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## A Certain Failure

By Richard W. Rahn

Published April 22, 2009

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### *When 'income' is uncertain at best*

Do you know what the word "income" means? My large Webster's dictionary is able to provide a clear and comprehensive definition in a mere 52 words. The shortest definition the Internal Revenue Service could provide in response to my request for its definition was 140 words - but the word income was included 10 times, missing the point that you do not include the word to be defined as part of the definition.

You may have read that President Obama has just appointed former Federal Reserve Chairman Paul A. Volcker to head a panel to make recommendations for tax reform. Its mandate is to simplify the tax code, raise more revenue, close loopholes, reduce the so-called tax gap - and not raise taxes for American families making less than \$250,000. The panel will fail!

It will fail for the same reasons former President George W. Bush's efforts and other presidents' attempts at tax reform failed, and that is because the complexity in the tax code cannot be lessened without a reduction in rates and the overall tax burden. It will fail, too, because the income-tax code and regulations contain many inconsistent and even contradictory explicit and implicit definitions of the word income, leaving taxpayers both confused and endlessly at risk legally.

When I first came to Washington many years ago, I was fortunate to be befriended by the smartest tax lawyer I ever met, the late Edwin S. Cohen. Mr. Cohen had been undersecretary for tax at the Treasury Department at the same time Mr. Volcker was undersecretary for monetary affairs.

Mr. Cohen for many years was a law professor at the University of Virginia and a partner in a major Washington law firm. Around 1980, we were discussing former President Ronald Reagan's proposals for tax reform, and Mr. Cohen said to me, "Ultimately the income tax is doomed to failure because it will endlessly grow more complex in a futile effort to define income."

Mr. Cohen, arguably the best tax lawyer of his day, also said he did not understand much of what was in the tax code - at that time a mere 4 million words or so, as contrasted with the more than 7 million words (almost 70,000 pages) in today's code. Last week, I was in a meeting with some of the nation's best and most experienced tax lawyers and tax economists, several of whom had served in the Treasury, and, again, there was the general lament that the tax code is so complex it is beyond their understanding and repair.

Those who claim that the government will be able to get a lot more tax revenue by increasing tax rates on the rich live in a fantasy world. As can be seen in the accompanying table, over the past 40 years, maximum income tax rates have ranged from 28 percent to 70 percent, yet tax revenues as a percentage of gross domestic product have been remarkably constant, ranging from a low of 16.3 to a high of 20.9 percent of gross domestic product.

TAX RATES, REVENUES AND WORDS					
	1975	1985	1989	1995	2005
Highest marginal tax rate (%)	70	50	28	39.6	35

Tax revenues as a percentage of GDP	17.9	17.7	18.3	18.5	17.6
Words in the income tax code (in millions)	2.9	4.4	4.8	5.7	7.1

During the same period, the number of pages in the tax code has increased 2 1/2 times, which has only served to increase complexity, uncertainty and the dead-weight cost of the income-tax system, without improving compliance or raising more revenue.

Under the current tax law, the top 1 percent of taxpayers pay 40 percent of the tax, and the top 5 percent pay 60 percent of the tax, while the bottom 50 percent of taxpayers pay just 3 percent. History - both American and that of other countries - clearly shows there is a limit to how much people are willing to pay in income tax, and even current rates are above those limits for many people.

The so-called rich have many options, including taking their income in nontaxable forms (such as buying tax-exempt state and municipal bonds), not working or moving to a more tax-friendly country, as many of the British and Swedes did in the 1970s. People always seem surprised that very rich people such as Warren Buffet, Sens. John Kerry, Edward M. Kennedy and Dianne Feinstein and House Speaker Nancy Pelosi pay much smaller effective tax rates than many in the middle class. One should not be shocked; the politically powerful have always protected themselves and their friends.

That is why many of the tax- reform proposals being floated, such as higher marginal tax rates on small-business owners and even more restrictive depreciation limitations, are tax increases on the most productive and entrepreneurial people in society who have not yet amassed sufficient wealth to be part of the nonproductive political class.

Even though American corporations pay the highest corporate taxes in the world, the Washington political class wants to further restrict the deferral of foreign-source income and make it harder for them to operate across the globe. The result of these reform efforts will be to force more companies to downsize or move to other countries in order to become internationally competitive. The people who will be most hurt by those tax attacks on business will be the workers who will lose their jobs or face more limited future job opportunities. In the meantime, the Washington political class will continue to amass a larger share of the nation's income for itself - a sign of a nation in decline.

Knowledgeable people know the present income-tax system is irreparably broken and must be replaced with a more consumption-based tax system. More Band-Aids on the present income tax system will only result in more complexity, requiring even more police-state tactics in a futile attempt to enforce it.

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