the firm indicates the VAT explicitly on all invoices or sales receipts, and deducts the VAT already paid by other firms in its purchases from its tax payment to the government. Under the calculation method, the tax is hidden from the consumer. The firm computes the difference between revenues and expenses, applies the VAT rate to the difference, and sends this amount to the government. The consumer does not know how much tax is included in the price. But what are the relative advantages and disadvantages of the two approaches?

As was noted earlier, the calculation method is far less costly to implement than the tax-credit (invoice) method, since with the former the tax may be computed simply from the firm's accounts, whereas the latter requires recording the tax on every invoice (for both sales and purchases). (Note: Implementation costs include both the government's administration cost and the firm's compliance cost.) An advantage of the invoice method is its self-policing feature, in which firms demand and retain invoices to verify their tax credits. A major factor determining whether the calculation method may be used is whether the country adopts a single-rate VAT or a multiple-rate VAT. Because the GATT has adopted the destination principle, a country may impose border-tax adjustments equal to the VAT, and it must, therefore, be able to determine the amount of VAT on each product exported. With a single-rate VAT, this may be done with either the calculation method or the invoice method. With a multiple-rate VAT, this is not feasible to do under the calculation method; the invoice method must be used.

In view of this situation, the US would have three alternatives, if it is desired to adopt a VAT: (1) adopt a single-rate VAT and use the calculation method; (2) adopt a multiple-rate VAT and use the invoice method; (3) persuade the other nations of the world to place the GATT on the origin principle, in which case border-tax adjustments are unnecessary and the calculation method may be used with either a single-rate or multiple-rate VAT. Since few nations have been able to resist the political pressures to allow multiple rates, and since it is probably unlikely to switch the GATT from the destination principle basis to the origin principle basis, alternative (2) (a multiple-rate VAT with the invoice method) is probably the most likely type of VAT to be adopted in the US.

The Calculation-Type VAT, Like the Income Tax, Is Hidden From Consumers

Since under a calculation-type VAT the tax is not indicated on invoices, it is hidden from consumers, just as the current income tax is hidden. This represents an advantage to the government, but a disadvantage to the consumer. The advantage of having the tax explicitly indicated is that it reminds us of the magnitude of the government's tax. On the other hand, people may view a 20 percent VAT as far worse than a hidden payroll tax and profit tax of even greater magnitude, say 30 percent. Regardless of where the economic burden of the VAT rests (on the consumer or on the firm), they may view an explicitly stated add-on VAT as a sales tax, paid by them, the consumers, whereas they may view a hidden VAT as a tax on business, not paid by them. If this were to be the case, popular opinion might prevent the passage of a VAT in this country.

Popular opinion concerning the incidence of a tax is based on appearances, not on economic theory. For example, in spite of the fact that economists generally view that the incidence of the burden of the "employer" and "employee" payroll taxes is on the employee, it is popularly held that half of the burden is on the employer and half on the employee, since the tax is *administered* as a 7.15-percent levy on the employer and a 7.15-percent levy on the employee. Because of the importance of appearances to the public, an explicitly stated 20-percent VAT recorded on all invoices / sales receipts would appear to be a 20-percent sales tax imposed on consumers, whereas a 20 percent hidden VAT would appear to be simply an income tax on business; it would not be apparent to consumers at all.

The Subtractive VAT Has Advantages Over the Additive VAT

With a subtractive VAT, the total cost of capital goods produced by the firm is subtracted from revenues, in determining value added. The total value added (over all firms in the economy) equals total sales. Since this type of VAT is a general consumption tax, it is called a consumption-type VAT. With the additive VAT, the firm subtracts only a depreciation allowance, rather than the total cost of capital goods purchased. Total value added equals national income. This type of VAT is called an income-type VAT; it is a proportional income tax (assuming the same VAT rate for all firms in all industries).

A subtractive VAT may be restricted to the distributive trades, in which case the base is simply retail sales, and the tax is then oriented toward application to consumer goods. The additive VAT is oriented toward service industries, such as the finance industry. Economists are not in agreement on the difference in economic impact of the two types of VAT. Some believe that the income-type VAT reduces the return on capital, while others believe that it raises the price of consumer goods.

From an economic viewpoint, then, there is disagreement on whether the burden of the VAT is on the consumer, even though the GATT views it as an indirect tax that raises prices.

Economists argue over the economic effects of the two types of VAT. With the subtractive (consumption-type) VAT, purchases of capital goods are tax-free. With the additive (income-type) VAT, the full VAT tax is paid on the capital goods when purchased and recovered (through a tax-deductible depreciation expense) over the useful life of the asset. Prepayment of the tax under the additive VAT appears to reduce the return on capital, since the present value of the investment stream is dramatically reduced by the large tax payment outflow in the first year. The subtractive VAT, on the other hand, represents a strong incentive to purchase new capital goods (plant and equipment) because they may be purchased tax-free. Under the current tax system, this would be the equivalent of a 100-percent first-year depreciation allowance.)

In addition to the apparent economic advantages of the subtractive VAT, it has a substantial administrative advantage over the additive VAT, since it avoids the problem of determining the appropriate depreciation rates to use for capital goods. Under the current income tax system, there is a wide variety of depreciation schedules, depending on the expected useful life of the equipment and the rapidity of the depreciation. By keeping the definition of the tax base simple, the accounting burden imposed on the firm by the tax is dramatically reduced. The firm's accounting may be directed toward improving the firm's business decisions, rather than to structuring accounts to please the IRS.

If an additive VAT is used, the unsolvable problem of defining profit rears its ugly head. This problem was never solved for the corporate income tax, and leads to an incredibly complicated and ever-changing definition of taxable income. To avoid this problem with a VAT, use of an additive VAT is not recommended. An additive VAT is an income tax, with all of the attendant problems of an income tax.

The Temptation to Allow Exemptions to the VAT Seems Irresistible

In almost all countries that have adopted the VAT, some consumption items are excluded (to some degree) from the tax. Only Denmark and Norway have adopted single-rate VATs, in spite of the significant advantages of the single-rate VAT relative to economic neutrality and compliance cost. Examples of excluded items include food produced and consumed on farms, food provided by employers, domestic services, services of financial institutions (checking accounts), food for home consumption, household utilities, medical care, and public transportation. The reasons for excluding these items are political and economic.

From an economic efficiency viewpoint, it is preferable to tax all items. A philosophical argument may be set forth, however, for not taxing some items. Suppose, for example, that it is desired to adopt a consumption tax, and that some type of VAT is being considered as a candidate. It may be argued that medical services are necessary for maintenance of one's health and ability to produce. On that basis, the cost of such services should not be regarded as a consumption item, but as an investment in human capital. On this basis, it should not be taxed if a consumption tax is desired. This same argument -- investment in human capital -- is used as a basis for exempting educational expenses.

On the other hand, the US Government has traditionally disallowed investments in human capital (for example, in education) as tax-deductible items. One problem with allowing tax preferences for human capital investment is that of scope -- where does one draw the line on what is consumption versus investment in human capital. Theoretically, much of what a human being consumes (food, clothing, shelter, utilities, transportation, medical services) can be viewed as necessary investments in human capital. The problem of defining "consumption" is as intractable as that of defining "income." For this reason, it is desirable, when proposing tax alternatives, to avoid taking philosophical stands such as "we want a consumption tax," or "we want an income tax." Such stands lead to interminable arguments about what constitutes income or consumption, and to a complex tax code that perpetually attempts to adjust to an unknown definition. It is preferable, from the practical point of view of obtaining a fair, simple tax, to identify and synthesize alternatives (such as the VAT or the payroll tax) and examine their costs and benefits relative to stated criteria (for example, ability to pay, invasion of privacy, compliance and administrative cost).

In general, the desire to exclude certain items from tax is often political. To many, it does not seem "fair" to tax medical services, since they are "necessary." On the other hand, the rationale for excluding financial services is practical. In the first place, many services of financial institutions are not fairly priced (such as free checking accounts), but are subsidized by loan charges. On the other hand, if a VAT is charged on bank loans, a strong incentive is created to make private loans in the underground economy (at lower interest terms because no VAT is charged). (The self-policing feature of the VAT fails because the lender has no inputs.) Furthermore, since many countries exempt financial institutions from the VAT, it is not practical for new countries adopting

the VAT not to follow suit, if they wish for their banks to be able to compete in international markets.

Tax Preferences Under the VAT: Exemption Versus Zero Rating

In discussions dealing with tax exclusions from the VAT, it is important to understand the meanings of two terms: exemption and zero rating. An exemption refers to the situation in which a firm pays no VAT and does not receive a tax credit (refund) for the VAT that already has been paid by his suppliers on his purchases (earlier in the production chain). The firm is not in the VAT system. Zero rating refers to the situation in which a firm is in the VAT system, but the VAT rate on a particular item sold by the firm is zero. Because the firm is in the system, it receives a tax credit (refund) for the tax already paid by other firms on his purchases.

If a retail firm is exempted, it pays no VAT, but neither does it receive a tax credit for the VAT already paid by its suppliers on its inputs. The government keeps all of the VAT already paid on the item by manufacturers and distributors prior to the exempted retail stage. Exemption of certain firms is granted when the government wishes to avoid the administrative burden associated with registration of the firms for VAT taxation, for example, in the case of small businesses or family farms.

If a retail firm is zero-rated, it not only pays no VAT (since the VAT rate is zero), but it further receives a full refund on all the VAT paid by its suppliers on its inputs. The government receives no tax at all from the production and sale of a zero-rated item. The item is truly not taxed. Zero rating is used when the government wishes to eliminate the tax on an item for some reason. For example, it may wish to eliminate the tax on medicines. Or, it may wish to eliminate the VAT on exports.

Both exemption and zero rating are referred to as tax exclusions or tax preferences. Zero rating may represent a much larger tax deduction, especially for firms late in the production/distribution chain. In granting tax exclusions, the government generally prefers to grant exemptions rather than zero ratings because it loses less tax revenue from exemptions (and may actually *gain* revenue if the exemption occurs prior to the retail stage).

If a firm that produces goods at an intermediate stage of production (prior to the retail stage, such as a manufacturer or wholesaler) is exempted, the total VAT is eventually collected (at the retail stage) because the production stage following the exempted stage will not receive a tax credit for its inputs. In fact, since exemption represents a break in the chain of tax credits, the total tax on the item may exceed the VAT rate, if any VAT was paid prior to the exempted stage. The government receives tax from phases prior to the exempt phase and after the exempt phase. Firms following the exempt phase receive no credit for taxes paid by firms prior to the exempt phase, and hence pay the full VAT on the product.

Exemption of firms at intermediate stages of production causes distortions in the tax rates; the VAT is no longer uniform, and no longer economically neutral. Since the exempt firm receives no tax credits and its customers receive no tax credits, it may be placed at a severe competitive disadvantage, in both domestic and international markets.

Exemption of intermediate firms both raises the tax rate and shifts the tax burden from the exempted firm to firms following it in the production chain. Exemption of intermediate firms is a disadvantage both to the exempted firm and to the taxpayers later in the production chain.

Tables 5 through 8 illustrate the effect of VAT exclusions, exemptions and zero rating. Four examples are provided: zero rating at the retail stage (Table 5); zero rating at an intermediate stage (a production stage prior to the retail stage) (Table 6); exemption at the retail stage (Table 7); and exemption at an intermediate stage (Table 8).

Table 5. Effect of Zero Rating at the Retail Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Zero Rated at the Retail Stage)

	<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	0	70
Purchases	0	50	100	200	350
VAT Credit on Purchases	0	10	20	40	70
Net VAT	10	10	20	-40	0

Table 6. Effect of Zero Rating at an Intermediate Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Zero Rated at the Manufacturing Stage)

	<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	0	40	80	130
Purchases	0	50	100	200	350
VAT Credit on Purchases	0	10	20	40	70
Net VAT	10	-10	20	40	60

Table 7. Effect of Exemption at the Retail Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Exempted at the Retail Stage)

	<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	0	70
Purchases	0	50	100	200	350
VAT Credit on Purchases	0	10	20	0	30
Net VAT	10	10	20	0	40

Table 8. Effect of Exemption at the Intermediate Stage, under a Subtractive Tax-Credit VAT (20-Percent VAT, Exempted at the Manufacturing Stage)

	<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	0	40	80	130
Purchases	0	50	100	200	350
VAT Credit on Purchases	0	0	0	40	40
Net VAT	10	0	40	40	90

If the retail stage is zero rated (Table 5), then the government receives no tax. This is the case, for example, for exporters; the exporter is zero-rated. The total amount of the VAT is removed, for all stages of production.

If an intermediate stage is zero-rated (Table 6), the government receives no tax from the product through the zero-rated stage, but it receives the portion of the tax from later stages of production.

If the retail stage is exempted (Table 7), the government collects the portion of the VAT at all prior stages.

If an intermediate stage is exempted (Table 8), the government collects *more* tax than if the stage had been included in the VAT system. The reason for this is that the chain of tax credits is broken. The firms following the exempted stage pay the full \$80-VAT because they receive no tax credits from the manufacturer (exempted in the example of Table 8). The government retains all VAT paid prior to the exempted stage because the exempted stage receives no tax credits. In this example, the exempted manufacturer receives no credit for the VAT on his purchases from the farmer (a tax gain of \$10 for the government). Since the exempted manufacturer charges no VAT, the wholesaler receives no credit for any VAT on his purchase from the manufacturer. He must pay the full \$40-VAT, not just on his own value added, but on *all* of the value added through his stage of production. The net tax gain to the government is hence \$10 -- the total tax paid prior to the exempted stages.

If exemption is a status that is associated with items (rather than with firms), a substantial additional complexity is introduced. The problem arises when a firm sells both exempt and nonexempt (taxable or zero-rated) items. In this case, the firm must decide what portion of its inputs is associated with the production of the exempt items versus the taxable (or zero-rated) items. It must make this decision because a refund is granted for inputs associated with taxable or zero-rated items, but not for inputs associated with exempt items. Some sort of allocation scheme would be necessary, such as allocating input costs to exempt and nonexempt categories in proportion to total exempt and nonexempt sales.

If an intermediate good is zero-rated, the government does not lose any tax revenue, since the revenue lost from zero-rating the intermediate firm is made up at the retail stage (the amount of the tax credit the retail firm receives for the zero-rated good is zero). The zero-rated firm receives a refund equal to the amount of the VAT already paid on its inputs, and pays no VAT. The production stage following the zero-rated stage receives no deduction for the zero-rated purchases, and pays the full VAT.

Exemption of firms is less costly to the government (in terms of lost tax revenue) than zero rating. For this reason, the government is more likely to use this method of tax exclusion than zero-rating. For example, if banks or educational institutions are exempted, they receive no tax credit for their inputs. The problems associated with exemption can be alleviated by allowing exempt firms the option of registering for zero rating, or by zero-rating inputs used primarily by exempt firms (for example, fertilizer, if farms are exempt).

This chapter has not recommended what items should receive VAT preferential treatment (exemption versus zero rating). Extensive discussion of these considerations is included in the VAT literature (see bibliography for references). In the VAT that is recommended later in this book, a limited-exclusion approach to exclusion is advised. If a liberal-exclusion approach is taken, the tax base is considerably reduced, so that much higher tax rates are necessary to raise the needed revenue.

As a general principle, all attempts to permit exemptions to the VAT should be resisted, unless absolutely necessary from a practical viewpoint, to accomplish passage of the VAT. Social economists had their chance to use tax policy as an instrument of social change over the past few decades in the US. The experiment failed. A principal motivation of the Tax Reform Act of 1986 was to purge the wide array of special-interest incentives that had crept into tax law. These incentives did little more than create "loopholes" for creative taxpayers and engender resentment on the majority of the population.

Utility, equity, and ability to pay are nice theoretical concepts, and they are useful in providing supporting qualitative arguments and general guidance. As a practical matter, the attempt to include specific incentives to promote equity and recognize ability to pay has backfired. These attempts introduced complexity into the law and, in the public view, created a system that blatantly favored the rich or tax-wise. In general, they had the overall effect of considerably narrowing the tax base, driving up tax rates, and contributing to budget deficits. Attempts to introduce equity and an appearance of fairness by means of specific exemptions, in practice, have had the opposite effect. People complain the least about simple, proportional taxes, such as the payroll tax and the sales tax, in spite of some economists' complaints about the regressivity of such taxes.

Packaging of the VAT Is an Important Consideration

If the VAT is presented to the US public as an apparent 20-percent sales tax, there is a good possibility that it will not pass, regardless of how many other countries in the world have adopted it at even higher rates *and* in addition to an income tax. On the other hand, if it is presented as a 20-percent tax on business value added (profit plus net rent plus net interest plus labor), it probably would pass. Viewed in this fashion, the tax appears to be a tax on business profits, and a socially desirable tax on the basis of ability to pay. To enhance the likelihood of acceptance of the VAT, there is a definite advantage in implementing it as a hidden tax on business, treated in exactly the same fashion as employer-paid payroll taxes and the business profit tax are now treated (hidden in the price of an item). In view of the unfamiliarity of the US public with national transaction taxes, the alternative approach (of explicitly indicating the amount of the VAT on transactions) may doom its adoption to failure.

If the VAT is proposed as a hidden tax on business (a calculation-type VAT), it should be proposed as a single-rate VAT, or the GATT should be changed to the origin principle.

Another major political consideration regarding the passage of a VAT is acceptance by states and local governments. Once again, there is a very strong reason for representing the VAT as a hidden tax on business. If it is viewed as a transaction tax, it may be regarded as a direct competitor of the state and local sales taxes. State and local governments, alarmed that the federal government is moving into their major source of income, may move to defeat adoption of the VAT. Representing the VAT as a business tax removes this danger. The VAT is too good a tax to risk losing simply because it is depicted in a way that is unacceptable to consumers or to state and local governments.

If the VAT is proposed as a hidden tax on business (a calculation-type VAT) and state and local sales taxes are continued, the federal, state, and local taxes will not be well integrated. The approach of continuing state and local sales taxes in addition to the VAT should be adopted only as a last resort, if states move against a sales-tax-type (invoice-type) of VAT and insist on retaining their sales taxes in addition to and separate from the VAT.

To ensure its acceptance by the US population and by state and local governments, there is a strong argument for adopting a single-rate, calculation-type VAT, at least initially. Consumers would view a calculation-type VAT as a type of income tax on business, and assume that business was bearing the burden of the tax. The VAT is presented as a tax on business, and the tax is included (hidden) in prices, as is the case for the current business profit tax. If this approach is adopted, it is necessary to use a single-rate VAT, so that the border-tax adjustments may be correctly determined.

There is, of course, no reason why an invoice-type VAT cannot subsume existing state and local sales taxes. Two approaches are possible. First, allow state and local sales taxes to continue at their current levels, and reduce the VAT at the retail level by the amount of the other sales taxes. Second, eliminate state and local sales taxes, and split the tax revenue (revenue share) between the federal government and the state and local governments.

If a tax system is proposed that significantly reduces the fiscal powers of the states or local areas, it may encounter such strong political opposition that it is not adopted. Chapter 18 presents a VAT-based tax system that replaces all of the revenue that would be lost by state and local governments, if the state and local personal income tax, business profit tax, retail sales, and gross receipts taxes were replaced by a VAT.

Criticisms of the VAT

In Charles E. McLure, Jr.'s book *The Value-Added Tax*, Mark A. Bloomfield discusses many of the criticisms that are levied against the VAT by its opponents (typically, proponents of the income tax). He calls those criticisms "myths:"

1. The VAT, as a Consumption Tax, is Regressive
2. The VAT Is a "Money Machine"
3. The VAT Is Inflationary
4. Consumption Taxes Are the Traditional Preserve of State and Local Governments
5. The VAT Is an Administrative Nightmare

Bloomfield notes that the arguments involving these criticisms are unfounded. The paragraphs that follow discuss these arguments.

The VAT Is Criticized as a Regressive Tax, but the Evidence for This Is Slim

The VAT has been criticized as a regressive tax, that is, low-income earners will pay a greater proportion of their income in the VAT tax than will higher income earners. This argument is based on the fact that, on an *annual* basis, low-income earners spend a greater percentage of their incomes on consumption goods than high-income earners. In technical terms, their propensity to consume (ratio of consumption to income) is greater, and they will, hence, be harder hit by a consumption tax. Based on annual data (or data for shorter time periods), this is true to a mild extent. For example, a person who is out of a job for part of a particular year will spend his savings during the period between jobs. His consumption during this period may easily exceed his income.

On a *lifetime* basis, as opposed to an annual basis, however, the picture is very different. On a lifetime basis there is very little difference in the percentage of income expended -- most people, rich or poor, spend about 95-100 percent of their income. In other words, using lifetime data instead of annual data, the regressivity of the VAT is very low. Another way of stating this argument is that current annual income is not a satisfactory measure of ability to pay. Basing propensity-to-consume calculations on current annual income biases regressivity calculations.

The VAT has been undeservedly criticized as a regressive tax. Some economists, arguing in favor of a progressive income tax over a VAT, have asserted that the VAT puts a substantial burden on the poor. In view of the data on propensity to consume, that assertion is false.

In summary, a consumption tax appears mildly regressive only if one adopts the position that a taxpayer's income over a short time period is an acceptable measure of ability to pay. The book *Examination of Basic Weaknesses of Income as the Major Federal Tax Base*, edited by Richard W. Lindholm, presents a detailed discussion of these concepts (p. 87).

The VAT Can Address Ability to Pay

If certain items viewed as necessities, such as medical care, are excluded from taxation, as is the case in many countries, the degree of regressivity -- already low -- decreases further. Because of the ability to exclude particular items from taxation with the VAT, the VAT can ease the burden of taxation for necessities with a degree of specificity that is impossible with the income tax.

In fact, any degree of progressivity can be incorporated into a VAT. For example, education, medical expenses, rent on low-income housing, and sales of owner-occupied housing may be excluded. Such exclusions can benefit low-income earners to a greater degree than high-income earners because these items comprise a greater proportion of their income. Of course, whenever exclusions are granted to particular products, firms, or sectors, the economic neutrality of the VAT is compromised. That loss of neutrality is the price paid for achieving a desired political or social goal.

The point is that the VAT *can* address ability to pay, if the government is willing to accept some loss in the economic neutrality of the VAT. In his book *The Value-Added Tax: Lessons from*

Europe, economist Henry Aaron observes that the most clear-cut lesson from Europe regarding the economic impact of a VAT is that the regressivity of the VAT can be moderated or eliminated by differentiating rates and exemptions. He notes that this result is consistent with the findings of other studies.

Transaction taxes (such as the VAT) are much better suited to grant preferential tax treatment for certain types of products and services than the income tax. Under the income tax, the government may decide to subsidize a poor person, but the exemption is a "shotgun" exemption, without reference to helping the individual in specific areas. The business income, or profits, tax does not exempt profits earned by producers of necessities consumed in large amounts by the poor.

In *The Economics of VAT*, Lindholm notes the curious fact that taxing the profits of a firm that produces luxury goods and the profits of a firm producing goods consumed mainly by the poor at the same rate generates no protests of regressivity. This phenomenon makes it politically feasible for the government to levy the same income tax on firms that produce necessities for the poor as on firms that produce luxury products. In this sense, the corporate profit tax is a highly regressive tax. The VAT can readily avoid this problem, through exclusion of certain products, if that is desired. In spite of this situation, detractors of the VAT point to the regressivity of the VAT and the progressivity of the income tax.

A criticism of the VAT on the grounds of regressivity has a hollow ring coming from a proponent of the income tax. In any event, recent tax legislation has exhibited a trend away from the concept of using taxes as a means of accomplishing social goals; the emphasis now is on achievement of social goals through spending policy, not tax policy.

This final point is very important. Even if one accepts the philosophy that the poor should receive benefits funded by the rich, it is not necessary that this transfer be effected *by means of the tax system*. As we have seen for the income tax system, the attempt to effect this redistribution of wealth by means of the tax system results in a complicated, intrusive system that is perceived as unfair. It is much more preferable to collect taxes by means of a simple, accepted system -- even though it is slightly regressive -- and to redistribute benefits by means of other programs. In other words, even if a VAT is regressive, that characteristic is no basis for rejecting the tax. If you have a concern for the poor, the important issue is whether the poor receive adequate help, taking *all* programs into account (the tax system and social and economic programs considered together).

This point is overlooked by economists who assert that the poor should be insulated from taxation. If there were no social and economic programs for the poor, that point of view would have merit. The fact is, however, that the US has a rich mix of social and economic programs, of which the tax system is but a single component. The important issue is whether the poor are treated decently, taking *all* of these programs into account. Imposing restrictions on each separate component (for example, forbidding the tax system to be the least bit regressive) is as foolish as requiring every member of a football team to weigh 280 pounds. Each component of the social/economic system -- as each player on the team -- has different functions and capabilities. It is unreasonable to hamstring the tax system by a requirement that it be progressive if this, in fact, hampers the nation's ability to collect taxes in a fashion that preserves a good relationship with the citizens. A tax system design that includes a requirement for the tax system to be progressive will result in a "local optimum," when what is desired is a "global optimum."

The poor voice little objection to the regressive Social Security tax because they perceive that they receive compensating benefits from the program. By the same token, they will accept a VAT if

they perceive that it is a fair system, whose powerful revenue-producing ability can enable a full range of social insurance to be provided to them, and provide economic strength to the country.

To reject a VAT on the singular basis that the poor should be insulated from tax does them a cruel disservice; it denies the country a sound tax system, and thereby denies the poor a higher level of social insurance. It insults their intelligence, since it implies that they cannot appreciate this argument. It suggests that the paying citizens so fear the poor that they are willing to forgo a sound tax system and a higher level of care for the poor, in order to accomplish the appearance of insulating the poor from taxes. Continuing with an inadequate tax system in fact isolates the poor from a comprehensive social insurance program.

Thomas Jefferson said that liberty is always threatened by those who have no property. That may be true, but it is threatened more by a cruel tax system whose very imposition requires a police state and tax court that operate outside the Constitution and whose powers supersede all individual liberties guaranteed by the Bill of Rights. The paying public have a right to a system that treats them as well as it treats the poor.

The response to the statement, "The VAT is regressive," is simple: So what? America's *total* program of support to the poor is not regressive. The poor receive all of the tax back and more. The benefits the poor would receive from the VAT would far exceed the tax on them. That is the very meaning of the statement that social goals are being realized through expenditures policy rather than through tax policy.

Liberals have opposed the VAT on the basis of its regressivity. That opposition is ill founded. The VAT, through its superior revenue-producing ability and ability to strengthen America's economic position, offers the opportunity to expand our social net, not reduce it. The VAT offers advantages to advocates for the poor, as it offers advantages to advocates of personal freedom, of business and of a strong nation. It is a good tax for all people.

In summary, several points are relevant to the criticism that the VAT does not address ability to pay well. First, the VAT may easily accommodate the concept of ability to pay by exempting the tax on goods and services such as food for home consumption and rent from subsidized housing. Second, the income tax itself embodies the concept of ability to pay very imperfectly. A millionaire with no earnings pays no income tax, whereas a school principal, having no net assets but earning a salary of \$30,000, pays substantial taxes. Yet most would agree that a millionaire has far greater ability to pay than an assetless school principal. Under a consumption tax (such as the VAT), a millionaire would likely pay more than a principal, since he would likely consume more.

As noted previously, a firm that produces goods consumed mainly by the poor has the same business-income-tax rates as one producing luxury goods. The personal income tax addresses ability to pay by means of progressive rates, exemptions, and special tax deductions. Several decades of experience with a progressive income-tax system have demonstrated that it is generally perceived as an unfair tax. The income tax is a poor device for addressing ability to pay.

In summary, the degree of regressivity of the VAT is low and does not constitute a basis for rejecting it, in the face of its many advantages. Furthermore, as is evidenced by the payroll tax -- or even local sales taxes -- a tax can be regressive and still be quite politically acceptable if it is viewed as worthwhile from other points of view (flat rate, beneficial, uniform, simple). Theoretical economic pronouncements about unacceptable levels of regressivity cannot take precedence over the empirical evidence that people, rich and poor, prefer fair and simple taxes, even though they may be slightly regressive, to unfair and complicated progressive ones.

The VAT Has Been Called a "Money Machine"

Because of its large tax base, the VAT has tremendous potential for raising large amounts of tax revenue. This feature is the essential reason why the VAT is a desirable tax for modern economies, in which large amounts of revenue are needed, and, indeed, a principal reason why the rest of the world is moving to the VAT. The concern has been raised, however, that once the VAT is introduced, at low levels, the federal government will quickly move to raise the VAT rate, and, flush with money, go on a "spending spree."

While there is some danger in this, it is largely irrelevant in the context of the tax system proposed in this book. In this book, we recommend replacing the personal income tax and the business income tax by the VAT. To do so, the VAT must be introduced at a high rate. The scenario of the government's introducing a low-rate VAT and then jacking the rate is irrelevant in this context.

The VAT *is* a money machine; that is why it can replace the personal income tax and the business income tax.

The Consensus: The VAT Is *Not* Inflationary

The first year that a VAT is introduced, prices to consumers will rise because the cost of items includes the VAT. This one-shot price rise is, however, offset by the fact that under the system proposed in this book, the VAT replaces the personal income tax and the business profit tax. The magnitude of the price increase is moderated by the elimination of the business profit tax, and the price increase that remains is offset by the additional income that consumers realize from the elimination of the personal income tax.

Because 39 countries have adopted the VAT since 1954, there is ample evidence concerning the difficulty of transiting to a VAT-based system and the inflationary impact of introducing a VAT. A recent book on the impact of introducing a VAT is *The Value-Added Tax: Lessons from Europe*, edited by Henry J. Aaron. The consensus is that the introduction of a VAT causes few detectable effects on prices, when the VAT is used to replace taxes yielding similar amounts of revenue and similarly distributed across industries.

In summary, the net effect on consumers is not great. Furthermore, the price rise is a one-time price rise, and it is offset by the elimination of other taxes (the business profit tax and the personal income tax, under the system proposed in this book). Some additional successive price rises may occur, if cost-of-living escalation clauses do not take into account the income increases that result from elimination of the personal income tax. After that, no further price rises occur due to the VAT. Some economists, arguing in favor of an income tax over a consumption tax, imply that the introduction of a VAT may set off a burst of inflation that can cripple an economy for years. That implication is unfounded and untrue.

"Consumption Taxes Are the Traditional Preserve of State and Local Governments" -- Are They Really, and So What?

The statement is often made that transaction taxes (such as retail sales taxes or the VAT) are the traditional domain of state and local governments, and that implementation of a federal consumption-type VAT would be an invasion by the federal government into a tax area traditionally used by state and local governments. Several comments are in order relative to this statement. First, state- and local-government use of the transaction tax is a relatively recent phenomenon, stemming from the Depression of the 1930s, when the property tax proved inadequate. Second, there is no constitutional basis for reserving transaction taxes to the states; in fact, at the time of the framing of the Constitution, business taxes were viewed as the principal source of revenue for the federal government. Third, a portion of the VAT revenue may be shared with the states. Fourth, the state- and local-sales taxes could be eliminated when the VAT was introduced, and the state and local governments allocated the same amount of revenue as they previously received.

A VAT Is *Not* an "Administrative Nightmare"

A calculation-type VAT imposes less administrative and compliance cost than the current income tax. It is true, however, that a tax-credit VAT would incur substantial administrative and compliance costs. The Treasury Department estimates that a VAT would require 20,000 additional employees and a cost of \$700 million per year. In addition, firms would be faced with an increased accounting burden to record the VAT on each invoice, as is currently done with the retail sales tax.

The principal reason for implementing an *invoice-type* VAT is to enable compliance with the GATT, in the case in which a country uses a multiple-rate VAT. (As noted previously, if a multiple-rate VAT is used, the invoice method is necessary to enable accurate calculation of the amount of VAT on a product; that amount is a permissible border-tax adjustment under the GATT.) This requirement arises because the GATT is based on the destination principle, under which exports are exempted from tax and imports are taxed. This costly approach to the VAT would be unnecessary if the GATT were based on the origin principle (exports taxed, imports not taxed). In view of the tremendous additional cost of the invoice-type VAT over the calculation-type VAT, the US would do the world community of nations a favor by pressing for an origin-principle-based GATT at the next round of international trade negotiations. The refund of any taxes on exported goods or services should be viewed as a subsidy, and be prohibited under the GATT.

In assessing administrative and compliance costs, let us consider the highest-cost type of VAT, that is, a tax-credit VAT. Since most VAT-using nations have adopted tax-credit VATs, there is ample data on the costs of this type of VAT. In his book *he Value-Added Tax: Lessons from Europe*, Henry Aaron comments on the European experience. He observes that although the VAT is simple in theory, it does give rise to paperwork and arbitrary rules (exclusions, preferential rates). He notes that, compared to individualized taxes such as the personal income tax, the VAT is simple and cheap to administer. On the other hand, he states that it is not the simple, self-enforcing tax that some have suggested. He identifies several areas in which problems may arise: transition; treatment of agriculture, nonprofit institutions, private sales, and financial institutions; and classification of a firm's purchases as business or personal.

In general, the administrative and compliance problems that Aaron identifies can be exacerbated or avoided by the design of the VAT. The problem of classifying a firm's purchases as for business or personal use occurs for most business taxes, and is not peculiar to the VAT. Analysis of the experience of European countries indicates that the administrative and compliance problems of the VAT can be largely avoided through careful design of the VAT. In some cases (for

example, Italy) the introduction of a complicated VAT (many rates and exclusions) has indeed led to administrative difficulties and evasion. In the case of the Netherlands, the self-policing aspect of the VAT (matching the tax credits of one taxpayer against the tax payments of another) has not been realized; the available administrative resources are applied mainly to processing returns. The point is made that attempting to accomplish distributional objectives (equity) by means of a VAT introduces complexities that cause administrative difficulties and economic distortions, and that distributional objectives should be accomplished by means other than the VAT.

In summary, the European experience with the VAT reveals that transition to a VAT-based system can be smooth, and that administrative and compliance difficulties can be avoided if the VAT design is kept simple. In view of the evidence, the VAT is *not* an administrative nightmare.

With the elimination of the personal income tax and the business profit tax, the net change in administrative and compliance cost to implement an invoice-type VAT would not be great, and could be zero or negative. The administrative cost of the personal income tax would disappear, and could easily offset the administrative cost of the VAT. The horrendous compliance cost of the personal income tax, especially the wasted productivity associated with tax avoidance, would disappear, and easily offset the compliance cost of the VAT. Although the total compliance cost (to individuals and firms combined) would decrease, it is true that the compliance cost to firms could increase for an invoice-type VAT. That shifting of the compliance cost from individuals to firms is, however, considered appropriate. Individuals should never have been burdened with the income tax in the first place. Businesses are the seat of economic activity, are accustomed to record keeping, and are the appropriate point in the economy from which income or consumption taxes should be extracted.

Levying taxes directly on individuals may be appropriate for wealth taxes if the individual is the registered owner of the wealth being taxed. There is absolutely no need, however, to levy an income or consumption tax directly on individuals. That procedure has created an administrative nightmare and has led to the loss of personal privacy and the establishment of a police-state regime -- the IRS -- in the US.

The government has mathematical models and staff that can produce firm estimates of the cost of implementation of alternative tax methods. No attempt is made here to determine detailed quantitative estimates of those costs.

Implementation of the VAT Causes No Constitutional Problems

Implementation of a VAT causes no constitutional problems, since the Constitution permits the federal government to levy indirect taxes without apportionment to the states. It is, in essence, the very type of tax on business that the framers of the Constitution had in mind for the central government. Whereas a constitutional amendment (the Sixteenth) was necessary to permit the federal government to collect and keep personal income taxes (which are direct taxes), no such amendment is needed for the VAT. (Note that a constitutional amendment *would be* required for the federal government to collect a net wealth tax, since it is a direct tax.)

If the federal personal income tax is eliminated and replaced by a VAT, the need for the Sixteenth Amendment is obviated. At the time it was passed, the Sixteenth Amendment was intended to enable income taxation of a very small number of US citizens -- very high-income earners, representing about one percent of the population. At the time of its passage it was not intended as

a mass tax at all, but as a tax on the rich. It was not until a generation later that it was converted to a mass tax. The framers of the Constitution were right in opposing collection and keeping of direct taxes by the federal government -- the practice simply gives too much power to the federal government.

The Sixteenth Amendment has dealt a crippling blow to the privacy of the US citizen. The income tax permits an unwarranted annual "search" of an individual's financial affairs by the federal government (and state governments, too, since they have generally followed the example of the federal government in imposing income taxes on both individuals and businesses). Not only should the personal income tax be abolished, but also, at the next constitutional convention, the Sixteenth Amendment should be repealed, to restore a fundamental freedom to US citizens. With the implementation of a VAT, this goal can be achieved with no disruption to the revenues of the federal or state and local governments.

Worldwide, the VAT Is a Very Popular Tax

The VAT has been gaining in popularity, and is now the major tax in European countries. At the present time, 39 countries have adopted it, since France first did so in 1954. These countries have done so because it has proved to be a good tax. Principal advantages of the VAT are that it has a broad tax base and therefore can produce large, stable revenue at low tax rates. The VAT puts the personal income tax and the business profit tax to shame. The VAT's rates are low, and its revenue is more stable than that produced by the personal income tax and the business profit tax.

In his paper "Criteria for Choice Among Types of Value-Added Tax," Professor Shoup comments on the explosive growth in adoption of the VAT worldwide, and notes that in the history of public finance, such rapid growth is unique, unmatched even by the rapid growth of the income tax. Because of its unparalleled acceptance as a modern tax method, countries that have not yet adopted it are therefore motivated to consider it.

16. Undesirable Alternatives to the VAT

This chapter discusses a number of taxes that may be considered as alternatives to the VAT. Those alternatives include a comprehensive tax on earnings, collected from the payer; a flat-rate income tax; a national retail sales tax; a mass net wealth tax; and a variety of other possibilities, such as a tax on imported oil or other excise taxes and tariffs. In every case, these alternatives have substantial drawbacks, compared to the VAT.

What About a Payer-Collected Earnings Tax?

The problem of the privacy intrusiveness of the personal income tax can be ameliorated by converting that system to one in which the tax is levied on and collected from the payer of earnings, rather than on the receiver of earnings. Such a tax is referred to as a "payer-collected earnings tax." The payer-collected earnings tax would be levied on both labor and nonlabor earnings (such as rent or interest). With regard to labor earnings, the payer-collected earnings tax is simply a payroll tax.

From a revenue viewpoint, the payer-collected earnings tax is equivalent to a "comprehensive income tax with withholding on all incomes." The payer-collected earnings tax is a tax levied on business, however, rather than an income tax levied on the individual. This tax is less intrusive of the individual's privacy, because the government does not need to monitor the income of individuals.

The payer-collected earnings tax can be a flat-rate tax or a progressive tax. There are some problems in implementing the tax as a progressive tax because the amount of tax paid to part-time workers would vary, depending on whether they were paid in one lump sum or in small installments. Also, the amount of the tax would vary if the worker received income from one source versus several sources. These problems are avoided if the tax is implemented as a flat-rate tax, with no exemptions or deductions.

With regard to self-employed individuals, the payer-collected earnings tax avoids intrusion of personal privacy if such individuals incorporate their businesses.

Taxation of Earnings From the Sale of Property (Capital Gains)

Just as is the case for the income tax, the payer-collected earnings tax is not well suited to taxation of capital gains (earnings from the sale of property). The problem that arises is that the "earnings" associated with the sale are a function of the "basis" of the item -- its cost plus the cost of improvements. This differs markedly from the case of labor earnings, in which the entire wage payment represents earnings. Taxation of capital gains is best accomplished by some other type of tax, such as a sales tax, or property transfer tax, or VAT.

The problem of determining the earnings from the sale of property is analogous to the problem of determining a businessman's profit. It unduly complicates the tax process, and should be avoided.

Some further comments are in order concerning the taxation of capital gains from personal sales. In many instances (such as the sale of a personal home), the capital gains from the sale do not

represent profit in any sense, but solely appreciation due to inflation. Since inflation in the US is caused mainly by government policies, and already represents a heavy hidden tax, imposition of a second tax is not considered appropriate. Sales of personal items should be exempted from taxation because their taxation necessitates government intrusion into the personal affairs of citizens. The social and economic cost of attempts to tax occasional personal sales far outweigh the value of the taxes collected.

The Payer-Collected Earnings Tax Is Less Costly to Administer Than the Personal Income Tax

Administratively, the payer-collected earnings tax is similar to the current personal-income-tax withholding system. With regard to the cost of administration, the payer-collected earnings tax would be less costly than the personal income tax, since the number of collection points (several million businesses and self-employed individuals) is far less than for the personal income tax (100 million individuals).

Use of a Payer-Collected Earnings Tax Eliminates the Need for the SSN as a Taxpayer Identification Number

Use of a payer-collected earnings tax does not resolve the issue of use of the SSN. The SSN is no longer needed as a taxpayer identification number, since the payer-collected earnings tax is a tax on the payer of the earnings tax, not on the individual. The SSN would still be required, however, if Social Security benefits remained tied to individual contributions (to the amount of Social Security tax paid by the employer on earnings paid to an individual), rather than to need. If government knowledge of a person's earnings history is regarded as unacceptable intrusion, benefits could be tied to need. The decision to do this may be made independently of the decision to implement a payer-collected earnings tax, however, and so the issue of the SSN is not resolved by implementation of the payer-collected earnings tax.

The Payer-Collected Earnings Tax Is Not Recommended, Since It Exhibits the Same Economic Problems of the Current Income Tax System

Use of the payer-collected earnings tax as an alternative to the personal income tax significantly reduces the level of government intrusion of privacy. No personal tax return is filed, and the government is not allowed the privilege of annual examination of a person's financial situation. The payer-collected earnings tax is less costly to administer. Also, since there are essentially no opportunities for tax avoidance, the massive, \$35 billion annual waste in productivity associated with tax avoidance is avoided.

In spite of its advantages, adoption of a payer-collected earnings tax is not recommended. The reason for this point of view is that, with the exception of the three advantages listed above, it suffers from all of the other economic drawbacks associated with the personal income tax. It represents a disincentive to save, compared to a consumption tax. It does not qualify for GATT preferential treatment. Because the tax base is narrow, tax rates are high. Because the business income tax would still be in place, the many drawbacks of the business profit tax would still remain: the incentive to use debt financing, subsidization of inefficient firms, disincentives to save and

invest. Furthermore, the strong incentive for business owners to retain earnings in their businesses and make purchases through their businesses would continue.

In summary, implementation of a payer-collected earnings tax would leave unresolved many of the problems of the income tax system. The payer-collected earnings tax is not a desirable solution to the income tax problem.

What's Wrong With a Flat-Rate Income Tax?

In their book *Low Tax, Simple Tax, Flat Tax*, Professors Hall and Rabushka proposed the introduction of a flat-rate income tax (FRIT). (As noted earlier, the Hall-Rabushka 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 percent.) The FRIT is not recommended as an alternative to the current system, for several reasons. Just as the personal income tax, it perpetuates the government invasion of privacy of the individual that is the hallmark of the personal income tax. Just as the business profit tax, it perpetuates the taxation of profit, and thereby represents a disincentive to economic efficiency and production. Finally, the FRIT is essentially a direct tax (since most of the tax is derived from individual income [direct tax] rather than from business [indirect tax]). As a result, it would not qualify for favorable treatment under the GATT; in our trade with nations using a VAT, the US is placed at a considerable disadvantage.

The income tax system that is being implemented under the Tax Reform Act of 1986 is similar in some respects to a FRIT. It has dramatically reduced the number of tax deductions, and reduced the number of tax brackets from 15 to four (0 percent, 15 percent, 28 percent, and 33 percent). Furthermore, the 33-percent tax bracket is used simply to eliminate the benefit of the 15-percent rate and personal exemptions so that the tax rate on very high income earners (over \$84,560 for single taxpayers and over \$149,250 for married taxpayers) is a flat 28 percent of income.

Relative to the VAT, the FRIT compares poorly. With a FRIT, the only way the taxpayer may reduce his tax liability is by earning less; that is, by producing less. With a VAT, the taxpayer can reduce his tax liability by purchasing less; that is, by saving. Not only does he retain the saved tax, but also he causes more resources to be available (his banked savings) for investment.

As noted earlier, recently, the Hall-Rabushka so-called flat-rate income tax has been referred to as a "personal-exemption-type VAT." Calling this tax a VAT is stretching the definition of VAT to absurdity. Although many VATs allow for exclusions (lower rates, exemptions) of particular products or services, all of them include labor as a component of value added. Through the personal exemption, the Hall-Rabushka tax systematically excludes a substantial portion of labor. To refer to a tax as a VAT when it systematically and totally excludes a substantial portion of labor -- which is in fact the major component of value added -- is ridiculous. The Hall-Rabushka tax should not be included in discussions of alternative types of VAT. It lacks both the salient and essential features of a VAT and the economic advantages of a VAT. It is not a VAT.

Because of its economic disadvantages, its privacy-intrusive character, and its inadequacy relative to preferential tax treatment under the GATT, the Hall-Rabushka income tax proposal is not viewed as a desirable alternative to the VAT.

Why Not a National Retail Sales Tax?

The advantage of a VAT over a national retail sales tax derives from the fact that the VAT spreads the tax over a larger base -- essentially, all national income, not just retail income. With a broader tax base, the tax rate may be lower. To keep the base as broad as possible, the tax should apply to all firms, not just wholesalers, manufacturers and retailers. The European practice of exempting many professions (such as law, accounting) has the disadvantage of decreasing the tax base for no good reason. The very broad base of the VAT enables a given level of revenue to be collected at a lower tax rate and produces more stable revenue collections.

A major problem with our current income-tax-based system is that the tax rates must be very high to produce the needed revenue. Retail sales represent less than 10 percent of total national income. Retail sales alone is too narrow a base to provide the needed revenue at low tax rates. With high tax rates, much productivity is wasted in tax evasion efforts, and the temptation for tax evasion is high. With a national retail sales tax instead of a VAT, it would still be necessary to tax income; the bad features of the present system would be retained. Little would be accomplished except the addition of another tax and more administrative cost.

What's Wrong with a Net Wealth Tax?

In his book *A New Federal Tax System*, Professor Richard Lindholm proposes the use of a net wealth tax (NWT). He presents several reasons why he believes that the NWT is a good tax. Applied as a mass tax, however, the NWT is as invasive of privacy as the personal income tax.

How the Net Wealth Tax Differs from an Ordinary Property Tax

The NWT is an annual tax that is imposed on a person's net wealth. Net wealth is simply the difference between a person's assets and his liabilities. The NWT differs from a property tax in that the property tax ignores liabilities. For example, suppose that a person owns a \$100,000 building outright. Under either a 2-percent NWT or a property tax (based on full-value assessment), the tax bill is \$2,000. Now, consider the case in which two people each own a \$100,000 building, but that Person A owns it outright and Person B has a \$100,000 mortgage. In this case, the property tax would place a levy of \$2,000 on each owner. In contrast, the NWT would similarly place a \$2,000 levy on A (.02 x net wealth of \$100,000), but, since B's net wealth is zero, a zero levy on B (.02 x net wealth of zero).

The NWT Reduces Private Concentrations of Wealth

Like the property tax, the basic purpose of an NWT is to reduce private concentrations of wealth. Major concentrations of wealth by private individuals or groups are considered a threat to democratic systems. The NWT eats away, every year, at these concentrations.

The NWT Is Justified on the Basis of Ability to Pay

A major argument in favor of an NWT is that it is considered to be a tax levied on the basis of ability to pay. For example, consider the case of a man who owns \$1,000,000 in net assets,

versus a skilled worker who owns nothing, but earns \$40,000 per year. Under the current income tax system, the millionaire may pay little or no tax, whereas the worker may pay almost one half his income in federal, state, and payroll taxes. Many people would argue that the millionaire has a greater ability to pay, yet he may pay no taxes. Under an NWT system, he would have to pay.

The NWT and the property tax are viewed as preferable to an inheritance tax because they eliminate the waste of effort in estate planning to avoid the financial "shock" of a major tax at the time of the death of the individual.

The Property Tax Is Less Privacy Intrusive Than the NWT

A property tax has significant advantages over a NWT. The concept of a NWT is appealing -- reduction in the concentration of wealth, and taxation on the basis of ability to pay. If implemented as a mass tax, however, the NWT is as severely intrusive of privacy as the current income tax. Each year, the individual is required to list all of his assets and liabilities for review by the government.

With a property tax based on real estate, the individual may remain totally anonymous. If he desires, he may own the property through a corporation, which pays the property tax. He may preserve his privacy.

The property tax is not as effective as the NWT in reducing concentrations of wealth. Both taxes represent an incentive to invest in assets that return a yield or increase in value. The NWT allows for tax deductions for mortgages since the tax base excludes liabilities.

If property taxes are used, the taxation of immovable property such as real estate and buildings represents less of a privacy compromise than the taxation of movable personal property. Real estate, by its very nature, is available to public view -- it may be privately owned, but it is not private. The imposition of a real estate tax hardly compromises the privacy of owner, especially if it is held through a corporation. On the other hand, in the absence of a personal property tax, it is quite practical to keep large sums of stock, gold, gems, or art private. The imposition of a tax on personal items forces you to reveal your personal possessions to the government; it destroys your privacy.

The taxation of private property for the purpose of reduction of the private concentration of wealth promotes the security and freedom of the individual. While many US citizens are willing to vest substantial power in a popularly supported government, private concentrations of wealth are viewed as potential threats to security, either because the power they represent may be misused or because they may contribute to economic instability and depression. While many people generally object to government interference in business, many are also in favor of breaking up large businesses, such as US Steel and General Motors, to enhance the likelihood of retaining freedom as an individual. For the same reason -- reduction of private concentrations of power -- it is desirable for the government to break up large labor unions, as well as large businesses. In some cases, such as the breakup of AT&T, this action may result in higher prices and inferior levels of service; that is a price that many are willing to pay to avoid strong private concentrations of wealth. Many people have little faith in the ability of the government to manage and regulate industries well, and are, in general, not in favor of regulated monopolies as an alternative, if unregulated nonmonopolies can do the job.

The NWT Promotes Risky Investments

A NWT of a low rate may in effect represent a tax on income at a high rate. For example, suppose that an asset is capable of producing a rate of return of 8 percent. A NWT of 2 percent would represent a tax of 25 percent on the return. A NWT of 2 percent on an asset earning 2 percent represents a 100-percent income tax.

Because a low-rate NWT represents a high-rate income tax, the NWT creates an incentive to shift from safe, low-yield investments to risky, high-yield investments. The NWT tax places a heavier tax burden on savings than an income tax, and thereby is a disincentive to save, compared to the income tax.

The NWT Would Require a Constitutional Amendment, and Would Face Opposition from States

In his book *A New Federal Tax System*, Professor Lindholm proposes the NWT as a federal tax. In his book *The Great Depression of 1990*, Dr. Ravi Batra proposes a federal property tax on the richest one percent of the US population, who currently own over one third of all US wealth. A number of European countries use a NWT. The introduction of a federal NWT in the US would require a constitutional amendment because an NWT is a direct tax.

From a political perspective, the introduction of the NWT would probably face substantial opposition from local governments, which depend heavily on property taxes for income. The NWT would replace, or at least compete with, property taxes. States do not seem to worry very much any more about their sovereignty *vis-à-vis* the federal government, but may prefer to retain their current level of control over the raising of revenue within the state.

Because of the severe invasion of privacy associated with a NWT, this book does not recommend the NWT implemented on a mass basis. On the other hand, it is accepted that extreme concentrations of wealth are undesirable. Current property taxes and inheritance taxes have not prevented the rapid rise in the concentration of wealth, and the income tax, even at high levels, has proved ineffective as an indirect means of preventing wealth concentrations.

Dr. Ravi Batra's proposal of a property tax (presumably a NWT, although Batra does not say) on the richest one percent of the population, deserves consideration. Such a tax would not be invasive of the privacy of most citizens: only one percent would be affected. Compromising the privacy of a small number of very wealthy individuals, for the general welfare, could be an acceptable cost. The danger in a NWT on one percent of the population is, of course, that the tax might be extended to a much greater proportion of the population. Remember that the income tax began as a tax on just one percent of the population, and was gradually extended to most of the population.

If wealth concentrations are to be reduced and maintained at reasonable levels, a tax on wealth is the most efficient, direct way to accomplish this goal. Indirect methods such as income taxes and an uncoordinated system of inheritance, estate, gift, and property taxes is a poor approach. An NWT imposed on one percent of the population can be set at a rate to reduce the skewness of the wealth distribution to an acceptable level. In spite of the danger inherent in establishing a federal NWT, this approach deserves consideration.

A NWT is not a feasible alternative to the VAT for raising large amounts of revenue. On the other hand, the VAT is ineffective for reducing concentrations of wealth. As a means of reducing wealth concentrations, a NWT on a very small proportion of the population deserves consideration as a complement to the VAT in a total, integrated tax system.

A constitutional amendment would be required to implement a federal NWT. The amendment could limit the tax to the wealthiest one percent of the population, to avoid the privacy invasion that resulted from the income tax amendment. A critical issue to address is whether it is feasible to tax the richest one percent of the population without compromising the privacy of the other 99 percent, in the process of identifying the richest one percent.

Other Undesirable Alternatives to the VAT

In his book *The Value-Added Tax*, Charles E. McLure, Jr., discusses several other alternatives to the VAT, as means of generating sufficient tax revenue to eliminate the US Government deficit. He discusses an oil import fee, a tax on all oil, an energy tax, a motor fuels tax, increased excise taxes and tariffs, and the business transfer tax (BTT) proposed last year by Senator William Roth, for consideration as tax reform. In every case, McLure notes substantial disadvantages in those proposals, compared to the VAT.

None of the alternatives discussed by McLure could generate sufficient revenue to enable repeal of the personal and business profit taxes. For this reason, regardless of their economic deficiencies, they are not considered feasible alternatives to the income tax because of their inadequate revenue-producing ability. Although they can, hence, be dropped from consideration relative to the goal of eliminating the income tax, it is nevertheless interesting to note their economic shortcomings relative to the VAT.

An oil import fee would cause serious economic distortions by artificially raising the price of all energy-intensive activities and petroleum-based products. Moreover, since domestically produced oil would not be taxed, this procedure would produce large profits for domestic oil producers and large tax revenues for oil-producing states from severance taxes (severance taxes are taxes on the extraction of oil, gas, and minerals).

A tax on all oil, whether domestic or foreign, causes similar economic distortions as the oil import fee, except for windfall profits for domestic oil producers and oil-producing states. □ A tax on all energy would cause economic distortion by penalizing energy-intensive activities and products.

Increasing the existing motor fuels tax (or other excise taxes) would introduce further distortions, by discriminating in favor of activities and products that are heavy users of motor fuels (or other commodities subject to an excise tax).

Raising tariffs could lead to an international "trade war," with decreased economic benefits for all nations.

McLure has particularly severe criticism of Senator William V. Roth, Jr.'s BTT proposal. The BTT is a subtractive calculation-method VAT, but with the provision that the tax be offset against the employer's portion of the payroll taxes used for Social Security, that is, the BTT includes a "FICA credit." (The acronym FICA stands for Federal Insurance Contributions Act -- another name for Social Security.) The problem that arises is that (under the destination principle) the GATT does

not allow for preferential tax treatment (border tax adjustments) for social security taxes. The reason why social security taxes are not granted GATT preferential treatment is that GATT allows preferential treatment of indirect business taxes (considered to raise prices) but not for direct taxes (considered to reduce income rather than raise prices). Since Social Security taxes are direct taxes, use of the FICA credit results in a tax subsidy equal to the amount of the credit, when the BTT tax is removed from the product prior to export.

Senator Roth's proposal for a subtractive calculation-method VAT would qualify for GATT preferential treatment if the Social Security tax were repealed; it does not qualify for GATT preferential treatment with the FICA credit provision. If the GATT were switched from the destination principle to the origin principle, the FICA credit would cease to be a factor (since no border tax adjustments would be made for the VAT).

In addition to proposing the FICA offset, Senator Roth proposes that all businesses having gross receipts under \$10 million would be exempted from the VAT. In addition to requiring higher VAT rates because of the exemption of a large sector of the economy, this exemption would introduce serious economic distortions. First, as discussed earlier, exemption of a firm prior to the retail stage places the firm at a competitive disadvantage, because it receives no credit for taxes paid on its inputs, and its customers also receive no tax credit. The total tax (over all stages of production) is in fact greater than if the firm were not exempted. For this reason, it is absolutely necessary to allow exempted firms to register for VAT taxation, if they desire.

Small retail service firms having few inputs can benefit from tax exemption, since they would not receive an appreciable tax credit on inputs, and would be exempted from charging a VAT on sales. Exemption of small firms in this case would discriminate strongly in favor of small firms over large ones. It could create an incentive for "fragmentation" -- the splitting of a large firm into several small firms to avoid taxes. Distributors would realize advantages in distributing through small dealers. Government attempts to restrict fragmentation would result in substantial administrative cost and government intrusion in business.

In summary, Senator Roth's suggestion that firms having up to \$10 million in gross receipts be exempted would introduce serious distortions and probably result in substantial administrative cost and government intrusion. The incentive to take advantage of the exemption would motivate strong efforts to take advantage of it, and hence motivate the government to expend substantial administrative cost to prevent this practice. Senator Roth's proposal for a subtractive calculation-method VAT with a FICA credit and a \$10-million-size exemption for small business has severe drawbacks. The analysis of this proposed VAT illustrates how easily the economic neutrality of a VAT can be destroyed, if a significant departure is made from a single-rate, universally applied VAT.

17. Payroll Taxes: Good or Bad?

Payroll Taxes Do Not Have to Be Intrusive

In spite of the fact that some payroll taxes are called employer contributions, payroll taxes are income taxes -- the burden of the tax is generally considered by economists to fall on the employee, not the employer. Although payroll taxes are in effect income taxes, however, they are not seriously intrusive of privacy as is the personal income tax. The reason for this is, of course, that they are collected by the employer -- the employee does not submit a payroll tax return. (The one exception to this is in the case of a tax overpayment when the employee earns more than the maximum taxable earnings limit -- now \$43,800 -- from more than two employers. In this case he must file for return of the overpayment on his personal income tax return.)

The potential for abuse of individual privacy associated with the payroll tax is relatively low. The potential for abuse is that, in auditing the employer's tax payments, the government would require access to employee records in order to contact of the employee to verify his earnings. Since auditing may be done on a probability-sampling basis, however, this possibility does not represent a certain, thorough, and continuing intrusion on the privacy of all taxpayers.

There are strong arguments in favor of and against the payroll tax. From an economic viewpoint, it would be preferable to fund Social Security out of general revenue derived from a VAT, to minimize economic distortions. Note that although Social Security taxes per se do not qualify for preferential treatment under the GATT, VAT revenue may be used to fund Social Security and still qualify for GATT preferential treatment. Because of this situation, it is possible to simultaneously avoid the economic distortions of the payroll tax (which discriminates in favor of capital over labor) and enjoy the preferential treatment of the GATT.

A strong case can be made for using a payroll tax in which benefits are strongly tied to contributions. In this case, the taxpayer views the tax as a contribution to a retirement or insurance plan, in which he realizes a return comparable to his contribution. In this case, the program is not a general tax, but forced participation in a retirement and insurance program. A possible compromise is to provide a very minimal level of benefits for all citizens, with an option to participate in a higher-benefit plan of some sort.

Although it makes more sense economically to include the entire tax burden in the VAT, there are two reasons for not doing this. First, the VAT rate would have to be over 35 percent, and it is unlikely that Congress would pass a 35-percent VAT. The maximum "standard" VAT rate in other countries is 23.46 percent (Sweden), and the maximum "higher-rate" is 38 percent (Italy). If this country were to switch to a VAT, it would probably begin with rates already "proven" in other countries -- generally about 20 percent. Politically, it makes more sense to make the total tax burden seem lower by imposing lower-rate taxes at more points in the economy. With no exemptions and no maximum taxable earnings limit, the payroll tax base is fairly broad: all labor earnings, approximately 60 percent of GNP. By retaining payroll taxes, it is possible for the VAT rate to be substantially lower than would be required if the VAT revenue were used to fund Social Security.

The Burden of the Payroll Tax Is Considered to Fall on the Individual

Ostensibly, the payroll tax is a business tax on labor. In order to assess the impact of the tax, it is necessary to estimate where the burden of the tax falls, that is, where is the incidence of the tax. If the burden falls on the business, the use of such taxes would create a heavy incentive for businesses to reduce the use of labor in favor of other factors of production (such as capital investment in robots), and would make US goods less competitive in the world market.

Economists are not in total agreement on the incidence of the payroll tax. Arguments seem to favor the position that the burden of a uniform payroll tax is borne mainly by the worker (in the form of lower wages), not by the business (in the form of lower profits) or consumer (in the form of higher prices).

It is generally agreed, however, that the economic burden of the payroll tax (even the so-called employer's contribution) falls on the worker, rather than the firm. The reason for this is that the tax is almost universally applied. The worker cannot avoid the tax by changing employers, as would be the case if only some firms were taxed. The payroll tax is somewhat lower in some other countries than in the US, but it is unlikely that a worker would move to another country just to reduce his payroll tax by a few percent.

Furthermore, it is regarded that lowering of wages does not induce workers to leave the labor market. Finally, many workers view that they receive substantial benefits as a result of the payroll tax. Since the worker cannot reasonably avoid the payroll tax, and since he does not withdraw from the labor market because of it (thereby forcing the employer to pay higher wages to retain labor), the burden of the tax is considered to fall on him.

To the extent that this is true, US firms do not face a disadvantage relative to firms in other countries having lower payroll taxes (for example, Australia at 1.6 percent of GDP versus the US at 8.3 percent of GDP), nor do they face an added incentive to move labor-intensive operations to low-wage-rate countries (higher than already exists because of the high labor rates in the US).

Since most countries use payroll taxes to finance social security, and since the level of the Social Security payroll tax in the US is low relative to many countries, the US is not placed at a strong disadvantage relative to other nations in using the payroll tax to finance Social Security.

Social Insurance Is a Responsibility of a Civilized Society

In this book, the premise is accepted that a civilized society has a responsibility to help those who cannot help themselves, such as the aged, the sick, and the disabled. There are alternative ways in which that responsibility may be discharged; for example, caring for the elderly in family settings with medical support provided by the state, versus homes for the aged. Some would prefer for the care of the elderly to be centered in the family, but in this country at this time, institutional care is the trend. In any event, the old-age, sickness-, and disability-insurance costs need to be covered in one way or another. Social Security is an organized, planned approach to provide for these contingencies.

From experience, it has been demonstrated unequivocally that a large proportion of individuals is unable to prepare adequately for emergencies such as unemployment or old age. In our society the elderly, in general, no longer live with their children, and the government ends up caring for

many elderly. For this reason, it makes sense to extract the cost of this care from all employees when they are able-bodied and employed.

Payroll taxes currently include old age, survivors, disability, and health insurance benefits. There is disagreement concerning whether medical and hospital ("health") insurance benefits should be covered by payroll taxes. The argument is that the benefits are not directly related to contributions; the benefit distribution varies substantially from individual to individual, depending on the health of the individual. The same argument could be made, however, regarding disabilities and even regarding old-age benefits, since one person may live much longer than another.

It is proposed that health insurance should be included in the social insurance covered by payroll taxes. A wealthy, civilized country such as the US has an obligation to care for its sick, disabled, and elderly. Medical and hospital insurance should be covered by payroll taxes by the same rationale as old age and disability are now covered.

The Payroll Tax Reminds Citizens of the Cost of Social Insurance

Some argue in favor of eliminating all payroll taxes, and paying for social and health insurance out of general tax revenue. They argue that the payroll tax is regressive, whereas general tax funds are progressive -- that paying for social security out of general revenue increases equity.

One of the advantages of the payroll tax is that it is a strong reminder to us of the cost of the pension or unemployment insurance funded by the tax. In addition, as a regressive tax, it provides the worker with a strong sense that he is bearing his full share of the tax burden. The tax is a constant reminder of the cost of government; this reminder could represent a restraining force on raising Social Security benefits.

Payroll Taxes Are Regressive, but the Social Insurance That They "Buy" Is a Good Deal for Low-Wage Workers

Some argue against the use of payroll taxes because they are regressive, that is, the tax burden is considered to fall more heavily on the poor. The Social Security payroll tax is regressive for high incomes because of the maximum taxable earnings limit -- individuals earning over the ceiling (\$43,800) pay a smaller proportion of their income in Social Security taxes than those earning less than the ceiling. A mitigating factor relative to the regressivity of the payroll tax is the fact that, on the average, low wage earners receive far more benefits from the system than an actuarially based system would provide. It has been suggested that payroll taxes be converted to progressive earnings taxes, or integrated with the income tax, to increase progressivity.

A Flat-Rate Payroll Tax Is Easier to Administer

There is a significant advantage in a payroll tax that is levied as a flat-rate labor earnings tax, with no exemptions and no maximum. There is also a significant advantage in tying benefits to needs, rather than to contributions (as is currently done), and for extending uniform social insurance coverage to all citizens, not just those currently employed. The advantages of these approaches are as follows. First, a flat-rate earnings tax is easy to collect by the employer -- hardly more difficult than the sales tax. It is somewhat less regressive than the current payroll tax, which has a

maximum taxable earnings limit, but the maximum is now so high that the difference in regressivity on overall collections would hardly differ if the maximum were eliminated.

Second, if benefits are not tied to contributions, there is no need for the government to keep files on each individual's contributions throughout his lifetime. Social Security insurance is viewed as a means of providing a minimal level of coverage to all US citizens in need. As basic minimal coverage, such coverage should not be proportional to contributions; the same basic minimal coverage should be extended to all citizens based on need. The wealthy can afford additional coverage from private investments and insurance.

A flat-rate earnings tax of 15-20 percent of all earnings can cover the cost of the Social Security program, including health insurance. With the elimination of the personal income tax, the tax on earnings would be just the payroll tax. While a 50-percent total earnings tax rate (coupled with a complicated tax system) is sufficient to cause much tax avoidance activity, a 15-20-percent flat tax on all earned income is unlikely to.

One disadvantage of the payroll tax with no maximum taxable earnings limit (a ceiling) is that, compared to a payroll tax with a maximum, it has an increased incentive for the owner of a firm to retain his earnings in the firm, and make purchases through the firm. With a payroll tax that has a maximum taxable earnings limit, this incentive diminishes as the owner's income increases. The disadvantage of having a maximum, however, is that the complexity of the tax increases, since it becomes necessary to keep track of every individual's earnings; with no maximum, the tax is a flat rate on total payroll.

The Payroll Tax Is Not Intrusive of Personal Privacy

The payroll tax is an earnings tax, an earnings tax collected and paid by the employer. An issue to address is what advantages and disadvantages the payroll tax has relative to the income tax and the VAT. First, since the proposed payroll tax does not require 100-percent inspection of the employee's financial affairs by the government, it is far less privacy intrusive than the income tax. A flat-rate payroll tax (with no exemptions) is vastly preferable to a flat-rate income tax, for this reason.

Proposal: Tie Social Insurance Benefits to Need, Not Contributions

In summary, improvements could be made to the US payroll tax (social insurance) system by making the following changes. First, continue payroll taxes for Social Security as a flat-rate payroll tax on all paid earnings. Extend Social Security coverage (old age, survivors, disability, and health insurance) to all citizens, and extend benefits to include basic, minimal-level benefits tied to need, not to contributions. With the elimination of the personal income tax, these changes would place the Social Security system on a sound financial footing, and would eliminate the need for the government to monitor individuals.

Social insurance benefits are, in essence, already tied to need, but by means of a complicated administrative mechanism. Low-wage earners receive a higher level of Social Security benefits than their contributions would earn in a private retirement plan. The Supplemental Security Income (SSI) provides benefits to those who are not eligible for Social Security benefits. The SSI

program is available to uninsured, essentially assetless citizens on the basis of need, regardless of their earnings history.

Levy the Payroll Tax Solely on Business

Note that there is a profound difference between the payroll tax discussed here and the payroll tax in current use. The tax discussed here is a tax that is placed solely (from a legal, not an economic viewpoint) on the employer. Since OASDHI benefits would be available to all US citizens based on need, there is no need to keep track of the tax on a per-employee basis, and to inform the government of earnings paid to individuals. There is, therefore, no invasion of privacy associated with this tax. Operationally, it is strictly a tax on business, computed as a fixed proportion of total wages paid.

The GATT defines direct taxes to include income taxes, estate and gift taxes, personal property taxes, and social security taxes. From the point of view of international trade advantages, then, as well as from a general economic point of view, it is preferable to pay for all Social Security out of general tax revenue, rather than out of a payroll tax. Nevertheless, it would not be desirable to attempt to cover Social Security costs with the VAT, for political reasons. The VAT would have to be about 35-40 percent if it were to include Social Security taxes, instead of 15-20 percent (the rate range in many countries). Congress would be reluctant to pass a VAT of this magnitude. Moreover, high tax rates cause discontent, and represent an incentive for evasion.

The payroll tax that is discussed here is a tax placed solely on the employer, for philosophical and practical reasons. The philosophical reason is that the US Constitution forbids indentured servitude, so that it is in fact illegal for the US Government to impress firms into service as collectors of taxes on individuals (such as the employee's income tax and the employee's portion of the payroll tax). The practical reasons are two. From an acceptance viewpoint, it is possible to keep the apparent payroll-tax rate lower by splitting the tax between the employer and the employee, as is the current practice. From a philosophical viewpoint, since the split-tax approach is already used, it represents no structural change; being familiar with the tax, the US public is more likely to accept its continuation as part of a major tax change. After a number of years (perhaps five years), however, shifting of the tax totally to the employer is recommended, in order to comply with the Constitution's prohibition on indentured servitude.

Some Additional Recommendations

An interesting aspect of the current Social Security tax system is that, in spite of the fact that it is a (slightly) regressive system, many individuals -- specifically, those at low incomes who pay a larger proportion of their incomes -- do not mind. They perceive that they are being taxed to pay for benefits (insurance protection) for themselves and their families. Granted, there is resentment of the tax by high-income individuals, who contribute far more than the value of the insurance benefits received, and who could retire wealthy on just a portion of their "contribution." Under the system proposed above, it is possible that this resentment would increase because of the recommendation to remove the income ceiling and to extend the benefits to all citizens on the basis of need, regardless of work history.

To address this concern, some additional recommendations are made. The proposed social insurance consists of five major components: retirement insurance (a pension), life insurance (for

survivors), disability insurance, medical insurance, and unemployment insurance. The following changes are recommended for each of these components.

Universal Trust Plan (UTP) Proposed for Retirement

First, eliminate retirement insurance from the social insurance coverage, and set up a system of mandatory saving, at 5 percent of earned pay for every worker. That is, 5 percent of the individual's pay would be deposited in a retirement savings account, insured by the federal government. This retirement trust fund would be owned by the individual, in the same way as a Keogh, IRA, 401(k), or other private trust fund. (Note: although many people are unaware of the fact, under the current Social Security System, workers do not have any property rights in Social Security benefits; Congress may reduce or eliminate benefits at will. Referring to the Social Security "Trust Fund" is simply another example of "doublespeak" -- tell a big enough lie, and people will believe it.) The individual could specify in what saving institution or institutions he wished to keep his trust fund. He would not be allowed to access the fund until retirement. At that time, he could, after purchasing a minimal-level annuity capable of covering his basic retirement needs, make withdrawals from the fund, at will. The purpose of requiring the annuity is to avoid the potential problem that someone might withdraw all of his funds, spend them or lose them, become penniless, and plea for public retirement support.

Such a mandatory savings/retirement plan was suggested by Dr. Martin Larson in his book, *Tax Revolt*, under the name of Universal Trust Plan (UTP). It is remarkable how large a retirement can result from a modest monthly deposit. For example, consider the case of a person earning \$30,000 per year, who deposits only \$125 per month. At a 10-percent interest rate (compounded continuously), after 40 years of contribution, his retirement estate is worth \$803,972. At 12-percent interest rate, it is worth \$1,506,380. The implementation of the UTP should remove the objection of high-income earners to the Social Security system, and to the removal of the income ceiling. With this change, they will receive a retirement income that bears a more equitable relationship to their contributions.

Upon the death of the individual, his annuity of course terminates. The remainder of his UTP, however, is passed on to his heirs as specified in his will.

It is proposed that, during an individual's lifetime, his retirement contributions be split equally (2.5 percent / 2.5 percent) between his account and that of his current spouse, if he is married. The contributions are deposited in separate funds. If they become divorced, the spouse (whether employed or not) carries away her fund, without change. Similarly, whenever his spouse works, he receives a contribution of 2.5 percent of the spouse's income.

In addition to the benefit of making the retirement part of Social Security more equitable, the US savings rate (now one of the lowest in the industrialized world) would be substantially increased, leading to increased investment and an improved economic situation.

During the lifetime of the individual, he or his employer could make additional contributions to his fund, above the 5-percent amount, if desired. (Note: since the corporate and personal income taxes would no longer exist, there is no consideration of "before tax / after tax" status of contributions.)

It is proposed that the 5-percent mandatory UTP contribution be separate from the 15-percent tax for other social insurance (survivors, disability, medical, and unemployment). If an individual or his spouse works too little to produce a reasonable retirement fund by retirement age, he (and his spouse) would be granted a minimum annuity.

With a UTP, the current strong incentive to retire in order to cash in on Social Security benefits is eliminated. If the individual wishes to continue to work, his trust fund continues to grow. Under the current system, if the individual continues to work, he simply loses the benefits he would otherwise have received. This 100-percent tax of Social Security benefits for working individuals would be eliminated. The current system's incentive to create criminals out of our older citizens by motivating them to hide additional income when drawing Social Security benefits would be gone. If the individual wished to cash in on his UTP to supplement his income or to travel, he would be free to do so (except for the required annuity). The strong discrimination of the current Social Security retirement program against the gainful employment of the older American would cease.

It is implied to the worker throughout his life that he is "earning" his Social Security retirement benefits, through his payroll contributions. Yet when he attempts to claim them, the government quickly takes them away if he earns money from another source. With a sense of having contributed the money in the first place -- the government itself refers to the Social Security taxes as "contributions" -- it is little wonder that some older Americans are tempted to cross over the line to criminal activity to receive benefits while receiving other income.

In addition to its many other defects, the current Social Security System has a fatal structural defect, related to demography. This single feature will eventually bring the system down. That feature is the pay-as-you-go nature of the system, in which current contributions of the working are immediately used to pay benefits to the recipients. The pay-as-you-go system is appropriate only for a demographically stable country, such as Sweden. For a demographically changing country (one in which the age distribution, or "population pyramid," of the country is changing), the pay-as-you-go system is absurd. As our country "ages" (that is, the relative proportion of aged persons increases), the burden of support on the economically active group increases to the point where it is a crushing burden that will both alienate the young and the old, and eventually deny the elderly adequate support. The pay-as-you-go system has periodically gone bankrupt, and will continue to do so; ultimately, it will fail. The system must be replaced with one in which people pay for their own retirement.

Instituting the UTP would get the federal government out of the retirement business. Since retirement pensions are the largest component of Social Security, this single move would free vast amounts for broader social insurance coverage. Retirement is a fact of life, and it can be planned for. Social insurance should be reserved to cover the extraordinary and unexpected expenses of sickness or accident, or to care for those with insufficient endowments to care for themselves. Including normal retirement pensions in the social insurance system has driven the cost sky high. This inclusion will eventually bankrupt the system, and will forever deny the country the wherewithal to implement a broad, civilized, social insurance program.

Survivors' Benefits

Apart from the UTP, all other social insurance benefits are based on need. If an individual dies before retirement, his surviving spouse and children receive need-based benefits similar to those

under the Social Security or Supplemental Security Income programs, without regard to the decedent's earnings history.

Disability Benefits

If the individual is permanently disabled, he and his family receive an income similar to that provided by a private long-term disability income plan.

National Health Insurance

This country has not faced up to the fact that its health system is an international disgrace. In 1985 there were 35 million US citizens under age 65 not living on farms who had no health insurance, public or private (*INC* magazine, July, 1987, "Unhealthy Benefits," by Jay Finegan and Sarah Clifford, pp. 29-30). (Note: the term "health insurance" is a misnomer. The person is insured against medical costs of sickness or accident, not against "health." A better term would be "medical insurance.") It's time to provide all US citizens with minimal health insurance. Today's health care costs and health care insurance costs are simply too much for the average family to afford.

In response to the situation, there appear to be two ways to go: socialized medicine (such as public hospitals, clinics and pharmacies) or national health insurance. The recent proposal to require all employers to extend minimal essential health care insurance benefits to all employees is totally inadequate. It would still leave millions of Americans unprotected and places a handicap on small businesses, which must pay significantly higher premiums than large businesses. Moreover, it would boost the cost of labor significantly, placing the US in an even worse competitive position internationally. It is proposed to keep health care in the private sector; national health insurance is therefore recommended.

It is proposed that all US citizens be covered, for all health contingencies, from planned maternity coverage to catastrophic coverage. Universal coverage may be expensive, but the high cost of health care is a fact of life in modern industrialized countries. By shifting the retirement cost outside of the 15-percent social insurance payroll tax, it should be possible to cover all of the cost from the payroll tax.

Note that we are talking about *basic* health insurance benefits. The call for "the finest medical care available" (for example, heart and lung transplants, extraordinary attempts to prolong the lives of vegetal persons) for all Americans or even all retired persons is not realistic. As wealthy as it is, even this country cannot afford that level of care for all citizens. While a small percentage of wealthy individuals may well be able to afford extraordinary care, a more practical, achievable goal is for *good* basic health care for all US citizens. Since the cost of universal finest-level care is prohibitive, proposals for national health insurance to date have failed. On the other hand, a basic-care national health insurance system is achievable. The US cannot afford for everyone to possess a twenty-room mansion and a Rolls Royce; it can afford for everyone to possess food, shelter, and access to transportation. Similarly, the US cannot afford gold-plated medical care for everyone; it can certainly afford good medical care for everyone.

Many residents of the island of Panay in the Philippines have access to better medical care than many residents of the US -- while the GNP per capita of the Philippines is \$660 compared to

\$15,390 for the US (*World Development Report 1986*, World Bank). This situation, in which many residents of one of the world's wealthiest nations have poorer access to health care than the residents of a lower-middle income country, is a planetary disgrace, and an embarrassment to a country that calls itself civilized. By removal of retirement from Social Security, the US could easily afford a dignified level of medical care for its citizens.

The woeful neglect by the US of the health needs of its elderly is receiving growing attention in the press. In early August 1987, hearings headed by Representative Claude Pepper were held before the House Select Committee on Aging, to address the problem of health insurers preying on the US elderly, taking advantage of them by selling them expensive policies that cost thousands of dollars a year but do not pay off. The US elderly are frightened to death that they will not receive adequate medical care in their old age. With the long life expectancy in the US, many elderly face years of prolonged illness and Alzheimer's disease.

In the hearings, testimony was given that more than one million Americans become destitute annually as a result of catastrophic illness. Insurance agents can and do prey on the fear of the elderly that their assets will be destroyed and they will be left destitute in the face of high health care costs. The elderly are being sold long-term health care policies with annual premiums ranging up to \$7,000. A General Accounting Office study released at the hearing described the deceptive sales practices to which a fearful elderly are vulnerable.

The US elderly deserve better than to be thrown to the mercy of unscrupulous insurance agents, motivated by rightful fears arising from a national health care and health insurance system that is simply inadequate.

Unemployment Insurance

It is proposed that all laid-off workers receive a benefit of up to one month's pay, beyond the end date of their last job, paid for by his last employer, and reimbursed 50 percent by the government. A day of severance pay would be earned for each month on the job, up to the limit of 20 working days of severance pay. This proposal is suggested as a means of eliminating the need for unemployment benefits for most people, by providing an automatic "cushion" between jobs.

Supplemental Retirement Coverage and Welfare

Under the UTP, it is possible that some individuals may reach retirement age with insufficient funds to pay for a minimal retirement annuity. If it is verified that such individuals have no assets and no family or church resources, they will be granted a minimal annuity. This and all other welfare assistance (for example, Aid to Families with Dependent Children [AFDC], general assistance) will be paid for out of general tax revenue.

If, after one month of unemployment, an unemployed individual still cannot find work, he may apply for employment assistance. If he is without economic resources (personal, family, or church), assistance will be provided as appropriate, in the form of monetary assistance, training, public sector employment, or a subsidized private-sector job.

The proposed social insurance plan includes all OASDHI programs (Social Security, including Medicare), as well as Supplemental Security Income (SSI), Unemployment Compensation (UC), and Medicaid.

Transition

A problem that must be addressed is how to determine benefits to workers who have participated in the current Social Security system. It is proposed to provide them benefits equal to the larger of what they would receive under the current system or under the new system. This approach is politically very acceptable because benefits are not reduced for anyone. It may be somewhat costly, but some transition cost is unavoidable, given the pay-as-you-go nature of the current system, under which the contributions of current workers are immediately used to pay the benefits for the current retirees.

Payroll Tax Rate

In his book *The Economics of VAT* (published in 1980), Professor Richard Lindholm notes that a mature social welfare program costs about 16-18 percent of GNP, and that the US spends half that amount. With the removal of retirement pensions from the program, a 15-percent payroll tax rate should eventually be able to fund the proposed social and economic services. Initially, during transition, and eventually, as the ratio of old population to young population increases, it may be desired to have a rate exceeding 15 percent. If this occurs, there are two choices: either the payroll tax rate is raised or it is held at 15 percent and the excess is paid from general revenue. An advantage in raising the rate is that taxpayers see how expensive the program is, and have an incentive to keep costs down.

□ In spite of the advantage of linking the tax rate to program cost, *under normal circumstances*, the latter is proposed, in order to avoid the disadvantage of a higher payroll-tax rate. If the payroll-tax rate is raised much beyond 15 percent, the incentive for tax evasion becomes noticeable. Furthermore, as the country ages (the ratio of old to young increases, due to the declining birth rate and increase in life expectancy), a heavier and heavier burden will fall on the employed to pay for the health care of the elderly. Much of the impact of this phenomenon will eventually be mitigated by the implementation of the UTP, by which many of the elderly will pay for their own retirement.

Note that the proposal for a 15-percent payroll tax was made under the caveat, "under normal circumstances." Well, unfortunately, circumstances are not normal. First, in moving to a new tax system there are transition problems. Additional cost will be incurred in paying current enrollees of Social Security retirement benefits that they view as having earned. Second, the country is running up massive budget deficits because of the inadequacy of the current system to produce the needed revenue. To address both of these problems, it is proposed to set the payroll tax rate at 20 percent, and, for the first five years of the new program, to split the payroll tax between the employer and the employee, as is currently done.

The 100-percent Pay-as-you-go Structure of the Current Social Security System Must Be Abandoned

The point made above, that as the country ages, the burden of Social Security support on the employed will increase dramatically, is a very important one. As long as the ratio of retired persons to working persons was low, the pay-as-you-go structure of the Social Security program was not too bad; the program kept running out of money, but "fixes" were always possible. Even at the present time, the "Trust Fund" contains less than one year's benefits. In the next century, the ratio of retired to working (beneficiaries to contributors) will become *very low* -- as low as two contributors per recipient. With all of the program's costs paid for by current contributions, the burden will become intolerable. The pay-as-you-go aspect is a very poor structure in the face of expected changes in the age distribution of the population. As soon as possible, we should shift to the UTP structure, in which each individual saves for his own retirement. Since the retirement portion of Social Security is about 65 percent of the total Social Security bill, this will take the pressure off the current beneficiaries (who will continue to pay for the health and disability insurance). Current beneficiaries can support the health and disability parts of Social Security, but not the retirement part.

To a certain extent, it is impossible to totally eliminate the pay-as-you-go aspect, especially for retirement benefits. (The same is not nearly so true for a family's medical benefits, many of which occur throughout the productive years of a worker.) That is because, in the final analysis, the young must always support the elderly, and, in the US, the ratio of the retired to the working is declining. No matter how wealthy the elderly are, the young must do the same amount of productive work to care for the elderly. Even if all of the elderly are millionaires, the burden of care will fall just as heavily on the young, and the elderly may not be able to obtain the care they desire, at any price. If the US debt to other nations continues to rise, the elderly will have to depend solely on the US young for their care, and the cost of obtaining that scarce care will wipe out even large retirement funds.

As a nation, however, if we dramatically improve our savings ratio, and return to the point at which the US is a net lender rather than a net borrower, the elderly will be assured that their savings will be able to obtain care in their old age, through purchases of labor from other nations having large young populations, or relocation to such nations. The ability to do this, however, requires that we maintain a strong US dollar, that we become a net lender rather than borrower, that we eliminate the deficit. This can be accomplished only if we move to a rational tax system capable of paying for the programs that US citizens demand.

Recently, in recognition of the fact that current population growth trends will eventually result in too few US workers to care for the elderly, US presidential candidate Pat Robertson proposed an increase in the US birth rate -- a new baby boom. In view of the extreme overpopulation of the planet by human beings and the terrible social, economic, and ecological problems that have resulted and are resulting, that suggestion has serious shortcomings. It is a "local-optimum" solution for the US that ignores the fact that we are but part of a larger, but finite, planetary system. A much better approach -- a "global" solution that recognizes the limitations of the planet's resources -- is for US citizens to save and (in their old age) purchase health- and elderly-care services from other nations having high birth rates and ample labor. Even this approach is a short-term one that capitalizes on the current disparity between the birth rate in the US and that of developing countries. In the long run, the planet must achieve a stable human population that lives in harmony with other species and recognizes limits on the biological support capacity of the planet.

Until now, National Health Insurance has been rejected as too costly. A major factor in viewing it as too costly is that approximately 65 percent of the nation's Social Security payroll tax goes for retirement, rather than for health and disability insurance. That setup -- the present one -- is a

foolish and financially unsound arrangement, that denies the US population access to a level of health care that is common in other developed nations. By shifting the cost of retirement from current workers to the retirees themselves (through mandatory saving and the UTP), the 15-percent payroll tax can easily accommodate universal health and disability insurance.

The current system is based on a ridiculous concept of not saving for one's retirement years. That system has gone bankrupt several times already, and will do so again. It jeopardizes the old age security of our people, and preempts and strangles the development of a modern, civilized social insurance system. The present Social Security system has failed (more than once). The time has come to replace it with a financially sound system capable of providing a decent level of care for all Americans.

The government stubbornly refuses to admit the inadequacy of the current system. About a year before the system first went broke, a couple of decades ago, actuaries were printing published accounts showing that financial estimates based on scientific projections of life expectancy indicated that the Social Security System would soon go broke. Incredible as it may seem, the government response was to brazenly contradict these reports. It published large newspaper ads in which the Secretary of Health, Education and Welfare testified that the system was in fact sound. This action was taken in spite of the fact that the Social Security System employs numerous actuaries. Shortly thereafter, the system went bankrupt. Do not depend on the US Government to tell the truth about the soundness of the Social Security System.

By continuing the fiscally unsound system, the federal government robs the future aged -- and they are us! -- of a decent retirement. Even with the most recent "fixes," the current system is scheduled to go bankrupt again in a few decades. By that time, the tax burden to provide decent Social Security retirement incomes for all elderly US citizens will be intolerable. It's time to stop deceiving the future elderly, and robbing them of a decent retirement. The future elderly are you and I! Let's move to prepare for our retirement before it's too late, and a social and economic disaster occurs.

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, which will serve him well in his old age, preserve his independence from the government, and be an asset that can be transferred to his heirs upon his death. The government may well prefer the current system, under which it perpetuates the master/slave charity relationship of the state to the citizen. The fight for private control of retirement plans will probably be a vicious one, in view of the loss of citizen control it will represent for the government.

18. A New Tax System

A Proposal for a New National Tax System

Based on the considerations of the previous chapters, a VAT-based tax system, described below, was developed. It is a significant improvement over the present income tax system. Based on consideration of how each tax method performed relative to these criteria, the VAT emerged as a hands-down choice over the personal income tax and the business profit tax, for many reasons. First, it can provide the needed revenue. Second, it avoids the severe economic distortions of the income tax. In the quest for an economically neutral tax, it is silly to settle on an income tax and then attempt to design one that causes few economic distortions. An elegant solution to this problem is to simply choose a tax that is known to be economically neutral in the first place -- a VAT.

In order to keep the VAT rate low, it is recommended to apply it to a high proportion (80 percent) of national income. A single-rate, calculation-type VAT is recommended. In order to integrate the federal, state and local taxes, it is proposed to subsume current state and local sales taxes into the VAT, with a split of the revenue to provide states and local governments the same level of revenue they are currently receiving.

To eliminate the invasion of privacy of the government into the private financial affairs of individuals, it is necessary to totally eliminate the personal income tax, not just reduce it. Also, to eliminate the need for the lifetime monitoring of the earnings of individuals, it is necessary to tie Social Security benefits to need, rather than to contributions. As noted earlier, social insurance benefits are in essence already tied to need; the Supplemental Security Income program provides social insurance benefits to citizens who are not eligible for Social Security benefits.

The retirement portion of the Social Security program is replaced by a Universal Trust Plan program in which each person owns his retirement plan. This plan has several distinct advantages over the current system: retirement benefits are tied more directly to contributions, providing a strong incentive to save; the plan will remain fiscally sound, even as the country ages; the US private savings rate will be dramatically increased; by removing retirement costs from Social Security, the country will be able to afford a comprehensive social insurance program, including national health insurance.

To reduce concentrations of wealth, continuation of current property, inheritance, and wealth taxes is recommended.

The new tax system is described below.

- Personal Income Tax: None.
- Payroll Tax for Social Insurance: 10-percent flat tax on employer, 10-percent flat tax on employee, no deductions, no maximum taxable 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: old age, survivors, disability, and health insurance (OASDHI), workers' compensation, unemployment insurance. Split the 20-percent tax 19/1 between the federal and state governments, in order to continue to operate the Unemployment

Compensation program at the state level. Share to greater extent with states if human services programs are shifted to states.

- Universal Trust Plan (UTP): 5-percent flat-rate mandatory contribution from employee, contributed to employee's *own* retirement fund.
- 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).

Table 9 (Part 1 and Part 2) shows the allocation of tax revenue under the tax system in effect before tax reform. The distribution is not expected to change much under tax reform. Table 10 (Part 1 and Part 2) presents the approximate distribution of tax revenue by source under the proposed new federal tax system, in which a VAT is substituted for the personal income tax and the business profit tax.

Table 9, Part 1. Distribution of Tax Revenue by Source Under the Current Tax System (Estimates, 1987) -- Federal Revenue

<i>Federal Revenue</i>	<i>Billions of Dollars</i>	<i>Percent of GNP</i>
Individual Income Taxes	364	8.2
Corporation Income Taxes	105	2.4
Social Insurance Taxes	301	6.8
Excise Taxes	33	0.7
Estate and Gift Taxes	6	0.1
Customs Duties	14	0.3
Miscellaneous Receipts	19	0.4
Total	842	19.1

Estimated GNP, 1987 = \$4,418.9 billion

Source: *Economic Report to the President, 1987* (Table B-73, p. 331, and Table B-74, pp. 332-333).

Table 9, Part 2. Distribution of Tax Revenue by Source Under the Current 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	2.58	14.9
--Public Welfare	0.95	5.5
--Highways	0.28	1.6
--Education	0.41	2.6
--Employment Security Administration	0.07	0.4
--Revenue Sharing	0.12	0.7
--Other and Unallocable	0.75	4.3
Property Taxes	2.56	14.8
Sales and Gross Receipts Taxes	3.03	17.5
Individual Income Taxes	1.72	9.9
Corporation Income Taxes	0.45	2.6
Other Taxes	0.74	4.3
Charges and Miscellaneous	3.34	19.3
Utility and Liquor Stores	1.08	6.2
Insurance Trust Revenue	1.82	10.5
--Employee Retirement	1.23	7.1
--Unemployment Compensation	0.44	2.6
--Other	0.15	0.8
Total	17.32	100.0
Total, excluding Federal Transfers, Utility and Liquor Store and Employee Retirement Revenue	12.44	71.8

Source: *Statistical Abstract of the United States, 1987*, Table 438, p. 257, and Table 702, p. 419. Data for year 1984.

Federal Revenue as a percentage of GNP = 19.1%

State and Local Revenue (excluding Federal Transfers, Utility and Liquor Store and Employee Retirement Revenue) as a percentage of GNP = 12.4%

Total Revenue (excluding Federal Transfers, Utility and Liquor Store and Employee Retirement Revenue) as a percentage of GNP = 31.5%

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:

Estimated GNP, 1987 = \$4,418.9 billion. (Source: *Economic Report to the President*, 1987, p. 331)
 20% VAT, split 12.5%/7.5% between federal and state and local governments, imposed on 80% of Total Personal Consumption Outlays.

Ratio of Total Personal Consumption Outlays to GNP, 1985 = $2600.5/3998.1 = .65$ (Source: *Statistical Abstract of the US*, 1987, pp. 419, 423).

Estimated Total Personal Consumption Outlays for 1987 = $.65 \times 4418.9 = \$2872$ billion.

Estimated VAT Revenue = $.125 \times .80 \times 2872 = \287 billion.

20% Payroll Tax, split 19%/1% between the federal and state and local governments, imposed on all salaries and wages.

Estimated GNP in 1987 = \$4,418.9 billion.

Ratio of Wages and Salaries to GNP, 1983 = $1984.9/3304.8 = .60$ (Source: *Statistical Abstract of the US*, 1985, pp. 433 and 436).

Estimated Wages and Salaries for 1987 = $.60 \times 4418.9 = \$2651$ billion.

Estimated Payroll Tax Revenue = $.19 \times 2651 = \$504$ billion.

Estimated *Universal Trust Plan* (UTP) Revenue = $.05 \times 2651 = \$133$

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

Notes:

Estimated Unemployment Compensation Tax Revenue = $.01 \times 2651 = \$26.51$ billion.

As percentage of GNP = $26.51/4418.9 = .60$

Federal Revenue as a percentage of GNP = 22.5%

State and Local Revenue (excluding Federal Transfers, Utility and Liquor Store and Employee Retirement Revenue) as a percentage of GNP = 12.9%.

Total Revenue (excluding Federal Transfers, Utility and Liquor Store and Retirement Revenue) as a percentage of GNP = 35.4%.

Universal Trust Plan Revenue as Percentage of GNP = 3%.

Total Revenue, excluding UTP, as a Percentage of GNP = $35.4 - 3 = 32.4\%$.

As mentioned, under the proposed system, both the corporate income tax and the personal income tax are eliminated. Elimination of the corporate profits tax should accompany repeal of the personal income tax, in order to eliminate discrimination against the corporate form of business. With the VAT as the nation's business tax, there is no discrimination against the corporate form of business versus other forms (individuals or partnerships). With repeal of both the personal and corporate income taxes, integration of the personal and corporate taxes is achieved.

The VAT that is recommended under the proposal is a 20-percent VAT on 80 percent of total consumption. Allowing for an exclusion of 20 percent of the potential VAT base is considered a limited-exclusion VAT. In *The Value-Added Tax* (p. 21), McLure gives a discussion of the items that could be excluded (either exempted or zero rated) under a limited-exclusion VAT. These 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

This book is concerned with general concepts of taxation, not with particular details. As noted, the government has the capability to estimate the cost and revenue production of system alternatives

and to explore the sensitivity of these estimates to variations in the tax rate and tax base definition (exclusions). Table 10 is an approximate (top-level design) tax proposal, not a "fine-tuned" tax budget.

The Proposed Change Keeps State and Local Revenues at Their Current Levels (as Percentages of GNP)

Note that, under this proposal, both the federal *and* the state income taxes are abolished. Furthermore, since the VAT includes a retail sales tax, it is proposed to incorporate the state retail sales and gross receipts tax into the VAT. In recent years, state and local tax revenues have represented about 14 percent of GNP. Excluding nontax items such as revenue from utilities and liquor stores and state employee retirement collections, state and local revenues are about 12.8 percent of GNP (1982 data). Of this amount (using 1982 data), state and local income taxes represent about 2.2 percent of GNP, and state retail sales and gross receipts taxes are about 3.1 percent of GNP; that is, state and local income taxes, retail sales taxes, and gross receipts taxes represent about 5.3 percent of GNP. If the state and local income taxes and retail sales taxes are eliminated, states lose about 30 percent of their revenue. To compensate the states and local governments for this loss, it is proposed to split the VAT between the federal government and state and local governments. If the federal government keeps five eighths of the VAT (that is, the split of the 20 percent VAT is 12.5/7.5) and transfers three eighths to the states and local governments, the lost revenue would be replaced (assuming that the 20 percent VAT is applied to 80 percent of consumption).

Continuing the state and local retail sales tax *in addition to* (as an add-on to) the VAT is not recommended. Since retail sales taxes vary by geographic location, having both taxes would remove an economic advantage of the tax -- its geographic uniformity. There are two ways of avoiding this problem, while preserving state and local revenues at their current levels. Either reduce the VAT rate for retail establishments by the amount of the retail sales tax rate, or split (as discussed above) the VAT tax revenue between the federal government and the state and local governments. While the latter method is simpler administratively (since merchants need file only a VAT return rather than a VAT return and a retail sales tax return), the states and local areas may wish to retain control over their sales taxes. If the states and local areas choose to continue to implement the sales tax as they have in the past, then some sharing of the VAT with the states and local areas would still be necessary, in order to replace the income lost from elimination of the state and local income taxes (in this case, the required average split would be about 17/3).

Table 10 depicts a "first cut" at a new tax system. The exact tax rates and bases should be determined after detailed studies of the expected revenue at various rates. The revenue estimates presented in Table 10 are based on simplified assumptions concerning the ratio of national and personal income to GNP. The federal government possesses econometric models that can accomplish a detailed analysis.

With regard to transition problems, it is observed that since 1954, 39 countries have implemented the VAT. The transition can be very smooth. With a VAT, the tax-return forms are remarkably simple. They resemble a one-page retail tax return, rather than a multipage income tax return.

How to Manage Social Insurance Without SSNs

Currently, the size of a person's Social Security retirement payment is determined by the size of his labor earnings in certain years. A question that could be asked is how this determination would be made, if the government did not keep track of individuals' earnings, using some form of identification such as the SSN.

There is an easy solution to this problem. As discussed in the previous chapter, make social insurance benefits (excluding retirement) the same for all individuals, that is, independent of earnings history, and available to all persons on the basis of need or age. In other words, tie benefits to need, not contributions. This change would make it unnecessary for the government to keep track of an individual's earnings. With regard to retirement benefits, the individual would only need to verify his age at the time of first collection. The rationale for this approach views social insurance as a "safety net" -- a minimal payment necessary to provide for an individual in the event of sickness or disability, and to provide him with sustenance in his old age.

The elaborate structure of our current Social Security System, with payments geared to past earnings, does little more than offer the government an excuse to monitor individuals throughout their productive and retirement years. The return on many individuals' contributions is so poor that the system, viewed as a retirement investment program, is a farce.

The price of a lifetime loss of privacy in return for a pitifully poor return on investment is too high. Low wage earners receive benefits out of proportion to their contributions, but high wage earners may realize substantially greater retirement incomes by investing in private, actuarially sound retirement plans. Since there is already little relation of benefits to contributions, it would be far better to totally eliminate the impression that there is, and simply to tie benefits to need. This would eliminate the need to assign SSNs to citizens, and eliminate the need for the government to monitor a person's lifetime earnings.

Viewed as a retirement plan, the Social Security System is a sham. It is actuarially unsound. It rips off high-wage earners, giving them a small fraction of their contributions and nothing to their estate if they die before retirement. It is doomed to eventual failure, and will bankrupt the country in the process, all the while consuming funds needed for decent social and health insurance protection.

As discussed in the chapter on the payroll tax, for retirement income we propose the initiation of a UTP system, in which the employee contributes an amount equal to 5 percent of his wages to an *employee-owned* retirement fund (placed in an insured financial institution). The employee would be unable to draw from this account until retirement, at which time he would have access to all except an annuity to cover a minimal pension for the rest of his life, in the event of his loss of the rest of the fund after withdrawal. With respect to identification, it is a matter for debate whether federally issued UTP account identification would be desirable, to ensure financial security of each citizen's account in case of failure of the depository bank. If it is decided that it is, legislation should be enacted so that no agency of the government other than the UTP insurance agency would have access to the account number or other information about the depositor. In other words, the same promise that the government originally made about the SSN, but this time with some teeth in it so that the government would not renege.

Why Not Use the VAT as a Means of Reducing Income Tax Rates?

The question may be asked: Why not just reduce the business profit tax and the personal income tax somewhat, and make up the difference with a VAT, rather than totally replace the business profit tax and the personal income tax by the VAT? There are many reasons. The VAT can collect all of 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. Having two major tax systems in effect is very costly. The instability of the revenue produced by the business profit tax contributes to an increasing national deficit.

The VAT qualifies for GATT preferential treatment -- the personal income tax and business profit tax do not. The VAT, as a tax collected by business avoids the privacy intrusion of the personal income tax. The VAT eliminates the perceived inequity of the personal income tax, and, because of the lower rates, reduces the incentive of business owners to retain income in the firm and make purchases through the firm. Although the extent to which the business profit tax has curtailed US economic growth is not known, the business profit tax imposes undesirable burdens and incentives on US business (for example, encouragement of debt financing over equity financing, reduction in savings and therefore investment, protection of inefficient producers). The business profit tax produces too little revenue to risk the economic damage it may potentially cause.

If it eventually accepts the proposition of a VAT at all, the US Government will probably propose simply adding the VAT to our tax system in addition to the personal income tax and the business profit tax, without eliminating them. The reasons for this are two. First, by increasing the number of income tax sources, the overall tax burden seems less. Second, the government would maintain the regimentation and control of citizens that is a necessary component of the personal income tax system. The approach of adding the VAT to our current income tax system would succeed in producing higher revenue, but at the cost of failing to eliminate most of the undesirable effects of the personal income tax and the business profit tax. Furthermore, the US is most likely to adopt a multiple-rate VAT, and therefore would need to adopt an invoice-type VAT. The invoice-type VAT has a heavy administrative cost, comparable to that of the income tax; it does not make sense to maintain two major different tax systems, when one of them (the VAT) can produce the required revenue.

Performance of Proposed VAT-Based System

The following paragraphs describe how well the proposed tax system performs relative to the set of criteria presented in Chapter 13.

Revenue-Producing Ability Criteria:

1. *Produces adequate revenue (no deficits).* The VAT can produce the revenue for our society's needs, at low tax rates.
2. *Produces stable revenue.* The VAT produces revenue that is much more stable than the progressive income tax imposed on a narrow tax base. The VAT is ideally suited to supporting achievement of social goals by spending policy. The VAT produces stable revenue and is well suited to supporting spending policy.

Sociopolitical Criteria:

3. *Not intrusive of privacy of individuals.* The proposed system is not invasive of individual privacy. It eliminates the personal income tax, and so no personal tax returns are required. Furthermore, by tying social insurance benefits to need rather than contributions, the need for the SSN and the government's monitoring of individuals is totally eliminated. The need for the SSN is obviated, both as a taxpayer identification number (because there is no longer a personal income tax) and as an identification number for tracking salary histories.
4. *Low incentive to engage in tax avoidance.* Under the proposed system, the incentive to waste productive effort in the activity of tax avoidance is virtually eliminated. Administratively, the VAT is similar to a sales tax. There is a strong economic incentive for preretail firms to participate in the VAT system. To receive a credit for the VAT already paid on his inputs, or (for pre-retail firms) to enable his customers to receive a VAT credit on his sales, the business owner is motivated to register as a VAT taxpayer and to pay the tax.
5. *Low incentive to engage in tax evasion.* If an invoice-type VAT is adopted, its self-policing feature makes evasion from the tax difficult.

Under the current system, the "discount" (due to personal and income tax savings) that an owner receives by making a purchase through his firm is up to 71 percent. Under the system proposed here, with a 20-percent standard VAT rate and a 20-percent flat-rate payroll tax, the discount is reduced to 40 percent. This is a dramatic reduction.

6. *High degree of simplicity.* The VAT is second in simplicity only to the retail sales tax. Under the subtractive calculation-type VAT, the firm computes the tax by applying the VAT rate to sales revenues less the cost of goods and services purchased from other firms. Under the subtractive invoice-type VAT, the tax is computed from invoices. There are no complicated definitions about what is tax deductible and what is not. The definitions of the terms involved in computing the VAT are unambiguous.

The payroll tax is computed as a flat 20 percent of total payroll. Since there are no exemptions and no maximum taxable earnings ceiling, and since benefits are tied to need, not contributions, there is no need to keep track of individual salaries for tax purposes.

7. *High perception of fairness.* Experience with a progressive income tax, the flat-rate retail sales tax, and the essentially flat-rate payroll tax show that people view the progressive income tax as unfair and the flat-rate taxes as fair. Under the VAT, individuals who are heavy consumers pay heavier taxes. Because consumption is related to ability to pay, the tax automatically accounts for ability to pay. Because the wealthy consume more, they pay more.

Because of its progressivity, the current income tax system has tremendous disincentives for a worker to work longer hours, or for a wife to work if her husband already works. The progressive tax system places an additional tax burden on individuals who increase their incomes by self-improvement (for example, by going to school).

The current system taxes this additional income at horrendous rates: on the order of 50 percent for moderate-income families. Under the VAT, the income obtained from working longer hours or from a spouse's working, is taxed at exactly the same rate. If a worker goes to school to increase his income, the additional earnings are taxed at exactly the same rate. The proposed VAT-based system eliminates the terrible unfairness of a progressive income tax system.

8. *High likelihood of acceptance by public.* Presented as a hidden tax on business, the subtractive calculation-type VAT is invisible to the public. It is no more evident than the corporate profit tax. The public would be aware of only the 20-percent flat-rate payroll tax. Because the income tax would disappear and the Social Security tax is already 14.3 percent (employee and employer contributions combined), the new system would appear to represent a dramatic tax reduction for most taxpayers.
9. *High likelihood of acceptance by states and local governments.* Under the proposal, the revenues currently collected under the state- and local-sales tax and the personal income tax would be completely replaced by the VAT. Because state and local governments would suffer no loss in revenue, they should have no reason to object to the VAT.
10. *Low tax rate.* Current marginal income tax rates and payroll tax rates for individuals range up to approximately 50 percent or more (33 percent federal income tax, up to 10 percent state income tax, up to 7 percent payroll tax). Current marginal business-tax rates are on the order of 50 percent (39 percent federal income tax, up to 10 percent state income tax, up to 7 percent Social Security payroll tax, up to 6 percent Unemployment Compensation payroll tax). Under the proposed system the tax on business is 20 percent of value added and 20 percent of payroll, and the tax on individuals is zero.
11. *Reduces concentrations of wealth.* Reductions in wealth concentrations are desirable to reduce envy and social unrest, to promote the security of citizens from threats from private concentrations of power, and to reduce economic instability and the severity of economic contractions.

The current US tax system attempts to reduce wealth concentrations directly through estate, inheritance, gift, and property taxes, and indirectly through the income tax. None of these approaches is working, as evidenced by the recent dramatic rise in the concentration of wealth in the US (with the richest one percent now owning over one third of all wealth). Use of a progressive income tax may accomplish the goal of reducing high incomes, but high *incomes* do not represent a serious threat to economic and social stability -- extreme *wealth* concentrations do. The football quarterback who earns a million dollars and spends it or invests it poses no threat. The rapidly growing number of billionaires in the US does (the number of billionaires in the US doubled in 1986).

While the desirability of reducing extreme wealth concentrations is recognized, the proposed tax system does not definitively specify how to reduce them. Under the new system, it is proposed to continue the estate, inheritance, and gift taxes as means for reducing concentrations of wealth. The use of income taxes or consumption taxes to reduce wealth concentrations has proved ineffective, and is considered inappropriate. Additional consideration of a net wealth tax imposed *only* on the very wealthy for the purpose of reducing extreme wealth concentrations is recommended.

The adoption of a federal NWT for concentration-of-wealth reduction is not recommended at this time. The move to a NWT is a very serious one, requiring a profound change in our political system -- a constitutional amendment. The framers of the Constitution outlawed this tax. Further study is recommended before making a decision on this issue. In any event, whether a NWT is adopted or not, the new system must be configured to reduce extreme wealth concentrations either by more aggressive use of existing inheritance, estate, gift, and property taxes or through implementation of a NWT. Exactly how this is accomplished is left for the detailed design phase of the tax system engineering process.

12. *High visibility of taxes to the citizen.* The VAT can be administered either as a visible tax (the tax-credit, or invoice method) in which the tax is indicated on all invoices and sales receipts, or as a hidden tax (the calculation method) in which the tax is an indirect business tax.

The calculation method imposes much less of an accounting burden on business and is much less annoying to consumers. To enhance the chance of acceptance, it is therefore proposed to administer the tax as a hidden tax on business (in the same way that the corporate profit tax is currently administered). As long as the GATT continues to operate on the destination principle, the proposal for a subtractive calculation-type VAT is considered feasible only if a universal, single-rate VAT is adopted. Otherwise, a tax-credit-type (invoice-type) VAT is recommended.

The employee's portion (10 percent) of the 20-percent payroll tax would be visible to citizens, since it would be reflected in their paychecks as a payroll tax.

13. *No "Marriage Tax" or "Marriage Subsidy."* In sharp contrast to the current tax reform system, the proposed system is neither profamily nor antifamily. The tax is simply a function of how much a family spends, regardless of the marital status of the partners. The tax is "family neutral."
14. *Constitutional: The tax does not itself violate the Constitution, and its implementation does not lead to violations of the Constitution.* A major flaw in the current income tax system is that its implementation leads to serious violations of the Constitution. The Sixteenth Amendment legalized the tax itself, but its implementation has led to routine and profound violation of most of the Bill of Rights amendments protecting individual liberties (search and seizure of property without due process, trial without a jury, a Tax Court outside the Judicial Branch, indentured servitude of firms to collect individual taxes). Under the proposed system, individuals are not taxed, and the incentive for the IRS to violate individual rights is eliminated. For "practical" reasons of transition, it is recommended to continue an "employee" portion of the payroll tax, which is unconstitutional; this provision would be removed after five years, making the tax fully constitutional. The elimination of the personal income tax will return the US to a new era of personal freedom under the Constitution.

Economic Criteria:

15. *High incentive to save.* The corporate income tax discourages saving in business (because profits are taxed heavily), and the personal income tax discourages saving for individuals (because home mortgage interest is tax deductible and interest earnings are heavily taxed). As a consumption tax, the VAT encourages saving for both individuals and businesses.

From the individual's viewpoint, the less he spends, the more he reduces his taxes and increases his savings. For every dollar that the consumer reduces his expenditures, he saves a dollar.

From the business viewpoint, the VAT also encourages saving. Under a 20-percent VAT, the firm gets to keep 80 percent of every dollar by which it reduces the cost of inputs. Under the current income tax system, the firm gets to keep only 51 percent of every dollar by which it reduces the cost of inputs (assuming a 39-percent marginal federal income tax rate and a 10-percent marginal state-tax rate).

16. *High incentive to produce.* The current system discourages workers from working longer, because of the high marginal tax rate (approximately 50 percent). Under the proposed system, if the worker earns an extra dollar, he gets to keep 90 percent of it (losing 10 percent to the payroll tax). The incentive to work longer hours or for a secondary family earner to work, is high.
17. *High incentive to be efficient.* The current income tax system taxes efficient, profit-making firms, and excuses inefficient, losing firms from the business income tax. The current system hence represents a subsidy for inefficient firms. With a 20-percent VAT, a firm gets to keep 80 percent of every additional dollar of profit, period. There is a strong incentive to reduce expenditures and earn profit. The VAT encourages efficiency.
18. *Low administrative cost.* The current tax system taxes all businesses (3 million corporations, 1.5 million partnerships, 10.7 million proprietorships) and all individuals (100 million). Under the proposed system, no individuals are taxed. The tax is restricted to businesses. The administrative cost per establishment will be no more than the administrative cost of the retail sales tax. Businesses are set up to collect and pay taxes; individuals are not. Billions could be saved in administrative costs, under a calculation-type VAT. Under an invoice-type VAT, the administrative cost of the eliminated personal income tax system could be used to pay for the cost of the invoice-type VAT.
19. *Low compliance cost.* Under the current system, with its insidious incentives to avoid and evade taxes, up to \$35 billion or more is estimated to be lost in (legal) tax avoidance activities alone. These incentives are removed under a VAT. Under the proposed system, there is no personal income tax; the high cost of income tax avoidance would be eliminated.

Under a VAT, the compliance cost to firms depends on whether a calculation-type VAT or an invoice-type VAT is used. A calculation-type VAT is similar in accounting burden to the business income tax, without the need to waste time in estimating profit or depreciation. An invoice-type VAT does impose an additional accounting burden on the firm. This book recommends a calculation-type VAT. For this to be a feasible approach, either the GATT should be converted to the origin principle or a single-rate, universally applied VAT should be adopted.

20. *Promotes tax harmony in international trade.* Under the GATT, a country may subsidize its exports by the amount of the VAT (proposed at 20 percent), and impose a border tax on imports at the VAT rate. Under the current US tax system, the US cannot do this, and, to the extent that income taxes result in higher prices, is at a disadvantage with respect to countries that use the VAT. If the US adopts the proposed system, its position in international trade will be improved. Its tax system will be in greater harmony with the rest of the world.
21. *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 (both individual and corporate). The VAT would subsume state- and local-sales taxes. The allocation of revenue among the federal, state, and local governments would be resolved as a separate issue from the collection of the taxes. States and localities could receive exactly the same amount (from the VAT collections) as their current annual sales and income taxes generate. In summary, an integrated VAT system is proposed. Harmonization of other state taxes (such as property tax, inheritance tax) is not addressed here; the proposed system assumes that these taxes continue as before.

22. *High incentive to use equity financing over debt financing.* Under the current system, interest payments are deductible to businesses, but dividends are not (that is, there is a high tax on the profit out of which dividends are paid). Firms hence have a strong incentive to use debt financing over equity financing. Under the proposed system, interest payments are still tax deductible, but the tax is at a much lower rate (20 percent versus about 50 percent). The profit from which dividends would be paid is also taxed at a lower rate (20 percent versus about 50 percent). For this reason, there is still an incentive to use debt financing over equity financing, but it is dramatically reduced.
23. *High economic efficiency.* The VAT is economically neutral. It does not create an incentive to change the mix of the factors of production. Such incentives occur in the current tax system, for example, in the favorable tax treatment given to capital investment. These incentives create economic distortions, and reduce the efficiency of the allocation of resources. The VAT does not create these distortions.
24. *Contributes to economic growth and stability.* Because of its narrow tax base (individual taxable income and corporate profits), the current tax system cannot produce the required revenue at low tax rates. The progressivity of the tax rates and the volatility of the corporate profit tax base contribute to large tax deficits in recessions. The result is an ever-increasing deficit.

The massive government debt portends economic disaster. The requirement for credit to cover the national debt will drive interest rates to high levels and dry up credit markets. Investment will be choked, and economic growth will be stunted. Unemployment will increase. Attempts to pay off the debt by printing money (to avoid interest-rate increases or tax increases) will cause inflation to rise. The current inadequate tax system is contributing to massive deficits and an economic catastrophe.

The proposed system *can* produce the needed revenue, at low tax rates (because the tax base is broad). By eliminating the progressivity of the income tax system, the revenue is stabilized. Because revenue is stable, spending policy can be implemented on a sound planning basis. Since revenue will decrease much less in recessions, the contribution of revenue instability to deficits will be significantly reduced. The US position in international trade will be enhanced. Under the VAT, saving and investment are encouraged. The VAT can contribute to economic stability and growth.

Under tax reform, the use of tax policy to further economic and social goals has in essence been abandoned. Under tax reform, social and economic goals will be achieved by spending policy. The VAT is much better suited to this approach than the income tax; the greater stability of its revenue reduces the occurrence of budget deficits or program cuts in recessions.

Experience suggests that the built-in stabilizer feature of the income tax system has not avoided recessions or even moderated their severity. This failure may arise simply because the built-in stabilizer is inherently an ineffective control mechanism, or possibly because the revenue surpluses have not been available from the boom years of the business cycle to cover deficits in the recession years. Many people believe that a great depression is likely to occur in the near future, that the stock market crash of October 1987 is the first step in a major economic collapse. Fluctuations in the business cycle are a fact of economics in a free-enterprise capitalist system.

In the face of these fluctuations and in view of the government's role of providing many basic services on a continuing basis, the need is for a tax that produces relatively stable revenue. The VAT, as a stable-revenue tax, is ideally suited to a modern government operating in a free-enterprise capitalist system. It enables government to continue the provision of basic services in the face of the economic fluctuations that inevitably occur in such a system. A consensus is arising that a fluctuating tax such as the income tax is not good, and that a better approach is to seek taxes that produce relatively stable revenue. Such a tax can fund government spending programs on a dependable basis, thereby reducing the need for radical-surgery program cuts when, in times of recession, revenue falls dramatically.

It will take a year or two to convert our income-tax-based system to a VAT-based system. The time to make this change is now, before the next recession or depression.

25. *Does not destroy capital accumulation.* Under the new system, it is proposed to continue estate, inheritance, and gift taxes. It also is proposed to continue property taxes on real estate and immovable property. Net wealth taxes are not proposed, because of their privacy-intrusive nature. Although current wealth and property taxes are not regarded as very effective in reducing private concentrations of wealth, they are considered adequate at the present time. They are not heavy and pose no danger to the detrimental destruction of capital.
26. *Robustness: The ability to accommodate rate changes without introducing complications or economic distortions, or necessitating changes in the structure of the tax system.* The VAT is a "robust" tax system. Because it is economically neutral and the base is large, its rate may be changed without necessitating a major revision of the system and without distorting the economy. Changing the rate of the income tax, on the other hand, causes major problems. With a narrow base and high rates, it is not possible to raise the rates without causing major problems -- increased complexity and economic distortions. With the VAT, business has a tax system that does not interfere with business decisions. Adjustments to the tax rate do not cause businesses to have to totally reconsider business strategy. It produces a tax environment that is conducive to long-range planning.

Note that the tax rates selected for the proposed tax system produce somewhat more revenue (as a percentage of total GNP) than the existing system. This is considered necessary to eliminate the federal government budget deficits. Although this book does not address the issue of what should be the overall tax level as a percentage of GNP (30 percent, 40 percent, 50 percent), it is considered absolutely necessary that the level of tax revenue be sufficient to cover expenditures. The growing federal deficit threatens to eliminate the private credit market and produce an economic collapse.

Recently (1985), the US became a net debtor nation. As noted by McLure in *The Value-Added Tax*, a direct result of this is the fact that we, one of the world's wealthiest nations, are borrowing a large portion of the world's savings, needed desperately by developing nations. The fact that one of the wealthiest nations, through fiscal irresponsibility based on conscious decision, chooses to deny capital and the opportunity for growth to poorer nations is, in a moral sense, outrageous. Had this situation occurred through stupidity or ignorance it would be pardonable; happening as it has through the conscious decision to continue a bankrupt tax system is unconscionable.

In spite of the passage of the Gramm-Rudman-Hollings budget cuts, it appears that the US population simply does not want to reduce the levels of many federal programs. As a percentage of GNP, the US total tax burden is one of the lowest of all industrialized nations (only Japan is lower, by a slight amount). The problem that is causing the deficit is not a too-high overall tax

burden -- it is the income tax. Using the income tax system, the government simply cannot raise the revenue needed to fund a reasonable budget without imposing crushing tax rates and enforcing ruthless collection methods.

By their reluctance to support the reduction in federal expenditures, the US population is in effect saying, raise taxes *overall* to pay for these programs. Unfortunately, with an *income* tax system as the primary source of revenue, the tax base is so narrow that raising taxes overall by a slight amount (for example, from 31 percent of GNP to 33 percent of GNP) would cause the income tax rate to increase by a large percentage.

Another reason why taxes are so high is that the US Government is, in essence, paying for retirements out of tax revenue. Retirement expenditures represent 20 percent of all federal outlays -- about \$200 billion a year. The current annual deficit is about \$200 billion per year, or about 5 percent of GNP. The single move of transferring the bulk of the retirement funding from the US Government to the private sector (through the UTP) would wipe out the deficit.

In short, then, the overall tax rate in the US *must* be raised somewhat, to cover the cost of demanded programs. Alternatively, the federal role of financing retirements must be dramatically reduced. The rates of the tax proposed in Table 10 are set at levels that would eliminate the US deficit, enable funding of current programs, and provide for a civilized health and social insurance program.

Although the VAT can no longer be called a revolutionary tax, the tax system proposed here constitutes a revolutionary change to the current US income tax system. Because of the severe social, political, and revenue-producing inadequacy of the current system, a major change is required. Because of the anger and frustration of the US public concerning taxes, a genuine reform is now possible. Major changes were made in our tax system in earlier times in response to social pressure. The pressure and the need are strong now for a revolutionary change in the US tax system.

What About a National Wealth Tax?

Although the VAT can raise the needed revenue, it does not address the problem of reducing extreme wealth concentrations. Current estate, inheritance, gift, and property taxes are ineffective in preventing extreme concentrations of wealth. In spite of the inadequacy of current estate, inheritance, gift, and property taxes, their continuation is recommended for the time being. This book has carefully considered the issues of privacy and revenue-producing ability of the tax system. It has scarcely considered the issue of the role of the tax system in reducing wealth concentrations. That issue needs to be examined in detail in a thorough systems engineering analysis of the tax system.

The need for reducing extreme wealth concentrations is accepted. The issue that has not been resolved is how to accomplish this goal. The proposal of a NWT on the wealthiest one percent of the population would be a direct, effective, and efficient means of accomplishing a wealth concentration reduction, and it would not invade the privacy of 99 percent of the nation's citizens. The problem that arises is whether a NWT could be contained to just one percent of the population.

A federal NWT would require a constitutional amendment. If the amendment included a clause that the tax was restricted to the wealthiest one percent and would not be extended to a greater portion of the population, the tax would accomplish the goal of reducing wealth concentration without compromising the privacy of all Americans. The tragic experience with the income tax, which began as a tax on just one percent of the population, illustrates the danger inherent in allowing any form of direct federal taxation. The government might decide, for example, that in order to determine precisely which citizens are the wealthiest one percent, it needs to examine the wealth of all citizens. The nation should be quite certain that it desires to take this step. Introduction of a VAT does not raise constitutional issues. Introduction of a NWT, like the income tax before it, does. The issue of a NWT over the richest one- percent of the population requires extensive national debate.

As in the case of the VAT, there is ample evidence from other nations concerning the impact of imposing an NWT. In recent times, 14 countries have used the NWT. Regarding the issue of reducing extreme concentrations of wealth, some observations will be made. The issue is not one of having a few wealthy people or even many; it is one of having a small percentage of the population owning a large proportion of the nation's wealth. It is the extreme concentration of wealth that contributes to envy, to a political loss of security for the many, and to economic instability.

The total value of US wealth ("net stock of fixed reproducible tangible wealth") is \$10.9 trillion (data cited here are from the 1987 Statistical Abstract). Of this, the government owns \$2.3 trillion, leaving \$8.6 trillion in private hands. Excluding the value of consumer durables, cash value of life insurance, equity in small businesses and farms, and the present value of pensions and Social Security, the total value of wealth held by families, that is, their net worth, is approximately \$4 trillion. Let's assume that this portion of the nation's wealth would form the base for a NWT. (Note: In asserting that the richest one percent of all families now own more than one third of the nation's wealth, Dr. Ravi Batra is referring to a reduced wealth base such as this one, not to the total \$10.9 trillion US wealth.) In the US today, there are approximately 400,000 millionaires (1982 data, 1987 Statistical Abstract), representing about .5 percent of all households. The net worth of these individuals is estimated at approximately one trillion dollars. If a 2-percent NWT were levied on these individuals, the revenue raised would equal \$20 billion. If a 5-percent NWT were levied on wealth in excess of \$1 million, the revenue would be \$30 billion.

There are approximately 1,300,000 wealthholders having net worth of \$500,000 or more, representing about 1.5 percent of all households. The net wealth of these individuals is estimated at about \$1.6 trillion. If a 2-percent NWT were imposed on these individuals, the revenue raised would equal \$32 billion.

We see, then, that the imposition of a heavy (2 percent) NWT on the richest one percent of the population produces relatively little tax revenue: on the order of \$20-30 billion (compared to a budget of on the order of \$1 trillion). The purpose of the NWT, of course, is not to raise revenue, but to reduce wealth concentrations. Because the NWT raises relatively little revenue there is little point to extending it to the entire population. The revenue increase would still be low, but the administrative cost would be very high and the loss in privacy severe. A mass income tax makes more sense than a mass NWT, since it raises more revenue with no greater administrative and privacy cost.

Modifications to Estate, Inheritance, and Gift Taxes

The new tax system proposed in this chapter recommends continuation of the current system of estate, inheritance, and gift taxes as means of reducing extreme concentrations of wealth, pending a decision concerning the implementation of a NWT. Those taxes are not highly intrusive of the privacy of large numbers of living individuals, and their economic impact is not great. In the absence of a NWT, they are the major taxes having the effect of reducing concentrations in wealth, even though their effectiveness in this regard is not high. Since they have not proved effective as means of reducing wealth concentrations, attention should be applied to modifying them (in conjunction with property taxes) to improve their effectiveness. In this regard, they are intended not as mass taxes for the purpose of revenue production, but as taxes on the very rich for the purpose of wealth concentration reduction.

With regard to modifying estate, inheritance, and gift taxes, a number of observations may be made. For example, it may be argued that estates of less than a million dollars should not be taxed. The taxation of such estates is not a major factor in reducing wealth concentrations and, besides, produces little revenue. Moreover, the desire of a person to preserve his estate and transfer modest wealth to his children is a strong factor in motivating him to produce. If he knows that his estate is to be effectively destroyed upon his death, he has much less to work for. This is an incentive that works for a large number of people, because the goal of accumulating an estate of \$1,000,000 is within reason; estates of that magnitude are not extremely rare.

On the other hand, the transfer of an estate of hundreds of millions of dollars to one's children serves no added good purpose, and is very rare in occurrence. The government's prevention or disassembling of such estates in the interest and intent of reduction of private power concentrations is socially and economically worthwhile, and it is such a rare event that the incentive to work hard to become moderately wealthy (such as a millionaire) is not affected.

The privacy of individuals of modest estates should be respected. Otherwise, the government will intrude unnecessarily in the private affairs of large numbers of responsible Americans. In a democracy the very wealthy must be prepared to sacrifice some financial privacy in the interest of the security of the many.

The gift tax is intrusive of privacy. Without it, however, wealthy individuals could transfer their estates *in toto* to their offspring, and private concentrations of wealth would grow without limit. With inheritance, estate and gift taxes, the individual has a choice. He may transfer his estate to his heirs while he is alive, and he will have to disclose the transfer to the government. Or, he may wait until he dies, at which time the disclosure will be made.

With the gift and estate taxes, the government can reduce private concentrations of wealth, and yet the individual has the choice of keeping his wealth private for as long as he desires. He must relinquish his privacy, however, at the point -- dead or alive -- at which he wishes to transfer his wealth to the next generation.

Under current law, estates under \$1,000,000 are hardly taxed; this is considered appropriate. Estate taxes should be applied heavily to substantial estates, whose power may threaten the freedom of the individual. Estates of \$1,000,000 in size do not pose serious threats to democracy or to economic or social stability and should not be destroyed by the government on the rationale that they do. An argument may be made, however, that the transfer of wealth to heirs spoils them. This argument is a product of envy. If the heirs put the inherited capital to good use, it will grow

and they will deservedly retain their wealth. If they are foolish, they will lose it to others who will likely put it to productive use.

The Next Step: The Detailed Design of a New Tax System

There are many issues that need to be considered in specifying, in detail, a new tax system. These issues include decisions on the type of VAT (calculation versus invoice); rate structure (single-rate versus multiple-rate), exclusions of products, firms, or sectors (such as treatment of medicine, banking, education, small business, agriculture, private sales, housing, nonprofit organizations); methods of tax exclusion (zero rating versus exemption); and transition. Serious consideration needs to be given to the issue of adopting a federal NWT.

All of these decisions must be made in the process of designing the nation's tax system. Using the methodology of systems engineering, this multiplicity of choices presents no problems. These decisions can be made in a systematic, logically consistent fashion. This book has but scratched the surface in identifying the advantages of a VAT-based system. In the language of systems engineering, it has proposed a "top-level design." Much additional analysis needs to be done before a detailed design is accomplished and implementation of a new tax system is possible.

19. What Can Be Done?

How to Eliminate the Personal Income Tax and Business Profit Tax

The personal income tax and business profit tax *can* be abolished. They can be abolished if US citizens let their elected representatives know how dissatisfied they are with the present tax law. You can make a difference by writing your congressmen (representative and senators), letting them know how you feel about these taxes: the personal income tax with its identification, registration, and monitoring of US citizens; the business profit tax with its undesirable economic incentives.

Figure 1 presents a draft of a letter that you can send to your congressmen. Write to both of your state's senators, regardless of the political party to which they belong or to which you belong. They represent you, regardless of your political affiliation.

Figure 1. Sample Letter to Congressman

(Your Street)
(Your City, State)
(Date)

The Honorable John Doe
The United States House of Representatives
Washington, DC 20515

Dear Mr. Doe:

or

The Honorable John Doe
United States Senate
Washington, DC 20510

Dear Senator Doe:

I recently read about a new tax system in the book, *The Value-Added Tax: A New Tax System for the United States*. This book proposes replacing the income taxes for individuals and businesses by a single tax -- the value-added tax, or VAT.

The VAT offers many advantages over the current income tax system: increased incentives for production, saving, and investment; lower collection costs; less time wasted in tax preparation and avoidance; and less intrusion in privacy. In addition, it offers advantages in international trade since, under the General Agreement on Tariffs and Trade, US exports may be subsidized by the amount of the VAT and imports may be taxed by the same amount.

The Tax Reform Act of 1986 has not solved the fundamental problems of our tax system. The "reformed" system is still very complicated, is costly to administer, and contains many undesirable economic and social features.

I urge you to support elimination of the individual income tax and the corporation income tax, and replacement of them with a VAT.

Thank you for your help.

Sincerely,

(Your signature)

(Your typed or printed name)

The representative you write should be the one who represents your congressional district. If your state has a single "at large" representative, write him. You can find out what congressional district you live in by looking in the telephone directory under "US Government, Congress," and calling each listed representative to find out who represents the district you live in. Alternatively, your local library can provide the names and addresses of your senators and representative. They are listed, for example, in the *Congressional Directory*, published by the US Government Printing Office, or in certain issues of the *Congressional Quarterly*.

If you want the US Government to stop invading your privacy, write a letter today. You can help rid the US of an intrusive tax, and help create a fairer, freer, more economically productive and internationally competitive country.

Transition Problems

A study is needed to determine the VAT rate that will replace the revenue lost if the personal income tax and business profit tax are eliminated. The federal government has funded the development of computer models that can estimate the impact of changes in tax law, so this can be done with relative ease. These models can be used to estimate the impact of tax law changes on various types of individuals and firms.

Impact of Elimination of the Income Tax on Tax Lawyers, Accountants, Tax Preparers, and IRS Agents

Some people have noted that if the income tax were eliminated, thousands of tax lawyers, accountants, tax preparers, and IRS agents would be put out of work, since they would no longer be needed to study and interpret the Rube Goldberg tax code, complete tax forms, devise tax avoidance schemes, process income tax forms, and audit and prosecute taxpayers. While the income tax system does, in fact, constitute one of the greatest make-work programs ever devised, the argument that these educated people would be out of work for long is difficult to accept, for several reasons.

First, tax lawyers and accountants are not stupid, untrainable, inflexible people who, having been trained to do a particular job, cannot do anything else. Rather, they are educated people with quantitative and analytical skills that can be utilized by the productive sectors of the economy.

Historically, when educated people have been displaced because of technological change, they have been very successful in finding new work. In the late 1950s and early 1960s, many college graduates had degrees in nuclear engineering. Demand for nuclear engineers fizzled, however, when the demand for new nuclear electric power stations turned out to be far less than originally anticipated. Many of these engineers found stimulating work in other fields, such as operations research, systems analysis, management science, and computer software engineering.

In the late 1960s, the effort to put a man on the moon came to an end and was not replaced by a space program of comparable magnitude. Tens of thousands of scientists and engineers lost their jobs in aerospace. Many of these engineers and scientists found new jobs in policy analysis, program planning and evaluation of the burgeoning social and economic programs that were funded in the 1970s.

In some instances -- coal miners in West Virginia or copper miners in Arizona -- displaced workers who have manual skills and are unwilling to relocate or enter training programs may, in fact, be unable to find new employment similar to their old employment and in the same location, to replace their lost jobs. Tax lawyers and accountants hardly fall in this category. They will undoubtedly be able to transfer their skills to new, productive jobs.

Under a calculation-type subtractive VAT, the administrative and compliance activities are similar to those for the corporate income tax, with the exception that the incentive for tax-avoidance activities is gone. Under such a VAT, a tremendous reduction in IRS staff would be possible (all those engaged in activities related to the individual income tax). Under a subtractive tax-credit (invoice-type) VAT, the IRS estimates an administrative cost of 20,000 employees and \$700 million per year. Although less than the administrative cost of the income tax, adoption of this type of VAT would enable the continued employment of many IRS workers. Expending a large amount of administrative effort on a tax that is despised and requires a national police force to enforce is ridiculous; expending that same amount of effort on a tax that the rest of the world has demonstrated to be a very good tax is a worthwhile expenditure of effort.

It is possible that some IRS agents may find it difficult to find private-sector jobs that pay as well as their civil-service jobs. Similarly, some tax lawyers may not be able to find jobs that pay as well as their previous professions. Granted, some adjustment in salaries may be necessary, as individuals train for other jobs. A free-enterprise society has, however, no obligation to continue to support make-work programs. If these individuals were never able to find private-sector jobs of equivalent pay, it would be evidence that their jobs as tax studiers, advisors, collectors and enforcers are based on skills whose productive value simply did not justify their previous high salaries. While this may be the case to some extent, the displacement of nonproductive workers is a small price to pay to regain the privacy of 100 million US citizens. Moreover, the US Government operates employee retraining programs that may be of value to these displaced persons; the considerable savings that will result from the abolition of the personal income tax and the business profit tax would offset the cost of these programs.

Transition to a VAT Will Cause a Temporary Economic Dislocation

Any change in the tax laws that redistributes the tax burden causes some economic dislocation. The demand for items that are taxed more heavily falls, because those items become relatively more expensive. Similarly, the demand for items that are taxed less heavily rises, since these items become relatively less expensive.

With a 20-percent VAT, the price of goods to domestic consumers will rise approximately 20 percent. If labor rates stay approximately the same and personal income taxes are eliminated, the increase in the cost of goods is offset by the decrease in personal income taxes.

As mentioned previously, tax change impact models need to be exercised to assess the impact of these changes and to plan for them. The costs of implementing a VAT are, of course, offset by the \$35 billion saving in tax-collection and tax-avoidance costs.

The fear of transition problems should not prevent the change to a VAT system. Many countries have switched to a VAT in recent years. That transition to new systems is feasible is evidenced by the passage of the corporate income tax, the individual tax, sales taxes, and, of course, the Tax Reform Act of 1986.

The Impact of the Tax Reform Act of 1986 on Abolition of the Personal Income Tax and Institution of a VAT

From the point of view of abolishing the personal income tax, the Tax Reform Act of 1986 is probably the best thing that ever could have happened. The new tax law will probably not last very long, for several reasons. First, although the marginal rates were high under the previous system, few people paid an average (effective) rate anywhere near the marginal rates. They were able to do this because of the wide variety of tax shelters. Under tax reform, many individuals will find themselves in a 30 to 50 percent *average* tax bracket, with no way out. The tax burden under tax reform will be severe for many.

Moreover, these individuals will not just be a few wealthy individuals -- they will represent approximately 20 percent of the population. It is this group of people that will bring tax reform down, and pave the way for the abolition of the income tax and institution of the VAT. This affected group of people includes many of the same lawmakers who passed tax reform. Many of them do not own their own businesses; rather, they are employees of the federal government. They will find the new tax system a bitter pill to swallow. From a political viewpoint, the tax reform legislation makes little sense. The very group that is in a good position to control legislation -- the top 20-percent income earners -- has straddled itself and a large proportion of the population with a severe tax burden; and the fundamental problems of the tax system have yet to be resolved.

In response to the higher tax burden under the Tax Reform Act, there is essentially no way out for most US citizens. For Congress, however, there is an easy way out: congressmen can raise their salaries, with the stroke of a pen. Because of the inability to shelter income under tax reform, Congress will, no doubt, attempt to raise congressional salaries substantially. The December 16, 1986, issue of the *Arizona Daily Star* reported on a proposal to double congressional salaries. Effective April 1, 1987, congressional salaries were raised from \$77,400 to \$89,000 -- a raise of \$12,100. Because of tax reform, the pressure for additional raises for congressional salaries is intense. The process of raising congressional salaries has just begun. US citizens should be

outraged at being straddled with an onerous income tax, while Congress averts this burden simply by increasing congressional salaries.

The creation of this very undesirable situation was completely unnecessary and avoidable. The call was for a fairer tax system. This could have been accomplished simply by imposing a flat 15-percent income tax. Instead, Congress seemed to confuse fairness with progressiveness.

A second reason why tax reform will not last is that the current system simply cannot produce the revenue needed by the US Government to fund the programs demanded by the US population. In view of the fact that the overall tax burden in the US is among the lowest of the industrialized nations, this clearly indicates that taxes are not too high -- the tax system is simply inadequate. In view of the fact that Congress has been unable to effect funding cuts, the massive US deficits will continue until the US abandons the inadequate income tax system.

For years, Americans ignored the deficit problem. Regarding the federal deficit the saying was often heard, "It's nothing to worry about -- we owe it to ourselves." That is no longer true. Since 1985, we are a debtor nation. The national debt is now \$2 trillion dollars, and the annual budget deficit -- even in boom years -- is running \$150-200 billion per year. The economic system is beginning to collapse. The recent (October, 1987) stock market crash is but a harbinger of things to come, if the US does not put its economic house in order. Americans *will* rise to this crisis, and demand that Congress adopt a tax system that can cover the budget.

A third reason why tax reform will not last is that, unlike the previous system, it does not offer the moderately well-to-do individual the option of relinquishing his income in exchange for increasing the size of his estate. That is, in essence, what tax shelters enabled. He had the option of paying his income to the government in the form of taxes, or of investing it in real estate (or other tax-deductible investment) for his estate. High earners didn't mind being forced to spend their money in certain ways, since those expenditures helped to increase the size of their estate.

Under tax reform, the moderately well-to-do will simply have one half of their income confiscated, and will receive no help in building their estates. Better tax systems *are* available. Under a VAT, for example, an individual who saves reduces his taxes. These people have the ability to influence legislation to stop this, and will do so.

A fourth reason why tax reform will not last is that, by removing tax shelters, it has created strong incentives for individuals to purchase items through their businesses -- indeed, to create businesses for the very purpose of taking advantage of tax deductions for business-related expenditures that are now denied the individual. The politics of envy will work, as it worked to remove tax shelters in the first place, to remove these incentives.

A fifth reason why tax reform is doomed is that it does not satisfactorily address the issue of international trade harmonization. Under the terms of the GATT, the US could tax foreign imports and subsidize US exports at the VAT rate, if it had a VAT. This border-tax adjustment is not possible under the current tax system. The US is at a disadvantage to the extent that the income tax results in higher prices.

As discussed in this book, there are many other reasons why the current US tax system will ultimately be replaced. Perhaps the most significant reason, however, is the incredible invasion of privacy and loss of personal-freedom guarantees that the income tax system has wrought on US citizens. To implement the income tax, the US has set up a police-state system that operates outside the Constitution and ignores individual rights supposedly guaranteed by the Constitution.

Americans are fed up with having their privacy violated and being oppressed by the IRS. They want to be let alone.

When Congress meets again to revise the US tax code -- and that will occur soon -- it will have an opportunity to pass truly historic legislation. It can abolish the personal income tax and institute a VAT. The result will be a tax system that is fairer, less intrusive, less costly, and more economically efficient than the current system. Perhaps most importantly, it will produce the level of revenue needed to eliminate the national debt, and thereby may avert an economic collapse. The "Tax Reform" Act of 1986 is a hoax, a fraud, a cruel deception. It has not solved the serious tax problem in this country; in many ways, it has made the problem worse. It will not last.

20. What if Letter Writing Doesn't Work?

How Can Meaningful Tax Reform Be Accomplished if Pressure on Congress Doesn't Work?

The preceding chapter discussed the approach of putting pressure on Congress to improve the tax system. This approach may be successful. Congress considered and passed the Tax Reform Act of 1986 in response to public pressure. Unfortunately, while public pressure (plus a push from President Reagan) succeeded in getting Congress to consider and pass legislation, their reform did not address the fundamental problems of the current US income tax system.

There was a lot of fanfare over the Tax Reform Act; it was called significant, comprehensive, radical, and even revolutionary -- in spite of the fact that it did little more than eliminate a lot of tax shelters that should never have existed in the first place. In one sense, the Act was a move in the right direction; it reversed the government's long-standing trend of using tax policy (deductions, incentives) as a means of promoting social economic goals. Overall, however, the essence of the tax system is the same as before: it is still a complicated, costly, privacy-intrusive income tax system with many serious sociological, political, and economic drawbacks, including an inability to raise adequate revenue. The traditional approach of going to Congress to obtain change in our tax laws has not accomplished meaningful improvement.

This chapter explores alternative methods that may be considered as means of eliminating the income tax and restoring your privacy if the approach of appealing to Congress for legislative relief does not work. The chapter begins with discussion of historical responses to tax repression, and a consideration of reasons why meaningful tax reform has not occurred in this country. The role of revolution as an instrument of tax reform in American politics is examined. An approach -- short of revolution -- for accomplishing tax reform is then discussed, involving passage of constitutional amendments. The approach involves passing amendments to repeal the income tax and to explicitly list privacy as an individual right.

Does Congress Not Realize How Much the Income Tax Is Despised?

It appears that Congress does not appreciate the profound dissatisfaction of the US citizen regarding the intrusion of the IRS into his privacy. The current tax system constitutes unwarranted search and seizure of property by the federal government: the very thing the framers of the Constitution attempted to avoid in forbidding direct federal taxation. The Colonists, unable to obtain a satisfactory response from the British Government regarding tax change, initiated the US Revolution in 1776. Flush with power, the new US Federal Government embarked on an excise-tax-levying binge and precipitated the Whiskey Rebellion of 1794. The US Government can push its people to rebellion and revolution again, if it continues to be unresponsive to the needs and concerns of its citizens.

Imposition of the personal income tax has fundamentally changed the relationship of the US citizen to the US Government. US citizens despise the income tax. It represents an elaborate pretext for monitoring the activities of virtually all US citizens. The income tax system has been responsible for a dramatic loss in our freedom. Through the income tax, our financial affairs are subject to annual review and questioning by the IRS.

This inquisitional approach to taxation is not consistent with the US heritage of freedom of the individual from government harassment. The IRS is the organ of the US Government that conducts a general citizen-monitoring function; relative to its role of citizen-monitoring, it is the functional equivalent of Nazi Germany's Gestapo or the Soviet Union's KGB. Do we really need a government agency of this sort in this republic? As long as we have a personal income tax system, the IRS will continue its monitoring of individual citizens. A tax system is needed whereby you may, if you desire, legitimately keep your personal financial affairs private from the government, and yet continue to participate in the economic and social life of the nation.

The inadequacy of our current tax system is not simply a fiscal problem; it is a sociological problem of profound magnitude. So far, Congress has evidently failed to grasp the significance of this problem. The income tax system strikes at the very heart of freedom and is destroying the relationship between the US Government and the US citizen. Through the income tax and the IRS, the federal government has usurped far more power than was intended by the framers of the Constitution.

The US citizen of today is in a very vulnerable position relative to the government. Formerly, the freedom of the individual from constant governmental review and the collective privacy of the citizenry represented insurance from the abuses of power by the federal government. The situation today is one of "divide and conquer." Through the income tax system, the federal government has placed itself in a one-on-one adversarial relationship with each citizen. Through the loss of privacy of the individual, the US citizenry has lost a large measure of its collective control of the strong power of the federal government. Individuals who are fully identified to a government are in no position to protest that government's actions.

Decades of Neglect of Individual Rights Has Caused the Loss of Much Personal Liberty in the US

It is time to restore privacy to the US citizen, before it is too late -- before the police-state system is so entrenched and its stranglehold grip on the individual citizen is so powerful that it cannot be dismantled. Several generations of life under an insidiously expanding personal income tax system have acculturated the population to the loss of privacy that has accompanied the income tax. The keen sensitivity of the US citizen to suffocating control by a strong central government has been dulled by the narcotic of a semi-welfare state. The US citizen has been seduced by social programming to accept all laws, regardless of their social consequences.

The framers of the Constitution were keenly sensitive to protection of the rights of the individual from usurpation by the government. The Bill of Rights serves as testimony to their concern. The Sixteenth Amendment, the income tax system, and the IRS have significantly eroded the security, privacy, and the dignity of the US citizen. The ideals of the founding fathers relative to the sanctity of the freedom of the individual have been destroyed by 200 years of neglect.

An Income Tax System Perverts the Relationship of a Citizen to His Government, and Characterizes His Role as a Revenue Producer for the Government

The current working relationship and interaction between the government and the citizen is based on a view of the citizen as a source of revenue -- a unit of production. While this view of human

beings may be appropriate for a slave-based society, it is detrimental to a society committed to the freedom of the individual and development of the individual to his full potential. This situation can be totally changed if taxes are extracted from business rather than private citizens. The relationship between the US government and its citizens will then center on the protection of the individual and his development, rather than on his utility as a revenue producer.

The revenue collection process should not form the essential basis for the relationship of the government to the citizen. As long as it does, the privacy-intrusive character of the citizen / government relationship will continue to weaken the bond between the citizen and his government, rot the fabric of our nation, and lead to its ultimate demise. The income tax system is a cancer in our society, and it must be excised to promote the long-term health of our society.

In the past 200 years, the relationship of the US citizen to the government has changed from one in which the federal government was created to serve and protect the individual to one in which the US citizen is a revenue-producing servant of the government. The essence of this relationship is emphasized by the frequent reference to US citizens as "taxpayers." Referring to US citizens as taxpayers depreciates their humanity and dignity. The term "taxpayer" should refer to economic production units: businesses, not human beings. When the personal income tax is abolished, human beings in this country will again be characterized as "citizens," not "taxpayers."

Referring to citizens as taxpayers reflects not only a dehumanizing stereotyping of human beings, but it emphasizes how much the perceived role of the citizen in US society has declined since colonial times, and how the function of the government has been changed from that of servant to that of master. The personal income tax is today's equivalent of the capitation tax on the slave of colonial times. The American human being must reject the role of slave/citizen, and cast off the yoke of the personal income tax. While the privacy of the slave may have been of little consequence to the government, the protection of the privacy and property of free citizens from the government was a strong concern.

The US citizen is no longer the *raison d'être* of the government; rather, the system has been transformed from one in which the federal government serves the people to one in which the individual serves as a revenue producer for the federal government. This transformation has occurred simultaneously with the conversion of the federal government's revenue system from one based on indirect business taxes to one based on direct personal income taxes.

US citizens deserve better than to become mere "standard service units" in a government / citizen relationship based primarily on the flow of tax revenue from the individual to the state. The previous tax system (before the Sixteenth Amendment), based on indirect business taxes rather than on direct personal taxes, was more humane. It can be reconstituted immediately, with the replacement of the personal income tax and the business profit tax with a VAT -- a business tax that is not only economically and administratively superior to the current personal and business income taxes on numerous counts, but also sociologically superior in that it preserves the privacy and dignity of the citizen.

The Framers of the Constitution Tried to Prevent the Federal Government from Direct Taxation, but Congress Has Thwarted Their Plan

In its ban on the use of direct taxes such as the income tax by the federal government, the only direct tax explicitly mentioned in the US Constitution was the capitation tax, a reference to the \$10

capitation tax on slaves. In proscribing federal direct taxes, the clear intent of the framers of the Constitution was to prohibit the federal government from dipping into the pockets of US citizens. Direct taxes, such as the personal income tax and the net wealth tax, are detrimental to the freedom of the individual from the tyranny of a strong central government today, just as they were 200 years ago: perhaps more so, in view of the government's enhanced abilities to monitor and control individuals, which has been brought about by technological development.

US citizens are not slaves; they deserve better than direct personal income taxes. Use of the personal income tax is a dehumanizing process; the humanity and dignity of human beings would be enhanced by elimination of this tax.

Can a Revolution Be Averted?

In our history, the response of Americans to tax oppression has been dramatic. The basic cause of the US Revolution was objection to the tax policies of the established government. Specifically, the colonists objected to taxation without representation. After a successful Revolution, the constitutional convention limited the powers of the new federal government to impose direct taxes, such as the personal income tax or the net wealth tax. In fact, it outlawed the very type of tax we have today. The Whiskey Rebellion of 1794 occurred in response to the imposition of heavy federal taxes. US citizens consider that the US Revolution was justified -- that revolution is an appropriate response to oppressive taxation. If Congress will not be more responsive to the need for meaningful tax reform in the future, it may again evoke this drastic response.

The income tax burden is heavy now. The response of the founding fathers of the US in the face of unacceptable taxes was revolution. Today, Congress has been totally unresponsive to the cries of the US population for *meaningful* tax reform. To accomplish this end, citizens may once again decide that it is necessary to fundamentally alter the structure of the US Government.

In passing the Sixteenth Amendment, Congress rejected the wisdom and concern of the founding fathers on the issue of direct taxation of individuals by the federal government. A lack of concern was evidenced again recently, in the passage of the Tax Reform Act of 1986 -- a cosmetic face-lift to preserve a harmful tax system and enforcement organization that should be dismantled, not perpetuated. What if the traditional process of appealing to Congress continues to fail to achieve improvement of our inadequate tax system? What if letter writing doesn't work? This chapter explores an alternative approach -- short of revolution -- to achieving tax reform, if Congress chooses to ignore or is unable to solve this significant problem.

In his book *Federal Tax Policy*, Pechman suggests three improvements that could be made in the legislative system to improve the tax legislative process. First, Congress should concentrate on major policy issues, not on the details of tax law. Second, the interests of the public should be given better representation in the deliberations of the Ways and Means Committee and the Senate Finance Committee. Third, conditions should be created under which structural reform of the tax system is considered in a systematic way. These are sound proposals. The tax system is too important to receive the second-hand treatment it has received in the past. Better, systems-oriented approaches are available, but are not being used. The public deserves a greater level of participation in the solution of this critically important problem. While Pechman's suggestions concerning the ills of the current system for legislating the tax system are very appropriate, he offers little advice on how to bring these changes about. This chapter addresses the issue of change.

The Long Wait for Tax Reform

In the fall of 1986, Congress considered and passed legislation to revise the income tax system. For years, many people said that substantive income tax reform would never happen - that the Rube Goldberg system had created so many special-interest features that substantive change seemed politically impossible. No matter what changes were proposed, some special-interest group would be hurt. Meaningful change seemed to be politically "gridlocked."

The US income tax system is a very expensive system; perceived as unfair; complicated (even IRS offices cannot complete the tax forms consistently, much less the lay citizen); and economically inefficient. The ordinary citizen has complained about the unfairness for decades, to no avail; the system simply became more unfair, more complicated, and more costly, as the government passed more and more rules and regulations. The complexity of the income tax has increased even more, under tax reform.

A few people spoke out against the wrongness of the income tax system, but little happened. People who refused to pay income taxes on the basis of their unconstitutionality were harassed and penalized, and their property was confiscated. Citizens were forbidden to introduce the IRS code or the Constitution as evidence in the IRS Tax Court. Finally, President Ronald Reagan, sensing the anger and frustration of the citizens with a bad tax system, promoted tax reform and succeeded in getting Congress to act on it.

The US Population Has a High Tolerance for Bad Laws

The point is that although the US population is not averse to revolution, it has a tremendous tolerance for putting up with bad laws and regulations. This stems both from a strong tradition of obeying the law and from a feeling of helplessness that the law can actually be changed. The fact is, however, that it can be changed, if a sufficient number of people are sufficiently angry to do something about it.

Citizens have their own lives to live, and most do not have time to campaign for changes in laws. The income tax is an example of a law that many people wanted to change for a long time, but were not able to. Many citizens view the income tax code as unfair and unjust. They put up with it, however, because of inertia. Furthermore, in the case of the income tax, it is difficult to demonstrate -- certainly for a layperson -- that it is "too" costly, "too" inefficient, or "too" inequitable. These are value judgments.

The Vietnam War cost billions of dollars, and was extremely unpopular -- widely viewed as a "political" war. It took about 15 years and the loss of 50,000 young men and women, before US citizens could persuade the government to withdraw. The problem is even worse with the income tax. Although it is perceived as a bad tax, it is impossible to "prove" that it is wrong, and besides, no one is getting killed over it. Since the government has convinced people that the income tax is necessary, and since it has a vested interest (control of citizens) in maintaining it, it will be very hard to eliminate.

A Constitutional Amendment Is Needed to Protect Privacy

The debate over the constitutional "right" to privacy is growing. Arguments are heard on both sides of the issue. In her July 8, 1987, article, "Fierce Argument over a New Interpreter," Washington Post Writers' Group syndicated columnist Ellen Goodman describes the constitutional issues. In a 1965 Supreme Court case (*Griswold v. Connecticut*) dealing with privacy, one justice wrote that privacy rights were inferred from the others in the first eight Amendments, dealing with freedom of expression, freedom from unwarranted search, and freedom from having soldiers quartered in one's home. The Constitution does not address privacy explicitly, and the Bill of Rights (first ten Amendments, plus Amendment 14) does not name privacy as a right. In this respect, a second justice cited the Ninth Amendment as supporting a right to privacy ("The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people."). In the 1973 decision, *Roe v. Wade*, the Supreme Court extended the right to privacy to include a woman's right to have an abortion.

Ms. Goodman notes that former Supreme Court justice nominee Robert Bork has said that the right to privacy simply doesn't exist. He claims that the framers of the Constitution and its Amendments did not intend to create such a right. Asked by *Time* magazine if he found a right to privacy anywhere in the Constitution, Bork replied unequivocally, "I do not" (*Time*, July 13, 1987, p. 11).

New York Times columnist Lloyd N. Cutler, in a July 20, 1987 editorial entitled "Robert Bork: The Fears of Liberals Could Be Unfounded," also summarizes Bork's viewpoints. He quotes Bork: "It is the task of the judge in this generation to discern how the framer's values, defined in the context of the world they know, apply to the world we know." This single sentence elegantly summarizes Bork's view of the role of the Supreme Court and the significance of the Constitution in American society. Given this statement, and the many Bill of Rights Amendments that represent privacy rights, it is difficult to see how Bork can view that a right to privacy was not an intent of the framers. Without the acknowledgement of a right to privacy, a sincere promulgation of the Bill of Rights Amendments would have not been possible. A right to privacy doesn't just "emanate" from the various amendments of the Bill of Rights -- it literally oozes from them.

The Constitution serves as the standard for the American rule by law. It is not, however, an absolute standard that is frozen in time. It is a living document, whose text and interpretation are continually subject to change, as the context of American society changes. The meaning of the Constitution is forever in a state of flux, as the Supreme Court continues to interpret the framers' values in the light of new circumstances. Furthermore, it is not binding on the American people. If we disagree with the conjectured values of the framers or with the explicit content of the document, we may modify it by the Amendment process, or Congress may overrule any interpretation of the Supreme Court (under Article III, Section 2, Paragraph 2). Upon amendment, the revised document becomes the subject of interpretation of the Supreme Court, given the values ("intent") of the amenders.

Under the original Constitution, it was clearly the intent of the framers to allow slavery to continue and to deny women the vote. A few generations later, those viewpoints were rejected as basic values, and the Constitution was amended to free slaves and extend the vote to women.

In a September 19, 1987, editorial, Washington Post Writers' Group columnist Mary McGrory criticizes Bork's strict-interpretation writings as devoid of humanity. This criticism seems to imply that a strict interpretation of the Constitution is not a humane interpretation. The original

Constitution was not, however, a very "humane" document by today's standards. It denied the vote to blacks and to women, and, with respect to representation in Congress, it counted Indians as zero and blacks as three fifths of a white. If we disagree with the degree of humanity of the Constitution, it is up to us to change it by the amendment process or by a congressional override of Supreme Court decisions. As our concept of humanity changes, the document may be out of step. If so, change it. Until then, adopt a strict interpretation. With a strict interpretation, we know where we stand. Without it, the IRS is allowed to run roughshod, with impunity, over US citizens. Under a strict interpretation, the IRS could not seize your property without due process, could not try you in an unconstitutional Tax Court, and could not impress firms into indentured servitude to collect personal income taxes.

The fears and complaints that a strict interpretation of the Constitution will eliminate the civil rights gains of the last three decades are unfounded, and do a disservice to both our Constitution and our congressional form of government. It is acknowledged that the Constitution should not spell out every law in detail, but rather cite general principles. It is up to the Congress to pass laws, and for the Supreme Court to assess their compliance with the Constitution. If the Supreme Court, following a literal view of the Constitution, decides that a civil right law is unconstitutional and US citizens disagree, there are two choices: amend the Constitution, or have Congress override the Supreme Court decision.

Strict interpretation or no, our culture will determine what civil rights will prevail. The Constitution is not an inviolate law of physics. If US citizens demand certain civil rights, they will have them, regardless of how the Supreme Court interprets the Constitution. The Constitution's role is simply to provide a standard by which we act -- a mutual compact. If the standard becomes obsolete, it can be changed. The accommodation of change is, in fact, incorporated into the document itself, through the amendment procedure and the power of Congress to override Supreme Court decisions. Remember, folks, these people work for us. If we don't like their decisions, we can require our elected representatives to set things right.

Today's US citizens are increasingly fed up with the invasion of privacy by the government and by private organizations. If, as Bork claims, the framers did not "intend" a right to privacy, it is time to pass an amendment, explicitly stating this right. The framers never anticipated the awesome power of the government to monitor citizens and the imposition of an income tax that necessitates a national police force. In view of these unforeseen changes, the document must be updated to preserve the concept of personal freedom. Otherwise, if the Supreme Court interprets that the values of the framers could indeed support a right to privacy in today's society, it is time to exercise this right.

Many US citizens are tired of being harassed by the government; they want simply to be left alone. The Sixteenth Amendment, instituting the income tax, has led to severe infringement of the US citizen's right to privacy. The Social Security Act of 1935, which established the SSN for private citizens, has further eroded the citizen's privacy. The Sixteenth Amendment should be repealed, and the Social Security Act's requirement for citizen identification should be declared unconstitutional. The requirement of the Tax Reform Act of 1986 to register all children over the age of four with SSNs should also be declared unconstitutional.

Americans of today, in carrying on the nation's founders' tradition of freedom, can benefit from their experiences and sacrifices. Our ancestors endured a trying Revolution and a bloody Civil War to forge our nation. Our forebears first attempted to found a nation on the Articles of Confederation. That experiment resulted in failure and led to the framing of the Constitution and a strong federal government. We, the living, the current generation of Americans, do not exist to

serve the Constitution, or the framers of the Constitution, or the founding fathers of the United States. At the same time, we demean their sacrifice if we allow, through careless neglect, America's experiment in democracy to fail. The Constitution lies in a shambles, gutted by a Supreme Court that bases its pronouncements on an ill-defined sense of social consciousness rather than on the written Constitution, a Congress that shirks its responsibility to protect the rights of the people by checking the Supreme Court, and an Executive Branch that would run roughshod over the American people, subjugating them to a national police force that operates outside the Constitution.

The Constitution -- either interpret it literally, or change it. The current process of simply ignoring it, or interpreting it to mean whatever is desired, or applying certain Amendments (such as the Fourteenth or the Sixteenth) in ways that nullify many others (such as the First through the Tenth) destroys the value of the document as a written standard. This process was described by Washington Post Writers' Group syndicated columnist George E. Will in his September 11, 1987, editorial discussing Robert Bork's qualifications for Supreme Court Justice. Since the Constitution does not explicitly list privacy as a right, Bork sees no Constitutional right to privacy. While I do not agree with Bork on the issue of privacy, his approach of strict interpretation of the Constitution would preserve the role of the Constitution as a written standard. With a written standard, literally interpreted, we know where we stand; there is a clear statement of the rights that we as a people have agreed to mutually support. Allowing expansive rather than strict interpretation does not expand our rights -- on the contrary, it weakens them because they become subject to the views of a few individuals on the Supreme Court. Just as in the case of guarantees in the retail trade, if our guarantees of personal freedom are not in writing, they don't exist.

Some may say that under a liberal interpretation of the Constitution, we have gained substantial civil rights. But that assertion is specious. We have lost far more than we have gained. We have lost all of our personal liberties to the IRS. Under a literal, face-value interpretation, the IRS could not invade citizens' homes and seize property without a court order and try US citizens in an illegal court. □ There is, of course, a price to pay for requiring explicit statement of all fundamental rights in the Constitution: the document must be amended in writing every time a current generation of Americans wishes to change the nature of government, specifically, the relationship of the people and states to the federal government. This process eventually results in a long, detailed, Napoleonic-code-style document, rather than a clear, crisp statement of general principles.

The Constitution serves the people, not vice versa. We are not involuntarily bound to it; rather, we bind ourselves by its terms of our own free will, by mutual agreement, as long as it serves our needs, purposes, and desires. The Constitution serves as a living document, for the living. The fact that a right to privacy was not explicitly stated in the original Constitution is of little consequence; if we desire such a right today, and the Supreme Court cannot agree that this right "emanates" from the terms of the current document, we may simply amend it to explicitly include this right as part of the document.

Changing the Tax System May Require Changing Our Form of Government

The personal income tax is so intrusive of privacy, and this intrusion is so potentially detrimental to human liberty, that going to great lengths to eliminate it is warranted. The constitutional safeguard of Amendment 10 has simply failed to prevent the removal of power by the federal government from the states and the people. It may be possible to accomplish the needed change in the context of the current system of government. If the change cannot be accomplished within

our current governmental framework, however, the importance of the issue may, in the view of many, justify modification of the form of government to one that would be more conducive to change. The following sections discuss a proposed government structure that is more accommodating to change than our current system. Before discussing government alternatives, however, our current form of government is discussed, and the reasons why change is difficult with that system are explored.

The Difficulty in Changing the US System of Government

When someone or a group complains about a law, you often hear the response, "If you don't like the law, then change it!" This phrase was heard, for example, in the trial of the Sanctuary movement members, who harbored Central American illegal aliens fearing loss of life if returned to their countries. Unfortunately, that is not a very useful response. While laws can be changed, it is not easy to do so. Moreover, our large, mature system of government has a lot of inertia: it does not readily accommodate change or dissenting opinion.

In spite of the requirement that US high school students take courses in history and government, many US citizens do not understand the nature of the US system of government, as contrasted to other forms of government. Such an understanding is necessary to appreciate why the system has not responded to the need for tax law change, and to appreciate what approaches may be required to effect needed change. Many US citizens have a vague concept of three basic forms of government:

- A "democracy," such as the US
- A "dictatorship," such as in Chile
- "Communism," such as in the Soviet Union

They are somewhat uncomfortable and a little uncertain of the term "socialism" -- and would probably describe it in a derogatory sense as "when a democracy flirts with communism," or in a favorable sense as "socialized medicine means free medical care."

Most US citizens understand "leftist" to mean "communist," "right-wing" to mean conservative, and "liberal" to signify in favor of civil rights and social programs. "Parliament" is the English word for Congress. A "Democrat" is in favor of programs that help the man in the street, the poor, blacks, and women. A "Republican" favors big business. A "republic" is a country. The US Government is the "best" form of government, promoting freedom of the individual and free enterprise.

What many US citizens do not realize is that our system of government works well for a relatively homogeneous population, but that it does not work particularly well in accommodating diverse points of view. Women, blacks, and Hispanics have encountered substantial frustration in attempting to have their points of view recognized. It is not recognized that it is the very form of our system of government that is a major factor in suppressing their points of view. The system accommodates and perpetuates the "old boy" network and preservation of the status quo. It does not accommodate change well.

Why is this so? What is it about our system that inhibits change? Are there other forms of government that better allow for expression of alternative points of view? While there are no simple answers to these questions, there are answers.

The US Is a Democratic Republic

To answer these questions, it is desirable to understand more clearly the nature of our system of government and the differences between it and other democratic forms. First, the US is not a pure, direct democracy. In a pure democracy, every member is allowed to vote directly to elect its leaders. While we do elect senators and representatives, we do not elect the president and vice president by popular vote. Instead, we elect members of an "electoral college," who in turn elect the president and vice president. The US *is* a republic -- a democratic republic. In a republic, the voters elect representatives (in our country, senators and representatives) who make laws, and generally represent the interests of their supporters.

In the US system of government, the president and vice president are elected to terms of four years, representatives to terms of two years, and senators to terms of six years. The two houses of Congress (the Senate and the House of Representatives) each elect a leader. The political party having a majority in the Senate elects the president of the senate. The political party having a majority in the House elects the speaker of the house.

Our System Accommodates the Majority Very Well

The US system of government works well when the population is largely homogeneous, and there are no groups having strong points of view that differ substantially from those of the majority. The reason it does not accommodate diversity well is that the nature of the system is to muffle the voice of minorities, both by making it very difficult for them to be elected as representatives in proportion to their numbers and by enabling the majority to outvote them on all issues, without penalty.

Take, for example, the case of the blacks. As a group, they had suffered substantial discrimination from the nonblack majority. They were not freed until millions of people had lost their lives in a bitter Civil War. For decades after, they complained of their shabby treatment, but it was not until they participated in public demonstrations, civil disobedience, and riots that their concerns were addressed. Why? In effect, because they had no voice in Congress.

There are two principal reasons for this. First, as a minority that was generally spread geographically throughout large portions of the nation, they were generally outnumbered by nonblacks. They could get a candidate on the ballot, but since they were a small minority, he would generally lose to a majority nonblack candidate. Blacks represented 10 percent of the population, but they could not elect 10 percent of the Congress. The few black Congressmen were Representatives from large black-majority districts. Hispanics, women, and other special-interest groups face the same dilemma to varying degrees. The problem exists both for at-large and district elections. Our system of elections effectively guarantees that minorities will not be elected in proportion to their numbers. This is the first step in the "tyranny of the majority."

Minorities Have No Leverage

Given the fact that the blacks will probably never have even a 10 percent representation in Congress, what can they do to achieve a voice in the affairs of Congress? What they do is attempt to form an informal voting block in an upcoming election by threatening to align themselves with whichever major political party will promise to promote their interests in its

"platform," or statement of objectives. This jockeying for a voice in power is informal, however, and not a formal part of the government process. The promises are not binding. There are no guarantees.

If they align themselves with a certain party and that party wins the election, they may realize some of their goals, but they probably won't (witness the disenchantment of blacks with the Republican party after the 1984 election). It is the classic "morning after" syndrome. Once the majority party wins the election, it is free to do whatever it pleases, and there is absolutely nothing the minority group can do about it. The minority group can't take back its votes, or threaten to dissolve the government. It is stuck for the next four years, when it can be seduced again.

The second principal reason why minority groups do not have a significant voice in the US system of government is that even if the group wins a number of the seats in Congress, it will be outvoted by the majority, with no recourse. The best it can hope for is to "sell" its block of votes, promising to back a near-majority party on certain issues in exchange for supportive legislation on other issues. While this approach may appear to be effective in principle, from a practical viewpoint it is not very effective, since the minority group has no leverage, or threat. The worst that may happen to the near-majority party, without the support of the minority group, is that it might lose issues that are decided on close votes. It will not, however, be out of power. The minority group can "beg for crumbs," but, without a serious negotiating "threat," or "bargaining position," its realization of any of its viewpoints depends on the largess of the majority party and the hope that it will receive a *lagniappe* once in a while.

On May 1, 1987, an interesting editorial was published by Washington Post Writers' Group columnist Ellen Goodman. The article, which was entitled "Women Make Their Mark in Iceland," describes the status of a feminist political party called the Women's Alliance. This party represents ten percent of the voters and therefore, under the proportional representation of Iceland's parliamentary form of government, it holds six of the 63 seats in parliament. Because the recent elections gave no coalition a majority, these women hold a key role in the formation of a new government. Under the parliamentary system, a minority group (in this case, the women's movement) can have a definite voice in government.

In summary, the US system of government promotes the majority viewpoint, with virtually no formal mechanism for accommodating viewpoints of minorities. The basic "rights" (such as free speech) of the minority are protected, but the laws need not in general reflect their interests, and they are effectively denied legislative power.

A Parliamentary Form of Government Provides Greater Flexibility

Is there a form of government that does accommodate minority viewpoints better than our current form? Yes, there is. The "parliamentarian" form of government appears to do a much better job of accommodating minority viewpoints. The parliamentarian form of government is used by many democratic countries around the world. In that form, the representatives are elected basically as they are in our system, by majority vote.

In the parliamentary system an individual runs for parliament (the body of elected representatives) as a member of some party (in some cases, consisting of himself alone). The manner in which representatives are elected can be either "districted" or "at large." In England, the country is divided into "boroughs": each party runs a candidate in each borough and the winner is seated in

parliament. This approach is similar to our own with respect to suppression of the representation of minorities.

Israel, on the other hand, has national at-large elections by political party without geographic assignment of parliamentary seats. The vote is by party, seats are assigned to each party in proportion to the vote, and members are selected from a party list, with the party leader first.

Although the concept of selecting representatives is similar to the US congressional system, the system works quite differently after the election process. The elected representatives all vote for a party, or a group (or "coalition") of parties, to lead the government. In European countries, there is usually a fairly large number of parties, with no single party having a majority. To win the leadership position, a large party may well be a minority party, and must typically win the support of one or more of the other minority parties in order to win the leadership position. This is done informally (as in the US in the case of a minority party throwing its support to a large party).

The big difference, however, is that the minority party retains some bargaining power. That is manifested in the following way. Certain votes in the legislature are called confidence votes. For example, a vote on the national budget is a confidence vote. If the leadership party ever loses a confidence vote, the parliament is dissolved, and a new parliament must be constituted, without waiting for the next regularly scheduled election. In other words, the minority party, throughout the duration of the administration, has a very serious threat -- it can withdraw its support on a vote of confidence and cause the leadership party to lose power. This feature of the parliamentary form of government substantially promotes the voice of minorities. Our system, on the other hand, not only tends to eliminate elected minority representatives in the election process, but also gives them little power if they are ever elected.

The Parliamentary Form of Government Would Eliminate Lame Duck Presidencies

Under the parliamentary form of government, the leader of the majority coalition is called the prime minister. The office of the prime minister corresponds closely to the office of president in the US system. A parliamentary system may or may not have a president (in addition to the prime minister). In parliamentary systems having a presidency, the president functions only as chief of state, not as chief executive of government or as commander of the military. The prime minister serves in the latter capacities. He is formally named to office by the president. The formal declaration of dissolution of parliament (after the loss of a vote of confidence) is made by the president at the request of the prime minister. The presidency may have other formal functions, but generally only ceremonial duties and powers. A few systems give the presidency slightly more real power (France, for example, under the previous constitution).

Implementation of a parliamentary system of government would eliminate "lame duck" presidencies. As mentioned, in a parliamentary system of government, the office corresponding closely to that of president in our system is that of prime minister. The prime minister is the leader of the party in power, leading the government. Whenever the country had lost confidence in a prime minister or his party, a vote of confidence could be called. Our current system, in which the last two years of a second-term president may be wasted because of a lack of power, paralyzes the US Government's ability to address important issues for considerable periods of time. On the other side of the coin, the ability to change governments on the basis of votes of confidence can lead to frequent changes in government and political instability; in the US system, an administration is in power for a fixed period of four years.

Under the parliamentary form of government, there are two branches of government, rather than the three of the US congressional system. Under the US system, there are three branches -- the Legislative (Congress), the Executive (the president and executive agencies and departments), and the Judicial (the Supreme Court and inferior courts). The founders feared the power of a president and established a system of "checks and balances" under which the government powers were shared between the branches, and each branch has checks on the power of the other branches. Under the parliamentary form of government, Congress (or rather, parliament) would no longer represent an equal branch of the federal government. The prime minister would be far more powerful than the president under our congressional system. Whether this is desirable is certainly a matter for debate. Our present system has served us well in many ways for a long time; on the other hand, the parliamentary system is more popular, worldwide, and has served other Western-civilization countries for a much longer time.

Some Americans Favor a Parliamentary Form of Government for the US

From the point of view of the income tax and privacy, it would appear to matter little whether the US system of government is parliamentary or congressional. The point is that, if a constitutional convention is called (for whatever reason -- to balance the budget, to extend equal rights to women, to repeal the Sixteenth Amendment, or to make explicit the right to privacy), the pressure to consider other amendments will be high. The issue of a parliamentary form of government for the US is receiving increasing discussion (for example, *American Heritage*, May/June 1987, pp. 53-71; *Time* magazine, July 6, 1987, pp. 30-32), and a constitutional amendment establishing a parliamentary system is certainly possible. US presidents and parties have long been frustrated at the restriction of Congress, and a desire for increased presidential power is consistently strong. The parliamentary form would destroy the Congress as a separate and equal branch of the federal government, and give much more power to the prime minister and his party. If a constitutional convention were called to consider certain amendments, it would be well to consider, in advance, others that may also be required or desired. The *American Heritage* article cited above presents changes that 30 prominent Americans would like to see considered.

One of the areas of concern in our system is the heavy burden placed on the president. He functions as chief of state, head of government, and commander and chief of the armed forces. Any one of these positions is a full-time job. The functions of chief of state are ceremonial: greeting dignitaries from foreign countries, dedicating nuclear submarines, making speeches on Memorial Day; under the parliamentary system, these functions are performed by the president. The functions of the head of government are to act as chief executive in the management of the execution of the law, to run the cabinet; in the parliamentary system these functions are the prime minister's responsibility. The function of the commander and chief of the armed forces is to direct the actions of the military; in the parliamentary system this function is executed by the minister of defense. In general, the three positions combined in the presidency are held by different individuals (although during the Second World War, Winston Churchill held two portfolios: he served as prime minister and minister of defense).

The point is that requiring the president to perform, in the most powerful country in the world, jobs that are customarily assigned to three people in many other countries, is unreasonable. The demands on the president's time are extremely and unnecessarily great and the pressure is intense. It is difficult to conceive that even an extraordinary person could perform such an assignment satisfactorily. About the only ways that the job can be done are to give short shrift to

certain responsibilities (for example, to emphasize state functions over executive functions, or vice versa) or delegate major portions of the job to others. In either case, a large segment of the electorate is likely to be dissatisfied. For example, although President Reagan has rationally scoped the job to manageable proportions, he has been criticized for doing so. The move to a parliamentary system could solve the problem of the overburdened office of the president.

Throughout the years, and certainly in recent times, Congress and the president have certainly locked horns in power struggles. These struggles have effectively served as a diversion, drawing attention away from the fact that, while the balance of power among the three branches of the federal government has remained largely intact, the balance of power has shifted dramatically away from the states and the people to the federal government. While the system of checks and balances worked well within the federal government, no similar effective system of checks and balances worked to preserve the power of the states and the people. The intent of the framers was to prevent arrogation or usurpation of powers by the federal government in two ways.

First, the powers of the federal government are enumerated in the 18 paragraphs of Article I, Section 8. Second, according to Amendment 10, "all powers not delegated to the US by the Constitution, nor prohibited by it to the States, are reserved to the States, respectively, or to the people." Article I, Section 8, empowers the federal government to do specific things. The 18 paragraphs of Article I, Section 8, explicitly identify those powers. Amendment 9 reserves to the people all rights not explicitly listed (a right did not have to be explicitly listed to be guaranteed).

Incredible as it may seem, the statement that the powers of the federal government were to be those explicitly listed and no others, has not prevented a massive shift of power from the states and the people to the federal government. Today, the states represent little more than fiefs of the federal government, and the people vassals.

Regarding the assumption of powers by the federal government, Congress passed laws creating the various agencies in the Executive Branch and the Supreme Court ruled them constitutional. The victory of the Union over the Confederacy in 1865 provided *a priori de facto* legitimacy for these actions, which began in the post-war Reconstruction era. By the present time, this procedure has caused a massive increase in the power of the federal government and will require a constitutional amendment if it is to be changed.

In the twentieth century, the federal government has arrogated multitudinous powers that, by virtue of their not having been mentioned in the Constitution, were originally intended for the states or for the people (by the Ninth and Tenth Amendments). These powers include not only the income tax and privacy intrusion, but the operation of health, education and social service systems as well. Instead of unnamed powers vesting in the states and the people, the federal government has in fact assumed them in direct violation of the explicit statement of the Constitution, and in clear violation of the intent of the framers to strongly curtail the power of the central government. Control of these social systems at the local level would remove much of the power of the federal government to regiment and control individual citizens.

In view of these developments, it would appear that the federal government may already be too powerful. The establishment of a parliamentary form of government would accelerate this trend toward the concentration of power in the federal government. A return to a more strict interpretation of the Constitution could correct and reverse this trend toward stripping the states and the people of their rights and powers.

The US System Worked Well, As Long as the "Pie" Was Growing

For many periods in its history, the US has been a mobile, loosely governed population. The country was very large, and minority groups could move to new places (for example, the Mormons to Utah). The country was in fact a "melting pot," with new immigrants generally willing to learn a new language (English) and customs in order to take full advantage of economic opportunities and to share in America's fabled wealth. This situation changed, however, and special-interest groups became more vocal. In some cases, if the underlying cause of a situation was "unconscionable" from a moral point of view (slavery, women's suffrage), their viewpoint was permitted a voice by the in-power majority.

We have entered a new time, however, in which the country is becoming crowded, and the standard of living is no longer increasing rapidly. The concerns of minority groups are no longer so clear-cut as the issues of slavery and voting rights for women. If certain minority groups are granted additional privileges, others will lose. Our society is becoming closer to a "zero-sum" game than it was before, when the country had very low population and the industrial revolution was enabling productivity increases so that minority groups could be accommodated and the standard of living could be increased at the same time. Since the "pie" was growing, it was relatively easy to redistribute the shares of the pie, with everyone getting a larger piece.

Now, however, the "pie" is not growing, or at least not very fast. If a minority group obtains a bigger piece, members of some other group are going to receive a smaller piece. If blacks are given preferences because of their race in layoffs, some better-qualified whites are going to lose their jobs. If Spanish is granted official-language status, some Anglos (for example, government employees) are going to have to learn Spanish, or lose their jobs to bilingual Hispanics. If abortion is outlawed, some women will be forced to raise unwanted children, and some taxpayers will have to provide support for some of those children. As income taxes are raised to pay for a broader spectrum of social welfare services, more and more women leave home and go to work to produce the tax revenue to pay for those services. If we eliminate tobacco subsidies, some farmers will be forced to grow less lucrative crops. If we ban shoe imports, some shoemakers' jobs will be saved, but everyone will pay more for shoes.

These are sticky issues because, often, if someone wins, someone else loses. To date, the special-interest groups who promote various points of view have been becoming increasingly frustrated. In the US system of government, blacks do not have a voice (or, at best, have only a token voice). Hispanics do not have a voice. Women do not have a voice. Minorities do not have a voice.

The Likelihood of a Constitutional Convention Is Increasing

The time may come for US citizens to decide whether the current form of US Government should be modified to provide for the accommodation of minority views. The country is no longer so wealthy that it can "buy off" the silenced minorities, through various welfare programs or other majority-decided actions. Most human beings don't want to be "cared for" by someone else -- they want to have a voice in determining their destiny. Our current system denies many an effective this voice.

The frustration level of blacks, Hispanics, women, and other minority (special-interest) groups will rise, as they are thwarted from participating in a meaningful way in our government. Having the

vote -- when the system ensures that your candidate will probably lose, and even if he wins that he will be outvoted -- is not satisfactory to minorities. If we do not modify our system peacefully to give minorities a voice in government, the level of frustration will mount, and the price of silence will rise accordingly.

In recent times, minorities have expressed keen dissatisfaction over the resolution of issues such as women's rights, abortion, a balanced budget, or the involvement of the federal government in health, education, and social welfare programs. Because of the inability of these minorities to accomplish accommodation of their viewpoints, thrusts have been made to modify the US Constitution. The likelihood of a constitutional convention increases each year, as the level of frustration mounts. A constitutional convention is a real possibility. If one occurs, far-sighted people should be prepared to make use of that opportunity to effect meaningful change in our system of government.

A constitutional convention is certainly possible, given the existence of highly charged issues such as abortion and women's rights, the growing federal deficit, and the high level of frustration of minority groups who believe that these issues are not being properly addressed. A constitutional convention will be convened whenever two thirds (that is, 34) of all the state legislatures apply (Article V). At the present time, only two more states need apply, and a constitutional convention will be convened. If a constitutional convention is called, the US people should be prepared to make a number of changes to the Constitution. At the very least, the Sixteenth Amendment should be repealed because of its privacy-invasive character. (Note that because of its privacy-invasive character, the income tax should be prohibited at all levels of government, not just at the federal level.) A constitutional amendment explicitly guaranteeing a right to privacy should be passed. At another extreme, a parliamentary form of government could be established. It would be well to discuss such topics in advance, given the profound effect they could have on our future.

If a constitutional convention is convened, there is a real possibility of a move to a parliamentary form of government in the US. The Executive Branch has been frustrated for decades and wants more power. If US citizens value the constitutional form of government, they had best be prepared to fight for it to maintain and recover the lost freedoms originally guaranteed by the Constitution. The federal government has arrogated tremendous powers from the people and will move to arrogate even more. While a constitutional convention may be a means to taking back your freedom, it could just as well be a means to losing even more.

Fundamental Tax Change May Require Fundamental Change in Our System of Government

What does all of the preceding have to do with the abolition of the income tax? Just this -- the US Government has evolved to a large and powerful system for monitoring and control of the individual; governments do not shrink of their own accord, and ours will not willingly relinquish this power. Because of the nature of the US system of government, the tyranny of the majority, it is very difficult to change laws or the status quo (such as the vote for women, the war in Vietnam). The income tax, with its concomitant requirement to identify and monitor individuals, will not die easily. The income tax represents a cancer that has been growing in our social tissue for over seven decades. Abolition of this form of taxation means a major change, and our system of government does not accommodate major changes well; that is, in fact, why it has endured so long. It may be necessary to change the form of government in order to accomplish this end. If

this becomes necessary, however, there will be a substantial concomitant advantage: a more flexible, more responsive form of government, which gives minorities a real voice.

The US Government Exists at the Pleasure of the People

When the proposal to abolish the personal income tax is suggested to someone, his initial reaction is generally along the lines that the government has a "right" to tax individuals, that the citizen "owes" the government taxes, and that the government can't afford the loss of the tax revenue. All of these reactions are unfounded.

First, we don't owe the government anything. In the US, the government was created by the citizens. It exists at our pleasure -- we impose taxes on ourselves, to pay for services we want. Or, that was the original concept. In fact, the government organization -- the bureaucracy -- that was created by our forefathers now has become an autonomous social organization, three million strong, perpetuating its own existence and feathering its own nest. The government has enacted legislation promoting the payment of high salaries to civil servants and political appointees and providing them with attractive fringe benefits, retirement incomes, and job security.

Second, as discussed earlier, the government can extract its revenue from many points in the economy. It can extract the revenue from 100 million taxpayers, in the form of a personal income tax, or from 15 million businesses, in the form of a business income tax. In actual fact, most personal income tax revenue is paid (in the form of withheld taxes) by businesses, not by individuals. Essentially, the only role of the individual in the current system is to verify his total income every April 15 and to make a minor adjustment in the tax. From an operational viewpoint, most of the personal income tax revenue collected in the US is collected in the form of a payroll tax.

All of the tax revenue could be collected from individuals, or all of the revenue could be collected from businesses, as is essentially the case. If not a single individual paid one cent in income tax on April 15, the government could collect the same level of revenue. As it now stands, almost all of the tax revenue is collected from businesses, not from individuals (even though the legal liability falls on the individual). The reason for this arrangement is that it is much more practical to collect taxes from 15 million sources (businesses) than from 100 million sources (individuals).

Since the taxes are already collected from businesses, why is the individual monitored at all? There is no need for this monitoring, other than to satisfy the government's increasing desire to monitor and control individuals.

On the Matter of Rights

Some may argue that we have an inalienable or God-given right to privacy, or a right not to be oppressively taxed. In an absolute sense, however, no one has any rights. A "right" is a just claim or legal title. It exists in the context of a particular moral or legal system, for example, a right we maintain for ourselves under a constitutional compact. An individual possesses a legal right to something only so long as those in power recognize that possession. The American Indians had a right to the land they once occupied in California. The Spanish had a right to California, once they displaced the Indians. The US Government now has a right to California, Texas, New Mexico,

Arizona, Colorado, and Utah because it forced Mexico to cede these lands to the US. The point is that "might makes right."

An individual may claim that he has a right to the land his house is on, since his state recognizes his title to it. At the present time, those in power -- the US Government and the state -- recognize that right. For a variety of reasons, however, they may decide that he does not have a right to the land, and they may take it.

In addition to the concept of legal rights, there is the concept of moral rights. Apart from any legal rights, a homesteader may claim a moral right to a farm that he carved out of the wilderness. What greater right does he have to a portion of planet Earth, however, than a landless Guatemalan peasant, who has worked just as hard all his life on a plantation? In a philosophical sense, one has no more "right" to the fruits of his labor or to occupation of his living space than the other. The point is that the land "belongs" to whoever was lucky enough to get to it first and to work out a social arrangement with those in power to permit him to occupy it and defend his claim from other would-be occupiers. The transfer of the land from one person to another is nothing more than cultural window dressing -- a ceremony, like marriage -- that is recognized by those in power.

In fact, in an absolute sense, no one has any intrinsic right to the land -- not the Indians, nor the Spanish, nor the Mexicans, nor the US Government, nor the coyotes.

Similar logic applies to rights other than the right to own land. A human being has no intrinsic right to breathe clean air, or even to breathe. He will enjoy the privilege of breathing just as long as the state or the US Government decides he shall. He has no intrinsic right to vote for those in power, nor for "life, liberty, and the pursuit of happiness." At best he is privileged to enjoy these things as long as he is sufficiently lucky or crafty to be in power or to strike a deal with those in power to do so.

The Tax System Will Be Significantly Changed Only If People Fight for Change

What does this mean with respect to the income tax and privacy issue? Just this: people have no intrinsic right to privacy or to avoid being identified, registered, and monitored by the US Government. If those in power decide they want to do this, there is very little that the individual can do about it. At best, you can convince a sufficiently great number of your fellow citizens that we would all be a little (or a lot) happier if we collectively agreed not to permit the continuation of an individual monitoring system.

US citizens have tacitly agreed to pay certain taxes in exchange for protection by the other members of society, that is, the US Government. The terms of the social contract between society and its members vary all over the world, and are constantly changing. In a philosophical sense, there is no rightness or wrongness to these terms -- they simply represent the power structure that has evolved, and the arrangement that has evolved between the individual and that power structure, in the course of the attempt by human beings to increase their level of living.

In many cases, however, the governmental infrastructure that evolves does not serve the interests of a large portion of the population. The recent history of Cambodia/Kampuchea illustrates this point well. The system may serve the interests of only a few, or, in fact, might appear to serve the interests of the system itself. The latter may be the situation in the case of the income tax; it

evolved over the past half century, but it is not necessarily to the advantage of many people. Just as a person has no intrinsic rights, however, the government has no intrinsic right to collect an income tax or to identify, register, and monitor the individuals in our society.

Power appears to be addictive, however, and it appears that the government will tend to want to maintain and increase this power, unless curbed by those governed. The US Government, with its current identification and monitoring of US citizens, has usurped more power than is needed to ensure the safety and enhance the level of living of individuals. An individual is essentially powerless to take back some of that power. If he can convince others that all would be better off as a result, then the government can be forced to relinquish this power.

The federal income tax and the net wealth tax are severely intrusive of the privacy of individuals. They represent excellent methods of taxation for police states, since they require, rationalize, and perpetuate the registration of citizens and the continued monitoring of their financial affairs. They have, however, no place in a democratic republic such as the US.

How, you may ask, can the income tax continue, if it in effect destroys so many constitutional rights of US citizens? The answer is that the Sixteenth Amendment is incompatible with the first ten Amendments and Amendment 13 (abolishing indentured servitude) and Article I, Section 8, Paragraph 9 (allowing tribunals *inferior* to the Supreme Court). The Supreme Court is in a quandary -- a "fix." The income tax is unenforceable as a voluntary tax. At today's high rates, it can only be collected by a tough national police force (the IRS), operating outside the Constitution. The Court evidently considers that interfering with the IRS collection of the tax is tantamount to denying the US Government needed revenue. The Supreme Court has, in effect, confused the government's right to collect *taxes* with its right to collect *income taxes*.

To date, the Supreme Court has closed its eyes to the blatant violation of constitutional rights that has resulted from the Sixteenth Amendment and its consequences. The solution to this dilemma is, however, very simple: (1) the people can convene a constitutional convention and repeal the Sixteenth Amendment; or (2) the Supreme Court can uphold the Bill of Rights over the police-state actions required to enforce the income tax and put an end to the IRS tyranny. Without constitutional support, the income tax would have to be replaced immediately with a form of taxation that was not incompatible with the Bill of Rights, Amendment 13, and Article I, Section 8, Paragraph 9.

It is indeed ironic that on this, the year of celebration of the 200th anniversary of the forging of the Constitution, many of the freedoms guaranteed by the Constitution's Bill of Rights have been lost. With the tremendous growth of the Executive Branch, the constitutional rights of the individual have been given short shrift.

This book is about how to stop the IRS. It has mainly addressed, however elimination of the income tax. What's the connection? Simply this. It is impossible to implement a personal income tax without a national police force such as the IRS, having extra-constitutional powers that precede individual rights. Other authors (such as Hansen) have recommended measures that could curb the power of the IRS, such as placing the burden of proof on the IRS. These proposals address the symptoms, not the problem. The problem is the personal income tax. The symptoms are the IRS and its police-state powers. It will not be possible to eliminate the police-state tactics of the IRS until the personal income tax is eliminated; it has simply proved impossible to collect the personal income tax without these police-state tactics.

Collection of a high-rate mass income tax *requires* the use of a national police force, the use of terrorist tactics, and the abrogation of the citizen's personal rights. With a mass income tax, it is not practical to place the burden of proof on the government. Since collection of the tax is impossible without police-state methods, the Supreme Court, in placing the Sixteenth Amendment above all others, has very logically reached the conclusion that the government could not collect the tax without the suspension of virtually all constitutionally guaranteed individual liberties, and has done so. Once again, it has confused a government's need to raise tax revenue with the need for an income tax.

The US Government has a long-standing tradition of supporting dictatorships; that penchant has reflected itself in the development and support of the authoritative IRS national police force in the US. It is time for the US Government to recognize that support of dictatorships and repressive forms of government are, in the long run, doomed to failure. Human beings demand, and ultimately will achieve, personal freedom. Humanity outlives governments. The US Government is earning the hatred of freedom-seeking foreign governments in its support of dictatorial repression and authoritarian rule; it is now in the process of earning the hatred of its own people.

Once the personal income tax is repealed, it will be possible to throttle the IRS, and bring its powers and practices within constitutional limits. Some of the changes suggested by Larson in his book *Tax Revolt* will then be feasible. Until the personal income tax is eliminated, however, Congress and the Supreme Court will never allow these changes, since they would impede the ability of the federal government to collect its major source of revenue. The federal government is not about to commit fiscal suicide, no matter if it means abrogating the entire Constitution, much less the Bill of Rights. Once the Sixteenth Amendment is repealed, the Supreme Court will be in a position to enforce the Bill of Rights. Until the US abandons the income tax, however, it is impossible for the Supreme Court to find in favor of individual rights over the IRS because IRS power underlies the federal government's ability to collect income taxes. The only way to restore personal liberties is to eliminate a tax system that collects taxes directly from individuals. □ Once the personal income tax is repealed, the following recommendations of Hansen would be feasible to implement. Note that, with the repeal of the personal income tax, IRS authority will be drastically curtailed. Hansen recommends:

1. Prohibit, by statute and regulation, the use of a quota system in the investigation, audit, and assessment of tax liabilities.
2. Improve and reform the entire review and oversight procedures of the IRS.
3. In addition to restraining the IRS in particular, restrain the Executive Branch in general.

With the repeal of the personal income tax, no longer will the IRS have authority over individual citizens relative to a personal income tax. The conflict between IRS rights and individual rights will be at an end. The IRS' authority will relate simply to collection of taxes from firms (and other taxes, such as death taxes).

The continuation of the national police force necessary to enforce a high personal income tax can continue only so long as the Supreme Court and the Executive Department collude to set the income tax over the Bill of Rights. Both, however, have a mutual vested interest in continuing the oppression and regimentation of the US population -- the continued growth of the power of the federal government, over the power of the people. The federal government is simply not going to give up the personal income tax, and the tremendous power for control of individuals that it represents, without a fight. (Some may criticize my anthropomorphization of the federal government -- the characterization of it as an entity with a personality, a will, goals and objectives.

Governments, agencies and other organizations in fact do have distinct personalities, defined in terms of their responses to other organizations or individuals.)

The Supreme Court has already spoken on the matter; it favors the income tax, and will back a powerful national police force to enforce it, no matter what the cost in terms of loss of personal freedom. If you want your freedom back, you are going to have to take it back, by repealing the Sixteenth Amendment. □ It's time to repeal the income tax, and take back your freedom!

The Supreme Court: Major Threat to Constitutional Democracy

In his book *Civil Liberties and American Democracy*, John Brigham discusses threats to constitutional democracy. He identifies three most likely threats to constitutional democracy in America: elites (holders of economic or military power), the people (forgetting or abandoning the constitutional compact under which we live), and the experts (legal experts). Brigham notes that, ultimately, the most sinister threat to constitutional democracy is the domination of civil liberties by legal experts. He observes that in the early years of the Republic, ordinary people debated the meaning of the Constitution. Deference to Supreme Court justices in matters of constitutional law was first asserted in the early 1800s, and was not widespread until the late 1800s. The Supreme Court now claims an exclusive role as final arbiter of constitutional rights. Brigham notes that the process of seizure of political authority by the experts (the Supreme Court) is well underway.

American Illiteracy and the Destruction of the American Republic

Brigham goes on to note that constitutional democracy requires an informed citizenry. In a July 26, 1987, editorial entitled "Illiteracy: The Framers Never Envisioned an Intellectually Lazy America," Knight-Ridder Newspapers columnist William Robertson discusses the recognition of the founding fathers that the constitutional government would be doomed unless citizens adequately educated themselves. He cites concerns expressed in recent best-selling books: *Cultural Literacy: What Every American Needs to Know*, by E. D. Hirsch, Jr., and *The Closing of the American Mind: How Higher Education Has Failed Democracy and Impoverished the Souls of Today's Students*, by Allan Bloom.

The fact that the IRS routinely violates the Constitution is lost on many Americans. Many others simply don't believe it is so. The prevailing attitude is reminiscent of the attitude toward the actions of the Gestapo in Nazi Germany during World War II. When a lonely few claim that the IRS is operating outside the law, few citizens pay heed. As Brigham notes, civil liberties like due process no longer reside in the hearts or minds of most Americans. No one is listening. They turn away as the IRS violates the liberties of individuals, either because they do not know the Bill of Rights or they are no longer committed to it.

Americans are in the process of losing the asset of a literate citizenry, steeped in the tradition of individual liberty and committed to retaining it. We are, through neglect, in serious danger of losing our individual freedom, our privilege of practicing constitutional democracy. While the decline and ultimate demise of constitutional democracy would be a tragedy of unparalleled proportions, it appears to be underway with barely a notice. We are in the process of squandering our birthright. What the communists could never take from us by force we are losing by neglect. The seductive narcotic of a high standard of living and an easy life has dulled our alertness to the

threat of tyranny and made us prey to it. We have succumbed to a threat from within; we have created our very master -- it is in fact the federal system itself.

Today, the 200th anniversary of the signing of the Constitution, is a sad day for all Americans -- a day of mourning rather than of celebration. Across the nation, Americans glorify the Constitution, unaware of, ignoring, indifferent to, or refusing to admit the fact that with respect to individual rights, it is no longer supported by the Congress, the Supreme Court, or the Executive Branch of the US Federal Government. Is anyone actually reading the Constitution anymore? We have failed to cherish the heritage bequeathed us by our ancestors, and we have thereby forsaken the birthright of our children.

A high-rate personal income tax is not compatible with a democracy and the concept of individual liberty. The tax cannot be collected without a major infringement on the privacy of the individual, and without an enforcement agency that possesses a national police force with powers that transcend those of the individual. The Supreme Court was forced to choose between the rights of the citizen (Amendments 1-10) and the powers of a national police force, and sided with the national police force. Around the world, supreme courts are viewed as protectors of individual liberty from invasion by governments. The US Supreme Court no longer takes this role to heart. The people must now act in their own behalf to recover and preserve their basic liberties.

On Saturday, April 25, 1987, 75,000 people demonstrated in Washington, DC, to protest US foreign policy -- policies concerning apartheid in South Africa, the Contras in Nicaragua. The US people have a tremendous capacity for caring for human beings. Increased attention needs to be focused on the fact that we are a free people only as long as we monitor and control the power of our government, and limit its power to monitor and control the citizen. We will not retain our freedom to demonstrate for the human rights of others if we lose our individuality. The income tax system has effectively destroyed the freedom of the individual. We have not protected that freedom, and it did not endure.

The recent spy scandal involving young Americans in Moscow dramatically illustrates the lack of respect that US citizens hold for our system and a lack of concern for its welfare -- the threat from the people that John Brigham addressed is real. Without care, America's grand experiment in democracy will die. The income tax system has done a great deal of harm, in stripping the individual of his personal liberties, and in creating an adversarial relationship between the citizen and his government -- one in which the citizen regards the government as his master rather than his servant and views the government with distrust, disdain, and even fear. This system needs to be scrapped to enable the reconstitution of a state, which promotes the dignity and humanity of the citizen, and thereby fosters his respect and pride.

Bibliography

There is a large literature on the value-added tax. The VAT has been discussed in the literature since early in the twentieth century. In 1954, France became the first nation to adopt the VAT; it was followed by the other member-nations of the European Economic Community (Common Market). Since that time, numerous articles and books have been written about experience with the VAT. The following is an annotated bibliography of books related to the problems of the income tax and the advantages of the VAT.

For a general introduction to tax policy analysis, a book on public finance should be consulted. A standard reference is *Public Finance in Theory and Practice*, by Richard A. Musgrave and Peggy B. Musgrave (4th ed., McGraw-Hill, New York, 1984). An excellent description of the US tax system is *Federal Tax Policy*, by Joseph A. Pechman (5th ed., The Brookings Institution, Washington, DC, 1987).

The problems of the income tax are described in detail in *Examination of Basic Weaknesses of Income as the Major Federal Tax Base*, edited by Richard W. Lindholm (Praeger, New York, 1986). A readable account of the massive economic flaws of the US income tax system is given in *Reforming the Income Tax System*, by William E. Simon (American Enterprise Institute for Public Policy Research, Washington, DC, 1981).

Additional description of the inadequacies of the US income tax system are presented in *Low Tax, Simple Tax, Flat Tax*, by Robert E. Hall and Alvin Rabushka (McGraw-Hill, New York, 1983), or in the authors' later version of the book, *The Flat Tax* (Hoover Institution Press, Stanford University, Stanford, California, 1985).

A book about the gross unfairness of the US income tax system before the 1986 tax reform is *The Rape of the Taxpayer*, by Philip M. Stern (Random House, New York, 1973).

A book that describes the history of taxation in Western civilization is *A History of Taxation and Expenditure in the Western World*, by Carolyn Webber and Aaron Wildavsky (Simon and Schuster, New York, 1986). An annual periodical that compares the tax revenues of different countries is *Revenue Statistics of OECD Member Countries* (latest edition 1965-1985) (Organisation for Economic Co-operation and Development, Paris, 1986). A book that describes individual taxes around the world is *Individual Taxes: A Worldwide Summary* (Price Waterhouse, New York, 1986).

Discussion of the activities of the IRS in enforcing the income tax are presented in *Tax Revolt: The Battle for the Constitution*, by Marvin A. Larson (Devin-Adair, Publishers, Greenwich, Connecticut, 1985), and two similar books by Congressman George V. Hansen: *To Harass Our People: The IRS and Government Abuse of Power* (Positive Publications, Box 23560, Washington, DC 20024, 1980 and 1985, \$6.95); and *How the IRS Seizes Your Dollars and How to Fight Back*, by George Hansen and Larrey Anderson, Jr. (Fireside Books, Simon and Schuster, New York, 1981).

One of several books suggesting steps that the US taxpayer may take to minimize the chance of an audit, and what to do in case of an audit, is *Audit-Proofing Your Return*, by Jack Wade Warren, Jr. (Macmillan Publishing Company, New York, 1986).

Books about the Tax Reform Act of 1986 include the following. *The Tax Reform Act of 1986* is Public Law 99-514. The Act is described in the two-volume *Tax Reform Act of 1986, Conference*

Report to Accompany HR 3838 (US Government Printing Office, Washington, DC, 1986). Additional explanation of the reasons for the provisions of the Act is given in the 1379-page *General Explanation of the Tax Reform Act of 1986* (US Government Printing Office, Washington, DC, 1987). This document is also published by the Commerce Clearing House, under the same title. The Act is also explained in *Prentice-Hall's Explanation of the Tax Reform Act of 1986* (Prentice-Hall Information Services, Paramus, New Jersey, 1986). Discussions of the economic impact of the Tax Reform Act of 1986 are presented in *Tax Reform and the US Economy*, edited by Joseph A. Pechman (The Brookings Institution, Washington, DC, 1987).

Background information on proposals leading to the Tax Reform Act of 1986 are presented in the 28-volume set, *Tax Reform Proposals: Hearings Before the Committee on Finance, US Senate, 99th Congress* (US Government Printing Office, Washington, DC, 1986). General explanation of the Treasury Department's proposals for fundamental tax reform are presented in *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President* (Department of the Treasury, Washington, DC, 1984). An earlier Treasury Department document is *Blueprints for Basic Tax Reform* (Department of the Treasury, Washington, DC, 1977). The President's proposals for tax reform were presented in *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (US Government Printing Office, Washington, DC, 1985).

Popular-press books describing the Tax Reform Act of 1986 include *The Price Waterhouse Guide to the New Tax Law* (Bantam Books, 1986); *J. K. Lasser's What the New Tax Law Means to You*, written by Julian Block of Prentice-Hall Information Services (Pocket Books, Simon and Schuster, New York, 1986); and *J. K. Lasser's Plans to Pay Less Taxes*, 1987 Edition, Bernard Geisman, Ed., (Prentice-Hall Press, Simon and Schuster, New York, 1987).

Books that describe the income tax include: *The Individual Income Tax*, Revised Edition, by Richard Goode (The Brookings Institution, Washington, DC, 1976); *Comprehensive Income Taxation*, Joseph A. Pechman, Ed. (The Brookings Institution, Washington, DC, 1977); *Must Corporate Income Be Taxed Twice?*, by Charles E. McLure, Jr. (The Brookings Institution, Washington, DC, 1979); *What Should Be Taxed: Income or Expenditure?*, Joseph A. Pechman, Ed. (The Brookings Institution, Washington, DC, 1980); *Equity, Efficiency, and the US Corporation Income Tax*, by J. Gregory Ballentine (American Enterprise Institute for Public Policy Research, Washington, DC, 1980); and *The Federal Income Tax Burden on Households: The Effect of Tax Law Changes*, by Attiat F. Ott and Ludwig O. Dittrich (American Enterprise Institute for Public Policy Research, Washington, DC, 1981).

Books that discuss alternatives to the income tax include: *Broad-Based Taxes: New Options and Sources*, Richard A. Musgrave, Ed. (The Johns Hopkins University Press, Baltimore, MD, 1973); *The Income Tax Is Obsolete*, by Joseph S. Duarte (Arlington House, Publishers, New Rochelle, New York, 1974); *Options for Tax Reform*, Joseph A. Pechman, Ed. (The Brookings Institution, Washington, DC, 1984); *Real Tax Reform: Replacing the Income Tax*, John H. Makin, Ed. (American Enterprise Institute for Public Policy Research, Washington, DC, 1985); and *Alternative Tax Proposals: How the Numbers Add Up*, by Paul V. Teplitz and Stephen H. Brooks (Lexington Books, D. C. Heath and Company, Lexington, Massachusetts, 1986). The last book gives a description of the types of econometric models that are available to assess the economic impact of alternative tax proposals.

Recent books about the VAT, from an economist's viewpoint, include the following. *The Value-Added Tax: Key to Deficit Reduction?*, by Charles E. McLure, Jr., with Commentary by Mark A. Bloomfield (American Enterprise Institute for Public Policy Research, Washington, DC, 1987);

Examination of Basic Weaknesses of Income as the Major Federal Tax Base, Richard W. Lindholm, Ed. (Praeger, New York, 1986); *A New Federal Tax System*, by Richard W. Lindholm (Praeger, New York, 1984); *The Economics of VAT*, by Richard W. Lindholm (Lexington Books, D. C. Heath and Company, Lexington, Massachusetts, 1980); *The Value-Added Tax: Lessons from Europe*, Henry J. Aaron, Ed. (The Brookings Institution, Washington, DC, 1981); *Value Added Tax in the EEC*, by Dennis Parkinson (Graham and Trotman, Ltd., London, 1981). This book describes the VAT in European countries, and the various exemptions of the VAT in Europe. A more recent comparison of VATs in Europe is presented in *A Brief Guide to VAT in European Countries* (Price Waterhouse, New York, 1986). A comparison of the VAT worldwide is presented in *VAT in Other Countries: An Arthur Anderson & Co. Study* (Arthur Anderson and Company, Chicago, 1980).

McLure's book *The Value-Added Tax*, provides a detailed description of the type of VAT (a subtractive, invoice-type VAT) that would likely be adopted in the US; he also presents discussion of VAT tax exclusions (zero rating and exemption), and identifies the items that might be excluded under "liberal" and "limited" exclusion policies. Lindholm's book *A New Federal Tax System*, presents detailed arguments on the superiority of the VAT over the income tax.

An older book about the VAT is *Value Added Tax*, by Alan A. Tait (McGraw-Hill, London, 1972). This book provides a good description of the VAT, with special reference to Britain, before its entry into the EEC, and adoption of a VAT. An older monograph summarizing European experience is *Value-Added Taxation in Europe*, by Eric Schiff (American Enterprise Institute for Public Policy Research, Washington, DC, 1973). A good general description of how the VAT affects firms is given in *What You Should Know about the Value Added Tax*, by Dan T. Smith, James B. Webber, and Carol M. Cerf of the Cambridge Research Institute (Dow Jones-Irwin, Inc., Homewood, Illinois, 1973). An excellent general description of the VAT is presented in *Value Added Tax*, Price Waterhouse Information Guide (Price Waterhouse, New York, 1979).

A description of the Michigan VAT -- the Business Activities Tax -- is given in *The Michigan Business Activities Tax: Value-Added Taxation in the Subnational Economy*, by Robert D. Ebel (Michigan State University, Graduate School of Business Administration, East Lansing, Michigan, 1972). Another book by Ebel on the application of the VAT at the state level is the report *An Evaluation of a Value Added Tax for the State of Hawaii*, Economic Research Center, University of Hawaii, Honolulu, Hawaii, 1973).

Recently, a conference was held at the World Bank for the purpose of presenting views on the application of the VAT in developing countries (World Bank Conference on Value Added Taxation in Developing Countries, Washington, DC, April 21-23, 1986. Twenty one papers were presented. One of the papers provided a good summary of the various types of VAT that may be considered: "Criteria for Choice among Types of Value-Added Tax," by Carl S. Shoup, Development Research Department, Economics and Research Staff, World Bank, Washington, DC, September 1986. A summary discussion of VAT experience in developing countries is presented in "Lessons from Value-Added Taxation for Developing Countries," by Malcolm Gillis, Carl Shoup, and Gerardo P. Sicat. The author wishes to thank Professor Shoup and Dr. Sicat for providing copies of the conference papers, prior to their formal publication.

A large number of books has been written on the subject of privacy. A recommended one is *The Assault on Privacy: Computers, Data Banks, and Dossiers*, by Arthur R. Miller (The University of Michigan Press, Ann Arbor, Michigan, 1971).

John Naisbitt's *Megatrends: Ten New Directions Transforming Our Lives* (Warner Books, New York, 1982) discusses sociopolitical trends.

Dr. E. Fritz Schumacher's book *Small is Beautiful: Economics as if People Mattered* (Harper and Row, New York, 1973) presents a discussion of the importance of including social and political considerations in economic analysis, as part of a humanistic approach to economics.

Numerous books are available on the US Constitution and US Government. A good description of the history of the forging of the Constitution, and explanation of its terms, is *CQ's Guide to the US Constitution: History, Text, Glossary, Index*, by Ralph Mitchell (Congressional Quarterly Books, Dept. EH, 1414 22nd St NW, Washington, DC 20037, 1986, \$7.95 plus \$1.95 shipping and handling). A comprehensive discussion of citizens' rights in the US is presented in *Civil Liberties and American Democracy*, by John Brigham (Congressional Quarterly, Inc., 1984). A history of the origins and development of the US Constitution is provided in *The American Constitution: Its Origin and Development*, 4th ed., by Alfred H. Kelly and Winfred A. Barbison (W. W. Norton and Company, Inc., New York, 1970). A description of judicial cases that have involved important constitutional issues, from 1787 (the year of the forging of the Constitution) to the present is provided in *The Constitution: That Delicate Balance: Landmark Cases that Shaped the Constitution*, by Fred W. Friendly and Martha J. H. Elliott (Random House, New York, 1984). A book that examines the impact of the Constitution on US culture is *A Machine that Would Go of Itself: The Constitution in American Culture*, by Michael Kammen (Alfred A. Knopf, New York, 1986).

A large literature exists in the field of systems engineering. The first major text in systems engineering was *Systems Engineering: An Introduction to the Design of Large-Scale Systems*, by H. Goode and R. E. Machol (McGraw-Hill, New York, 1957). Another early text is A. D. Hall's *A Methodology for Systems Engineering* (Van Nostrand, Princeton, 1962). A handbook of systems engineering techniques is *Systems Engineering Handbook*, by R. E. Machol, Ed. (McGraw-Hill, New York, 1965). A more recent text, addressing the utility of systems engineering in addressing societal problems, is *Methodology for Large-Scale Systems*, by Andrew P. Sage (McGraw-Hill, New York, 1977). A recent general text on the procedures of systems engineering and systems analysis is *Systems Engineering and Analysis*, by Benjamin S. Blanchard and Wolter J. Fabrycky (Prentice-Hall, Englewood Cliffs, New Jersey, 1981). Dr. Chadwick's paper on the importance of including cultural considerations in modern management methods is "The I Ching and Global Modeling" (by Richard W. Chadwick, Political Science Department, University of Hawaii, Honolulu, Hawaii 96822), draft of a paper, with bibliography, prepared for the *Fifth International Conference on Chinese Philosophy: The Revitalization and Reconstruction of Chinese Philosophy*, sponsored by the International Society for Chinese Philosophy. A review of Dr. Chadwick's paper is presented in the October, 1987, issue of the journal *Simulation*, in the column "Simulation in the Service of Society," by John and Suzette McLeod (pp. 189-191).