HOW THE IRS TRIES TO MAKE YOU DIE POOR

Why a National Retail Sales Tax is the Best Tax Policy For USA

by Daniel J. Pilla

The United States is engaged in a debate which promises to be long and emotional. Before it is over, it will pit Americans against one another in a battle of class warfare such as this nation has probably never seen. The debate is over tax reform. The question is who should pay and in what amounts. At issue is the level which constitutes the "fair share" of tax one should pay.

This report attempts to answer these and other pivotal questions and proposes solutions to our nation's tax ills. The solutions address steps we can take at both the national level and the individual level to solve tax policy and enforcement problems that plague a cross-section of society.

Our Tax System is a Mess

Our tax code consists of about 17,000 pages of law and regulation that were changed more than 100 times just during the decade of the 1980s alone. In 1996, Congress passed four major pieces of legislation, each having a significant impact on the code. In all, those four measures changed more than *750* code sections or subsections.

With the myriad of tax laws and law changes comes a field fertile and ripe for mistakes and abuse. In the four most common areas of tax law administration where the IRS is likely to contact the average citizen, the agency is guilty of repeated and egregious mistakes. In some cases, experience shows the IRS deliberately bluffs and intimidates citizens into paying taxes they do not owe. The combination of the officious and obviously powerful nature of the IRS agent and the citizen's lack of understanding of the law and his rights leads to billions in assessments which are simply not valid.

In April, 1997, at the invitation of The Heritage Foundation and Americans for Tax Reform, two Washington DC, public policy institutes advocating radical reform of our tax system, I appeared in Washington to address a congressional policy forum at the US Capitol. In my discussion of the problems with the IRS and the tax code, I spoke extensively on the four areas of tax law administration in which the IRS has a deplorable record. The four areas are computer notices, audits, penalty assessments and tax assessments in general. Using some of the data I presented in Washington, let me highlight these concerns, one issue at a time.

1. *Notices*. Each year the IRS issues about 60 million notices communicating with citizens about their tax accounts. The notices cover approximately $200 billion in account transactions. Since this works out to around $3,300 per notice, I am sure you will agree this is no small matter.

Yet for years, the IRS has been guilty of wholesale mistakes when it comes to computer notices. As early as 1988, the General Accounting Office (GAO) reported that as many as 48 percent, virtually one-half, of all IRS notices were either wrong or incomprehensible. Still, most people simply pay the bills rather than try to fight back because they either do not understand how to fight or believe they cannot afford to stand in the gap.

And while the IRS claims to have made strides in correcting the problems, the facts indicate a different story. In 1994, the GAO revisited the issue. It examined forty-seven of the most common notices the IRS uses to communicate with citizens. The report plainly indicates that the picture has not brightened. According to GAO, thirty-one of those notices -- 66 percent of those examined -- used inspecific language, unclear references, inconsistent terminology, illogical presentation of material, and insufficient information and guidance.

Most recently, the IRS' newly created Taxpayer Advocate issued his report to Congress summarizing the twenty most common problems the public has with the IRS. *Number four* on the list is "erroneous notices." The problem continues to be a major one for citizens struggling to comply with a confusing and always-changing tax code.

In my book *The IRS Problem Solver,* I provide examples and step-by-step guidance for dealing with computer notices and other IRS correspondence. The book examines of the major letters and notices the IRS uses to collect additional taxes and penalties through the correspondence process. Using my sample responses as a guide, citizens have saved countless thousands of dollars over the years in taxes they did not owe.

2. *Audits*. Each year, the IRS runs about 2 million citizens and businesses through a face-to-face audit. (Virtually all tax returns filed are examined through a computer-audit process. That is one of the reasons so many notices are mailed by the IRS each year.) In 1995, its audits of 1.91 million individual tax returns resulted in additional assessments of about $7.75 billion in taxes, penalties and interest. That translates to about $4,000 per tax return. Just 11 percent of those audited were given a clean bill of health while 89 percent were said to owe more money.

At best, tax audits are inconvenient, stressful and time consuming. At worst, they can lead to financial havoc and sometimes out-and-out ruin. These facts are particularly troubling when we acknowledge the reality that the IRS' audit results are wrong a high percentage of the time.

In my work as a tax litigation consultant, I have seen thousands of audits and know that the IRS makes a lot of mistakes in the process. Based upon my experience and IRS' own data, I have reported in the past that the agency is wrong between 40 to 50 percent of the time with its audit results.

However, a 1993 GAO study shows that even those reports are low. In that report, the GAO analyzed IRS Examination and Appeals Division data to determine the types of issues reviewed by the IRS and the results of its audits. The report concludes that audit results are wrong between 60 to 90 percent of the time, depending upon the issue at stake.

In its annual report to Congress, the Taxpayer Advocate not only identified the top twenty problems that citizens have with the IRS, but it also analyzed the reasons why citizens seek help from the agency's Problems Resolution Office (PRO). The PRO was set up to function as a liaison between the IRS and the citizen. PRO case workers become involved in a case where it is shown that the actions being taken or about to be taken by the IRS will cause "significant hardship" to the citizen and where the normal channels for resolving disputes have failed.

The number one reason why citizens turn to PRO for help is for "audit reconsiderations." The term "audit reconsideration" is a term of art used by the IRS to describe a bogus audit result. The reconsideration process is a discretionary remedy available to a citizen only when he can show that IRS auditors made mistakes in calculating his tax bill.

Of all the possible reasons a person may seek relief from a tax problem, the fact that bogus audit results is number one on the list speaks volumes about the IRS' capacity to "get it right" in the first place. On the basis of this evidence alone, there are countless numbers of citizens suffering this day from the results of bogus audits. Unfortunately, the complexity of the tax code provides the IRS with the perfect cover for perpetuating continued abuse.

My book, *How to Win Your Tax Audit*, provides a step-by-step guide to dealing with audits and appeals, showing exactly how to use your rights to keep from paying taxes you do not owe. The book is an expose of the IRS new and aggressive "economic reality" audit program which presumes that you are a tax cheat. It exposes the troubling new ways the IRS intends to audit every citizen in an effort to unearth evidence of hidden income. Anybody who files an income tax return must read this book.

3. *Penalties*. There are over 140 different penalty provisions in the tax code and the IRS uses them with reckless abandon. Each year, the agency assesses about 34 million penalties against individuals and businesses. Generally, businesses carry the heaviest load when it comes to penalties because so many of the provisions relate to withholding and tax deposits. The IRS can and routinely does issue thousands of penalties against businesses whose actual taxes are paid in full. The penalties relate only to some procedure blunder regarding the payment process.

The Taxpayer Advocate states in his report that of the top ten reasons citizens seek help from PRO with a problem, penalties are numbers six and seven on the list. The report breaks penalties down into two categories, hence the reason it holds two places

on the list. The first are those of a general nature and the second are those relating to withholding requirements. Nearly $15 billion in additional revenue is assessed through this blizzard of penalties. When interest is added, the revenue doubles and sometimes triples.

Over the past fifteen years, we have seen an outright explosion in the number of penalty assessments, even at a time when Congress claimed to have simplified the tax laws. In 1980, the IRS assessed 19.59 million penalties for revenue of $1.55 billion. By 1987, after the massive Tax Reform Act of 1986 which was to make life so much easier for all, penalty assessments climbed to 26.97 million for revenue of $9.99 billion. So while tax law compliance was "simplified," the number of penalties grew by 37 percent and penalty revenue exploded by more than 640 percent. Since that time, the number has grown only larger.

Yet the IRS' own statistics show that such penalty assessments are wrong about 40 to 50 percent of the time. In the critical area of employment tax penalties, the IRS admits that it abates more than "60 percent of the penalty amounts when taxpayers request an abatement and provide sufficient justification." Most people simply pay the penalty rather than following a simple formula for canceling it.

For details on how to effectively challenge improper penalty assessments, please consult my book, *The IRS Problem Solver*, available from Winning Publications. Perhaps the easiest of all tax problems to solve is the assessment of improper penalties. With just a little guidance, virtually anybody can cancel any penalty assessment. Unfortunately, most have no idea how to go about the process and are clobbered with penalties they just do not owe.

4. *Tax Assessments*. An assessment is created when the IRS determines that one owes taxes. Once the assessment is made, if the tax is not paid upon notice and demand, the IRS may resort to all of its enforced collection tools to secure payment. These include the potent weapons of the lien, levy and seizure.

As of November, 1996, there were over 19 million unpaid tax assessments on the IRS' books. Each year, there are at least 3 million more delinquent accounts added to the inventory of collection cases. Behind the numbers are millions of people who cannot pay the taxes they owe. They face enforced collection often leaving them in the unenviable position of having to make a choice between paying their taxes and feeding their families.

Incredibly, by the IRS' own admission, these assessments are incorrect a disturbing percentage of the time. IRS researchers state that "twenty-five percent of the [accounts receivable] inventory results from administrative duplication and erroneous assessments."

Those facing tax collection problems must review my book, *How to Get Tax Amnesty*. It has helped tens of thousands of people reduce or eliminate tax debts they cannot pay using programs for debt reduction administered by the IRS. The book walks the reader step-by-step through five programs which can help to manage, reduce or even eliminate tax debts you cannot pay. It also helps to obtain installment agreements, release wage and bank levies and deal with the Problems Resolution Office.

Why is the System so Complicated?

Reasonable people repeatedly ask, "Why can't the tax laws be more simple?"
The answer is they *can be* more simple. The reason they are not is Congress uses the tax laws for reasons other than that for which they were intended. It is the hybridization of the tax laws which accounts for the complexity of the system. This manifests itself in two prominent ways.

First, Congress uses the tax laws as a kind of "currency" to buy and sell legislative favors. Think back to the last local congressional or senatorial campaign you witnessed. Each of the candidates promised that, "if elected," he would work for tax breaks for this group or that. Or, perhaps, the candidate promised "tax hikes" on certain individuals or businesses. Tax laws which grant special favors or treatment to one group, industry, or segment of the population are provided as *repayment* for its support of the candidate. Each time the tax laws are amended to accommodate such a repayment, the law becomes more confusing, convoluted, more difficult to comply with and administer.

Even worse, however, is the second problem. For the past forty years, Congress has used the tax laws as a means of enforcing the transient notion of "social justice." Our graduated income tax laws are used to punish certain segments of society in order to benefit others who are perceived to be "less fortunate" or who have been "taken advantage of" by others.

Examples of this abound, but perhaps the best is found in the 1993 budget proposal of President Clinton. The president was in his first term of office after being elected on the promise of cutting taxes for the middle class and raising them on the richest 2 percent of Americans, those earning more than $150,000 annually. His reasoning as expressed in the Administration's written proposal was to get even with those whom he perceived to have gotten a free ride in the 1980s, what he called the "uneven prosperity of the last decade."

As a result of his dislike of those who were successful in the 1980s (ironically, his wife was among those who "scored big" in options trading), his "tax reform" imposed the largest single tax hike in American history. The 1993 Clinton tax law increased taxes by *$326 billion*. It was not done for any sound fiscal or constitutional policy, but to "get even" with a particular segment of society. Unfortunately, as is often the case with tax hike proposals, they are sold as increases on the rich, but the middle class ends up doing the heavy lifting. Of the eighty-one different provisions of Clinton's law, just a handful applied to the so-called "rich."

These are *illegitimate* uses of the taxing power of government. Our Founders imparted taxing authority to the federal government for the sole purpose of allowing it to raise revenue to fund its legitimate, clearly defined constitutional functions. It has no authority to use its taxing powers to create an egalitarian utopia.

Whether you personally agree or disagree with such social engineering is not the issue. The issue is whether the United States has the legitimate right to use its taxing power for a means other than that intended. I maintain it cannot and I challenge any constitutional scholar to demonstrate that the taxing authority of Congress may be lawfully used to artificially reduce one's standard of living solely to impose social change. In short, the Congress should not be able to wield the power to make you die poor.

Congress' legitimate power to tax derives from Article 1, section 8 of the Constitution. The power to tax, like all powers delegated to the federal government under the Constitution, is limited. The section reads, in relevant part, as follows,

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States;...

The taxing power, as you see, is limited to just three general categories: (1) paying the debts of the nation, (2) providing a national defense, and (3) ensuring the general welfare (read, "soundness") of the United States. As you can plainly see, there exists no power to employ the taxing authority for social purposes.

The Founders never intended such a power to exist for one simple, very logical reason. The social agenda of the nation is subject to change with each change of power in Washington. Each group has its own idea of "the ways things should be." Each individual election at every level represents, at least ideologically, a shift in that power. If each group were allowed to use your standard of living as the means of affecting its social agenda, you are deprived of the most basic rights guaranteed by the Constitution. You are deprived of your property and the pursuit of happiness so that others may impose their notions of social utopia upon you without your consent.

It makes no difference that you may happen to agree with those ideals. In a society with free elections, it is inevitable that sooner or later, some group will come to power proposing ideals with which you *do not* agree. Is it your contention that the economy may be falsely manipulated provided you support the social agenda, but may not be so manipulated if you do not support it? You cannot have it both ways! You either support a free economy, in which case no social agenda may be furthered at the economic expense of others, or, you are a socialist.

The idea of using the power of taxation to accomplish purely social goals was espoused by Karl Marx himself. The Marx philosophy of socialism was designed to create an all-

powerful state and to eliminate individual property rights. As we know from experience in eastern Europe and the former Soviet Union, socialism does not work. With all incentive to produce removed from their economies, Soviet nations and their satellites simply stagnated. All citizens but the ruling class were reduced to abject poverty with no hope of bettering their conditions.

In Marx's Manifesto, he described the process of achieving the destruction of individual property rights. He writes,

> The proletariat [defined by Marx as the "wage-labor working class"] will use its political supremacy to wrest, by degrees, all capital from the bourgeois [defined as "middle-class property owners"]; to centralize all instruments of production in the hands of the State, i.e., of the proletariat organized as the ruling class; and to increase the total of productive forces as rapidly as possible. Of course, in the beginning this cannot be affected except by means of *despotic inroads on the rights of property, and on the conditions of bourgeois production...*

To achieve the state-enforced transfer of wealth he envisioned, Marx developed a 10-point plan to impose in "advanced countries" through the process of legislation. Points two and three read,

> 2. A heavy progressive or graduated income tax.
>
> 3. Abolition of all right of inheritance.

Without question, the concept of transferring wealth to impose a social agenda is an idea repugnant to the Constitution and our system of limited government. To solve America's fiscal problems, we must therefore abandon this practice in favor of a politically and socially *neutral* system of taxation. To satisfy the financial needs of the nation and remain true to our heritage, our tax system must be broad based. It must not favor particular industries, factions or individuals at the expense of others. It must not fall more or less heavily upon one faction or industry solely because of its social standing.

Taxation to Provide for the "General Welfare"

The Constitution's authority to permit taxation to "pay the debts" of the nation and to provide for its "defense" seem clear enough. But what of the power to provide for the "general welfare?" This clause is the source of great misunderstanding.

You may be inclined to suggest, as many have, that the "general welfare" clause of Article 1, section 8, seems to impart broad authority on Congress to enact funding measures which it alone deems appropriate. Indeed, does not the use of the phrase "general welfare" itself grant license to utilize taxing powers to achieve social goals? After all, is not "welfare" the quintessential social undertaking? This certainly is the contemporary interpretation. However, to ascertain its true meaning, we must visit the opinions of those who wrote it.

The term "welfare" as used today implies all manner of programs designed to uplift the poor, the disabled, the uneducated, the orphaned or widowed. Welfare programs of

every description exist at both the state and local level and are responsible for hundreds of billions annually in government spending. I am persuaded that early advocates of such programs attached the term "welfare" to their designs in order to color them with the appearance of constitutionality.

But if our Founders had intended to allow government spending for such programs, they clearly would not have used the term "welfare" to describe them. In his singular essay entitled, "The General Welfare," noted historian and constitutional scholar Clarence B. Carson observes that,

What Americans began calling welfare programs in the late 1930s, or thereabouts, the Founders would have known by the name of "poor relief," so far as they were familiar with it at all.

The Federalist Papers provide great insight to the thinking of the time. They are a series of essays by Alexander Hamilton, James Madison and John Jay. The articles were written in response to opposition to the Constitution offered from various quarters. Hamilton and Madison addressed the taxing power under the Constitution and the "general welfare" clause of Article 1, section 8.

Madison expressed what might today be termed the "conservative" viewpoint. He reasoned that since the specific powers of the federal legislature were limited to but six narrow areas, the taxing power of Article 1, section 8 could be no broader. Congress has the power to raise an army and provide a common defense. It is empowered to maintain domestic tranquility and facilitate intercourse among the several states and with foreign governments. Certain utilitarian functions are imparted to the national legislature, such as the maintenance of post offices and post roads. Madison affirmed that the federal government enjoyed no power which was not expressly delegated under the Constitution. It therefore could use its taxing authority for nothing other than affecting the clear and limited purposes of the Constitution.

During the public debate, some claimed that Article 1, section 8 imparted unlimited taxing powers to the federal government because of the undefined "general welfare" clause. Madison retorted, "No stronger proof could be given of the distress under which these writers labor for objections, than to their stooping to such a misconception." He explained there is no authority for Congress to rely upon the "general welfare" expression to expand its taxing power, if in so doing, it disregarded "the specifications which ascertain and limit" its authority.

Hamilton, on the other hand, asserted what we would today call a more "liberal" view of the Constitution’s taxing authority. Like all our Founding Fathers, he recognized the powers imparted to the new government were *limited*, but clearly aspired to create a more proactive federal government. In Federalist No. 34, he explained the taxing power was "indefinite." He viewed the clause as imparting to Congress "the discretion to pronounce" the objects of taxation which "concern the general welfare."

Despite the broad divergence of opinion of the two authors on the topic, both were in agreement that the power of taxation did not involve the power to redistribute wealth. The "general welfare" clause does not grant license to establish a welfare state under which largess is distributed to one class of citizens at the expense of another. Even in Hamilton's very liberal view of matters, he cautioned,

> The only qualification of the generality of the phrase in question, which seems to be admissible, is this: That the object of which an appropriation of money is to be made be *general*, and not local; its operation extending in fact or by possibility *throughout the Union*, and not being confined to a particular spot.

If it is true that appropriations must be general in nature, not confined to "a particular spot," it must logically follow that programs which benefit only selected groups or classes of citizens cannot possibly meet the constitutional test of relating to the nation's "general welfare."

If Madison represented the more conservative view, and Hamilton the more liberal view, then Jefferson must have expressed the *correct* view. Of all our nation's founders, Jefferson's influence was clearly the strongest. He sheds further light upon the issue, remarking,

> The laying of taxes is the power, and the general welfare is the purpose for which the power is to be exercised. They [Congress] are not to lay taxes ad libitum [defined, "at pleasure"] for any purpose they please; but only to pay the debts or provide for the *welfare of the Union*. In like manner, they are not to do anything they please to provide for the general welfare, but only to lay taxes for that purpose.

These remarks clearly indicate that taxation and government spending is intended for the welfare of the *nation* as a whole, not its *individual* inhabitants or locales. The authority to tax exists only to further the greater concerns of the Union itself. We can therefore conclude that the power to provide for the "general welfare" does not authorize distributions from the treasury to the benefit of private interests, individual concerns, or purely local pursuits. More importantly, there plainly exists no authority to employ the power to tax as a means to bring about perceived social order or to correct perceived social injustice.

Taxation under our Constitution, even from the liberal view, was never designed to favor one business over another or one property interest over another. Taxation is nothing more than the simple expedient of raising money for the operation of the legitimate functions of government--period.

Professor Carson concludes his essay by writing,

> In sum, then, it is most unlikely that the makers of the Constitution would have chosen the phrase, "general welfare," to authorize the federal government to provide what they understood to be poor relief. It would have violated both their understanding of the meaning of the words and the common practice as to what level of government should provide the relief. On the contrary, it appears that

relief came to be called welfare to give it a semblance of constitutionality. Indeed, close analysis within the sentence and the context of the Constitution points to the conclusion that the reference "to provide for the general welfare" was the *restriction* of the taxing power rather than a separate grant of power.

Whether politically conservative or liberal, our Founders shared a common goal. As seen from the juxtaposition of Madison and Hamilton, they may have approached it differently, but their purpose was the same. Each possessed a burning desire to establish and ensure the greatest measure of individual liberty possible. They recognized that unlimited taxing power is a direct threat to such liberty.

Look What's Happened to Your Tax Burden

Most Americans believe we have always lived with both an income tax and a significant tax burden. However, this is not the case. It was not until 1913 that the income tax became a fixture in our economic constellation after ratification of the 16th Amendment. But even then, the minimum tax rate was just 1 percent. The maximum rate of 7 percent applied to income in excess of $500,000. In 1913, it was just the *extremely* rich who paid any income tax whatsoever. The income tax affected just 0.009 percent of the work force. For tax year 1913, only 360,000 income returns were filed nationwide.

Prior to the 16th Amendment, the United States relied exclusively upon import duties and manufacturer's excise taxes to fund the federal government. In the first place, the Founders and their immediate antecedents recognized the *limited* nature and power of the federal government. Thus, its need for revenue was not great by any means.

Secondly, the Constitution provides that the Congress *cannot* adopt a direct tax unless it is apportioned among the states. This provision was specifically enacted to *prevent* the federal government from doing what it does today in the name of collecting taxes: getting into the faces of individual citizens with audits, computer notices, penalty assessment, wage and bank levies, tax liens and property seizures. Our nation's earlier statesmen respected this limitation while today's politician cannot even explain what it means.

Hamilton, the liberal, was chiefly behind the use of manufacturer's taxes as the principal means of funding the functions of government. First of all, they were fair. Hamilton observed that "Taxes on consumable articles have, upon the whole, better pretensions to equality than any other." Our Founders knew that achieving political equality, i.e., making all citizens equal *in the eyes of the law*, did not mean punishing one group of citizens or segment of society in order to benefit another. Therefore, the standard of fairness in taxation was measured by the uniformity of the tax. To be fair, the burden of the tax must fall upon all citizens proportionally. Excise taxes are particularly suited to this goal.

Secondly, the Founders knew the basic economic reality that what you tax, you get less of. To tax income and capital gains, or as Hamilton phrased it, "the articles of our own growth and manufacture," was to limit the young nation's economic potential. Consequently, the Founders expressly rejected income taxes in general, and the graduated income tax in particular, since both are antithetical to the foundations and growth of liberty which they had labored so long and at such great cost to birth.

Nothing speaks so clearly to this truth than to observe the affects the encroaching income tax has had upon all of us. Even though the income tax was in effect in 1913, the average American paid no income taxes until about 1943, when Congress passed the Victory Tax Act to fund World War II. It was presented as a "temporary" measure, to be repealed at the war's conclusion. With it came income tax "withholding." For the first time, the federal government got its hands directly into the pockets of the American people. It has not removed them since.

When enacted, the income tax code consisted of just a handful of pages of law and regulation. Today, it encompasses more than 17,000 pages. There are thousands of tax forms and tens of thousands of pages of incomprehensible instructions intended to guide us through them. The IRS reports that in 1995, Americans spent 5.3 billion hours in the mind-numbing task of making records and preparing more than 210 million individual and business income and employment tax returns. That is an increase of 4 percent over the time spent in 1994. On top of that, businesses are annually required under threat of substantial penalty, to prepare and file more than one billion (that's *BILLION*) information returns, such as Forms W-2 and 1099. Through these forms, businesses report to the federal government the financial activities of those with whom they associate. The requirement to report expands on a regular basis.

With the growth of the compliance burden came an equally oppressive growth in the level of taxation. By the 1950s and 1960s, the average American paid about 20 to 25 percent of his income in federal, state and local taxes. By 1996, the average family paid between 42-45 percent of its income in taxes at all levels.

In 1996, the median family income for a dual income family was $53,091. That family paid a total of $21,883 for federal, state and local taxes. To see why the average middle income family of today cannot survive on a single income, we need only examine the tax burden faced by families in the 1950s. That same family, in 1955, measured by 1996 inflation-adjusted dollars, paid just $6,665 in taxes. Today's family pays *more than three times* what our parents did on the same relative income.

Each year, the Tax Foundation of Washington, DC, releases its calculation of "Tax Freedom Day." Tax Freedom Day represents the average day on which a citizen has worked enough time to pay all his federal, state and local taxes. In 1997, Tax Freedom Day was May 9. If you dedicated all the income you earned to paying taxes beginning with January 1, you would have to work 128 days, or until May 9, to pay them all.

However, very few of us work seven days per week, week in and week out. Therefore, let us put the 128-day tax burden into the context of *working days*. Let us assume we work five days per week for fifty-one weeks, with ten days off for an assortment of holidays, unpaid leave, etc., and a one-week vacation. At that, we work about 246 days per year. If 128 of those are needed to pay taxes, we need about 52 percent of the time to earn money just to pay taxes.

There should be no doubt in your mind that taxes make you poorer. Despite the flowery Washington promises of more benefits through more programs pointed at more people to alleviate more problems, the fact is, *taxes make you poorer!* There is a complicated economic principal at work here which the Washington social engineers seem not to understand. Let me see if I can explain it. Here goes -- *Higher taxes* cost more money *than lower taxes*. Did you get that? If you have to commit a growing percentage of your income to pay taxes, you have a shrinking percentage available for food, clothing, etc. In fact, at current levels, taxes consume more of the family budget than food, clothing, housing and medical expenses--combined!

Ultimately, your standard of living must fall to accommodate the growing demand for your income. Gerald W. Scully, professor of economics at the School of Management, University of Texas at Dallas, illustrates this point vividly. His analysis of the affect of growing taxes upon the economy finds that if overall tax rates had remained in the low-20 percent range, the "optimal level of taxation," as they were in the 1950s and 1960s, real gross national product (GNP, the measure of national production) would have been about $13.6 trillion by 1989. That is about *twice* what GNP actually was that year.

The impact of this upon the average family is staggering. It means that the average family today would have about twice as much real income as it now has. Professor Scully observes that, "In general, the US economy has sacrificed $2 worth of income for every $1 of tax paid beyond the level of optimal taxation." Furthermore, Professor Scully’s data show that in addition to the increase in income, the average family would have about $100,000 more in assets owned *outright*, that is, free of debt.

Ask yourself this question. Just exactly how much government aid would you need if your tax burden were cut in half, your spendable income was twice what is now, and you had $100,000 more cash in the bank, or equity in your home, or cash in your retirement fund? That is precisely the condition we would find the average family but for the increasingly burdensome tax and spend policies of the past forty years.

And while Americans continue to demand more from government, ironically, the majority of taxpayers believe their current burden of up to 45 percent is too high. A sweeping survey by *Reader’s Digest* in 1996 showed that a virtual cross section of citizens believe the maximum "tax burden that Americans think a family of four should bear is 25 percent of its *total income*."

The amazing aspect of the survey is that is was not pointed at specific classes or ideologies. Researchers questioned Democrats and Republicans, conservatives and

liberals, blacks and whites, rich and poor, men and women, old and young. By the rate of 68 percent, a level which can only be termed a compelling consensus, Americans agree their taxes are about 2 to 2.5 times higher than they should be.

Professor Scully's study found that economically speaking, total tax rates in the low-20 percent range allow the government to collect sufficient revenue to fund its legitimate functions, but do so with the least amount of negative impact on sustained growth. The fact is, all taxation causes some negative impact on the economy. The question is at what level do they actually accelerate the damage *beyond* what government programs are able to offset. The answer appears to be that the point of diminishing returns begins at the low-20 percent range.

Incredibly, what Professor Scully found through his economic research the American people seem to know instinctively. Ironically, however, people continue to call for more and more government programs. It is as though we want the perceived benefits of government but are unwilling to pay the cost. What we know full well after forty years of social planning is that government is not free. Not only is it extremely expensive, it is wasteful, inefficient, impersonal, unreliable and often riddled with fraud. We must recognize that in the majority of cases, government is not the solution to our economic and social ills. In the majority of cases, it only makes matters worse by making people poorer and hence, more dependent.

Estate and Gift Taxes Make Matters Worse

As if it is not bad enough to pay a growing tax burden during your life, estate, gift and inheritance taxes make it possible for the government to continue getting into our pockets even after death. But while estate, gift and inheritance taxes are tremendously burdensome for many families, they are of little or no benefit in terms of raising revenue.

Most citizens believe that estate taxes are pointed only at the extremely wealthy. As a result, people tend to feel that such taxes have no impact upon them and, in fact, can only help them. This belief has been with us since 1916, when Congress enacted the first of the modern estate tax laws. As we shall see, the estate tax hits the "little" guy much harder and in more ways than we imagine at first blush.

The driving force behind the 1916 estate tax legislation, like its 1913 predecessor the income tax, was social egalitarianism. The framers of tax policy set out to attack concentrations of wealth for purely social and philosophical reasons. The estate tax was never intended as a tool to raise revenue. Its express purpose is to destroy capital; to break up family holdings and thereby prevent them from being passed on to succeeding generations.

In 1946, Beardsley Ruml, then chairmen of the Federal Reserve Board, expressed the belief of social engineers of the time regarding taxation. He stated that the prime concern for planners in imposing tax burdens is not to raise revenue. Instead, he observed, "the inevitable *social* and *economic* consequences of any and all taxes have now become the prime consideration in the imposition of taxes."

Ruml's statement takes us 180 degrees *away* from the intent of the Founders in granting taxing power to the United States. The fact that policy makers have used taxes for social and economic planning purposes in addition to raising revenue, has pushed us down a very slippery slope. The resulting tax burdens are now choking the average family.

Ruml explained that rather than raising revenue, taxation had four other primary purposes. Two of those purposes are,

1) To express public policy in the distribution of wealth and of income, as in the case of progressive income and estate taxes;
2) To express public policy in subsidizing or in penalizing various industries and economic groups.

Ruml's observation about estate taxes in general is quite telling. It clearly shows that the tax is of no significance other than preventing the passage of wealth from one generation to another as a result of arbitrary public policy dictates. Listen:

> The second principal purpose of federal taxes is to attain more equality of wealth and of income than would result from economic forces working alone. The taxes which are effective for this purpose are the progressive income tax, the progressive estate tax, and the gift tax. What these taxes should be depends on public policy with respect to the distribution of wealth and of income. It is important here to note that [the primary purpose] of estate and gift taxes. . .is the social purpose of *preventing what otherwise would be high concentrations of wealth and income at a few points*, as a result of investment and reinvestment of income not expended in meeting day-to-day consumption requirements. These taxes should be defended and attacked in terms of their effects on the character of American life, *not as revenue measures*.

It is clear that the purpose of estate taxes is simply to take money from people. Another way of saying the same thing is that estate taxes facilitate the process of *stealing* assets families have lawfully built during a lifetime.

Ruml was dead right in saying that estate and gift taxes have no significant impact on revenue. Historically, they have accounted for barely 1 percent of total federal revenue. In 1994, for example, out of total federal receipts of $1.259 trillion, the estate and gift tax accounted for just $15.225 billion, or 1.2 percent of the total. This is not at all unusual. Even during the high estate tax rate periods of the 1940s when America was embroiled in a world war, estate taxes never accounted for more than 12 percent of total federal revenue.

Ironically, the IRS attacks estate tax returns through the audit process with much more vigor than any other category of return. In 1993, the IRS audited nearly 17 percent of every estate tax return filed. That is 8.5 times higher than the individual tax return examination rate. However, of those filed, more than 57 percent were for gross estates of under $1 million. The families of such estates are certainly not the super-rich Rockefeller-type fat-cats we normally think of when the estate tax comes to mind.

If estate taxes are not effective for collecting revenue, they are effective for destroying small businesses and capital. While many believe only the super-rich face estate tax hits, the fact is, 90 percent of all estate tax returns filed are for estates with less than $2.5 million of total assets. And while this may seem like a lot of money, the majority of the valuation comes from the assessment of a single, small family business built by a patriarch or matriarch over a period of decades.

The sad reality is that estate taxes destroy many of these businesses simply because the family does not have the cash available to pay the estate taxes. And the fact that so many are audited only exacerbates the situation, costing many thousands of dollars in legal and accounting fees on top of the IRS' traditional assessments of tax, interest and penalties. In a 1996 report by The Center for the Study of Taxation, we learn that,
More than 70 percent of family businesses don't survive the second generation and 87 percent don't make it to the third generation. Many of these businesses fail because the owners' estates don't have the liquidity to pay the estate tax due.

Do not dismiss the "family business" as an unorganized, economically insignificant gesture emanating from a garage or basement. The fact is, 78 percent of all new jobs created in the United States between 1977 and 1990 were created by family businesses. More than 90 percent of all American businesses are family businesses. They generate "49 percent of our GDP and employ 59 percent of the US work force."

When a business collapses because the family does not have the cash to pay the estate tax, jobs and productivity die with it. For this reason, we all should be concerned about the continuation of the estate tax. Many of our jobs depend upon the continuity of the family business environment after the death of the owner. You do not have to be rich to be adversely affected by the estate tax. Your very job may be destroyed if the owner of the business you work for dies and his estate is unable to raise the cash to pay the tax. Based upon the survey of 2,500 family businesses conducted by The Center for the Study of Taxation,

> Only 26 percent of the family business owners participating in *The Tax Impact Study* said that their estates would have sufficient liquid assets to pay estate taxes if their heirs were to inherit the business today. Of the remaining business owners surveyed, 30 percent responded that their families would have to sell all or part of the business to pay the tax, and 41 percent said they'd have to borrow money using at least a portion of the business as collateral. In total, 71 percent would have to liquidate, sell or leverage a portion of the business to pay the required estate taxes.

As you can plainly see, the estate tax is directly responsible for the destruction of jobs, the destruction of capital, reducing the standard of living for succeeding generations and reducing productivity for all of America.

Upon establishing the Constitution in our newly formed republic, the Founders quickly set about the task of *disestablishing* many of the English practices standing in the way of liberty. Among them were the severe limitations on owning property and passing

estates. First, they eliminated the encumbrance upon property known as "quitrent." This was a periodic payment on land owed to the king. After severing ties with England, Americans held their property in "fee simple." Fee simple ownership is where one enjoys the entire property, "with unconditional power of disposition during his life, and descending to his heirs and legal representatives upon his death intestate."

Following the lead of Thomas Jefferson and Virginia, the states also rapidly eliminated both the practices of "primogeniture" and "entail." Primogeniture was the practice of vesting the entire estate in the hands of the first born male child. No other member of the family was entitled to any distribution. Entail prevented the estate from ever leaving the family. These policies placed serious restrictions on the right of property and the disposition of one's estate. They were "vigorously opposed" by Jefferson. By eliminating them in Virginia in 1785, he set about to create "a system by which every fibre would be eradicated of ancient or future aristocracy, and a foundation laid for a government truly republican."

The idea of limiting one's property rights or redistributing his wealth against his wishes was wholly abhorrent to the Founders. Because the estate tax is in patent violation of the constitutional purpose of taxation, because it is a social planning tool designed to destroy capital under a Marxist-type graduated tax plan, and because the destruction of businesses and capital mean the destruction of jobs and growth, we should abolish estate and gift taxes in their entirety. More than any other form of taxation, estate and gift taxes represent nothing more than outright government theft intended to make you die poor.

Capital Gains Taxes Reduce Your Standard of Living

The arguments in favor of retaining capital gains taxes are much the same as those for the estate and gift tax. They focus more upon the socialist notion of redistributing wealth than they do their revenue import. This is because the capital gains tax, like the estate and gift tax, has little impact on the overall federal revenue picture. In 1994, total federal receipts from all sources were $1.259 trillion. Revenue from the capital gains tax amounted to approximately $36.32 billion, or less than 3 percent of the total. The capital gains tax has never been responsible for a significantly larger share of federal revenue in a given year.

On the other hand, capital itself plays a critical role in the development and growth of business, and concomitantly, jobs and wages. The three cornerstones of sustained economic growth are savings, investment and productivity. Savings provide the source of funds (capital) used by business to make investments. Businesses invest capital in such things as machinery, raw materials, facilities and labor to produce goods and services. Capital investments increase productivity which, in turn, leads to more jobs, higher real wages and improved working conditions.

The capital gains tax is pointed squarely at capital, one of the essential ingredients needed for economic growth. What you tax, you get less of. When you tax the return on

invested capital, you *discourage* investment. A tax on capital means there must naturally be less capital available to business. What is available is therefore *more expensive*. This is reflected in higher interest rates that businesses must pay to finance expansion.

Economist Dr. James L. Payne draws a succinct correlation between capital gains taxes, available capital, the growth of business and ultimately, the creation of jobs. He writes,

> [Capital gains tax discourages individuals from investing in new business opportunities. For example, when higher tax rates for capital gains were adopted in 1976, the flow of capital to new ventures practically stopped. Whereas in 1968 more than 300 new high-technology companies were founded, in 1976 none were formed.
>
> Prior to 1986, the law allowed a substantial exclusion from income of long term capital gain. The 1986 Tax Reform Act removed it. At present, long term capital gains are taxed as ordinary income, but are capped at 28 percent. This fact caused much capital to be invested elsewhere. In most cases, the capital found its way into tax exempt government bonds. Why invest in a fully taxable transaction when there is a *tax exempt* investment vehicle available? This kind of negative tax treatment is what economics call a "disincentive."

As I stated earlier, all taxes cause some amount of distortion in the market. The distortion created by the capital gains taxes is to redirect investment capital to other investments which, but for the tax consequences, would otherwise not be as attractive. The capital gains tax is a disincentive to invest in start-up companies or existing businesses.

However, investment in government bonds only exacerbates a negative situation. Capital invested in private industry leads to the *production* of goods and services and ultimately, a rising standard of living. But capital invested in government leads to the production of *nothing*. Government does not produce; it only consumes. Dr. Payne suggests that for every dollar raised through capital gains taxes, it costs the economy $1.23 in lost production because of the disincentives.

The flow of capital away from business means only one thing. In order to attract investments, businesses must "bid up" the price they are willing to pay for capital. The price of capital is *interest*, and rising interest rates mean reduced profit for investors, further disincentive to invest. Rising rates also mean reduced wages for workers and increased cost to consumers, all of which add up to a reduced standard of living.

The combination of these factors has a profound *negative* impact on capital investment. In 1992, our rate of domestic investment was just 2 percent of net national product. Between 1980 and 1990, the investment rate averaged 5.6 percent annually. However, during the 1950s, 1960s and 1970s, the investment rate averaged 8.2, 7.9 and 7.9 percent respectively. Since 1992, the picture is not much better. We are still at

dangerously low levels of domestic investment as compared with earlier decades. There is no telling just how many successful businesses do not exist because their creators were starved of capital in the formative stages. How many could have grown to the likes of Microsoft we will never know.

It is not just the tax on capital gain that dries up capital investments. The tax law clobbers investment in two additional ways, each of which play a role in discouraging investment. The first way is through limited depreciation of capital assets and the second is through limited ability to deduct capital losses.

Let us first discuss depreciation. "Depreciation" and "depletion" are the legal mechanisms under which investors recapture their capital investment. Our law does not tax the return of invested capital (it taxes only the profit), but it greatly limits the investor’s ability to recover his investment. Under the Tax Reform Act of 1986, depreciation schedules were greatly modified, extending recapture periods for years in some cases, decades in others. In addition, the Alternative Minimum Tax (AMT) was greatly strengthened. The AMT was specifically designed to prevent companies from eliminating their income tax liability through capital investment.

This has the direct negative effect of discouraging capital investment. Investment by its very nature is speculative. Profits are not assured. Therefore, venture capitalists often look for a quick recapture period in order to minimize their risk. When the tax law pushes the recapture period out several years, or even decades, this creates substantial disincentive to invest.

The lack of investment capital is especially hard on upstart businesses with no track record of profits. Existing businesses can somewhat offset the prolonged recapture period by paying current income to investors (termed "dividends") on the profits generated. But if there are no immediate profits, as is often the case with start up businesses, the investor’s ability to recapture his capital is greatly limited.

The Clinton administration’s 1993 tax changes made an already difficult situation even worse. Under prior law, nonresidential real estate could be depreciated over 31.5 years. A company which invested in buildings was limited to recovering its capital investment over that lengthy period. However, under 1993 amendments, the recovery period was pushed to thirty-nine years. There is now even less incentive for business to invest in manufacturing or office facilities.

Let me illustrate just one way these recovery periods adversely affect the whole economy. According to the National Association of Home Builders (NAHB), construction starts of multi-family housing dropped from 669,000 units in 1985, to 372,000 units in 1989. Note that prior to 1986, real estate projects such as multi-family housing received favorable depreciation and capital gains tax treatment. Through the 1986 Tax Reform Act, both these advantages were *eliminated*. The multi-family housing industry went south with the tax incentives.

As rental property becomes more scarce, that which is available is naturally more expensive. According to NAHB, the hardest hit segment of the housing industry is low and moderate-income rental housing. The number of rental units available for less than $350 per month "declined by 75 percent from the first half of 1986 to the first half of 1989." With nearly all incentives to invest in low and moderate-income housing projects removed from the tax law, actual investments in such property virtually dried up. Those who suffer are low- to moderate income families. They must either pay more than they can afford for housing or they cannot find housing at all.

Let us now discuss capital losses. Investment is discouraged through the limited ability to deduct one's capital losses. A capital loss deduction is limited to just $3,000 per year. Thus, if an investor loses $100,000 in a failed business, he is limited to deducting that loss at the rate of $3,000 per year over a period of thirty-four years.

As a result, investors who take the risk of capitalizing business get no assistance from the tax law if the investment fails. However, if the investment succeeds, they are pounded in the various ways outlined above. In light of all this, the only logical remaining question is, why would any sensible person bother making any investment at all? Increasingly, the answer seems to be a growing unwillingness to do so.

Attacks on capital do not affect only the so-called "rich investor." The fact is, when businesses are unable to update facilities, equipment, etc., productivity drops. When that happens, wages paid to workers drop as well. It is not surprising, therefore, that we have seen a marked decrease in the growth of real wages. Lawrence Kotlikoff, professor of economics at Boston University, confirms that the growth of total compensation to employees, consisting of wages and benefits, grew by less than "3 percent per year" each year since 1975. In contrast, compensation grew at the rate of *35 percent* each year for the fifteen years preceding 1975. This is what we now call "middle class stagnation." We have our tax laws to thank for it.

The two greatest myths about capital gains taxes are (1) they are paid only by "rich" people and, (2) cutting capital gains taxes benefits only "rich" people. In fact, neither declaration could be further from the truth. Social planners often cite statistics suggesting 60 percent of the benefits of capital gains tax reduction are claimed by citizens with incomes in excess of $200,000. "Why," they ask, "should we grant tax relief to citizens with more than $200,000 in annual income?" That would be nothing more than granting tax relief to the richest 1 percent of the population at the expense of the middle class.

What they do not tell you, however, is that a careful analysis of the numbers tells a much different story. The reality is, the total income of those claiming a capital gain exceeds $200,000 only *because the income includes* the capital gain in question. Capital gain income is *combined* with annually recurring income, such as wages, business income, etc., to arrive at total income.

However, when the transaction creating the capital gain is *removed* from the income computation, a much different picture emerges. When you consider ordinary, annual recurring income--such as wage income--we find that 65 percent of citizens paying capital gains taxes earn annual incomes of less than $50,000. Over 25 percent of citizens paying capital gains taxes earn less that $20,000 annually. On the other hand, just 5 percent of citizens paying capital gains tax have annual incomes above $200,000. It is clear, when we look at the question honestly, it is the average, middle income American who is paying capital gains taxes, not just rich folks.

How is it that middle class Americans pay so much of the capital gains taxes? It happens for two reasons. First, middle class Americans are often forced to liquidate capital assets to provide financial relief. Let me provide just one very common example. A citizen living in southern California is laid off from his job in the aerospace industry. To find work, he must move to the mid-west. He sells his home in California and buys a similar property in his new state. But the home in California was much more expensive than the new home. Because he does not reinvest all the proceeds from the sale of the California home, he faces a capital gains tax on the difference. Why did he not purchase a new home of equal value? Simple. He could not afford the payment. His new job pays much less than the lucrative job in the aerospace industry.

This pattern is not hypothetical. It is repeated over and over throughout the nation. And there are several variations on the theme. What it evidences is rich folks *are not paying* capital gains taxes. *Middle class Americans* pay the tax. Moore writes,

In fact, 1992 Internal Revenue Service data indicate that 56 percent of all returns reporting capital gains were from households with incomes below $50,000. Eighty-three percent, or 7 million returns, were for households with incomes below $100,000.

Ironically, middle class Americans end up stuck with the tax precisely because they are not rich enough to avoid it! That is right. Rich people have the power to avoid capital gains taxes, and they do. This is because the capital gains tax is, at least in some sense of the word, a *voluntary* tax.

This brings me to the second reason why middle class Americans pay the tax. It is based upon an economic reality. The reality is, what you tax you get less of. When you tax capital gain income, you get less capital gain income. Congressional Budget Office (CBO) studies show that when the capital gains tax was over 40 percent in the mid-1970s, citizens in the top 1 percent of income earners accounted for just 33 percent of all taxable capital gains. However, when the capital gains rate was cut to 20 percent in 1981, the top one percent of income earners reported 55 percent of all taxable capital gains.

Why does this happen? When capital gains tax rates are high, rich folks simply do not sell their appreciated capital assets. They hold them. This is a phenomenon known as the "lock-in effect." Capital becomes locked in assets which people do not liquidate because they do not wish to pay the high capital gains tax.

Rich people, unlike their middle income neighbors, have a choice. They do not need the money to feed their families so they simply do not take profit from the asset. They bide their time. They know from history that sooner or later another tax law change will come down the pike. When the law is more favorable to the transaction, then they sell--but only then.

What happens as a result of this is a substantial drop in capital gain revenue. Moore observes,

> Over the past 30 years a consistent pattern has emerged: every time the capital gains tax has been cut, capital gains tax revenues have risen. Every time the capital gains tax has been raised, capital gains tax revenues have fallen.

To illustrate, revenue from capital gains went from $41 billion in 1987 to $26 billion in 1991. This is despite the fact the capital gains tax rate went from 20 percent to 28 percent during the same period. As I am fond of saying, you can tax the pants off a person when he engages in a particular transaction, but you cannot *force* him to engage in the transaction in the first place. When capital gains tax rates are high, those with a choice simply do not engage in taxable capital gains taxable transactions. Those who end up paying the tax are those who have no choice. More often than not, those people are middle income Americans.

In order to make a garden grow, you must have good soil, adequate water and proper fertilizer. Reduce one of these elements and you negatively impact the harvest. Eliminate one of these elements and you eliminate your crop. An economy is no different. To make it grow you need savings, which is not unlike soil. You need capital, which is the economy's water. And you need productivity which acts as fertilizer. When these elements are taxed, you get less of them. This is basic economic truth.

With fewer available essential elements, the economy, like the garden, produces fewer crops. To make the nation's economic garden grow, we must free the essential elements from the burdens of the income tax. Failure to do so means that your standard of living is reduced and federal tax policy takes you one step closer to dying broke.

The Social Security Program -- Washington's Financial Black Hole

Social Security began as a modest program to provide "supplemental" retirement income to the nation's elderly. Since then, the program has grow in scope and reach. New benefits have been added expanding the number of beneficiaries well beyond those envisioned by the program's architects. Moreover, medical assistance programs, Medicare and Medicaid, put the federal government into the business of providing health care assistance to the poor and aged.

These programs are responsible for pushing the federal budget to the breaking point. In 1994, expenditures for these programs alone amounted to more than $624 billion. This

represents nearly 43 percent of federal spending for 1994, but more than 49 percent of total federal revenue.

Virtually one-half of every dollar you pay in federal taxes goes for Social Security and health insurance programs. And you should look for the percentage to rise dramatically in the near future if significant systemic changes are not made--*and soon*. In January, 1995, the Bipartisan Commission on Entitlement and Tax Reform issued its final report to the president. In it, several proposals for reforming the Social Security, Medicare and Medicaid programs were discussed. But the most chilling aspect of the report was the Commission's findings regarding the projected growth in the cost of these programs versus available revenue to fund them. Consider this,

> The gap between Federal spending and revenues is growing rapidly. Absent policy changes, entitlement spending and interest on the national debt will consume almost all Federal revenues in 2010. In 2030, Federal revenues will not even cover entitlement spending.

I hope you grasp the significance of this. The uncontrolled growth of these programs, coupled with the changing demographics of the US population, means if these programs are not fundamentally altered, by the year 2030, they will consume 100 percent of federal revenue. In that case, there will not be *one dollar* left to pay interest on the national debt, to pay the salary of one soldier, to purchase one missile, or to pay the salary of one federal employee. This staggering reality caused the Commission to plainly state that, "The current spending trend is unsustainable."

Why are Social Security and other "entitlement" programs heading for a financial brick wall? The answers are found in several areas. First, the program was actuarially unsound to begin with. In the early years of the program, those receiving benefits obtained far more from the system than they ever put in. This was not a problem in 1935 when the system began. At that time, there were fifty workers paying into the system for every one drawing benefits.

As Congress expanded programs, benefits and granted cost of living adjustments (COLAs) thereby increasing the monthly benefit to those already drawing payments, the system began to bog down. By 1950, there were about twenty workers paying in for every one drawing out. In 1990, there were about five paying in for each one drawing out. The Commission projects a steady decline from there, to the point where in 2030, there will be just three workers paying in for each one drawing benefits. You do not have to be an actuary to know this cannot work.

Next, let us add the fact that Americans are living longer now than when Social Security was created in 1935. At that time, the life expectancy of a person at birth was 61.4 years. By 1995, it was 75.8 years and is expected to grow. In 1935, a person was expected to live just 12.6 years after reaching the age of sixty-five. By 1995, a person was expected to live 17.5 years after reaching the age of sixty-five.

Third, the percentage of the population over the age of sixty-five has risen steadily and will continue to rise. For example, in the year 1900, fewer than 5 percent of the population was in excess of sixty-five years old. By 1940, after Social Security became operational, the number had grown, but just slightly, to about 6 percent. However, by the year 2000, more than 13 percent of our population will be over the age of sixty-five. In 1995, there were 24.1 million Americans over age seventy and by 2030, when the baby boomers begin to retire, there will be almost 48 million over age seventy, a doubling of the number.

Nobody anticipated these changes in 1935. But even if they had, the system was not established on the same sound actuarial footing as, say, a standard annuity contract offered by a garden variety life insurance company. As a result, there is no way for the system to accommodate these radical demographic changes.

Historically, the rising demand for benefits under the various "entitlement" programs has led to higher and higher taxes. The Social Security and health care programs are paid for through payroll taxes. These are flat tax assessments on wage and self-employment income that most citizens never see. Like income taxes, Social Security taxes are taken right from your pay. Unlike income taxes, however, you never file a return to report Social Security taxes. You perform no calculation of your burden. And you claim no deductions, exemptions or credits against the tax.

As a result, most citizens are wholly ignorant of the fact that they *pay more* in Social Security taxes than they do in income taxes. This is true despite the fact that Social Security taxes are assessed at 7.65 percent of wages, exactly one-half that of the *lowest* income tax bracket. (The self-employed face a Social Security tax burden of 15.3 percent of net business profit. The tax is not reduced by personal exemptions or itemized deductions.)

If the Social Security program is to have any hope of ever making good on the promises politicians have made, staggering increases in these already high tax rates must occur. In fact, while the Bipartisan Commission did not reach a consensus on how to "save" Social Security, all but one of the five separate proposals for reform involve raising taxes to fund benefits for future retirees. The reality, however, is that citizens are already taxed to the breaking point. To raise payroll taxes to the extent necessary to "save" the system will break the backs of those currently struggling to feed their families. Indeed, the Commission itself points out that the cost of both Social Security and Medicare will rise 150 to 300 percent as a share of worker pay if structural changes are not made. The current load on workers is 15.3 percent, which is the combination of the tax taken directly from your wages, plus the matching liability your employer must pay on your salary. In an economic sense, that is taxed to you because if your employer did not have the burden, the amount he pays in taxes would be available to pay higher salaries. If those taxes grow to 61.8 percent, as the "Official High-Cost Projection" suggests, and your federal and state income and other taxes remain just static, you will effectively have *no money* left to pay your personal living expenses.

The present liabilities of Social Security, Medicare, etc., are $17.4 trillion. Of those, $14.4 trillion are *unfunded*. The assets of the program, including buildings and equipment, total just $2.4 trillion. Now, you tell me, is there *any way* to pay the benefits? The money is just not there--period. The Commission repeatedly refers to the benefits package as nothing but "unsustainable promises." By the year 2029, the Commission estimates that the Social Security "trust fund" will be exhausted.

The worst part of all is the Social Security program is premised upon a lie. When the program was sold to the public in the 1930s, Americans were convinced that Washington created a "trust fund" for future retirees. The concept seemed reasonable enough to the otherwise conservative citizens of the time. Washington would take the funds paid through Social Security "contributions," invest them in some safe and secure manner, then pay them to those same citizens when they retire.

In fact, you can contact the Social Security Administration today and ask for an earnings statement of your Social Security "trust account." It will send you an official statement showing all your direct "contributions," matching employer "contributions" and interest "accumulations." After reviewing it, you might say to yourself, "Wow, I have built up quite a nest egg." There is only one problem. There is absolutely no money--*not a dime*--in your "trust account." In fact, there is not even a "trust account" anywhere in your name.

From the first, the Social Security program was designed to be a "pay as you go" system. That is, the money you pay into Social Security today is immediately redistributed to current beneficiaries. You do not make "contributions" to a "trust account" held in your name. Rather, you pay an additional *income tax* measured by wages or business profit that is paid into the Treasury's general fund. Let us examine the Internal Revenue code for proof of that assertion.

Subtitle C of the tax code applies to employment taxes. Section 3101, the first section within that subtitle, addresses "old age, survivors, and disability insurance," the heart and sole of the Social Security program. Section 3101(a) provides, in part, as follows,

In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages. . . [The statute goes to detail the rate of tax imposed.]

Section 3101(b) uses precisely the same language to impose the tax for "hospital insurance," the Medicare and Medicaid component.

Section 3102 states, in part,

The tax imposed by section 3101 [the Social Security and the hospital tax] shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid.* * *

Hence, we see plainly that what is taken from your check in the form of Social Security "contributions" are not contributions at all. Rather, they are nothing more than additional income taxes paid to the US Treasury's general fund and spent by Congress. In his book, *The Big Lie*, A. Haeworth Robertson, former chief actuary of the Social Security Administration, describes the funding process this way,

[C]urrent workers pay taxes that are used to pay benefits to retired workers and other beneficiaries. This is in contrast to advance funding methods used under most employer-sponsored pension plans, or when an individual saves for his own retirement. When Social Security collects more than enough to pay benefits in a given year, *the excess is spent by the government*.

But what of all the "surpluses" that have been paid into the Social Security system over the past many years? When the system was faced with the possibility of bankruptcy in the 1980s, Congress passed legislation designed to make Social Security healthy and viable well into the twenty-first century. In both 1982 and 1983, massive tax increases were pointed squarely at Social Security. The 1983 Social Security amendments increased both the rate of tax and the wage ceiling to which it applies. You may have noticed that each year, Social Security taxes apply to a higher level of wages.

In 1984, these huge tax increases began to create surpluses on the books of the Social Security Administration. But Congress could not keep it hands off the money. So rather than leave the money in interest bearing accounts or otherwise invest it, Congress began appropriating the funds to make it look as though it were running smaller annual deficits.

For example, in 1994 alone there was a surplus of $95.301 billion on the accounts of all federal trust funds, Social Security being responsible for the lion's share. The actual operating deficit of the federal government in 1994 was $298.672 billion. However, the government used *every dime* of the trust fund surplus to pay down the deficit. That is, the money was used to pay the government's general operating costs. It therefore reported its deficit at $203.370 billion. The difference is exactly equal to the trust fund revenue. Since this practice began in 1984, Congress has tapped every dime of the "trust fund surplus" created by the tax increases, an amount now well in excess of $500 billion.

When the money is lifted by Congress from the "trust funds," the federal government issues an interest-bearing bond to the account equal to the amount taken. However, the bonds are nothing more than accounting sleight of hand. They are not like traditional bonds which are sold to the public in exchange for cash. The bonds held by the Social Security system cannot be sold to the public. They are IOUs of the same character you would place in your own cookie jar after helping yourself to $20. Robertson explains the process,

The government pays interest on the bonds by issuing still more bonds to the trust funds. In future years when then-current Social Security taxes are inadequate to pay benefits, the bonds will be paid off, or redeemed, and the proceeds will be used to make benefit payments.

That seems simple enough. But the question any reasonably responsible person should ask is, where will government get the money to pay off the bonds when it needs the cash? The only answer can be that it *must* raise taxes on the current working generation to pay benefits to the retired. And when it needs to pay the benefits of that generation, it must again raise taxes on the working generation, and so on, until the system simply collapses due to one generation's inability (or unwillingness) to pay the previous generation's benefits.

In the real world, such an arrangement is known as a chain-letter or Ponzi scheme. Both are immoral and illegal. If any private citizen did this with the retirement funds of his employees, he would be jailed for fraud--and rightfully so. Why do we allow the government to engage in the practice?

The Social Security system has reduced our standard of living in two very important ways. First, it has induced us to stop saving on our own. Most people, especially older Americans, came to believe--because they were led to believe--that Social Security would "be there for them" when they retired. Why save on your own when the government is taking money from your pay to fund your retirement? As a result, our national savings rate is hovering at an anemic 2 percent level. The relationship of savings and investment to business growth, jobs and wages was discussed earlier. When the rate drops, everybody is hurt.

Perhaps more importantly, however, is the fact that lies and false "security" promoted by the system have prevented many Americans from becoming financially independent in their retirement years. If Americans were allowed to faithfully invest in their own retirement, most would have substantial nest eggs lined with real wealth as opposed to the "unsustainable promises" offered by Social Security. Let me illustrate.

Suppose a young worker began saving just $2,000 per year at age twenty. If he saved at that rate for just ten years, he would have a total of $20,000 cash invested. If he left that money sit until age sixty-five, what do you suppose would be the cash value of his account? At a very modest 5 percent annual rate of growth, he would have $145,694 cash at age sixty-five. If the account grew at the more moderate annual rate of 7 percent, he would have $282,000 at age sixty-five. If his account grew just a bit aggressively at 10 percent annually, he would have *$742,270* from his initial investment of $20,000.

Now suppose he were faithful the entire forty-five years of his working life and invested $2,000 per year. At age sixty-five, he would have invested a total of $90,000. But his account would be worth $335,370 at 5 percent, $611,503 at 7 percent, and an unbelievable $1,581,590 at 10 percent! This is cash money he could spend, use to live on in his golden years, pass on to his children or grandchildren, fund college or trade school for children or grandchildren, provide funding for a new or existing business, pay medical bills, etc. In short, he would simply not need government assistance.

Now let us contrast that with what happens under Social Security. If our young man earned the average income of about $28,000 annually, he would have 7.65 percent taken from his check each year for Social Security and hospital "insurance." (If self-employed, the amount is twice that.) That is an annual "contribution" of $2,142, slightly more than the annual savings in our earlier example. But his employer must *match* his "contribution," so the actual annual "investment" is $4,284. Furthermore, under Social Security laws, our young worker does not have the option of dropping out after ten years. He must make the "contributions" during his entire working life. Assuming his salary never increases (which is impossible) and taxes never go up (equally impossible), he would "invest" a total of $192,780 over the forty-five years of his working life. One-half of the money comes directly out of his pocket, the other half comes from the "contributions" of his employer.

Upon retirement, what is the cash value of this account, given its projected growth over forty-five years? The cash value is *zero*--NOTHING--*squat!* The Social Security account is not an asset you can tap to use as you see fit. It is nothing more than a monthly annuity payment, *but you must live to the next month to get it*. If, for example, you die within one month of retiring, *you get nothing*. What's more, you estate gets nothing which pass to your heirs.

Not only is the account worthless, but you have no legal claim to even so much as the benefits you were promised when you began work. Social Security *is not* a contractual obligation enforceable by you against the government. Congress has in the past and will continue to change the benefits package and you have no personal say in the matter. For example, the retirement age was changed as part of the 1983 amendments. If you were born between 1943 and 1954, you must be *sixty-six* to draw full benefits from Social Security. If you were born in 1960 or later, you must be *sixty-seven* to retire with full benefits. Furthermore, Congress may decide to tax the benefits, which is just another way of cutting them without calling it a cut. The 1993 Clinton tax act did just that, providing that up to 85 percent of Social Security benefits are included in taxable income under certain conditions.

Unless the system is radically changed, the Social Security program will make you die poor. If current working Americans are to have the opportunity to become financially independent, even wealthy, in their retirement years, we must give them the flexibility to opt out of the current system's immoral pyramid of "unsustainable promises." We must privatize our nation's old age pension system and give people the choice of providing for their families in the manner that best suits them. It is clear from the evidence amassed over the many decades of Social Security's existence that the government cannot do it.

Renewing the Promise of Prosperity for All

Since 1995, three congressional commissions have issued reports addressing federal tax policy, our system of taxation and our enforcement and administrative agency. The commissions are

The Bipartisan Commission on Entitlements and Tax Reform,

The National Commission on Economic Growth and Tax Reform, and

The National Commission on Restructuring the Internal Revenue Service.

Taken together, even without the empirical evidence cited throughout this text, it is quite clear to even the most casual observer that our tax system is a failure. It is built upon an unsound foundation that is crumbling and cannot be saved. Reasonable people must accept that it is time to abandon our failed experiment with the income tax and seek a suitable alternative.

When the National Commission on Economic Growth and Tax Reform issued its report in January of 1996, it concluded that our present system is unworkable. Among other things, it destroys capital, discourages savings and investment and punishes productivity. These represent the antithesis of economic growth and precisely the *opposite* conditions one would expect to find in a free society. While the Commission did not specifically endorse a particular replacement for our current system, it did reach consensus on the six basic elements of such a system. They are:

Economic Growth--"The engine of opportunity and prosperity, can only be unleashed by a tax code that encourages initiative, hard work and saving."

Fairness--"Treating all citizens equally."

Simplicity--"So that anyone can figure it out."

Neutrality--"Because the tax code should not pick winners or losers, or tax savings more heavily than consumption."

Visibility--"So that everyone gets an honest accounting of government's cost."

Stability--"So that people can plan for their futures."

All who honestly consider the facts agree that our present system contains none of these elements. The system discourages saving, investment and hard work, the three cornerstones of *economic growth*. In the ways I have detailed throughout this report and in ways we have not discussed, the current tax system is responsible for stagnating wages, productivity and personal economic growth. The system itself stands in the way of lower and middle income citizens making their way up the economic ladder of success.

The overriding consensus among the public is that the system is *unfair*, giving breaks and special favors to those in particular income brackets or social classes.

With 17,000 pages of law and regulation, it is terribly *difficult* to comply with and administer. Even our simplest tax return, the 1040 EZ has more than thirty pages of instructions to accompany it. Even though nearly 70 percent of all citizens file the short form each year, slightly in excess of 50 percent seek professional help in the preparation process.

I explained earlier in this treatise how the tax code is used to favor one group of citizens or businesses over another. In this way, the system is not neutral, but rather, a *partisan activist* in the economy. The government determines who shall win or not win in the race for success and prosperity. The under-girding principle of our constitutional republic is

that all men stand equal before the law. The government should not, and for the first century of our republic's existence, did not, cast favor or disfavor upon citizens based on their economic standing or social class. The only legitimate purpose of the tax law is to raise revenue needed to carry out the legitimate, clearly defined constitutional functions of government.

Most of our current tax burden is *hidden* from view. As a result, people have no idea of their true tax load. Two classic examples are Social Security taxes withheld from your pay and the matching funds paid by your employer. Since you file no return with regard to these taxes, you likely have no idea that you pay more in Social Security taxes than you do in income taxes. Furthermore, most citizens do not realize the matching funds paid by the employer are in fact payroll dollars which otherwise would go to fund wage increases. Even the income tax is hidden from view, especially the income tax paid by businesses. Every product and service carries a cost reflecting the business tax burden. This cost artificially drives up the cost of living, which in turn reduces your standard of living.

Our tax system is incredibly *unstable* and has been for nearly fifty years. The law was changed more than one hundred times during the decade of the 1980s alone. In 1996, Congress passed four major legislative packages which changed more than 750 code sections. In such an environment, it is impossible to plan for the future. A classic example is the Individual Retirement Account (IRA). Millions have established IRAs to take advantage of the deduction for saving as well as tax-deferred growth of the funds. However, rules with regard to IRAs change repeatedly. What's more, nobody knows what the tax laws will be when it comes time to withdraw funds upon retirement. Will rates be low or high? Will withdrawals be penalized or not? Because these rules are constantly in flux, it is impossible to adequately plan for the future.

I am persuaded that the largest single problem with the income tax is the enforcement mechanism. The Internal Revenue Service is the nation's largest, most powerful police force. With an annual budget of nearly $8 billion and some 115,000 employees, it is five times the size of the FBI. Furthermore, virtually all of the constitutional protections that apply to a citizen in the normal course of his affairs *do not* apply to the IRS.

Not only is the IRS largely free of the constitutional restraints placed on all other law enforcement agencies, it routinely ignores even its own rules and regulations while enforcing the tax code. In my books *How to Fire the IRS* and *IRS Taxes and the Beast*, I thoroughly document abuses by the IRS in virtually every kind of tax case. Many such abuses involve what may be termed "minor" violations such as improper penalty assessments involving just a few dollars. Often, however, they are abuses of great magnitude having the capacity to financially destroy a citizen.

In its report, the National Commission on Restructuring the Internal Revenue Service identified many of the current problems with the IRS. It made recommendations on procedural and law changes to address some of them. However, as I said in meetings with the commission, the system is built on an unsound foundation. As such, it matters

little how often you fill nail holes or paint walls. You will never fix the problem. The only way to fix it is to bulldoze the system and start over.

The Internal Revenue Service is the largest single threat to liberty this nation has faced in the past fifty years. Without question, it represents the most significant domestic threat to liberty we have seen since the era human slavery. I therefore am adamant that any tax reform proposal *must* dismantle the IRS. Anything short will not free the American people from the hassle, anxiety and heartache of dealing with tax collection. No federal agency should have the power of financial life and death over the citizens of a free society.

The Flat Tax Cannot Fix Our Problem

Of late, much attention has been given to the so-called flat tax as a legitimate alternative to the present income tax system. However, it most certainly *will not* achieve the goals set forth above. The most compelling argument against the flat tax is that it will not eliminate the IRS. A flat tax is still an income tax. As such, citizens remain required to file income tax returns annually. This means they must continue to make and keep records, prepare and file returns, and remit revenue to the IRS.

And while it is true that a flat tax can make life easier *vis-à-vis* preparing returns, life will get no easier for those who cannot pay the taxes they owe. Each year, millions face IRS sponsored wage and bank levies, property seizures and tax liens. Enforced collection action has destroyed countless businesses, families and even lives as people are financially wiped out by the IRS. If we are to preserve the blessings of liberty to all citizens, we must eliminate the IRS.

That the flat tax cannot solve our tax problems is further evidenced by the fact that for all practical purposes, 70 percent of Americans are already on a *de facto* flat tax system. Seventy percent of Americans file the short form. Though they may not all be taxed at one rate (but most certainly pay in the 15 percent bracket), they do not struggle with complex forms each year and they do not claim complicated deductions. How will a flat tax help these people?

What's more, the flat tax cannot prevent IRS abuse, as its proponents claim. The reason is quite simple. A flat tax system requires an income tax return and income tax returns can be audited. Do not be misled into believing that flat tax returns cannot be audited by the IRS. They can be and are on a regular basis. My book, *IRS Taxes and the Beast* documents two important facts in this regard.

First, the largest segment of tax returns audited by the IRS are short forms claiming less than $25,000 of income. Virtually 40 percent of all returns audited fall into this category. What is there to audit?, you ask. The IRS audits the *income* claimed on the return. The agency believes that low income citizens are actually hiding income. That is why the audits concentrate on the income side of the ledger.

That brings me to the second fact regarding flat tax returns. The agency is in the midst of conducting what it calls "economic reality audits." These audits are premised on the notion that all citizens across the board hide income. In fact, the agency believes that *all* self-employed persons underreport income, some by nearly 80 percent. This is driving the agency to focus more attention and resources on the income side of the ledger in all cases.

The economic reality audit is the single most invasive enforcement program the IRS has ever undertaken. It seeks to explore every aspect of your private life, including how you spend every dime you earn. The IRS wants to evaluate your home, furnishings, fixtures, clothing, jewelry, etc., to determine whether you appear to be living beyond your means. The invasive and oppressive economic reality audit was specifically designed for a flat tax system since such a system has no deductions to bog down the search for unreported income.

Now let us discuss businesses for a moment. Businesses will see no relief whatsoever under a flat tax system. Businesses are responsible to file over one billion information returns each year, reporting to the IRS all the money paid to workers, contractors, etc. This cannot change under a flat tax because it is still an *income* tax requiring the IRS to know all you earn and where and how you earn it. Even worse, four of every five dollars paid to the IRS are paid by businesses through wage withholding on its employees. This will not stop under a flat tax system. As a result, businesses will continue to face the daunting tasks of withholding funds from its workers, keeping records regarding both its payroll and tax deposits, filing five (not one--*five*) employment tax returns annually and last but perhaps most difficult, dealing with the IRS' constantly changing employment tax reporting and deposit rules. In fact, of the millions of penalties issued by the IRS annually, nearly 60 percent are assessed against businesses in connection with employment tax problems.

In short, the flat tax system does not cure the two largest problems we face under our current system. The first is the horror of an IRS that is out of control. Between abusive collection and outrageous economic reality audits, we must find a way to eliminate the "beast."

The second is the crippling cost of contending with the IRS each year. The compliance burden is responsible for hundreds of billions of lost production each year. Millions of Americans chase their tails annually in the desperate hope of complying with an ever-growing rat's nest of rules, regulations, procedures and instructions not even the IRS can figure out. If we are to truly simplify the system, we must eliminate these two incredible problems.

What Tax System Fits the Bill?

First and foremost, our new system must respect the constitutional requirements of a tax system envisioned by the Founders. Secondly, it must bear the six elements laid out

by the Commission on Tax Reform. And lastly, it must eliminate the Internal Revenue Service. Once in operation, the tax system, whatever it is, must be used solely and exclusively for the constitutional purpose of raising revenue to pay for the legitimate functions of government. Any use as a social tool to achieve an egalitarian utopia is *illegitimate, unconstitutional,* and leads only to complexity, confusion and resentment.

On the question of a proper tax system, Alexander Hamilton stated in *The Federalist* No. 35, "It might be demonstrated that the most productive system of finance will always be the least burdensome." What, therefore, is the least burdensome system? That is the one we must adopt.

Hamilton favored excise taxes as the primary means of raising revenue. An excise tax is one which attaches to a product upon production or sale. Classic examples are manufacturers' taxes on such products as cigarettes, gasoline and alcohol. At the retail level, the best example is the retail sales tax. Excise taxes are simple, fair and efficient. They do not favor one group of citizens or businesses over another. They do not penalize savings, investment and productivity.

To solve our nation's tax crisis, to free the American people from the crushing burden of our tax system and the horrors of the IRS, we must adopt a national retail sales tax to replace our entire graduated income tax system. In fact, I would replace all five of the major taxes that exist at the federal level with one national sales tax. Those five taxes are: 1) the personal income tax (of which the capital gains is a component), 2) the corporate income tax, 3) the social security tax, 4) the unemployment tax (which is part of businesses employment tax load) and 5) the estate and gift tax. These five taxes collect 98.5 percent of all federal revenue. That revenue can be provided through one national retail sales tax.

Of all the potential tax systems to consider, only the national retail sales tax meets all six of the criteria called for by the National Commission on Economic Growth and Tax Reform and my requirement that the IRS be dismantled. Let us examine them again, this time against the back drop of the national sales tax.

1. "Economic growth through incentives to work, save and invest." A national retail sales tax eliminates all disincentives to work, save and invest. Under a retail sales tax, one does not have to earn $1.50 to save $1. Rather, no tax attaches until the money is spent. As long as your money remains saved or invested, there is no tax burden whatsoever. This is precisely the opposite of the current tax code and why our national savings rate has dropped to dangerously low levels. What you tax you get less of. Tax savings and investment, get less savings and investment. Under a national retail sales tax, there is no penalty for saving money. There is no penalty for successful investing. There is no penalty for citizens who wish to work harder and earn more money to climb their way up the economic ladder.

One of the greatest benefits of a higher national savings rate is that the cost of capital--interest--becomes *less* expensive. All the responsible economic models computed on a

national sales tax show that long term interest rates drop by as much as two to three percentage points. For business it means less expensive expansion, retooling, inventory and operations. For individuals it means less expensive homes, autos and credit card payments. In turn, the economic growth of the nation increases and all citizens benefit.

2. "Fairness for all taxpayers." For well over the first one hundred years of our existence, the term "fairness" meant that every person stands equal before the law. The term "fairness" meant that no person is given special treatment because of his economic status or social standing. For the past five decades, however, the term "fairness" has been twisted to mean that somehow those who are more successful should be punished.

The income tax code is complicated because it has been used as the tool of social engineers to carry out the now transient notion of "fairness." The national sales tax would end tampering with the tax code. It would restore the proper role of taxation, i.e., to raise revenue to fund the legitimate functions of government, not to punish or favor one group of citizens over another.

The national sales tax is not "regressive" as suggested by many of its opponents. Rather, it is proportional as suggested by Hamilton. That means that all citizens pay the tax in proportion to their spending. Higher income people naturally pay more taxes because they spend more money. Lower income citizens pay less taxes because they spend less money. The "rich" do not avoid "their fair share" since their opulent, consumptive lifestyles necessarily lend themselves to higher taxation under a retail sales tax. Conversely, the parsimonious lifestyles of lower income citizens lend themselves to minimizing their tax burden.

To maintain the fairness of the system, the tax should apply to all goods and services across the board. Certain products or services should be not singled out for "exemption" from the tax. That only leads to a more complicated system as discussed below under point three. In fact, introducing exemptions only means the tax on all other items must be that much higher to make up the difference. For example, suppose medical care is exempted from sales tax. Since medical care constitutes about 14 percent of our economy, the tax on every thing else must be 14 percent higher to raise the same revenue.

When the *tax base* (the target of the tax) is spread as wide as possible, the tax rate (the amount of tax charged) can be reduced to the lowest possible level. This does two things. First, it reduces the financial burden each citizen must bear. Secondly, and perhaps more importantly, it keeps government’s hand out the market. What is exempt from taxation will naturally be a more desirable product. In that sense, government plays a significant role in determining winners and loses, a role which must cease. See point four below.

3. "Simplicity so that anyone can figure it out." Nothing could be easier than a retail sales tax. Just ask yourself which is easier to figure out--your state income tax or your

state sales tax. The sales tax is paid at the point of retail purchase of goods and services. For the vast majority of Americans, there are no forms to fill out, no records to keep, no accountants to pay, no IRS to contemplate, no audits, penalties or enforced collection to suffer through. After the tax is paid at the point of purchase, the case is closed as to that transaction.

It is in defense of simplicity that the tax should apply across the board, to all goods and services purchased at retail. The moment we introduce exemptions or various levels of taxation, we lose the virtue of simplicity. The door is opened for every special interest group to swarm Washington, pressuring Congress to grant favored treatment to its particular cause. What we end up with is what we have now: 17,000 pages of law and regulation nobody can understand, amended with nauseating regularity.

One of the reasons we have declining compliance with our current tax laws is because they are so complicated. In fact, former IRS Commissioner Shirley Peterson once told lawmakers that, "A good part of what we call non-compliance with the tax laws is caused by taxpayers' lack of understanding of what is required in the first place." There can be no lack of understanding with a sales tax and no accountant is needed to get us there. It is because the sales tax is so easy to comply with and is readily perceived as fair that sales tax cheating is *de minimus*.

4. "Neutrality that lets people and not government make choices." The government should not decide who wins and who loses in the game of life. Unless a person is actively depriving others of their property through force or by fraud, the government must leave that person free to pursue his lawful calling without hindrance. That is the essence of liberty. The sales tax does just this. It does not stand in the way of any one person's success. There is no penalty for saving, working harder, investing and making life better for yourself and your family. The sales tax restores the proper role of taxation. It takes away Washington's power to manipulate success and failure at its whim.

5. "Visibility to let people know the cost of government." Nothing is more visible than a sales tax. The tax is added to the product only at the point of purchase. It is not a hidden manufacturers' excise tax such as those on gasoline or alcohol. It is not a complicated and hidden value added tax, such as operates in many countries of western Europe. Rather, it is in plain view for all to see when they buy goods and services.

When taxes are hidden, it is easier for lawmakers to raise them. When consumers see rising prices, they are more inclined to blame "greedy" corporations than Washington. However, a visible tax such as the retail sales tax is more difficult to raise because consumers immediately feel the pinch and immediately know who is to blame. For this reason alone, the sales tax is much preferable to other forms of taxation. It puts pressure on Washington to control itself in an important new way.

6. "Stability so people can plan for their future." One of the worst parts of our tax system is the fact that our tax code is changed so often. Congress changed the law more than one hundred times during the decade of the 1980s alone. In 1996, four major tax acts changed more than 750 code sections. With such instability, it is nigh impossible for people to make long term financial plans. A visible tax is less conducive to such change, as is one which is simple to begin with. Therefore, the sales tax lends itself well to stability over the long term. How often are the rules and rates of your state sales tax changed?

On the other hand, it is the natural tendency of government to encroach upon liberty whenever possible. Therefore, it is fundamentally necessary to bind our lawmakers to a fixed rate of taxation to enforce a stable environment. Under such circumstances, government can realize revenue growth only when the economy grows. This is great incentive for government to keep its hands off the economy and allow the unseen hand to work the miracle of the market. As the market grows and government spending is brought under control--as it must be--we shall actually see a drop in the national sales tax rate. That in turn means even more prosperity for America's working class.

How the Sales Tax Should Operate

Now that we have examined the economics of the sales tax, let us examine its mechanics. Quite simply, the national retail sales tax can eliminate 100 percent of the current income and employment tax compliance burden *and the IRS*, if properly established. To accomplish this, we must eliminate both the personal and corporate income tax and all employment taxes. Some sales tax proposals intend to leave Social Security taxes in place. These plans miss the mark by a wide margin.

In the first place, by leaving employment taxes in place, we guarantee that businesses must continue to contend with: 1) five employment tax returns each year, 2) wage withholding for Social Security purposes, 3) filing over one billion information returns annually, and 4) the horrors of employment tax audits and enforced collection.

Secondly, there must continue to be a federal enforcement arm to collect these taxes. Surely, the IRS will remain in force, at least to some degree. If not, some other federal agency will rise from the ashes of the IRS to continue in its footsteps. Such enforcement agencies are both undesirable and unnecessary in a free society.

The most attractive alternative is to have the states responsible to collect just one national retail sales tax to fund all aspects of the federal government. Such a tax can stand in place of all five of the major taxes that exist at the federal level. Already, forty-five of our fifty states operate in whole or in part with a sales tax. That means the enforcement and administrative infrastructure is in place in exactly 90 percent of the places it must be. The states can collect the national sales tax piggy back with their own state sales tax at no additional cost to businesses and at no cost whatsoever to consumers. Retail businesses are already accustomed to complying with state reporting

and payment requirements. By adding a line to the state sales tax form to report federal revenue, we do not add to their burden.

More importantly, by making the states responsible for collecting the tax, we radically reduce the collection points of the tax. At present, federal taxes are collected from 210 *million* collection points. Those are the number of federal tax returns of all kinds filed each year. The system could not be any more inefficient. However, under a national sales tax administered by the states, the number of collection points drops to just *fifty*--the number of states in the union. That means the IRS is reduced from over 115,000 employees whose job it is to harass citizens, to about one hundred employees whose job it will be to monitor state agencies for compliance. We would see a similar drop in the agency's $8 billion annual budget. In one careful move, the American people are free of the IRS.

Objections to this plan are voiced on the premise that the states should not be required to fund the collection of taxes for the federal government. Indeed they should not. No burdens should be foisted upon the states by the federal government which are not founded upon a strict reading of the Constitution.

First of all, the federal government simply must bear the burden of collecting the tax. You can be quite sure, however, that such cost is well beneath the current $8 billion (and growing) annual cost of funding the IRS. Remember, 90 percent of the states already collect sales taxes and adding a line to their forms and sending a periodic check to the US Treasury imparts little if any additional cost.

Secondly, the Constitution requires that any "direct tax shall be apportioned among the several States." Historically, if the federal government determined that a given amount of money was needed for various functions, the cost was "apportioned," or meted out to the states, on the basis of population. That, and determining the number of representatives who sit the House, are the reasons the Constitution calls for a periodic census.

In that fashion, an equal amount is collected from each citizen. It was up to the states as to the specific way of raising the money. This was the Founders' way of keeping the federal government out of the pockets and lives of the American people. In sum, the federal government's act of passing the task of tax collection to the state's is not antithetical to the constitution.

It was the 16th Amendment which altered the apportionment requirement. This alone made it possible for the federal government to collect taxes directly from the American people on a one-on-one basis. Our current system, therefore, is clearly outside the constitutional model while a state-administered sales tax is well within its bounds given the apportionment clause.

Objections to the Sales Tax

The chief objections (other than those already discussed) to the sales tax are found on three fronts. The first is that the tax is "regressive" and as such, hurts the poor. The second is that since it eliminates deductions for mortgage interest and real estate taxes, it will crush the housing market. The third objection is that by eliminating deductions for charitable contributions, it will seriously hamper non-profit organizations in their quest for donations. Let us address each in turn.

Regressivity. We have already discussed some elements of this claim, but there is more. A sales tax is not regressive. As pointed out by Hamilton, the tax is *proportional*. In that sense, it is totally fair as it falls on all income levels in proportion to their income. The fact is, the sales tax creates an environment where the poor and middle class have a *better shot* at the American dream than under any other tax system, for several reasons.

First, by eliminating all wage withholding for income and Social Security taxes, the low income worker realizes an immediate 15 to 20 percent increase in his spendable income. If one works for $6 per hour, he *takes home* $6 per hour. He loses no wages to federal withholding. The worker now has more money to spend on needed goods and services.

Secondly, by eliminating the income tax, we eliminate the tremendous compliance burden. That burden is the cost to individuals and businesses of dealing with the IRS, keeping records, completing complicated forms, etc. Even the conservative estimates of this cost place it as high as $200 to $300 billion annually. Economist James Payne has fixed the cost at about 65 percent of the amount collected. If this is so, it is more in the range of $700 to $800 billion annually. That cost, including the cost of employment taxes, is built into the price of every product and service we buy. Eliminating the burden means the cost of goods and services can drop significantly, perhaps by as much as 15 percent. As a result, lower income individuals not only have more spendable income, but they use it to purchase less expensive goods and services.

Third, under a sales tax, all forms of saving are exempt from taxation. When one puts money into an IRA, CD, savings account or similar device, he does so free of sales tax on both the investment and the return. Tax is not paid unless the money is spent. This means lower income citizens suddenly have a degree of control over the rate of tax they pay. To reduce their effective rate, they need only save a few dollars. This not only decreases their tax burden, but increases their net worth. Even if one saves just $5 per month, that is $5 per month which goes untaxed and forms the basis of an ever-increasing nest egg. Over time, lower income people can indeed work their way up the economic ladder and can do so without being pounded by an income tax every step of the way.

Fourth, studies show that under a national sales tax, the nation’s savings rate rises substantially. This leads to a corresponding increase in capital available to fund new businesses. That, in turn, drives down the cost of capital. And that, of course, means

lower interest rates. Studies show a sales tax reduces long term interest rates by as much as two to three percentage points. Consequently, the cost of homes, autos, and other items is cut substantially. This significantly benefits lower income citizens.

In short, the national sales tax broadens opportunity for economic growth and prosperity among lower income citizens, it does not punish them as does the current income tax. Now let us examine how the sales tax affects the housing market and charitable contributions. Both arguments are premised upon the notion that the tax consequences of the transaction are all that drive either a home purchase or charitable giving. It is certainly true that taxation has an impact on behavior. However, it is *not true* that favorable tax consequences are solely responsible for home purchases or charitable donations.

Let us start with the premise that nearly 70 percent of all citizens *do not* claim any deduction for mortgage interest, real estate taxes or charitable contributions. That is because 70 percent of all citizens file the short form and claim no itemized deductions whatsoever. Is it arguable that these people own no home or make no charitable contributions? Of course not.

Many people elect to file short forms and forego their legal deductions because they are intimidated by the IRS and afraid to "raise the red flag." Those who are not afraid to claim their legal deductions simply may not have sufficient deductions to push them above the standard deduction ceiling. For example, a married couple filing a joint return is entitled (as of 1996) to a standard deduction of $6,700. In order to itemize, all Schedule A deductions must exceed that amount. In a significant number of cases, the combination of itemized deductions does not push the average family over the top. As a result, the elimination of deductions can have no affect on 70 percent of the tax filing population.

Now let us ask why people either own a home or contribute to charities. Is it solely because of the tax benefits of their actions? When it comes to a home purchase, many factors influence the decision to buy. A study commissioned by Citizens for a Sound Economy shows that people buy homes to relocate, take advantage of low interest rates, address family needs, have more room or improve personal security. Only 8 percent of those queried said they bought a home solely for "tax purposes." The largest factor in driving a home purchase was interest rates, with 68 percent of respondents claiming that as their motivation.

We find similar results when asking what motivates charitable giving. The vast majority give for reasons other than the tax benefits. They give because they attend regular religious services or were asked by a member of the clergy; they give because somebody they knew well personally asked, or because of something the saw in the news, or because they were involved with youth groups, volunteer work, or were a past recipient of charitable help. In short, the tax benefits have little to do with the decision to contribute to a charity.

The fact is, economic studies show a substantial increase in personal wealth as a result of shifting to a national sales tax. Savings and investment increase and productivity grows. As a result, real wages paid to workers go up. Because of the elimination of the tax compliance burden, the cost of products and services drop. Perhaps most important of all, interest rates fall by a significant margin.

All this means we have *more disposable income* available to save, spend, invest (in a home or otherwise) and contribute. The only reasonable conclusion to draw based upon all the facts is that the national sales tax can only lead to more home ownership and greater charitable giving as the rising economic tide lifts all boats.

Twenty-Seven Reasons Why We Need a Sales Tax

It is time to make this simple. In no particular order, here are twenty-seven reasons, expressed in twenty-five words or less, why the sales tax is the most desirable alternative to all current federal taxes.

1. Properly established, a sales tax eliminates the IRS.
2. No citizen would be required to make a financial report to the federal government, nor would the government have the power to audit him.
3. Enforced tax collection against individuals, including wage levies, tax liens and property seizures, would no longer occur.
4. No citizen would be required to make and keep records of his income, expenses, etc.
5. Citizens no longer would report to the government the financial activities of their fellow citizen. Forms W-2 and 1099 would be extinct.
6. Businesses and individuals would save hundreds of billions of dollars annually in compliance costs they now face.
7. Every worker in the country would see an immediate and substantial increase in real wages and take-home pay.
8. Every business would see an immediate and substantial increase in its productivity, brought about by the influx of new capital.
9. The nation would see an immediate and substantial increase in the national savings rate.
10. Interest rates would drop because of the new influx of capital and the increased rate of savings.
11. Government would have a vested interest in keeping its hands off the economy--to let it grow naturally--since its revenue is based upon consumption.
12. The nation would see a gradual but substantial decrease in the cost of every product and service because of the elimination of the federal tax compliance burden.
13. The rich would pay more taxes since they spend substantially more money.

14. The poor would immediately benefit since they would take home 100 percent of what they earn and all products and services will cost less.
15. The poor would immediately benefit since they would have the ability to save money tax free, thus building a capital base, however slowly.
16. The poor would immediately benefit since the cost of all products and services they purchase would be less expensive to begin with.
17. The nation's tax base will increase substantially, since all foreigners traveling in the United States would pay sales tax on their purchases.
18. Companies would become more competitive overseas since they would no longer pay employment taxes or compliance costs and because capital costs would drop.
19. Forty-five of fifty states have sales taxes. Collecting the national tax would be no more costly than collecting their state tax.
20. Federal revenue collection points would drop from 210 million (the number of returns filed) to just fifty (the number of states).
21. Taxpayers would save more than $8 billion annually, the IRS' yearly operating budget.
22. Taxpayers would not have to fund the $23 billion Tax Systems Modernization program, which GAO has proven to be of little benefit anyway.
23. Taxpayers would realize significant budget savings for the Department of Justice and the Attorney General's office, since virtually all tax litigation would end.
24. The states which now have an income tax would eliminate it and move toward consumption taxes as their chief source of funding.
25. Churches would no longer be held hostage by the IRS under threat of challenging their tax exempt status.
26. A sales tax has a better chance of capturing the underground economy than an income tax.
27. Evasion is minimized under a sales tax, since the public recognizes the tax to be simple, fair and efficient.

Conclusion

For decades, our tax system has been operating on an unconstitutional footing. It has been used for reasons and to achieve goals outside the narrow scope of Congress' taxing authority. As a result, we are suffering with crippling rates, stagnated economic growth, an incomprehensible tax code and an enforcement authority that is out of control.

If all citizens are to have an opportunity to live the American dream, we must free our nation from the ravages of the income tax and the IRS. Anything less than bulldozing the existing system and erecting a true constitutional model will not suffice. In short, we cannot have both freedom and an income tax co-existing in the same society. One must necessarily drive out the other. My challenge to you is, which will it be?

Heartland links:

https://www.heartland.org/search-results.html?q=Pilla
https://www.heartland.org/news-opinion/news/ten-principles-of-tax-policy

Ten Principles of Federal Tax Policy Report

Ten Principles of Federal Tax Policy

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