



Good Intentions Do Not a Tax System Make

Tax Notes

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The current federal income tax is a national disgrace that ought to be replaced immediately before it can do further harm. It has characteristics that would be condemned in any human personality. It is inexcusably class conscious, it is hypocritical, it is meddling, it is overbearing, it is mean and hurtful, it is covetous and, above all, it is downright foolish.

Reading the Internal Revenue Code (assuming anyone could actually do it) is truly a journey into the absurd. There is a rule for nearly everything that exists and some that do not -- including "passive activity."

Ridicule is too easy and beyond a point serves no constructive purpose. The current federal income tax has few defenders. Its long list of fundamental defects is well-known. I take it as a given that it will be replaced (or, at least, radically restructured) in the near future. Therefore, I will address myself to the design of the new tax system for America's future. Given the obvious defects of current law, replacing it with a better one might seem an easy task. Unfortunately, reality is otherwise.

At this particular time in history, we definitely do have a unique opportunity to succeed. To do it right, once and for all. To design and enact into law a rational tax system that will fairly and efficiently raise revenue in a way that neither distorts behavior nor misallocates resources. But we also face the prospect of failure -- by repeating in a different context many of the same mistakes that underlie the existing federal income tax or by making some new ones of our own. Initial success also does not necessarily translate into long-term success. The new tax system is likely to remain stable only if it is built around self-reinforcing core principles of enduring merit and, then, only if the American people truly understand and agree with those principles.

Otherwise, lacking that firm foundation and as the prevailing political winds shift in the future, what might have been a fine new tax system at the outset can quickly be converted into one as bad or worse than the one we now have. We already have a long and recent history of tax

instability. A succession of congresses has for decades incessantly spewed forth a constantly changing kaleidoscope of amendments to the existing federal income tax. The American people are accustomed to that. If we now further demonstrate that the entire tax system can be repealed and replaced, we better get it right to start with. Once started, what can be radically changed in one direction today can also be radically changed in a very different direction tomorrow.

Success requires much more than good intentions. The present and failed income tax is not the result of bad motives. Wrong basic principles compounded by a succession of mistakes, yes. Ideological biases, bad economics, parochial agendas, narrow self-interests, political expediency, bureaucratic inertia, and a large degree of plain old incompetence -- all very definitely yes. A disgraceful abdication of their own responsibility by elected officials who have relied more on the nostrums of so-called tax "experts" than on their own common sense -- also yes; but not evil intent. Only the result is evil.

I would caution everyone to beware of "experts" -- particularly the kind of expertise applied by the economists and lawyers who are the real architects of the current federal income tax. They are of the baroque school of tax design and policy. Therefore, they are specialists in multifaceted intricacies who, according to Mr. Webster, use convoluted, even gargoylian, forms and other bizarre imagery. When applied to taxes, baroque techniques make the simple complex and the complex incomprehensible to everyone but the experts themselves. Witness the federal income tax of today.

Writing in the American Tax Policy Journal a few years ago, the very learned Emeritus Professor James C. Eustice probably said it best of all and from the perspective of a lifetime spent mastering and then remastering the constantly changing intricacies of the income tax.

A definition of an expert is a person who avoids the small errors as he sweeps on to the grand fallacy. Perhaps the trouble with the tax law is that it has been written and interpreted by so many 'experts'; that it has lost sight of the fact that there are some people out there someplace that have to function under this system.

We are, indeed, an expert-afflicted society with an expert-afflicted tax system, but before we either throw up our hands in despair or start burning books and closing schools, let us remember that there is another kind of expertise -- a higher order of expertise that is perfectly suited to the design of an ultimately rational, highly utilitarian, nonintrusive tax system. This is the kind of expertise found in minimalism -- the theory or practice in art or design of using the fewest and simplest elements to achieve the greatest effect.

When applied to the design of a tax system that can actually function in a highly complex economy where thousands of different events and transactions must simultaneously be taken into account, minimalism first involves a mastery of all details. It then, if successful, cuts through to the heart of the matter. The result should be a tax system with only a few precisely honed rules that, when consistently applied throughout the economy, automatically produce the correct and logical result in all situations.

A tall order, to be sure, but such a highly desirable result must be sought and must be achieved. In my view, that process and that result is what The National Commission on Economic Growth and Tax Reform is all about. To succeed in this endeavor will require the highest order of expertise, but a very different kind than is reflected in the existing tax system.

Obviously, designing a new tax system for America is not a matter that has first arisen with your Commission. A great deal of thought has been given to all these issues by a great many people over many years. All the basic alternative tax structures before your Commission are of the minimalist school of design. Some are more perfect examples than others and the best may be yet to come -- perhaps through some amalgamation that takes the best parts from two or more.

The most well-known are the USA Tax by Sens. Pete V. Domenici, R-N.M., and Sam Nunn, D-Ga., the Flat Tax by Rep. Dick Armey, R-Texas, and Sen. Richard C. Shelby, R-Ala., and, in a general sort of way, a national sales tax suggested by Sen. Richard G. Lugar, R-Ind., and perhaps others. Of these three, the most fully developed and articulated -- in all its operational details -- is the USA Tax. In my opinion, and in the opinion of many others, the USA Tax is, thus far, the high water mark in the attempt to design a crisply efficient tax system of the minimalist school (a) that will actually work in a complex global economy, (b) that takes a balanced approach to correcting all (not just some) of the deficiencies in current law, and (c) that is sufficiently in-tune with the on-going political ethic in this country to be enacted into law and to endure. I highly recommend the USA Tax for your most intense and thorough consideration.

In brief, the USA Tax consists of a simple 11 percent tax on corporations and other businesses that allows full expensing of capital equipment and inventories, allows a credit for the employer-paid payroll tax, and levels the international playing field with respect to imports and exports. For individuals, the USA Tax is a simple, progressive-rate system that allows a full credit for the employee-paid payroll taxes and a full deduction for saving. The USA Tax has very few moving parts. It is written in a simple, understandable style. The entire USA Tax code is a tiny, highly readable document compared to the monstrous and incomprehensible Internal Revenue Code of 1986. The USA Tax also has the right philosophy, which is fully and well articulated in Title I of the statute itself.

The all-inclusive mandate of your Commission is for a "fair" tax system. The USA Tax provides a correct definition of fairness -- a fair opportunity to save, a fair opportunity to invest, a fair opportunity to compete in international markets, and a fair opportunity to achieve a better standard of living through one's own work and thrift. The USA Tax does not stop with rhetoric. It goes on to provide a fully articulated tax structure that actually does what it says and that will actually permit the American people to regain control over their own income and taxes, and to plan and provide for their own future well-being. It is hard to ask for more from any tax system.

The USA Tax is not perfect, but it is getting close. About the only significant criticisms I have heard are (a) the false impression that USA Tax is too complex and (b) the complaint that its

marginal tax rates are too high.

The USA Tax is not complex. In and of itself, it is quite simple. It is the economy that is complex. The complexity of the economy has been confused with the simplicity of the USA Tax because its proponents have fully illustrated the application of its few simple rules to a wide range of complex domestic and international transactions which are themselves not easy to understand. The proponents of other alternative tax proposals have not done that. Unlike the USA Tax, they also have not addressed the transition from the old tax system to the new tax system. Thus, the USA Tax appears more complex than it in fact is and other proposals appear simpler than they in fact are.

Things are not always as they may superficially appear. That is also true with respect to the marginal tax rates under USA. While higher than I personally would like and higher than under the Flat Tax, the marginal rates under USA are not as high as they may seem. Similarly, the actual marginal rates under other proposals such as the Flat Tax are not as low as they may seem.

Because the USA Tax allows a full credit for the nearly 8 percent employee payroll tax, the 8, 19, and 40 percent individual rates include the payroll tax. /1/ The 20 percent rate under the Flat Tax is in addition to the 8 percent employee payroll tax. Therefore, to compare the two, the rates under the USA Tax must be considered to be 0, 11, and 32 percent (or the rate under the Flat Tax must be considered to be 28 percent).

The top marginal rate under the USA Tax could be lower. It is set to achieve a revenue-neutral result. It is also set to maintain the same progressive distribution of tax liabilities by income class as under current law. If the Congress were to decide to modify progressivity or not to be revenue neutral, the tax rate could be lowered. The important and uniquely valuable structure of the USA Tax can accommodate any rate desired -- even a single flat rate. A single rate is not the exclusive province of the Flat Tax, which has a quite different and, in my view, less good overall structure.

The special and enduring value of the USA Tax lies in its smoothly functioning, fully integrated structure where (a) all income (labor and capital) is taxed and taxed alike, but only taxed once, (b) a full deduction for saving is allowed, and (c) all international transactions (including exports and imports) are treated correctly. I find it hard to believe that anyone could claim much credit for fundamental tax reform if that new tax system did not allow a full deduction for saving or if that new tax system continued to penalize U.S. competition in foreign markets while granting a virtual "tax holiday" to foreign companies in U.S. markets.

If your Commission should decide to recommend a new tax system with a single flat rate of tax (or lower multiple marginal rates), I very strongly urge that your Commission also recommend that the rate (or rates) operate within the highly salutary structure of the USA Tax.

Your Commission is a vital part of what I think of as the American Tax Revolution. I understand you are near to completing your fact-finding hearings and are about to begin your

deliberations looking toward making recommendations to the Majority Leader and the Speaker before year end. Your task is going to be very difficult. In preparation for it, let me share my favorite quote from Dwight Eisenhower:

"I have one yardstick by which I test every major problem -- and that yardstick is: Is it good for America?"

Further, let me also share with you a few other points of advice that may be helpful.

- Resist over-concentration on achieving one or two goals to the exclusion of others. Just as the current tax system has many defects, the ideal tax system should have many positive attributes. I assure you that it is possible to design a simple and fair tax system that lowers rates, allows a deduction for saving and investment, taxes all income once and only once and the same, and treats all international transactions correctly in a manner that is consistent with international practice and the principles of free trade.
- Insist that any new tax system be simple, but be certain that you correctly understand what are and are not the sources of tax complexity. The fact that a tax has two or three rates, instead of only one, is not the source of any material tax complexity. Similarly, allowing a few personal deductions (such as for home mortgage interest and charity) is also not the source of significant tax complexity. The tax complexity that afflicts the public today -- and wastes billions of dollars and hours -- arises mostly from a multiplicity of rules and from exceptions to those rules. Current law has thousands of rules and thousands of exceptions. Specialized deductions and credits have specialized eligibility requirements. The remaining complexity under current law arises from prolixity of writing and from the fact that savings is not deductible. I have recently been amazed to find how much of the current tax code exists solely because savings are not deductible.
- Resist the temptation, which we all face, of thinking about the new tax system too much in terms of the old tax system. Old issues that have occupied our minds and inflamed our emotions under current law may have little to do with the proper design of the new system. This is one case where past experience may not be such a good guide to the future.
- Beware of large exemptions that remove large numbers of people and voters from the tax rolls -- lest we quickly end up with a situation where a majority made up of nontaxable voters is deciding how heavily to tax a minority of voters who have no recourse. Decoupling the fundamental obligation of citizenship (paying taxes) from the fundamental right of citizenship (voting) is not a good idea. Large exempt levels of income are also unnecessary under a properly designed tax system. If it is necessary to have high exemption levels, the tax rate must be too high or too flat. If the large exemption is designed to relieve large numbers of people from having to fill out and file a tax return, the tax must be too complicated. Moreover, large exemptions tend to grow and to push tax rates higher. Low marginal rates and high exemptions are inconsistent over the long term.

- Keep marginal rates as low as possible, but be certain you have fully accounted for the payroll tax. Unless a credit is allowed for the payroll tax, any stated marginal rate must be increased by the nearly 8 percent payroll tax to arrive at the real marginal rate. Otherwise, the supposedly lower marginal rate is a gimmick -- reminiscent of current law -- that will not fool the American people.
- Beware of leaving a vacuum. It will quickly be filled. For example, we have a long history of taxing corporations and, if properly done, it is not illogical to do so. But some have proposed to you a "household-only" tax where the tax would be collected only from individuals. I suggest that the "gap" -- no corporate tax -- would quickly be filled in the future. It is better to occupy the field from the outset with a properly designed corporate tax. Similarly, some have suggested only taxing retail purchases and having no income tax at all, but, again, we have a long history of taxing income and that gap would quickly be filled if left unoccupied. We could have a badly designed income tax and a sales tax.
- Do not put much faith in labels such as "income tax," "consumption tax," "flat tax," "VAT," and so forth. They mean little, often mean different things to different people and most often serve to confuse. Instead, concentrate on the real substance of various tax designs without regard to name. For example, do not be misled into thinking that only a VAT (in the sense of a European-style sales tax) can be correctly adjusted at the border for exports and imports or be misled into thinking that any tax with such adjustments is a VAT. It's not true. For example, the USA Tax correctly adjusts for imports and exports, but it is clearly not a sales tax.
- Look very carefully at the issue of multiple rates vs. a single rate and do that from several perspectives. First, neither a single rate nor multiple rates is the exclusive province of any particular alternative tax proposal. For example, the USA Tax can accommodate either. Second, do not assume that rates are the sole source of progressivity or that multiple rates are the source of "redistributive" effects. Exemptions also produce progressivity, but large exemptions cause other severe problems that should be avoided. If progressivity is desired, it is best achieved primarily through rates.
- Beware of treating capital income differently from labor income and further beware of appearing to do so. I include within this caveat any proposal to exclude interest, dividends, and gains from tax at the individual level.
- Insist on a deduction for saving and beware of theories that suggest that allowing no deduction for saving but exempting the earnings on saving is the same as allowing a deduction for saving. As a practical matter and as a political matter, they are not the same.
- Pay special attention to the transition from the old tax system to the new, and, in doing so, beware of either creating windfalls or appearing to do so. For example, exempting the earnings on new saving is one thing, but exempting the earnings on all existing capital is quite another.

- Avoid a parochial or insular perspective that focuses only on the "domestic" economy. There really is no such thing anymore. A global economy requires a global tax perspective and a tax system that correctly takes into account international transactions.

Finally, keep in mind the obvious. To have any effect, the new tax system you recommend must be capable of actually functioning in a complex economy and must be enacted into law. To be enacted, it must be understood by the American people and be consistent with the American political ethic. Therefore, avoid extreme and unfamiliar approaches that may make sense to theoretical economists but are counter-intuitive to the American people.

FOOTNOTE:

1. These are the permanent, revenue-neutral rates in S. 722 beginning in the year 2000. The transitional rates in 1996 are 19, 27, and 40 percent.