Vol. XXXIX No. 3

ECONOMIC EDUCATION BULLETIN

March 1999

Published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

Why the Income Tax Will Always Need Reform and Why it is Beyond Reforming

In their *Communist Manifesto* of 1848, Marx and Engels called for "a heavy progressive or graduated income tax." They were neither the first nor the last to favor such a tax.

We mention Marx and Engels as early proponents of the income tax only because the notion of an income tax is in keeping with so much else of Marxism. As the collapse of communism has amply demonstrated, the use of naming with a strong intuitive appeal (such terms as "surplus value," "exploitation," "the bourgeoisie," etc., come to mind) does not ensure that the names can be easily or usefully applied to practical situations and problems. Marxist thinking, for the most part, has been discredited by experience. Yet nearly every country of the world has some sort of income tax on its books. Why?

For one, and somewhat perversely, the income tax did not play a very big role in the functioning of communist economies. Since virtually everyone was paid by the state, there was little reliance on explicit income taxation. Thus, it was not seen as something to be discarded when the system collapsed. More to the point, the notion that those with more should pay more continues to have a visceral appeal.

Nevertheless, in this country, virtually no one approves of the way in which income taxes are levied and collected. This is the situation with taxpayers' opinions of the system in general or with respect to their own taxes in particular. "Tax reform" legislation has become almost an annual ritual, and it is likely to remain so for the foreseeable future. Both major political parties perennially promise tax changes — today the Democrats generally favor "targeted" tax breaks and some Republicans would like to see rates reduced. These proposals stand as exemplars of all current prospects for reform. Whether income tax reform involves changes in tax breaks or tax rates, there are always two basic issues involved.

First, to what degree should the tax be "progressive," *i.e.,* require not only larger payments from the "rich" but also a larger proportion of what they have. Most people's inclination seems to be to have punishingly high rates apply to those with incomes higher than their own. This, obviously, is not a satisfactory basis for rate setting.

History does not relate, as far as we are aware, what rates Marx and Engels had in mind when they called for a "heavy progressive or graduated income tax." We would guess that they would have been astounded by the 90 percent and higher top rates that were imposed in much of the industrialized world in the middle of the twentieth century.

In any event, we do seem to have learned from experience that such confiscatory rates produce little revenue. Top rates in the range of 40 to 60 percent have become the norm around the globe as politicians have attempted to set top rates at levels that produce the largest amount of revenue from the top brackets, however defined.

But the progressivity of the income tax is not only a function of tax rate schedules but also of "tax breaks," *i.e.*, what is not subject to tax. The system becomes more progressive when the basic amount of income not subject to tax is enlarged. Even the "flat" income tax proposed by erstwhile Presidential candidate Steve Forbes would have remained progressive, as a very large part of most persons' incomes would not have been taxed at all. On the other hand, tax breaks allowed on the basis of certain kinds of spending or investments ("loopholes"), tend to make the tax payments less progressive, because they are mainly of use to the "rich."

Which brings us to the second issue in any tax reform — what is to be taxed. While nearly everyone has some notion of what constitutes income and what an income tax should tax, such notions can be wildly at

variance with one another. The issue of defining income is the fundamental problem of the income tax. It is even more basic and intractable than the essentially political and more frequently disputed question of how "heavily" progressive or graduated it should be.

What is Income?

In a purely economic sense, income is *consumption plus change in net worth*. No tax collector has ever devised a way to tax income in this sense.

Many forms of consumption (do-it-yourself projects, for example) do not involve transactions accessible to the tax collector. The value in consumption of durable goods and structures may be spread out over many periods, and it can fluctuate after the initial purchase. Net worth can increase or decrease with changes in the market value of holdings as well as from saving and borrowing. Whether or not changes in market values are realized in a transaction, they may reflect to some extent changes in the value of the currency in which they are denominated rather than genuine gains or losses to the holders.

Income can also be received in somewhat roundabout ways. Consider, for the moment, two somewhat extreme examples. Let us say that a movie director, for "artistic" reasons, decides that he needs to shoot a scene with a swimming pool in a certain location. That location just happens to be in the producer's back yard, which does not have a swimming pool. The pool is built as an expense of the production and remains there after the movie is finished. At the other end of the income spectrum, a consumer who declares bankruptcy will have his net worth increase, say from a negative amount to zero, when his debts are wiped out. In either instance, the economic income (a new swimming pool, whatever was purchased with the defaulted credit) is unlikely to be taxed to its recipient.

"Taxable Income"

In short, what we call the income tax does not tax income at all!

What it really taxes is cash receipts — wages, interest, dividends, rents, royalties, etc., received and the proceeds of asset sales — and only a portion of that total. Some or all of certain categories of cash receipts (welfare benefits, workers compensation, social security, municipal bond interest, etc.) may be *excluded* from taxable income right off the bat, as are certain items received in kind such as employer-paid health insurance, subsidized housing, or food stamps. Whatever cash receipts are deemed to be taxable are subject to a myriad of adjustments to determine "taxable income."

Some of the adjustments to cash receipts are very straightforward. When a taxpayer sells something, the cost is deducted from the proceeds of the sale. A self-employed tradesman, say, a plumber, is not taxed on his gross receipts but is allowed to deduct the cost of the materials he uses in his work.

In many more instances, the adjustments are complex and have far less to do with economic fundamentals[1] than with the predilections of the politicians and/or the convenience of the tax collector. What is the rate at which capital assets can be written off against cash receipts? What expenses of employees can be set against wages? Can I deduct union dues? The cost of tools that my employer requires me to bring to work, or the nice clothes I am expected to wear on the job? The answers to these and a host of other questions are arbitrarily written into the tax code by the lawmakers. Their answers can and do change from time to time. Moreover, they often reflect motives other taxing income evenhandedly.

A major example of this is the deduction allowed for mortgage interest on owner-occupied homes. These make no economic sense. Interest incurred to purchase income-producing property (such as securities in a portfolio of investments, or merchandise and equipment used in a business) is quite clearly a legitimate expense when calculating income. In the instance of owner-occupied homes, however, the income from the property purchased with the mortgage is received in kind — a place to live — and not taxed as income. (Some European governments reportedly attempt to impute to taxpayers the income from owner-occupied homes, but it has never been done here.) Presumably, politicians have decided to do this to encourage homeownership.

There are innumerable other aspects of the tax code that similarly reflect the lawmakers' efforts to encourage citizens to act in certain ways. Such "normative" taxation often has unintended consequences: taxpayers with sharp-penciled accountants and lawyers find ingenious ways to apply the law to their client's circumstances. Obviously, and to repeat, these are more useful to the "rich," than to the "poor" who, even if they do act in the ways that the politicians want to encourage, receive less benefit from the relevant provision of the tax code either because they are in a lower bracket or because their total deductions are less than the standard deduction available to all taxpayers.

To avoid such "favoritism" to upper-bracket taxpayers, some of the special provisions of the tax law are calculated as tax credits — which directly reduce the tax due rather than the amount subject to tax.

Finally, because these various special provisions of

[1] For example, personal computers, which can become obsolete in as little as three years, must be depreciated over five years, while rental housing, which tends not to depreciate at all if properly maintained, may be written off in as few as 10 years.

the tax code can enable some taxpayers with high incomes to report little or no tax liability, there is also the "alternative minimum tax," designed to make such taxpayers pay more tax than the main provisions of the tax code would call for.

Evasion and Avoidance

Some taxpayers no doubt adjust their tax liabilities downward by the simple expedient of evasion — not reporting income. Evasion is believed to be widespread among persons who are commonly paid in cash. These include those engaged in relatively low-income occupations (restaurant workers, domestic servants, *et al*), as well as shopkeepers, art and antique dealers, even doctors and other therapists, and, of course, those engaged in illegal activities for whom the "crime" of tax evasion is only incidental to their drug dealing, racketeering, etc.

All estimates of the extent of evasion are conjectural. They typically run to about 10 percent of total economic activity in the United States, which would amount to roughly $850 billion per year of untaxed income distributed, as the foregoing suggests, across all income levels.

On the other hand, tax avoidance generally means complying with the law, often in excruciating detail, rather than flouting it. As such, it is commonly believed to be the domain of the "rich" for whom the stakes are large enough to warrant hiring the requisite accountants and lawyers. Estimates of the extent of tax avoidance are more precise ("tax loopholes" defined as deviations from the "normal structure of the income tax" are estimated to have totaled about $536 billion in 1998) but they are no less conjectural, as their effects are cumulative and one person's "loophole" is another's eminently fair and warranted provision of the tax law.

Somewhere in between evasion and avoidance is a large "grey area" of deductions which may or may not be allowed and may or may not be genuine. These usually involve the self-employed, but not always — did you really put as much in the collection plate as you claimed on Schedule A?

What Have We Wrought?

There are two major consequences of all this. First, determining the "taxable income" reported on one's return is, for many people, like filling in the answer to an inscrutable puzzle. Most taxpayers have to turn to experts to solve this puzzle and the answer may have only a remote resemblance to the taxpayer's circumstances. There may not even be a single answer as the opinions of experts can differ (readers who do not believe this should try presenting a situation of even modest complexity, say, with some rental income or a casualty loss, to two different tax preparers or to the Internal Revenue Service's (IRS) taxpayer assistance service).

In any event it is incontestable that what individual taxpayers actually pay often is very poorly correlated with economic income. Most people are aware of this, but their general comprehension of the process and the issues involved is very dim. For example, one New Hampshire voter interviewed on Public Radio during the last Presidential primary season stated that she had been in favor of Steve Forbes's flat tax proposal until she learned that "businesses would still get deductions." The interviewer did not ask her why she seemed to think businesses (such as the aforementioned plumber) should be taxed on gross receipts rather than on net income, and it was not clear that she would have grasped the distinction.

Second, in enforcing the income tax we have gradually allowed the tax authorities to assume vast powers. Some observers have concluded that the investigative and surveillance capability of the IRS over our personal lives now exceeds what has been available to the police of totalitarian regimes, such as the Gestapo or the KGB. For example, the Bank Secrecy Act (which might have been better titled the Bank No Secrecy Act) is designed to ensure that everything going through a bank account is recorded and available for government inspection.

Moreover, despite the vaunted new "kindler, gentler" IRS, the Constitutional safeguards against self-incrimination and the presumption of innocence that apply in criminal proceedings are largely absent in taxpayer disputes with the authorities. This is all the more remarkable because the United States, unlike nearly every other country of the world, treats tax evasion as a crime rather than a civil matter.

As a result, few, if any, citizens can face an IRS audit with equanimity. The extraordinary complexity of the tax code and the possibly severe penalties (incarceration, seizure of property) for what may have been simple oversights or misunderstandings foster fear and loathing among even the most upright of citizens.

All this would have astonished the Founding Fathers. Alexander Hamilton, for example, wrote in the *Federalist* No. 36, which discussed and defended the proposed U.S. Constitution: "The abuse of this power of taxation seems to have been provided against with guarded circumspection."

Why?

How then did we get to where we are now? As we suggested at the start of this essay, the most fundamental reason is the very notion of "income" as a suitable object of taxation. This notion is based on glib assertions regarding economic relationships rather than on an understanding of practical problems or experience.

Traditional objects of taxation, such as property, sales, or even capitation ("poll" or "head" taxes), can usually be established relatively unambiguously and without a lot of inquiry in the circumstances of the taxpayer. This is not to say that such taxes cannot be evaded or avoided, but the taxpayer either owns property or he doesn't, a taxable transaction took place or it didn't, the taxpayer is alive and well or he isn't, and so on and so forth.

In contrast, income exists only on paper. As we have seen, for practical reasons, and because the definitions are subject to the whims of the politicians, "taxable income" may have only passing resemblance either to everyday notions of income or to its strict economic definition.

Such anomalies might not be very objectionable if the rates were moderate (as they were when the tax was first imposed, with rates of 1 to 7 percent, applicable to income in excess of $20,000 in 1913 dollars, equivalent to roughly $200,000 today). But our politicians believe they need more revenue than moderate rates could provide. To finance the insatiable claims of a gargantuan government, the tax-collector now claims what our forebears would have viewed as an intolerable burden. Moreover, and perhaps even worse, because the tax is based on calculations that can involve nearly every aspect of the taxpayer's life, we have sacrificed much of our liberty, and most of our privacy to an IRS with draconian powers.

Tax expert Charles W. Adams has summed this up well:

> The income tax as it has evolved can be likened to a dirty industrial smelter that does an efficient job of refining an ore that is essential for society but that pollutes the air, poisons the streams, and kills the forests. These direct side effects will be tolerated if the refined ore is essential and if no cleaner method is available. Like the dirty smelter, we pollute the social order with our income tax system. We seek a society in which integrity, and liberty abound, but the income tax pulls us in the opposite direction. Instead of equality we have inequality, intentionally and deliberately fostered upon us. Instead of integrity we have fraud. Instead of liberty we have totalitarian surveillance and inquisitions. In short, the income tax is a dirty tax and the more we have demanded of it the dirtier it has become.*

* *For Good or Evil, The Impact of Taxes on Civilization,* Lanham MD, Madison Books, 1993.

Economic Education Bulletin (ISSN 0424-2769) (USPS 167-360) is published once a month at Great Barrington, Massachusetts, by American Institute for Economic Research, a scientific and educational organization with no stockholders, chartered under Chapter 180 of the General Laws of Massachusetts. Periodical postage paid at Great Barrington, Massachusetts. Printed in the United States of America. Subscription: $25 per year. POSTMASTER: Send address changes to ***Economic Education Bulletin***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.

ECONOMIC EDUCATION BULLETIN

AMERICAN INSTITUTE FOR ECONOMIC RESEARCH
Great Barrington, Massachusetts 01230

Periodical postage paid at
Great Barrington, Massachusetts

ADDRESS SERVICE REQUESTED