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Summary: *Americans suffer from an assault on their privacy because of the way our tax code taxes income. Fundamental tax reform is the key to redressing this invasion of privacy, but proposed international "information exchange" rules would undermine any potential for tax reform and privacy protection. These new rules should be opposed, and tax reform pursued, to protect the privacy of American taxpayers.*

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THE ROAD MAP TO TAX REFORM™

TAX REFORM:

The Key to Preserving Privacy and Competition in a Global Economy

By Dan Mitchell, Ph.D.

INTRODUCTION: THE INTERNAL REVENUE CODE VS. PRIVACY

The personal income tax requires individuals to either disclose or make available upon demand almost every shred of their personal financial data to the Internal Revenue Service (IRS). This sweeping assault on privacy *might* be justified if it represented appropriate and necessary enforcement of good tax policy. But that is not the case.

The loss of financial privacy is caused by the fact that the Internal Revenue Code taxes some forms of income more than one time. Indeed, the combination of the capital gains tax, corporate income tax, personal income tax, and death tax means that some income is taxed as many as four times. Economists routinely condemn this bias against capital formation since it has a powerfully negative impact on growth rates, productivity, and wages.

While it may seem as if the tax code was created to undermine privacy, this is not the case. In almost every instance, the forced disclosure of intimate financial information is the inadvertent—yet inevitable—result of bad tax policy. Before we look at how tax reform could remedy the tax code's invasiveness and inefficiency, let's survey the many ways income can be double-taxed in the current system.

TAXING INCOME MORE THAN ONCE

TAX ON INTEREST

The IRS imposes an additional tax on any interest generated by after-tax income that is saved or invested. The tax is bad for privacy because it means that government must know, or have the ability to demand, all details about a taxpayer's bank accounts and bond holdings.

Dividend tax

When a corporation earns a profit, it is subjected to a corporate income tax and then distributed as dividends to the corporation's owners (shareholders). The income is then subject to another layer of tax. The tax is bad for privacy because it means that government must know, or have the ability to demand, all details about an individual's financial holdings that generate dividend income.

Tax on foreign income

"Territorial taxation," according to which governments only tax the income earned inside their borders, is a principle of good tax policy. The Internal Revenue Code, however, imposes tax on the income that individuals and businesses earn abroad. But since that income is taxed already in the country where it is earned, this means that foreign income of U.S. residents is subject to two layers of tax.

Taxing Assets and Net Changes in Assets

Death tax

The death tax, which can seize more than 50 percent of a taxpayer's wealth, imposes a heavy burden on assets that were purchased with after-tax dollars. The tax is bad for privacy because the taxpayer (actually expensive lawyers and/or accountants hired by the taxpayer's family) must make a complete report on all assets owned at the time of death.

Capital gains tax

The capital gains tax is a tax on the transfer of after-tax dollars, even though the increase may reflect a future stream of income that will be taxed, and even though "gains" may represent nothing more than years of inflation. The tax is bad for privacy because it permits the government to know when an asset is purchased, how much it is worth when purchased, how long it is owned, when it is sold, and how much it is worth when sold.

Making Taxpayers Overstate their Income

Alternative minimum tax

The alternative minimum tax (AMT) requires a growing number of taxpayers to calculate their tax liability a second time, according to a different set of rules, and then pay the government the larger of the two amounts. The current AMT is a horribly complicated system that forces taxpayers, both individual and business, to divulge more of their financial affairs to the government.

Depreciation

When a business spends money to build new plants and buy new equipment, those expenditures are a cost of doing business. The bulk of the costs cannot be deducted until future years (a process known as depreciation). This tax is bad for privacy because it forces taxpayers to provide the IRS extensive details on the type of investments and the timing of those investments.

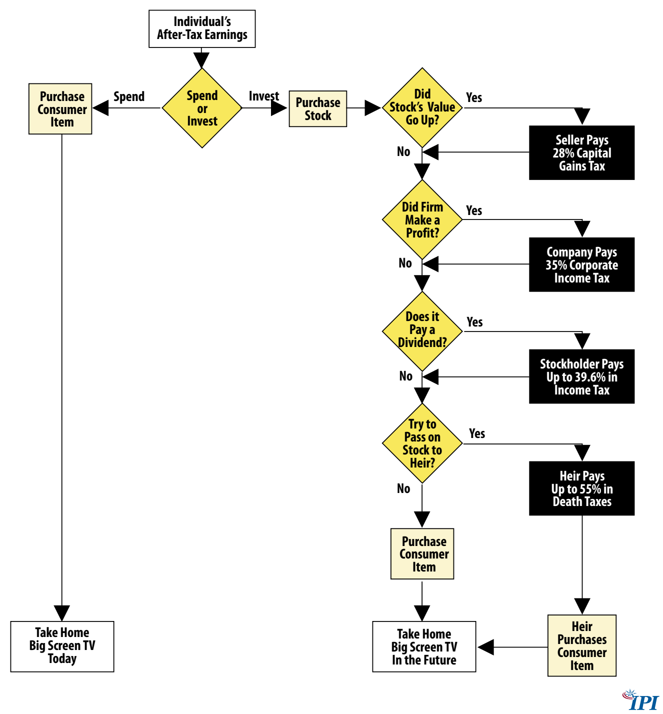
Defining Income Properly so Savings are not Double-Taxed

How do the above-mentioned tax policies affect economic growth? They discourage saving. People save because they will earn a return—or because other people are willing to pay them a return in exchange for the use of their money. In other words, people are willing to postpone consumption today because of the expectation that they will be able to consume even more tomorrow.

This is where taxes enter the picture, particularly double taxation. Double taxation distorts this decision because it reduces the return earned from income that is saved and invested. This means, of course, that people will have less incentive to save and invest. The accompanying chart illustrates how this process penalizes capital formation. [See Figure 1]

Figure 1

Savings and Investment Can Be Taxed Up to Four Times
Message to Taxpayer Is "Spend Now"



In the jargon of economists, this means that there is a bias against future consumption and a bias in favor of current consumption. And because this bias results in less saving, less investment, and less capital formation, double taxation reduces economic growth.

This bias against savings and investment should be eliminated. It should be eliminated to improve the economy's performance. And it should be eliminated to boost worker productivity and wages. But is also should be eliminated because privacy is a characteristic of a society that respects the individual.

The Tax Reform Solution

Eliminating the bias against income that is saved and invested is a core feature of every major tax reform plan. This means that fundamental tax reform is the solution to an invasive tax code that gives government the right to know every detail about a taxpayer's financial existence.

The Flat Tax

In a flat tax system, households directly pay tax only on their wages, salaries, and pensions. As a result, the tax collection agency has no need to track how they use the money that is left after paying that single layer of tax.

Sales Tax

The final tax on a product would be the same regardless of how many times the product was sold as it moved from raw material to manufacturer to wholesaler to retailer. Sales taxes, by their very nature, do not require individual taxpayers to divulge any information on income and assets to the IRS.

Inflow-Outflow Tax

Taxpayers would be able to fully deduct all forms of savings under the inflow-outflow tax, but they would pay a tax on all withdrawals, including both interest and principal. While the inflow-outflow tax would yield economic benefits similar to the Flat Tax and the sales tax, the impact on privacy would be muted. In short, politicians must keep track of the money flowing into this front-ended IRA.

Why Privacy Matters

With the exception of criminals, people voluntarily choose to provide personal information because they expect a benefit in return. This is not true of the tax code. The IRS demands detailed data in order to take money away from people. There is no benefit to the taxpayer.

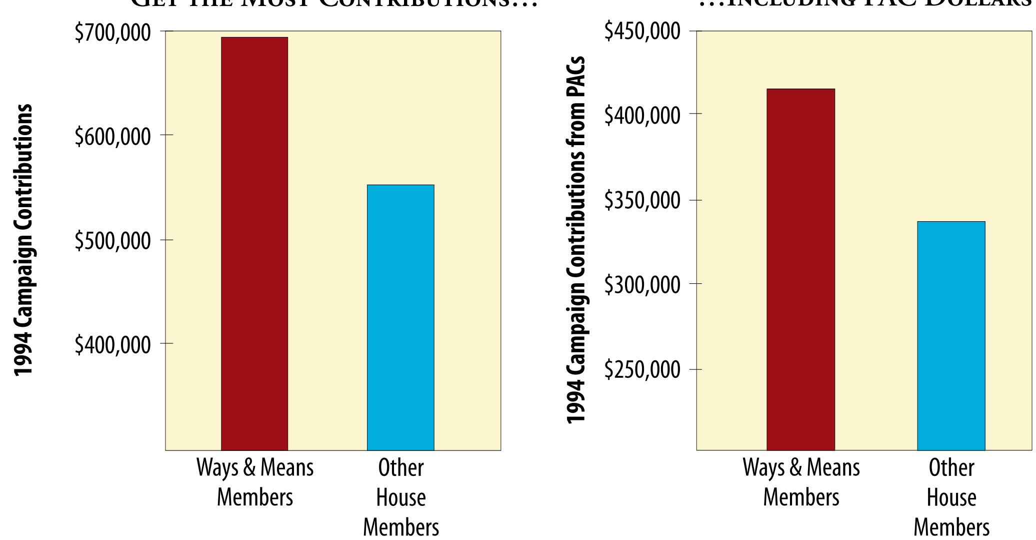
The current tax code is a Byzantine contraption that requires 753 forms and instructions and 280 publications and notices. And that is just what is available on the IRS website. This avalanche of paperwork is a direct result of a complex tax code, and the complex tax code exists because lawmakers neglect principles of sound tax policy. They do so in part because of the pressure of special interest groups, who seek special provisions and favors in the growing complexity of the tax code. As Figure 2 illustrates, those who write the tax laws are those who receive the most political contributions.

An assault on financial privacy could be justified if it served an important purpose. But the tax code does not pass this test. As discussed above, all of the provisions that undermine financial privacy are the unambiguous result of bad tax policy. Fix these flaws in the tax code and financial privacy—along with economic growth—is the result.

International Tax Harmonization and The Threat To Privacy

The potential for true tax reform and privacy would be seriously undermined if international bureaucracies are allowed to rewrite the rules of international commerce and taxation. The Organization for Economic Cooperation and Development (OECD), the European Union (EU), and the United Nations (UN) want to give high-tax governments the power to tax income earned in low-tax countries.

Figure 2 Those Who Write the Tax Laws… Get the Most Contributions… …Including PAC Dollars



Source: Federal Election Commission.

This policy, known as "information exchange," would be a blow to privacy. Governments around the world would be collecting and sharing private information on personal investments. Information exchange also would be a deathblow to tax reform, which is based on the principle that income should not be taxed more than one time and the principle that governments should not tax income earned outside their borders.

The OECD and Fiscal Imperialism

The OECD has identified 41 jurisdictions around the world as "tax havens." These are jurisdictions that have both strong financial privacy laws and low levels of tax. The OECD wants its member nations (mostly high-tax European welfare states) to be able to tax income that is earned by their residents in these low-tax countries.

Essentially, these market-based economies are being asked to provide private financial data to OECD member nations. If the low-tax countries do not agree to this "information exchange" policy, the OECD will declare that they are "uncooperative" and ask member nations to subject them to financial protectionism.

Implications for Privacy

Advocates of the OECD agenda claim that people no longer need to worry about individual freedom and government oppression. Yet the United Nations recently stated, "For much of the twentieth century, governments around the world spied on their citizens to maintain political control. Political freedom can depend on the ability to hide purely personal information from a government."

But bank secrecy laws do more than just protect privacy. They also provide systematic benefits to a country's financial institutions. The OECD even admits this point: "Customers would be unlikely to entrust their money and financial affairs to banks if the confidentiality of their dealings with banks could not be ensured." As a result, bank secrecy laws can help stimulate a vibrant financial services industry.

Implications for Tax Reform and American Competitiveness

The OECD agenda is contrary to America's interests. The United States is a low-tax country and a haven for foreign investment. In large part because of our attractive tax and privacy laws, foreigners have invested more than $9 trillion in the U.S. economy.

If the OECD agenda is approved, tax reform would be very unlikely. The flat tax and sales tax are territorial systems. Yet the OECD and other international bureaucracies believe that territorial taxation—the common sense notion that governments only tax economic activity inside their borders—is a form of "harmful" competition.

The Big Picture

Tax reform is a way of boosting economic growth. Lower tax rates will improve incentives to work, save, and invest. The elimination of special preferences and penalties will encourage people to invest resources for wealth maximization instead of tax minimization. Simplification will free up resources that are being wasted to comply with a convoluted tax code. Territorial taxation will make American companies much more competitive in the global economy.

Every tax reform would reduce the amount of personal information that the government has to know. And the two major plans—the flat tax and the national sales tax—eliminate any tax-related reason for the IRS to know an individual's financial assets. The United States should have a tax system worthy of a great nation. Tax reform plans like the flat tax and sales tax fulfill that promise. They treat people equally and remove barriers to upward mobility. Tax reform is a way of returning privacy and control to the American people.

Editor & Publisher . . . . Tom Giovanetti

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