

David L. Smith's Cassandra Chronicles

“Study the present in light of the past for purposes of the future”

An invitation to think outside the box

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PROHIBITION'S HANGOVER

Prologue

“The income tax must go” is an idea whose time has come. President Bush believes a consumption tax is “an interesting idea,” and has appointed a bipartisan Advisory Panel on Federal Tax Reform to look into overhauling the tax code. The panel’s report is due by July 31, 2005. Federal Reserve Board chairman Alan Greenspan, testifying recently before the panel, favored a consumption tax to stimulate growth and encourage savings. Many economists agree. John Linder in the House ([HR25](#)) & Saxby Chambliss Senate ([S25](#)), offer comprehensive bills to kill all income and Social Security/Medicare payroll taxes outright, and provide a IRS-free replacement in the form of a retail sales tax.

As taxpayers struggle through the annual spring ritual of sifting through shoe boxes of tax-deductible receipts, writing sizable checks to their tax preparers and plodding through inscrutable tax forms and impenetrable tax-code jargon, they may well wonder, *how did we acquire such a complicated and invasive tax system, and is there a better way?*



The income tax was an afterthought from the same folks who gave us Prohibition. Progressive reformers within both major parties crusading against “demon rum” at the turn of the century had a problem: Prohibiting the sale of liquor would do away with the liquor excise tax, source of about 40% of federal revenues at the time. Raising existing tariffs on imports and taxes on tobacco was politically impossible, so they supported the income tax instead.



At the turn of the twentieth century, taxation of income was not a novel idea in the United States. It had been adopted as a wartime emergency by both sides during the Civil War, reportedly with little success, and abolished in 1871. In 1893, Treasury deficits created by the depression ending the "Gilded Age," provided Democrats with a suitable pretext to impose a 2% tax on incomes over \$4,000. Two years later, however, the Supreme Court ruled the tax unconstitutional on the rather narrow grounds that it was not uniformly assessed upon the states in direct proportion to their population, and consequently would be primarily borne by wealthy states like New York and Virginia.¹ The court's decision left the Progressives and their country cousins, the Populists with no alternative but to amend the Constitution. Ironically, the Constitutional amendment was recommended by President Taft and introduced by Congressman Payne in the House, both conservative Republicans, who fully expected the amendment to fail, if not in Congress, then in the States, foiling the liberals' ambitions for the tax. They were wrong.

A Flurry of Constitutional Amendments: 1909-1919

Constitutional amendments up until that time had been slow in coming, and, as in the case of slavery, arduously contested. In 120 years following the adoption of the Constitution and Bill of Rights, only five amendments were passed, about one every quarter of a century. Undaunted, the reformers of the day passed not one but *four* constitutional amendments in the decade between 1909 and 1919: the income tax, popular election of senators, prohibition and women's vote. It was a new century, an Age of Reform.

The Sixteenth Amendment: The Income Tax

Passed in 1909 and ratified shortly after President Wilson's inauguration in 1913, the Sixteenth Amendment granted Congress the power to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

As originally proposed, the tax was intended to "soak the rich," who, in the heyday of burgeoning industrialization, were both highly visible and widely resented. At a time when personal income averaged \$621 annually, a 1% tax was levied on incomes in excess of \$2,000, escalating, at \$50,000, from 2% to 7% for incomes in excess of \$1,000,000. A mere seven percent of the fabled income of the Rockefellers, Carnegies, Vanderbilts, Whitneys, Mellons, Morgans, Stanfords and other assorted "robber baron" dynasties seemed, to most, a small price to pay not only for national sobriety but also for the reduction of burdensome tariffs in the bargain. In this leftward Age of Reform "the rich" were fair game.



Raising the Income Tax Rate

It didn't take long to explode the liberals' naïve notion that a small percentage of large incomes could carry the government, particularly since the very rich deftly managed to avoid payment of taxes through the use of "charitable

¹ Article 1, Section 9, Clause 4 reads: "Clause 4: No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.")

foundations" they funded and controlled. Within four years of ratifying the Sixteenth Amendment, Congress hiked the top tax rate from 7% to 78% in order to finance America's participation in the Great War. (Except for a brief interlude between 1925 and 1931, when it was reduced as low as 22%, the top tax rate remained well above 60% until the Reagan tax cut in 1981.) For nearly thirty years, however, the income tax remained a levy upon the rich, a "class tax," according to its wealthy detractors. Having gained access to income as a source of revenue, government became a growth industry. From an average annual growth rate of 2% prior to 1916, U.S. government revenues grew at a brisk 8.6% compound rate thereafter until 1940.

The Eighteenth Amendment: Prohibition - 1917-1919



Prohibition had to wait upon World War I, not only because liquor tax revenues were needed to finance it, but also, no doubt, to encourage participation in the war by young men who might have demurred had they been sober. The Eighteenth Amendment prohibiting "the manufacture, sale or transportation [though, interestingly, *not* consumption] of intoxicating liquors" passed in 1917, the same year the U.S. entered the war, and was ratified in January 1919, before the troops could return to object.

With just three short paragraphs, the Progressives committed the full faith and jackboot of the U.S. Government to the suppression of the liquor trade. The "Roaring Twenties" that followed amply demonstrated the "Law of Unintended Effect": while the poor were, in fact, deprived of much of their beer, the rich drank more than ever, and the bootlegging underworld grew rich, powerful and increasingly violent. (In a nice touch or irony, the prohibitionists' nemesis, Al Capone, was eventually put away by Prohibition's hangover, the Income Tax Code.)



Dismayed by the appalling consequences of Prohibition, President Roosevelt's new crew of reformers repealed the Eighteenth Amendment as their first order of business. The ostensible reason given for repeal was the creation of legitimate jobs in the liquor industry that were then being lost to Canadian distilleries and homegrown bootleggers. However, Prohibition's offspring, the income tax, progressed through its adolescence, still a "class tax" levied upon the rich until World War II.

Expanding the Tax Base: World War II



Whereas World I had provided the pretext to raise income tax rates beyond their initial modest levels, World War II prompted Congress to expand the taxes' reach beyond the upper classes, laying to rest the early conception of the income tax as "a small tax on large incomes." The advent of withholding in 1943 and the wartime expansion of the tax base to include all but the lowest incomes, converted the "class tax" into a "mass tax." Such direct taxation would have amazed and troubled our founding fathers, who paid virtually no Federal taxes, back when most such taxes were indirect, collected from shipping companies in seaports.

A Reappraisal of the Income Tax a Century Later.

Since neither the original reason (Prohibition) nor the rationale ("soak the rich") for the income tax have existed for over sixty years, it is reasonable to ask whether the nation is well served by this method of taxation. What have we learned with more than a century of hindsight?

If the truth be told, in its present incarnation, the income tax is a creature only lawyers could love. And in fact, they do. In essence, the tax is *complex* and *adversarial*, the very qualities that characterize legal training and the practice of law. And since lawyers draft, enact, interpret, calculate and enforce its provisions - no surprise - the income tax seems to them perfectly normal, fair, workable, even sensible. But is it to the rest of us?

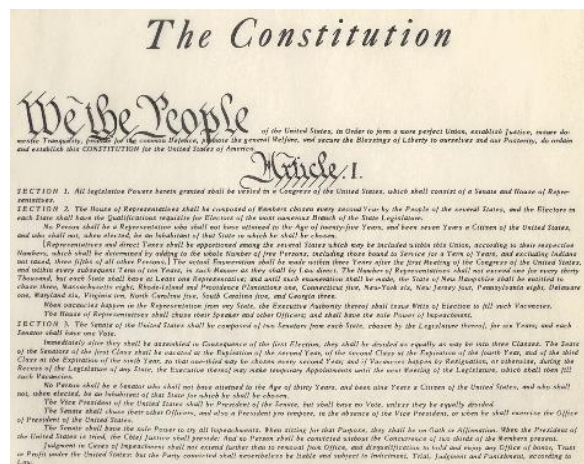
The Constitutional Issues



The founding fathers described in the Constitution a society that works and in the Declaration of Independence one that didn't. The essence of a society that works, according to the framers of the Constitution and the Bill of Rights, is one that minimizes antagonism and conflict between a free people and their government. By way of contrast, conditions provoking revolutionary antagonisms and conflict in Colonial times were listed in the Declaration of Independence as the "history of repeated injuries and usurpations" by mad King George III, such as: "He has erected a multitude of new offices, and sent hither swarms of officers to harass our people and eat out their substance." Sound familiar? Ask anyone who has ever been audited. Two complaints in particular sound very much like today's Tax Court: "He has made judges dependent on his will alone, for the tenure of their offices, and

the amount and payment of their salaries." and "He has . . . given his assent . . . for depriving us in many cases, of the benefit of trial by jury." The income tax clearly runs afoul of the Declaration of Independence; how does it fare by the Constitution?

The fact that a constitutional amendment was required to bring the tax into being renders it immediately suspect. However, lawyers and judges (who else?) assure us that the Sixteenth Amendment settled the constitutional issues, and therefore, that all constitutional challenges to the income tax are "without merit," the province of kooky tax resisters, period, end of subject. Nevertheless, a close reading of the Sixteenth Amendment reveals that it addressed *only* the population issue raised by the Supreme Court in 1895. Specifically, the Sixteenth Amendment states: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without



apportionment among the several states, and without regard to any census or enumeration." The Amendment makes no mention of myriad other potential constitutional conflicts.

We have given up a lot for the privilege of having our income taxed. In the domain of "due process," income tax law deprives us of trials by jury, a right the founding fathers regarded as important enough to be assured in criminal and common law cases by the Sixth and Seventh Amendments, respectively. Lacking trials by jury, tax law is not subject to the humanizing scrutiny of citizen jurors. Consequently, tax law has drifted off into surreal realms of complexity, comprehensible only to tax lawyers and accountants, and even they disagree as to the law's meaning. Daily, therefore, taxpayers are punished for breaking laws they cannot understand, an affront to elementary standards of justice. Further, in forfeiting jury trials, we are being asked to trust the government to be the impartial arbiter in matters concerning its own revenues, a clear case of putting the cat amongst the pigeons. As Mark Twain famously wrote: "You tell me whar a man gits his corn pone, en I'll tell you what his 'pinions is."

Not only is trial by jury forfeited to the demands of the tax system, but so too are the presumption of innocence and right to remain silent - each a cornerstone of American constitutional tradition. Forfeiting the presumption of innocence means the government regards us as criminals first and as good citizens only if we can surmount the Herculean task of proving our innocence by producing records in detail that would challenge a saint at the pearly gates. Otherwise we remain criminals in the eyes of our government, eternally Jean Valjean under the accusing glare of Inspector Javert. This is hardly in the spirit of minimizing antagonism between the people and their government. Conditioned to think of all taxpayers as criminals, the IRS has become arrogant and autocratic to the point where Congress has been forced to enact a "Taxpayers Bill of Rights." Lest we forget, the presumption of guilt is one of the injustices our European forbears fled their homelands to escape.

They also sought to escape forced confessions in criminal proceedings, a process that achieved its greatest notoriety during four centuries of the Spanish Inquisition. The right to remain silent, to avoid self-incrimination, popularly known as the Fifth Amendment, was intended to prevent government from coercing citizens into testifying against themselves, leaving the burden of proof to the government. However, we cannot "take the Fifth" in tax matters. As a practical matter, it would be impossible for the government to bear the burden of proof concerning the amount of our income and the manner in which it was spent. Instead, we must disclose all under penalty of perjury or go to jail. Tax returns, therefore, are in the nature of a forced confession, the threat of jail replacing the *jarra*, fire tongs and rack of the Inquisition.

The Eighth Amendment prohibits the imposition of "excessive fines" and yet the tax code is riddled with instances of such excesses - ask any businessman who has been a day late in filing his quarterly employee withholding tax report.

If giving up the rights to trial by jury, presumption of innocence and freedom from self-incrimination and unreasonable fines weren't enough, the tax code further requires that citizens abandon their constitutional right to privacy, to be "secure in their persons, houses, papers and effects, against unreasonable searches and seizures." Tax audits can be undertaken at random, without "probable cause" or warrants required by the Fourth Amendment, yet the government's access to taxpayers "houses, papers and effects" granted by the tax code is virtually without limitation. There exists enormous potential for government abuse of these extraordinary powers, as we learned in the days of Lyndon Johnson and Richard Nixon, when "enemies" were subjected to grueling tax audits. But even on more

mundane levels, the loss of privacy concerning one's personal financial affairs is nearly universal. Anyone applying for a home mortgage or other major credit is required to surrender to the lender tax returns containing far more detailed personal information than required to issue credit. Consequently, sensitive personal information becomes widely accessible, both through legal and illegal means, as occurred recently when identity thieves purchased such information from ChoicePoint.

And why do we value financial privacy? It could be as simple a matter as not wanting the competition to know the state of one's finances in a bidding situation, or the sale of one's business. Or it could be as complicated as being persecuted for "un-American activities" through inferences drawn about one's reading material or organizational affiliations, revealed as "Dues and Publications," Form 1040, Schedule C, page 1, Part II, line 13.



Now we ask ourselves: If these constitutional conflicts are so obvious, violating five of the first ten amendments, why then is the income tax code allowed to exist? The Sixteenth Amendment says only that in taxing income Congress may disregard *apportionment among the states and any census or enumeration* as criteria, *not due process and the Bill of Rights*. Ah, that brings us back to lawyers, who are the ones who decide these matters. To lawyers, this whacked out system seems perfectly normal, even a thing of beauty, since complex and adversarial proceedings are the essence of what they learned in law school and practice daily. Besides, as the dominant political profession, lawyers are little inclined to change the system since they benefit enormously from those very complexities and antagonisms, both in private practice and in public service as legislators.



Clifford Berryman, June 1933

Consider the members of Congress. As incumbents, members of Congress, mostly lawyers by profession, are in a position to extract significant campaign contributions from special interests by promising to support this tax exemption or to vote against that tax increase. Voting on tax matters is a legislative act with national repercussions, engaging thereby many powerful lobbies, political action committees, industry associations, corporations and wealthy contributors. In short, the income tax is the incumbent congressman's ultimate campaign funding device. Is it any wonder then, major tax reforms - each purporting to solve once and for all the complexities and inequities of the tax code - surface at election time with uncanny regularity? And is it surprising that all such attempts fail to accomplish either objective, but rather are derided as "tax lawyers' and accountants' full employment acts"?

The ability to manipulate the income tax code provides congressional incumbents with often- insurmountable advantages in raising campaign funds, "the mother's milk of politics." Reportedly, members of the tax-writing House Ways and Means Committee receive an average of about 50 percent more campaign contributions than their

colleagues. The net result is that, notwithstanding the worst fiscal record in the history of the planet, numerous ethics scandals and financial fiascos, more than 90 percent of these worthies are routinely returned to Congress at election time.

Why is this high reelection rate disturbing? Because it runs counter to perhaps the most fundamental contribution of democracy: *prompt, peaceful political responsiveness to change*. Remember, democracy replaced monarchy - family rule - a very slow-changing political system, granting life tenure to most political office holders and their descendants. Unable to adapt to changes wrought by the Enlightenment and the British Industrial Revolution in the late Eighteenth Century, the French monarchy was overthrown "with extreme prejudice" more than two hundred years ago. This at about the time when we Americans were forming our republic after having displaced the British monarch, who was similarly slow in adapting to change.

Democracy sought to replace tenured family rule with frequent elections, so as to provide new leadership promptly when changing circumstances demanded it. *Democracy flows from the premise that it is easier to replace leaders than to change their minds.* However, with the political persistence assured by incumbency's control over the income tax code, the U.S. Congress exhibits political rigidity the French Louis' would have envied. None would have been more surprised than the framers of the Constitution to witness the emergence of the politician as a tenured profession. Accordingly, facilitating prompt, peaceful political change, democracy's fundamental contribution to political progress, has in large measure been thwarted by the income tax - a dangerous state of affairs given the acceleration of change in modern society. Repeal the income tax and the need for term limits would be vastly diminished.

In tranquil times of peace and prosperity political rigidity and the forfeiture of fundamental rights pass unnoticed. It is in troubled, changing times, when governments feel threatened and are inclined to abuse their powers, that we feel the absence of fundamental democratic principles. By then it is too late. Legitimate dissenting voices are suppressed in the name of the crisis, and the nation deprived of their constructive alternatives. The forfeiture of civil rights and liberties inherent in the income tax greases the skids for the suppression of dissent.

In troubled times more than two hundred years ago, American dissenters observed first hand the injuries and injustices wrought by the absence of fundamental rights to trial by jury, presumption of innocence, freedom from self-incrimination, freedom from unreasonable fines and from unreasonable search and seizure. Their constructive alternatives are embodied in the U.S. Constitution and the Bill of Rights. Are we forgetting lessons our forbears paid dearly to bequeath us?



Practical Considerations

Constitutional issues aside, consider the complexity of the system. Can you imagine what we would say if the gas or telephone companies demanded of us the same kind of mind-numbing, Form 1040 calculation and record-keeping just to pay our bills? We would be outraged. Taxes are our government bill. Why should our threshold of tolerance for paperwork and accountability be different for government? Well, say the politicians, government is different because government wants us to receive its bill according to our ability to pay. In other words, *fairness is the principle said to*

underlie the taxation of income. And to be fair in the taxation of income, government needs to know how much income we receive, and how we spend it, granting tax-favored status to some of our income and expenditures and not to others. The problem, as with most institutions operated by lawyers, is that *the fairness is not worth the complexity*, particularly when one considers how readily the fairness can be tampered with (e.g. tax shelters, special exemptions and tax rates). Plato had it right: "When there is an income tax, the just man will pay more and the unjust man less on the same amount of income."

Increases in Social Security taxes over the years have rendered the taxation of income highly regressive. Indeed, payroll taxes have become our most regressive form of taxation, presently taking 15.3% of the income of those earning less than the maximum to which the tax applies (currently \$90,000) but none of the income above that. Consequently, while the poor and middle classes pay a straight 15.3% of their income (between employee and employer contribution) in payroll taxes, the percentage for the wealthy diminishes as income rises. For the individual earning \$500,000 per year, payroll taxes represent a minuscule 2.75%, and for CEO's receiving multi-million dollar paychecks, such taxes dwindle into insignificance. To be sure, the Social Security benefits received by the very rich are commensurately insignificant relative to their total retirement income. Nevertheless the notion of progressive taxation is based on "ability to pay" not "need for benefit." Payroll taxes turn the Wilsonian reformers' ideal of progressive taxation on its head. Since payroll taxes have in recent years grown to represent nearly 40 percent of federal taxes paid, this regressiveness is of considerable significance.

But how else can taxation be made simple and fair?

That, indeed, is the relevant question. The answer is simplicity itself: *Instead of taxing income, tax expense.* In other words, replace all payroll, corporate and personal income taxes with a national sales tax of 27 percent. The 27 percent rate is arrived at as follows (using fiscal 2004 as an illustrative year):

(Figures for 2004 in trillions)

Nominal Gross Domestic Product (GDP) (trillions)		\$11.7 of which
Personal Consumption Expenditures	\$8.2	
Residential Housing Investment	<u>0.7</u>	
Consumption tax base:	\$8.9 trillion	

Federal budget expenditures of \$2.292 trillion divided by \$8.9 trillion tax base equals 25.8 percent tax rate needed to fund the government for 2004. A 27 percent national sales tax rate would have yielded \$2.403 trillion in FY 2004, closing the deficit gap and leaving a surplus of \$111 billion. This surplus, added to \$148 billion in "other" federal revenues (excise taxes, fees, duties, estate taxes, etc.), would have added up \$259 billion that could have been set aside by the government in U.S. corporate equities as a reserve against future Social Security and Medicare expenses (a much better idea than personal/private Social Security accounts). The idea of setting the tax rate slightly higher than the current level of government expenses goes against President Bush's politically expedient insistence on "revenue neutral" tax reform. Nevertheless, if we are going to reform government finances, we might as well go all the way, and cure the deficit and fix Social Security in the process.

The national sales tax rate must be set high enough to cover all government expenses, thereby eliminating the budget deficit gap with its accompanying upward pressure on interest rates and potential for intergenerational conflict. If we are to reform the tax system, perhaps it is also time to revive the debate about a balanced budget amendment to

the Constitution. Certainly, as Chairman Greenspan has urged, it is time to reinstate the pay-as-you-go (PAYGO) rules for enforcing budget discipline. PAYGO essentially requires that any reduction in taxes or increase in expenditures be paid for with a corresponding offsetting increase in taxes or reduction of expenditures so as not to increase the deficit. The implementation of such sound fiscal policies would discourage the present ethically suspect practice of currying votes by promising government benefits to today's voters while passing the bill on to tomorrow's taxpayers.

Just to put things in perspective, here are the basic U.S. Government budget figures for the year ending September 30, 2004:

Fiscal Year 2004

Revenues

Individual income taxes	809	
Corporate income taxes	189	
Social insurance taxes	733	
Other	<u>148</u>	
Total	1,880	
On-budget	1,345	
Off-budget	535	(Mainly Social Security and Medicare)

Outlays

Discretionary spending	895
Mandatory spending	1,237
Net interest	<u>160</u>
Total	2,292
On-budget	1,913
Off-budget	380
Deficit (-)	-412

(Source: Congressional Budget Office)

A Graduated National Sales Tax Considered

"But," comes back the standard knee-jerk response, "isn't a sales tax regressive, imposing a greater burden on the poor (who spend most if not all of their income) than the rich (who are able to save and, thereby avoid tax)?" Answer: Only if it is a *uniform* sales tax. If, however, the sales tax is *graduated*, exempting essentials, surtaxing luxuries and taxing everything else at a standard rate, a sales tax can be made progressive, requiring the poor to pay virtually no taxes and the rich to pay proportionately higher taxes than everybody else, satisfying the notion that taxes should be, in some measure, proportionate to ability to pay. Starting from a benchmark 27% rate on consumer purchases, a higher luxury tax rate would be imposed to cover the cost of exempting essentials. What could be fairer according to the "ability-to-pay" principle? (Unfortunately, in the current political climate favoring tax breaks for the wealthy, a surtax on luxuries will be a hard sell without extraordinary support from the public.)

A noteworthy consequence of a graduated national sales tax would be the return to the people of political dialogue on taxation.

People on park benches would not only have opinions about the national sales tax rate, but could also be expected to intelligently discuss whether a luxury car should be defined as a \$30,000 Buick or a \$50,000 Cadillac. By contrast, today, who discusses the fairness of straight-line, double-declining-balance, units-of-production, sum-of-the-years-digits or ACRS methods of depreciation? Or whether



short-term capital loss carryover or alternative minimum tax provisions are equitable? To be sure, congressional definition of essentials and luxuries would, to some extent, get us back into the problem of tampering with the tax code as a campaign funding device. (Perhaps that's the compromise we must accept in exchange for having Congress give up the ability to tamper with the income tax code.) However, at least with a comprehensible, graduated sales tax, such tampering would be open to public scrutiny and restraint. Any member of Congress who tried to slip in a \$50,000 Cadillac as a non-luxury car would be immediately ridiculed by Leno and Letterman.

Perhaps the safest way to avoid political tampering with the definitions of exempt, basic and luxury goods and services could be to classify goods and services according to an immutable relative pricing standard. For example: items priced in the bottom quartile exempted from tax, those in the top quartile surtaxed as luxuries and remaining middle 50 percent taxed at the basic 27 percent rate. The surtax rate on the top quartile would be calculated to yield revenue equal to that foregone from the exempt quartile. In this day and age of readily available price and volume data, accurate and sophisticated statistical sampling techniques, and ubiquitous automated data processing, such calculations and classifications should be easily performed. As a side benefit for consumers, a price-based sales tax system would intensify price competition among producers of goods and services seeking to gain the competitive advantage of qualifying for the lowest feasible tax rate.

It is precisely because the tax debate would return to the popular forum, that many legislators - who deep down believe that politics is too important to be left to the people - resist the idea of a national sales tax. Moreover, every time we bought something we would be reminded of the cost of government, something lawmakers would prefer to disguise and obscure, as they now do with the fiction of "employer contributions" to Social Security and by withholding taxes before we ever see the money, rather than taking it from us after we have put it in the bank.

Perhaps one answer as to why income is taxed rather than expense, is that we receive paychecks less frequently than we buy things, and therefore, are less frequently reminded of the burden of government than we would be if expense were taxed. Consequently, a national sales tax would provide taxpayers with a constant and highly visible reminder of the cost of government. With a tax rate pegged to the Government's share of national expenditure, legislators seeking reelection would be under pressure to pare government wasteful, fraudulent and porcine government expenses, gaining votes by justifiably reducing this highly visible tax rate. Just as the taxation of income led to explosive growth of government, highly visible taxation of consumption would discourage that growth - a persuasive argument for those who truly want to restore sound fiscal policy and curb unwarranted intrusion of government into the private sector. However, given the vested interest today's incumbents have in the income tax system, the replacement of the income tax by a consumption tax will be achieved only through extraordinary public

pressure demanding such a change or, less probably, by unusual acts of altruism on the part of members of Congress.

What about estate and gift taxes?

Even with the imposition of a luxury tax (and particularly if one is not imposed), in this day and age of outrageous multimillion-dollar compensation for top corporate executives, a national sales tax system may still result in socially destabilizing accumulations of wealth in the hands of the privileged few. Executives earning five or ten million dollars



a year, for example, may choose to scrape by on a million dollars a year and save four to nine million dollars annually free of tax. A few million dollars here, a few more million there and pretty soon we're talking real money, accumulated thanks to inappropriately cozy relationships between top management and cronies on boards of directors failing in their duty to look out for the interests of shareholders. The dangers of great concentrations of wealth include widespread popular resentment leading to revolutions (as the French aristocracy learned in 1789), and abuses of economic power by

“malefactors of great wealth” (as Republican Teddy Roosevelt learned during his trust-busting presidency). Inherited wealth, as the British landed gentry amply demonstrated during the Industrial Revolution of the 19th century, often fosters indolence and inept asset management among coddled heirs. Accordingly, if the income tax were repealed, the estate and gift taxes should stand as a last bastion of income redistribution to assuage the detrimental effects of maldistribution of wealth. Moreover, the estate tax should be stripped of its eviscerating loopholes (trusts, for example) with which the very wealthy avoid and postpone estate taxes indefinitely.



The common argument advanced by those in favor of repealing estate and gift taxes - namely that accumulated wealth has already been subjected to taxation at the corporate and individual levels and, therefore, should not unfairly again be taxed at death or upon bequest - would no longer apply. Under a national sales tax system, savings are not taxed, all such wealth would have been accumulated free of tax, and therefore would be fairly subjected to estate or gift taxation. Unwisely, though not surprisingly, both Republican-sponsored national sales tax bills before Congress would, if enacted, repeal estate and gift taxes which now apply only to the wealthy. You have to ask yourself: Whose interests are members of Congress looking out for?

The Economic Arguments for a graduated national sales tax:

From an economic standpoint, a graduated national sales tax is eminently compelling:

- An obvious consequence being the collection of taxes at last from the "underground economy" on the theory that "while you can't tax a criminal's income you can tax the car he buys." The government could recapture an estimated \$100 billion per year presently lost to income tax evasion.

- Being vastly simpler and less costly to implement, a consumption tax would lift a the dead weight of a reported \$200 billion in tax preparation costs from the economy, freeing up corresponding resources for added production, consumption and investment.
- Less obvious but equally important are the benefits of a regular, predictable flow of government revenues to be derived from taxing steadily rising consumption rather than volatile *net* income.
- By agreeing to a national sales tax rate sufficient to cover all government expenses (in effect achieving a balanced budget), the U.S. government would no longer invade world capital markets, which now put upward pressure on interest rates, make the U.S. increasingly beholden (and vulnerable) to foreign creditors and heighten the potential for future inter-generational conflict.
- And let us not forget the encouragement of savings, the source of economic growth and security. Encouraging savings by taxing, and, therefore, discouraging consumption would stimulate economic growth and reduce American dependence on foreign lenders, as Chairman Greenspan and most economists agree.
- As for surtaxing luxuries, there can be no questions raised about ability to pay or diversion of funds from productive investment. To the extent wealthy individuals enjoy luxury, they pay a premium for the privilege; to the extent they refrain from purchasing luxuries, they save and thereby contribute to the investment pool upon which economic growth depends.
- In addition, the ability to isolate the tax component of corporate retail prices would enable American business to eliminate the sales tax from international sales, in the same way as Europeans now do with their value added tax, enhancing American price competitiveness abroad, boosting exports and narrowing the trade gap.
- The combination of heightened export competitiveness and increased personal savings (by discouraging consumption), would reduce and, perhaps, even eliminate, America's international balance of payments deficit. In so doing, America's dependence on foreign creditors and investors would be reduced, as would be the dangers to U.S. financial markets posed by a potential flight from the dollar by foreigners now reportedly holding 38 percent of the \$4 trillion in U.S. Treasury bonds, 11 percent of the \$6.1 trillion in agency bonds (such as those issued by Fannie Mae and Freddie Mac), 23 percent of the \$6.5 trillion in U.S. corporate bonds and 11 percent of the \$15.5 trillion in U.S. equities outstanding.
- The elimination of the corporate income tax, would enable American business to make business decisions strictly based on economic merit, without the distorting influence and uncertainties of tax considerations, thereby increasing efficiency, lowering costs and enhancing competitiveness. Likewise, elimination of the corporate income tax would avoid the bad publicity and resentments surrounding tax-motivated decisions by American corporations to avail themselves of foreign tax havens.
- Moreover, capital gains taxes, the double taxation of corporate dividends and the taxation of other investment income would be eliminated, encouraging savings, thereby fomenting the formation of investment capital and its attendant economic stimulus.

Collecting taxes at the cash register rather than on paydays and April 15th would be far simpler, more accurate and easier to enforce. With one sentence: "The Sixteenth Amendment is hereby repealed." and a few hundred lines of programming to modify businesses' existing computerized state sales tax programs, we could dispense with tens of thousands of pages of impenetrable Internal Revenue Tax Code, hundreds of thousands of pages of IRS rulings and regulations, millions of pages of court cases and other legal precedents, 62 million lines of IRS computer programming required to manage the current tax code, hundreds of millions of tax forms submitted annually, \$13.7

Form 1040A U.S. Individual Income Tax Return 2001

Department of the Treasury, Internal Revenue Service

Use the IRS label (shown on page 1) to file your return.

President Election Campaign: Yes No

Filing status: Single Married filing joint return (even if only one had income) Married filing separate returns (enter spouse's social security number above and full name here) Head of household (only qualifying person) (see page 21) If the qualifying person is a child (do not your dependent, enter this child's name here) See page 22

Exemptions: Yourself Spouse Dependents (see page 22)

Income: Wages, salaries, tips, etc. (Attach Form(s) W-2) Taxable interest (Attach Schedule I if required) Tax-exempt interest (Do not include on line 8c) Ordinary dividends (Attach Schedule I if required) Capital gain distributions (see page 25) Social Security Total IRA Total pension and annuity Long-term capital gain (see page 25) Social Security Total IRA Total pension and annuity Long-term capital gain (see page 25)

Adjusted gross income: Add lines 7 through 14b (for right column). This is your total income. Subtract non-interest deduction (see page 31) Add lines 16 and 17. These are your total adjustments. Subtract line 18 from line 15. This is your adjusted gross income.

billion spent annually by the IRS and other government agencies to administer and enforce the current tax code and \$200 billion reportedly spent annually for tax preparation by private citizens. (For additional numbers revealing the absurdities of the current income tax system see <http://www.scrapthecode.com/educating/taxfacts.html> .)The repeal of the Sixteenth Amendment, moreover, would provide several hundred thousand bright, capable tax lawyers, accountants, tax preparers, IRS agents and their staffs with the opportunity to perform useful work at last. Seen from the perspective of the Sixteenth Amendment repealed, the work of income tax preparers, collectors and enforcers is revealed for what it really is: so much digging of holes in the sand and then filling them up. Ask yourself, if all income taxes were abolished and all your past tax returns were lost in a fire, what would you be willing to pay to have them restored?

If a graduated national sales tax were adopted, the entire burden of calculating, collecting and remitting taxes would be shifted to retail businesses whose personnel are trained in such matters already, and whose accounting and cash management systems are already channeling sales taxes to the majority of state governments. Business would be delighted to replace the complicated payroll tax and income tax systems with an expansion of the relatively simple sales tax system. Sensibly, the "Fair Tax" bills now before Congress provide for the collection and remittance of the national sales tax through existing State sales tax channels, resulting in the dismantling of the IRS. One cannot help but wonder, if the bulk of federal taxes were presently collected at the cash register, would the American people regard the taxation of income an attractive new alternative? Why keep it, then?



For the IRS or its successor, a national sales tax would be a breeze to enforce, requiring intensified scrutiny of a few thousand providers of retail goods and services while eliminating the far larger costs associated with monitoring of more than 120 million income taxpayers. Presently a handful of corporations account for the vast bulk of retail sales, so the opportunity to evade national sales taxes would be marginal, as has been demonstrated by state sales tax systems. The government's ability to collect about \$100 billion in revenues it presently estimates is lost due to cheating and evasion would go a long way toward closing the deficit. Concurrently, the average citizen would be relieved of the necessity of preparing Form 1040 and its myriad of attached forms and schedules, would no longer have to collect and store scraps of paper to support deductions, would no longer have to pay tax preparers, would no longer fear to open envelopes marked "Internal Revenue Service," would no longer have to wrestle with conscience in fear of audits.

All of the foregoing sounds remarkably like the objectives set forth in the President's Executive Order of January 7, 2005, creating the President's Advisory Panel on Federal Tax Reform:

"Purpose. The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury in accordance with this order a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. These options should:

- (a) simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws;
- (b) share the burdens and benefits of the Federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and
- (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace.”



Congressman Linder

John Linder (<http://linder.house.gov/>) member of the House Ways and Means Committee in the House (Fair Tax Act of 2005, [HR25](#) See: <http://thomas.loc.gov/cgi-bin/query/z?c109:H.R.25:>) and Saxby Chambliss in the Senate (<http://chambliss.senate.gov/default.cfm?CFID=8266194&CFTOKEN=33008549>) ([S25](#) See: <http://thomas.loc.gov/cgi-bin/bdquerytr/z?d109:SN00025:>), both



Senator Chambliss

Republican members of Congress from Georgia, offer identical promising, though flawed, comprehensive bills to kill all income and Social Security/Medicare payroll taxes outright, and provide a IRS-free replacement in the form of a retail sales tax. They also propose to:

- Repeal the estate and gift taxes (ill advisedly, I maintain)
- Set the national sales tax rate at 23 percent (which may be about 3 to 4 percent too low, depending on what is taxed, resulting in more deficits) beginning in 2007, with adjustments in the rate in subsequent years
- Make no provisions for a luxury surcharge or exemptions from tax (but provide a measure of progressivity for low-income families by offering a monthly sales tax rebate equal to the tax rate multiplied by the monthly poverty level - an intrusive, administrative nightmare which could be readily obviated by exempting from tax low-priced goods and services preponderantly bought by poor families)
- Abolish the Internal Revenue Service, turning over the administration and collection of the national sales tax to the States (not a bad idea, since the States already have the mechanisms in place; however, once the States get hold of the revenues, they might be reluctant to send them along to Washington, particularly if the States and the Federal Government get into a snit involving states rights or unfunded mandates).
- Establish in the Department of the Treasury: (1) an Excise Tax Bureau to administer excise taxes not administered by the Bureau of Alcohol, Tobacco and Firearms; and (2) a Sales Tax Bureau to administer the national sales tax.

The House bill has 27 co-sponsors, the Senate bill, none.

Common objections:

In presenting the idea of a national sales tax in speeches around the country, I have found a common objection comes from those concerned about the loss tax deductions for mortgage interest payments and charitable contributions. The objective of these deductions is to enable taxpayers to make such payments with pre-tax dollars. Under a national sales tax system, such payments, exempt from taxation, would be paid with pre-tax dollars (since all income, not being subject to tax, would be pre-tax). So the net effect on mortgage payments and charitable contributions would be the same as under the present system.

Another objection arises around the issue of the complexities of transitioning from one system to the other. The taxation of used goods, for example, poses a ticklish problem, particularly as relates to housing. Capital loss carry-forwards left over from the superseded income tax system would also be problematic. Many other issues will emerge as policymakers analyze the process of transition; however, addressing such issues exceeds the scope of this essay. Whatever they may be, the complexities of transitioning are trivial compared to the complexities of the current tax code. Concern about such complexities, coupled with a savvy Washington insider's anticipation of the instant opposition likely to spring from powerful lobbies, prompted Chairman Greenspan to advocate implementing a blend of both systems. While I don't mean to minimize transitional complexities, I believe they are resolvable in an age of readily accessible data and ubiquitous data processing capacity. Given the manifest shortcomings of the income tax system, better to make a clean sweep of the tax system on a date certain than to perpetuate any vestiges of this albatross.

For those concerned about the fairness of eliminating corporate income taxes, do not be deceived. Corporations don't pay income taxes; their customers do, since customers are a corporation's ultimate source of revenue and profits. In the final analysis, all business activity, including wholesale and business investment, eventually serves a retail end, so the retail customer's expenditures are the appropriate measure of economic value suitable as a tax base. Accordingly, there is no need to institute two tax systems (one corporate and another personal) when one system will collect revenue from the ultimate taxpayer equitably, efficiently and at a time when funds are available - each important attributes of an effective tax system.

Another knee-jerk objection to a national sales tax is the concern about inflation. Adding a 27% sales tax to the price of goods and services would create a substantial one-time surge in prices, to be sure. However, the elimination of payroll and income taxes presently withheld from paychecks would simultaneously provide the wherewithal to pay the higher prices. There is no free lunch; what is gained in the earning is lost in the spending. After so many years of receiving paychecks ruthlessly shrunken by withholding, most taxpayers must radically readjust their mindset to envision a world in which people get to keep everything they earn. Only when this realization sinks in will the prospect of paying a stout national retail sales tax seem palatable.

Perhaps the most strenuous objection comes from those who quite properly observe that 27 percent tax added to the cost of goods and services we buy is a whopping chunk of change. And, indeed it is (as are current income taxes). And so too is the \$2.3 trillion the federal government spent in 2004, not to mention the \$1.3 trillion in state spending currently funded by a combination of sales, property and income taxes. The inescapable truth is that government is expensive and, like it or not, must be paid for by taxes, whether on income, consumption or wealth. Those who deem a 27 percent national sales tax unreasonably high should complain to public officials in Washington *about the size and scope of government*, not about the rate of taxation. (See my comments in the previous paragraph regarding the necessary mindset regarding the tradeoff of withholding taxes from paychecks and collecting them at the cash register.)

Summing up:

Since Americans spend about 99% of what they earn, the tax bases on which taxes can be levied - income or consumption - are roughly the same. Consequently, the main differences between an income tax and a consumption

tax are the methods by which taxes are computed and collected. Taxing income before it is received is inescapably complex, obscure, expensive, adversarial (direct), expensive, intrusive, unconstitutional, tempting to evade, difficult to enforce and administer. Collecting taxes at the cash register is relatively simple, transparent, inexpensive, non-adversarial (indirect), non-intrusive, constitutional, difficult to evade, easier to enforce and administer. Moreover, taxing income discourages the work ethic, encourages wasteful (deductible) spending, discourages savings and investment, increases indebtedness to foreign creditors and dampens economic growth. Taxing consumption encourages the production of (tax-free) income, discourages wasteful spending and encourages savings and investment, reduces indebtedness to foreign creditors and stimulates economic growth.

President Bush has said: "Freedom is on the march." As I have argued, the replacement of the cumbersome and costly income tax by the simpler and more efficient national sales tax will provide The United States with a significant competitive advantage. In order to remain competitive in a global economy, America's trading partners may also deem it advantageous to scrap their income tax systems, thereby restoring freedoms forfeited to the income tax system. Can you think of any other policy initiative likely to advance the march of freedom around the world more surely or painlessly than the replacement of the income tax by a national sales tax?

With but six words - "The Sixteenth Amendment is hereby repealed" - five constitutional rights would be restored, millions of taxpayer hours spent preparing taxes would be eliminated, billions in tax preparation costs would be saved, the IRS would disappear as would personal audits, government revenue would be boosted and stabilized, the federal budget deficit would be eliminated, savings would be encouraged, the economy would be strengthened and April 15th would pass unremarked, fifteen sunsets after April Fools' Day.

Epilog

The tipping point for radical, sound tax reform is at hand. Another "tax fairness and simplification" act tweaking today's Byzantine income tax code just won't do. All present income taxes - payroll, personal and corporate income -- must be completely scrapped and replaced with a graduated national sales tax sufficient to pay all the U.S. Government's expenses. PAYGO rules must be reinstated so as to ensure a balanced budget. Estate and gift taxes must remain in place.

However, given Congressional vested interest in preserving the income tax system as a campaign funding vehicle, the replacement of the income tax by a national sales tax will be achieved *only through extraordinary public pressure.* Fortunately, we live in a democracy in the age of the Internet, so the marshalling of public opinion behind this important cause can be readily achieved with the click of a mouse. Remember: "All that is necessary for evil to triumph is for good men (and women) to do nothing."

Make a difference: forward this *Chronicle* with your endorsement, to thoughtful, open-minded individuals on your mailing list and urge them to do likewise. Forward the accompanying condensed *Executive Summary* version entitled "A National Sales Tax: An Idea Whose Time Has Come" to those on your mailing list with short attention spans, and to policymakers and opinion shapers including:

- Your members of Congress (<http://www.visi.com/juan/congress/>)
- John Linder (<http://linder.house.gov/>) sponsor in the House of the Fair Tax Act of 2005, [HR25](#) and
- Saxby Chambliss <http://chambliss.senate.gov/default.cfm> sponsor in the Senate of [S25](#) offering a comprehensive bills to kill all income and Social Security /Medicare payroll taxes outright, and provide an IRS- free replacement in the form of a retail sales tax.
- President George W. Bush: president@whitehouse.gov or by mail to 1600 Pennsylvania Avenue, Washington, DC 20502 or fax to 202-456-2461
- Vice President Richard Cheney: vice_president@whitehouse.gov or by mail to 1600 Pennsylvania Avenue, Washington, DC 20502
- Chief of Staff Andrew J. Card, Jr. 1600 Pennsylvania Avenue, Washington, DC 20502
- Joshua Bolten, Director, Office of Management and Budget, 725 17th Street, NW, Washington, DC 20503. Fax (202) 395-3888
- Joel David Kaplan, Deputy Director, Office of Management and Budget, 725 17th Street, NW, Washington, DC 20503. Fax (202) 395-3888
- Assistant Secretary (Tax Policy), U.S. Treasury, 1500 Pennsylvania Avenue, N.W., Room 3120, Washington, D.C. 20220 (Let us hope that the fact that this position is currently vacant is not an indication of the administration's lack of commitment to tax reform and hope further that the position will soon be filled. See: <http://www.ustreas.gov/offices/tax-policy/organization/keypersonnel.shtml>)
- The Honorable Alan Greenspan, Chairman, Federal Reserve Board, 20th Street and Constitution Avenue, NW, Washington, D.C. 20551 (Send him "Prohibition's Hangover." He is one official in Washington capable of appreciating the historical background.)
- Secretary John W. Snow, U.S. Department of the Treasury, 1500 Pennsylvania Avenue, Washington, D.C. 20220.
- Mark J. Warshawsky, Assistant Secretary for Economic Policy, U.S. Department of the Treasury, 1500 Pennsylvania Avenue, Washington, D.C. 20220.
- Robert J. Carroll, Deputy Assistant Secretary (Tax Analysis), U.S. Department of the Treasury, Office of Tax Analysis, 1500 Pennsylvania Avenue, N.W. Room 3120, Washington, D.C. 20220
- Senator Connie Mack, Chairman, The President's Advisory Panel on Federal Tax Reform, 1440 New York Avenue, NW, Suite 2100, Washington, D.C. 20220 See: <http://www.taxreformpanel.gov/contact/>
- Senator John Breaux, The President's Advisory Panel on Federal Tax Reform, 1440 New York Avenue, NW, Suite 2100, Washington, D.C. 20220 See: <http://www.taxreformpanel.gov/contact/>
- The President's Advisory Panel on Federal Tax Reform, comments@taxreformpanel.gov by e-mail as MS Word Attachment or by mail: 1440

New York Avenue, NW, Suite 2100, Washington, D.C. 20220 See:

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 - <http://www.salestax.org>
 - <http://www.geocities.com/cmcofer/ftax.html>
 - <http://pafairtax.org/calc.php>

You have my permission, indeed my encouragement to forward this issue of the *Cassandra Chronicles* to anyone who might fruitfully enlist in the service of the future hour.

Kind regards,



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