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The test on tax reform

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If politicians tell you they favor "tax reform" and "tax simplification," what do you think they mean? The fact is most politicians, including the current presidential candidates, say they will give us tax reform and simplification, but what they mean differs widely.

Each candidate will strive to try to define those words in such a way that will attract more voters than they repel, and some will be sincere (like President Reagan), and some will be less sincere (like the first President Bush and President Clinton). The test for the voters is to determine who is sincere and who is not; the test for the candidates (at least the sincere ones) is to come up with a plan that is real reform and simplification and one that will also attract a majority of the voters.

As is well known, the current U.S. income tax system and the Internal Revenue Service are a huge and unnecessary drag on both the economy and individual liberty. The IRS code and regulations have become hopelessly complex and grown to about 7 million words. No one can possibly understand the present code, including even those at the IRS. Thus no matter how well-meaning, the taxpayer is always at risk for noncompliance -- such laws are characteristics of totalitarian, not free, societies.

Compliance costs are conservatively estimated at more than \$350 billion, and 5.8 billion man-hours, which represent a work force of 2.5 million, larger than the populations of Dallas and Detroit combined. The system taxes savings and investment -- the seed corn of the economy -- multiple times, and is so riddled with special provisions it is grossly unfair.

Responsible presidential candidates will say (and actually mean) that the present tax code and system must be scrapped. The system is beyond repair and can only become more police-state-like intrusive and economically destructive as the people find ways around it and the authorities engage in a losing war to stop them. Again last week, the IRS reported for the umpteenth time its loss of hundreds of computers with confidential data.

Fortunately, serious tax lawyers and economists have developed alternative proposals for true tax reform. Constructive reform means:

* Increasing fairness by taxing all people at the same low maximum rate while ensuring low-income people, through tax credits or a tax rebate, pay little or no tax.

* Making sure income is only taxed once so people are not taxed again on their productive savings and investment, a serious impediment to economic growth.

* And greatly simplifying the tax code by either not requiring reporting or making it so simple and straightforward it can be reported on a postcard. Two alternative serious proposals, with substantial political constituencies, meet those criteria: the "flat tax" and the national sales tax, better known as the "Fair Tax."

Under the flat tax, people only pay tax on their wages, salaries and pensions, and not on their interest, dividends, estate or capital gains. It is a single rate tax, but does provide for a standard exemption so low-income people, in effect, pay no tax or a much lower rate. The IRS only needs to know how much a household has received in wages, salaries and pensions, and no other information.

Under the Fair Tax, people are only taxed on their purchases of final products. The government would give all legal residents a grant to offset the tax they have paid on purchases up to a specified amount, so again, low-income people would pay no or little tax. The tax would be administered by state sales tax authorities, and the IRS would neither need to know nor have any information about individual taxpayers.

Though it would be desirable to abolish the 16th Amendment to the Constitution (the income tax amendment), it is not absolutely necessary for either the flat or Fair Tax. Were the IRS prohibited from collecting information about individuals' incomes or assets and also were forced to destroy old files, it would be very difficult to reinstall an income tax system without politically unacceptable cost and privacy invasions.

Candidates for president who are serious about fundamental tax reform would be well advised to endorse either, or both, the Fair Tax or flat tax, because each alternative can raise as much money as the current system and would be a vast improvement in terms of economic growth, fairness and personal liberty.

Both proposals are doable, and both have very large numbers of responsible citizens supporting them. From a practical political standpoint, as well as economic soundness, a candidate would make a serious mistake by saying he or she would not sign them into law, if either made it to the president's desk.

Economists, like yours truly, will grade the various candidates' tax reform proposals in the coming months. It will be interesting to see who passes and who doesn't.

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