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Summary: *Complying with the current income tax code costs Americans 3 million person-years each year. This represents a deadweight loss to the economy and resources that could have been spent on otherwise productive efforts. The chief source of federal tax complexity is the income tax. Substantial reform can come only from replacing the income tax system with a consumption-based system such as the flat tax, a national retail sales tax, or a consumed income tax.*

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THE ROAD MAP TO TAX REFORM™

Simplifying Federal Taxes:

The Advantages of Consumption-Based Taxation

By Chris R. Edwards

In 1976, president-to-be Jimmy Carter called for "a complete overhaul of our income tax system. I feel it's a disgrace to the human race." Since Carter's attack, though, the number of pages of federal tax rules has doubled (Figure 1), and the "tax industry" of IRS employees and private sector tax professionals has only grown. Tax fees have soared in recent years, more than doubling in the past seven years for the top 100 firms, and more than doubling in the past five years for the top 8 firms (Figure 2). This tax system, employing more than 1 million people, is growing ever more complex and in need of repair.

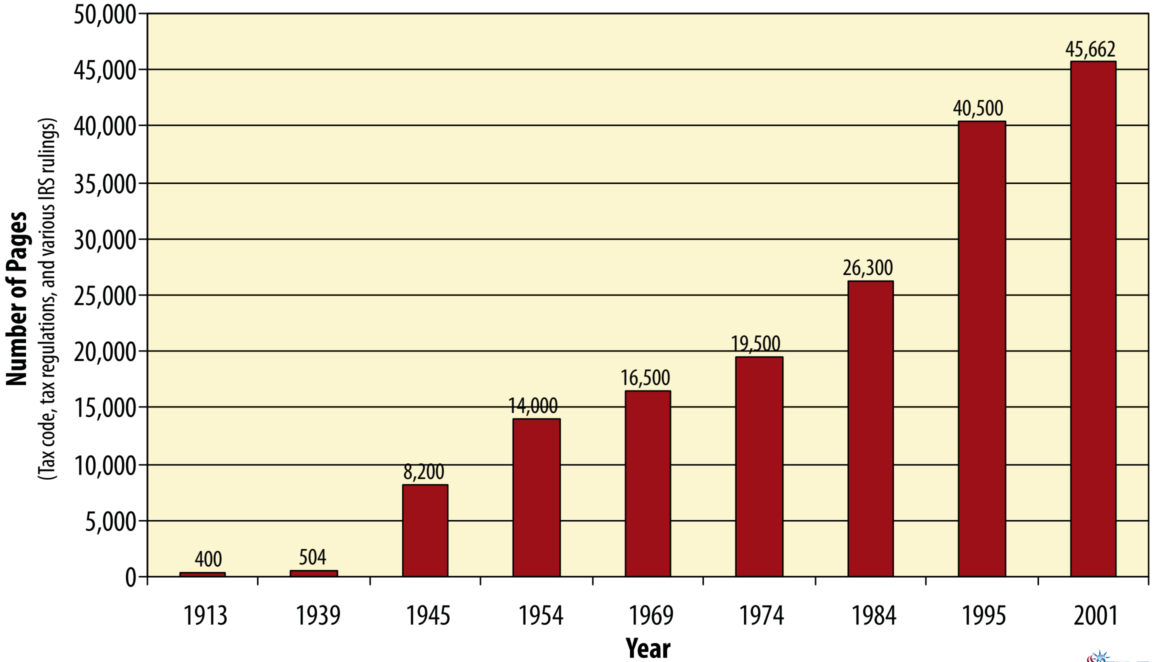
Congress has taken a few small steps to raise the visibility of the tax complexity problem, but incremental fixes will not be enough. Substantial reform can come only from uprooting the income tax system and replacing it with a consumption-based system. Not only will this vastly simplify federal tax administration, it will spur greater economic growth.

Tax Complexity is Costly

At the beginning of the 20th century, federal taxes accounted for about 3 percent of the nation's gross domestic product (GDP), and the entire tax code and related regulations filled just a few hundred pages. Today, federal taxes account for 21 percent of GDP, and federal tax rules span 45,662 pages. Each year, Americans spend 6.1 billion hours—more than 3 million person-years—on tax compliance activities such as filling out tax forms, keeping records, and learning tax rules. Those activities, which the Office of Management and Budget estimates cost $183 billion a year, represent a pure loss to the economy—resources and human effort that could otherwise create useful goods and services.

Businesses bear the biggest brunt of tax complexity costs. There are currently 700 separate provisions of the tax code that affect individuals, but 1,500 provisions affecting businesses. All Americans will gain if businesses spend less time

Figure 1 Total Pages of Federal Tax Rules



Source: CCH Inc. Number of pages in the CCH Standard Federal Tax Reporter.

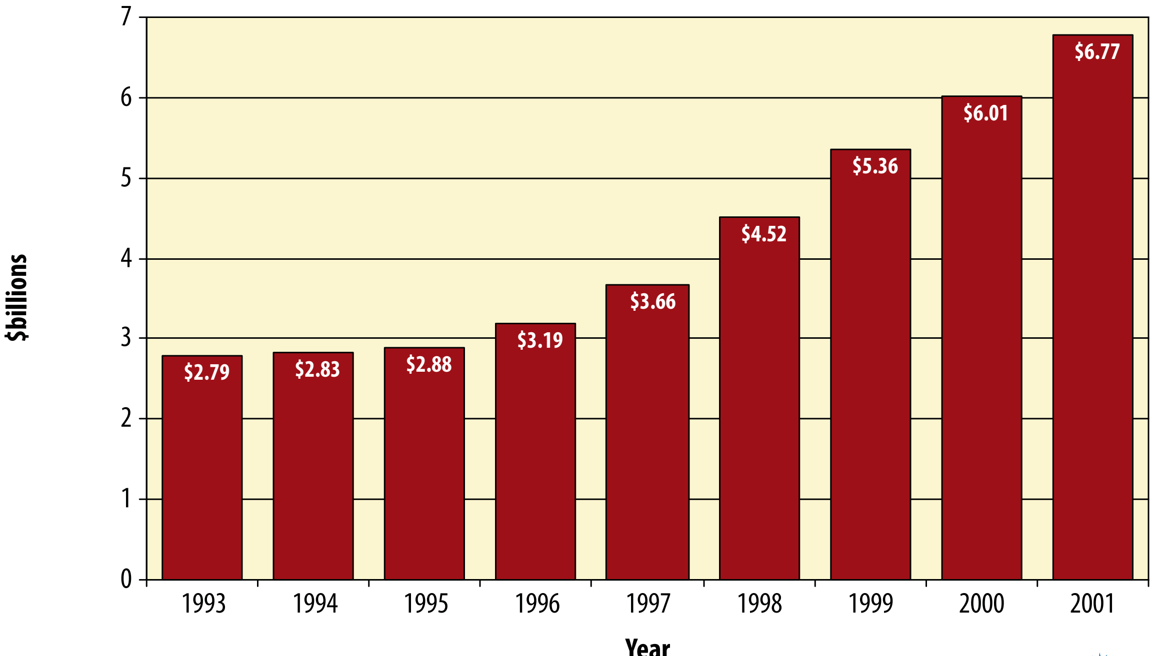
and money buried in tax paperwork—many large corporations spend $10 million per year on tax paperwork—and more time creating better products with lower costs.

The income tax system injects uncertainty into the economic planning of both households and businesses in areas such as retirement planning and business investment. Since 1954, more than 500 public laws have made tax code changes, and the past five years have seen 1,916 changes to the code.

Tax complexity creates uncertainty over the effects of current laws—let alone the effects of future changes. One famous demonstration of excessive complexity comes from *Money* magazine's annual test of tax experts, who are asked to compute taxes for a hypothetical family. In 1998, the 46 experts surveyed came up with 46 different answers; their calculations of taxes owed ranged from $34,240 to $68,912.

Tax complexity is also costly because it leads to noncompliance with the tax system, whether through confusion or a desire to evade taxes through cat-and-mouse games with the IRS. The General Accounting Office estimates that the government loses about 17 percent of income tax revenues to noncompliance, or about $200 billion annually.

Figure 2 Tax Consulting Revenues of the Eight Largest U.S. Accounting Firms



Source: Author's calculations based on data from Public Accounting Report. Years are PAR survey years.

Finally, the complexity of the tax code creates unfairness when it exacerbates "horizontal inequities," which occur when similar families pay different amounts of taxes due to special preferences. For example, tax incentives for education may reward individuals who pay to take classes but not individuals who learn by themselves at home.

Causes of Income Tax Complexity

The Sixteenth Amendment to the U.S. Constitution, enacted in 1913, allowed for the income tax, but it failed to define how income should be measured. Statutory definitions that followed were just as vague, and legal wrangling and congressional gyrations over the definition of the proper base for the income tax have been the pattern ever since.

Academic thought has been dominated by the Haig-Simons definition of income, which defines income as consumption plus the rise in market value of net wealth during a year. For example, if a worker had wages of $30,000 and unrealized stock market gains of $10,000, a Haig-Simons tax base would be $40,000.

While Haig-Simons income is simple in the abstract, it is very impractical to use as a tax base in the real world. One fundamental challenge lies in determining the market value of all assets, each year, in order to measure changes in net worth.

As a result, policymakers have fallen back on an array of ad hoc rules. Some income is exempt from tax, some income is taxed once, and other income is taxed multiple times. Income may be taxed when earned, when realized, or when received. There is no consistent standard under present tax policy for what constitutes income or when it should be taxed.

One key problem is how to deal with inflation's affect on asset values. If inflation is not specifically accounted for, taxes are too high and tax rates across different investments are distorted. But fully adjusting the income tax for inflation would require excessive paperwork. This is a particular problem with capital gains taxation. As a result, Congress periodically enacts makeshift adjustments as a rough solution. Meanwhile, taxpayers seek to recharacterize ordinary income as capital gains. The government responds with extensive rules to prevent taxpayers from unduly taking advantage of the preferential treatment of capital gains. Unfortunately, elaborate rules to define and limit capital gains are inevitable in an income tax.

Policymakers have gyrated between broader and narrower tax bases, which cause large gyrations in business investment and economic growth. Before 1986, for example, favorable tax provisions and economic factors led to a construction boom in commercial real estate. Then, the Tax Reform Act of 1986 increased the capital gains tax rate and changed the depreciation schedule. These changes contributed to a dramatic drop in real estate prices, which in turn created loan defaults at savings and loan institutions and commercial banks that held substantial real estate assets. Some failed. While the wisdom of the tax rules in question is debatable, the broader message is this: continual change in tax rules can create widespread damage to affected industries and even the broader economy.

The Simplification Advantages of Consumption-Based Taxes

Nearly all of the major tax reform plans introduced in recent years would replace the individual and corporate income taxes with a consumption-based tax.

Dramatic gains in simplification could be achieved, for example, under a "flat tax" based on the design of Robert Hall and Alvin Rabushka of the Hoover Institution. House Majority Leader Dick Armey (R-Tex.) has introduced a version of this in Congress. According to the Tax Foundation, replacement of the income tax with a flat tax would reduce tax compliance costs by 94 percent.

Dramatic simplification gains could be also achieved under a national retail sales tax. Rep. Billy Tauzin (R-La.) has proposed the National Retail Sales Act, which would replace the individual and corporate income taxes, and the estate tax, with a retail sales tax set at 15 percent.

According to the Tax Foundation, replacing the individual and corporate income taxes with a retail sales tax would produce a 95 percent saving.

The basic difference between an income tax and a consumption tax lies in the treatment of saving and investment. For individuals, consumption-based taxes can treat saving under rules similar to those that govern either regular IRAs or Roth IRAs. In the first case, saving is initially deducted, and later withdrawals are included in the tax base. This is the approach taken by proposals for a consumed-income tax.

In the second case, no deduction is given for saving initially, but returns to saving are not taxed. The flat tax adopts the Roth IRA treatment of saving. Under the flat tax, dividends, interest, and capital gains are not taxed at the individual level and do not need to be reported to the IRS. This would dispense with the need for businesses and the IRS to keep track of over half a billion Form 1099s.

For businesses, the flat tax would vastly simplify some of the most complex areas of the tax code, including accounting for capital purchases and inventories. Simplification would occur because consumption-based taxes use cash-flow accounting in place of accrual accounting, which is generally used under the current income tax. Accrual accounting requires that firms accurately match revenues and expenses each year to measure net income and to capitalize the expenses that create future benefits. Such timing of income and expense recognition under the income tax is a key source of complexity.

There is no need for all this complexity. Because consumption taxes do not measure broad-based income, they do not require the complexities of accrual accounting. As tax expert David

Bradford notes, "income accounting is more difficult than cash-flow accounting. That difficulty is responsible for much of the complexity in the current income tax system."

Americans interested in saving a portion of their current income to support themselves in later years also face an enormously complex array of tax rules. Different rules come into play for ordinary income, capital gains, 401(k)s, IRAs, traditional pension plans, and other saving vehicles. Employers face heavy burdens with the administrative complexity of tax rules for pension plans.

One result of this complexity is that individuals do not save as much as they might, because minimum distribution and other complicated rules limit the attractiveness of employer-provided plans. The tax and ERISA (the Employee Retirement Income Security Act of 1974) rules for employer-based pension plans have gotten so complex that many firms have dropped those plans altogether, particularly defined-benefit plans.

All this complexity is an artifact of the income tax. Consumption taxes would exempt personal saving from taxation. The flat tax exempts from personal taxation the returns to saving, including dividends, interest, and capital gains. It works essentially like an unlimited Roth IRA but without any of the Roth IRA rules. It would be much simpler, fairer, and more efficient for individuals themselves, not the federal government, to choose the form and purpose of their saving.

Under the income tax, companies may take a variety of legal forms—sole proprietorship, partnership, LLC, S corporation, and C corporation—each with different income tax implications. This patchwork has created tax complexity and economic inefficiency. The flat tax would treat all business activity equally and eliminate special forms of business organization. It would also bring greater efficiency, as different investments would return the same after-tax returns no matter which business structure the investment took.

The taxation of interest is problematic under current rules; at least 10 types of interest are subject to special deduction limitations. Various inconsistencies lead taxpayers to arbitrage of different tax code provisions to lower their tax burden. The government responds with complex rules to limit such "abuse," and taxpayers invent new methods to get around the rules.

A flat tax would eliminate most of these intractable problems because it generally disregards financial flows at both the individual and business level. Under a flat tax, individuals would not deal with financial flows at all, as they would be taxed only on wage and pension income. Neither would nonfinancial businesses have to deal with financial income or expense items. Interest, dividends, and capital gains income would not be included in business taxable receipts, nor would interest expenses be deductible.

Tax Reform for the 21st Century

Most of the problems with the income tax relate to the taxation of capital income; that is, the returns to saving and investment. This has become an ever-growing problem for both households and businesses. Today, about half of American households own mutual funds, in either taxable or tax-favored accounts—up from a mere 6 percent in 1980. U.S.-headquartered multinational companies, meanwhile, face a tax system that puts them at a comparative disadvantage to their international competitors.

Glen Hubbard, chairman of the Council of Economic Advisers, got it right when he called the income tax "fundamentally flawed" because of its inefficiency, complexity, and unfairness. It is time to replace the flawed income tax with a consumption-based alternative as part of a broad reform to create a lower, flatter, simpler federal tax structure.

This study is a summary of IPI Policy Report # 168, *Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation*, by Chris R. Edwards, Director of Fiscal Policy Studies for the Cato Institute.

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