

Simplifying Federal Taxes The Advantages of Consumption-Based Taxation

by Chris Edwards

Executive Summary

This year's \$1.35 trillion tax cut reduced income tax rates and modestly liberalized the tax rules for retirement saving plans. However, the new tax law did not slow the progression of the tax code toward increasing levels of complexity. In fact, the law made 441 changes to the tax code and created a complicated series of phase-in periods for tax changes. Meanwhile, the congressional Joint Committee on Taxation released a 1,300-page study cataloging the excessive complexity of federal taxes but providing only limited proposals for reform.

Minor simplification reforms will not be enough. The tax system is caught in a spiral of continual change and nonstop growth in rules. Since the mid-1980s there have been 7,000 federal tax code changes and a 74 percent increase in the number of pages of tax rules. Complying with federal tax requirements wastes 6 billion hours each year as families and businesses fill out tax forms, keep records, and learn tax rules.

The key factor that causes rising income tax complexity is that the tax base is inherently difficult to measure. The Haig-Simons measure of income favored by many academic theorists is economically damaging and too impractical to

use in the real world. As a result, policymakers have fallen back on ad hoc and inconsistent rules to define the income tax base. That intensifies complexity and creates instability as policymakers gyrate between different definitions of the tax base. In addition, the lack of a consistently defined tax base increases the use of the tax code for special-interest tax breaks, thus further adding to the system's complexity.

The complexity and inefficiency of the individual and corporate income taxes have led to great interest in replacing them with a consumption-based tax. The leading consumption-based tax proposals, including the national retail sales tax and the Hall-Rabushka flat tax, could dramatically simplify federal taxation. Those tax systems would eliminate many of the most complex aspects of federal taxation, including depreciation accounting and capital gains taxation.

Imposing the largest federal tax on income was a historic mistake: no simple, efficient, and stable measure of income has been found in nine decades of the income tax. It is time to recognize this mistake and replace the income tax with a consumption-based alternative.

Switching to a consumption-based tax holds the promise of spurring greater economic growth and vastly simplifying the federal tax system.

Introduction

At the beginning of the 20th century, federal taxes accounted for about 3 percent of the nation's gross domestic product, 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.¹

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.² The complexity of the tax system has spawned a huge public and private “tax industry” to perform administrative, planning, avoidance, and enforcement activities. Those activities represent a pure loss to the economy since they consume resources and human effort that could otherwise be used to create useful goods and services. In addition, tax complexity leads to inequitable treatment of citizens, causes high error rates, promotes evasion, and impedes economic decision-making by creating uncertainty.

The chief source of federal tax complexity is the income tax on individuals and corporations. Two-thirds of Americans think the income tax system is “too complex.”³ Treasury Secretary Paul O'Neill called the system an “abomination.”⁴ 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.”⁵ Since Carter's attack, the number of pages of federal tax rules has doubled.⁶

In 1988 Princeton professor David Bradford, a former deputy assistant secretary in the Department of the Treasury, noted that “recent experience confirms the tendency of an income tax . . . to evolve toward ever greater complexity.”⁷ Another decade of experience has underscored this reality. There have been 1,916 changes to the tax code in the past five years and 7,000 changes since 1986.⁸ This year's tax cut law creates 441 separate tax code changes.⁹

The good news is that this is a problem

about which policymakers can do something. Congress has taken a few small steps to raise the visibility of the tax complexity problem, most recently with the release of a 1,300-page report from the Joint Committee on Taxation.¹⁰ The study cataloged the excessive complexity of federal taxes and proposed more than 100 specific reforms. However, most of the proposals were quite narrow and limited in scope, as required by the committee's mandate.¹¹

Limited simplifications will not be enough. Substantial reform can come only from uprooting the income tax system and replacing it with a consumption-based system, such as the Hall-Rabushka flat tax, a national retail sales tax, or a consumed-income tax.¹² Switching to a consumption-based tax holds the promise of spurring greater economic growth and vastly simplifying the federal tax system.

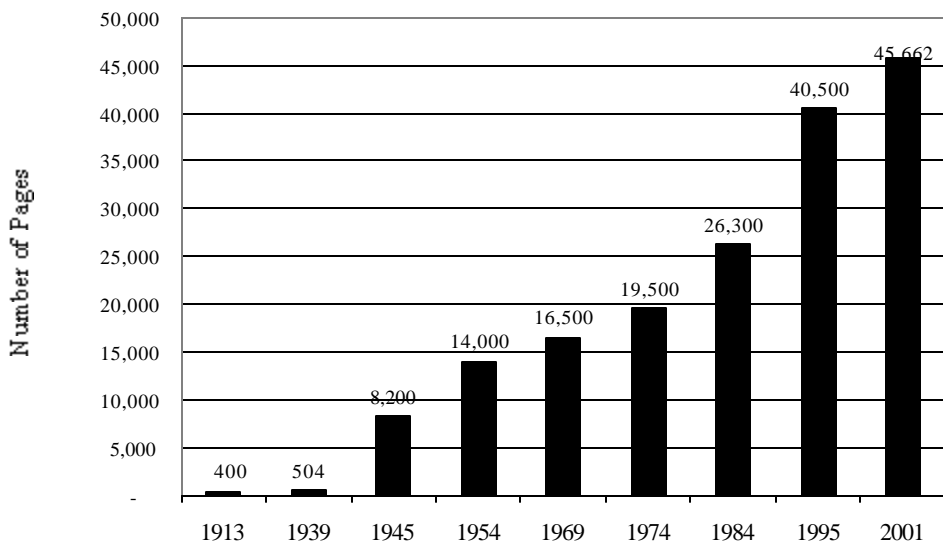
This study examines the magnitude of federal tax complexity, the costs created by that complexity, the problems inherent in taxing “income,” the simplification advantages of consumption-based taxes, and some long-term economic trends affecting the tax system.

The Magnitude of Federal Tax Complexity

The Growth of Federal Tax Rules

A century ago the federal government relied on excise taxes and customs duties for 91 percent of its revenue. As the government grew and sought new sources of revenue, it enacted the corporate income tax in 1909 with a 1 percent rate and the individual income tax in 1913 with rates ranging from 1 to 7 percent.¹³ The income tax began with just 16 pages of tax laws, and the entire federal tax system still had only 500 pages of laws and regulations in the late 1930s.¹⁴ World War II launched the income tax on a trajectory of continual growth, fueled by employer withholding begun in 1943.

Figure 1
Total Pages of Federal Tax Rules (tax code, tax regulations, various IRS rulings)



Source: CCH, Inc., *Standard Federal Tax Reporter*, 2001.

Today, total federal tax rules span 45,662 pages, having more than doubled in length since the 1970s (Figure 1). This page count includes the full tax code, tax regulations, and summaries of various Internal Revenue Service pronouncements such as letter rulings and technical advice memoranda.¹⁵ The tax code itself runs at least 1.4 million words and has increased in length 51 percent since 1985.¹⁶

The growth in tax complexity can also be discerned from other statistics, as summarized in Table 1. For example, the number of different tax forms produced by the IRS increased 23 percent in the past decade from 402 to 496.¹⁷ Taxpayer phone calls to the IRS doubled during the 1990s from 56 million to 111 million, even though the number of taxpayers grew only 12 percent.¹⁸ Apparently, the growth in usage of home computer tax software, and the 1.5 billion annual hits to the IRS Web page, have not reduced taxpayer confusion.¹⁹

The Tax Industry

The complexity of the tax system has spawned a huge “tax industry” engaged in tax filing, administrative, planning, avoidance, enforcement, and other activities. The

most visible part of the tax industry is the IRS with a budget of \$9 billion in fiscal 2001. The IRS employs 97,000 people and uses about 74,000 volunteers each year during tax-filing season.²⁰ In addition, there are about 24,000 tax workers in other federal agencies.²¹

The complexity of the income tax has overwhelmed federal tax workers. Year after year the IRS answers a large proportion of taxpayer phone queries incorrectly. The most recent government investigation found that IRS workers provided incorrect answers to taxpayer questions 47 percent of the time.²²

Alongside the federal tax bureaucracy, a huge private tax industry of accountants, lawyers, and other workers has developed. Of the 1.6 million accountants in the country, perhaps 30 percent, or 480,000, are in tax practice.²³ Of the 1,048,000 attorneys in the country, perhaps 10 percent, or 105,000, are in tax practice.²⁴ Enrolled agents are another group of tax specialists and number at least 35,000.²⁵ There are also uncounted thousands of computer specialists, administrative personnel, and others in the tax industry, as well as tens of thousands of tax workers in state and local governments.²⁶

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Table 1
Escalating Income Tax Complexity

Item and Time Period	Change
a) Total pages of federal tax rules, 1984–2001	Up 74% in 17 years
b) Words in federal tax code, 1985–2000	Up 51% in 15 years
c) Words in federal tax regulations, 1985–2000	Up 58% in 15 years
d) Number of IRS tax forms, 1990–2000	Up 23% in 10 years
e) IRS phone queries from taxpayers, 1990–1999	Up 98% in 9 years
f) Percentage of taxpayers using paid tax preparers, 1990–2000	Up 19% in 10 years
g) H&R Block U.S. tax preparation revenues, 1996–2001	Up 74% in 5 years
h) Top 8 accounting firms' tax revenues, 1996–2001	Up 112% in 5 years
i) Pages in Form 1040 instruction book, 1995–2000	Up 39% in 5 years
j) Time to complete Form 1040 and Schedules. A, B, D, 1990–2000	Up 47% in 10 years
k) Number of changed provisions in the tax code since 1986	7,000 in 15 years

Sources: Author's calculations based on a) CCH, Inc. tax code, regulations, and IRS rulings; b) Tax Foundation; c) Tax Foundation; d) IRS; e) JCT; f) IRS; g) H&R Block; h) Public Accounting Report; i) National Taxpayers Union; j) NTU; k) CCH, Inc.

Total tax industry employment is probably more than 1 million workers.²⁷ That means that there are more workers in the tax industry than there are in the entire motor vehicles and parts industry.²⁸

The following statistics indicate the rapid growth of the tax industry:

- Individual Tax Preparation: This year 57 percent of individual tax filers used a paid preparer, up from 48 percent in 1990 and from fewer than 20 percent in 1960.²⁹ With about 73 million individual taxpayers using paid preparers, and an average H&R Block fee of \$112, basic tax preparation costs individual taxpayers at least \$8.2 billion per year.³⁰ Many taxpayers have more complex tax situations and pay thousands of dollars for tax help.
- H&R Block Revenues: H&R Block is the largest tax preparation firm, with 90,000 workers.³¹ H&R Block's tax preparation revenues are up 74 percent in the past five years.³² In addition to H&R Block, there are thousands of smaller practitioners. An IRS tabulation found that 1.1 million different tax preparers had signed individual tax returns in 1997,

although some of those may have been unpaid preparers.³³

- Business Tax Preparation: Providing tax help to 25 million U.S. businesses is big business. Tax fees generate 29 percent of revenues for the top 100 accounting firms, led by PricewaterhouseCoopers and Ernst & Young.³⁴ 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).

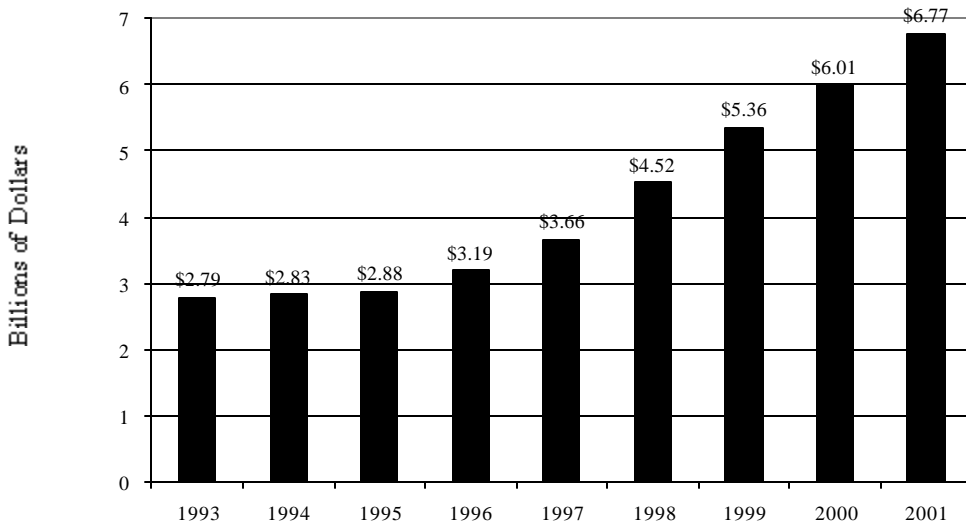
Costs of Tax Complexity

It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood . . . or undergo such incessant changes that no man who knows what the law is today, can guess what it will be tomorrow.

James Madison, *Federalist* no. 62

H&R Block is the largest tax preparation firm, with 90,000 workers. H&R Block's tax preparation revenues are up 74 percent in the past five years.

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



Source: Author's calculations based on data from Public Accounting Report, 2001.

Compliance Burden

The compliance burden is the total time and money wasted on filling out tax forms, keeping records, learning tax rules, and other tax-related chores. The Office of Management and Budget estimates that Americans spend 6.1 billion hours, or 3 million person-years, on federal tax compliance each year.³⁵ With the opportunity cost of compliance time equal to \$30 per hour, based on an OMB figure, tax compliance costs of lost time are about \$183 billion.³⁶ Most tax compliance costs are associated with income taxes. Estimates of federal income tax compliance costs range from about 10 to 20 percent of income tax revenues.³⁷

Business Compliance Burden

Businesses bear the biggest brunt of tax complexity under the income tax. There are currently 700 separate provisions of the tax code that affect individuals but 1,500 provisions that affect businesses.³⁸ At least 55 percent of the income tax compliance burden initially falls on businesses.³⁹

Many large corporations spend more than \$10 million per year on tax paperwork. Mobil Corporation once brought its federal tax docu-

ments to a congressional hearing to illustrate the magnitude of the compliance burden. Those tax documents ran 6,300 pages and weighed 76 pounds.⁴⁰ Citigroup's tax return sometimes exceeds 30,000 pages in length.⁴¹ For small businesses, tax compliance costs can be larger than actual taxes paid.⁴²

Business tax simplification is a key reason to pursue major tax reform. All Americans will gain if businesses spend less time buried in tax paperwork and more time creating better products with lower costs.

Enforcement Costs

In addition to the basic compliance costs of filing returns, many taxpayers incur costs after they've filed their returns. Responding to IRS audits, notices, liens, levies, and seizures and fighting the IRS in court can cost individuals thousands of dollars and businesses millions of dollars. The IRS assesses about 30 million penalties each year, thus imposing extra time and money costs on taxpayers.⁴³ Because of the complexity of the tax system, many penalties are erroneous. In fact, the high error rate caused the IRS Taxpayer Advocate to identify IRS penalties as one of the most serious taxpayer problems,

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and penalties are one of the most litigated areas of tax law.⁴⁴

Errors

In addition to added time and money costs, tax complexity causes taxpayers, the IRS, and tax experts to make errors. IRS errors have already been noted: the IRS gets the answers to about half of taxpayer phone inquiries wrong and often assesses erroneous penalties.⁴⁵ Errors can cost taxpayers money. For example, a new General Accounting Office study found that more than half a million taxpayers together lose more than \$300 million per year because they take the standard deduction when they should itemize their deductions.⁴⁶

Other evidence of excessive complexity comes from *Money* magazine's annual test of tax experts who are asked to compute taxes for a hypothetical family. *Money's* results consistently show wide variations in experts' answers, as a result of the complexity of the tax laws. In 1998, 46 experts surveyed came up with 46 different answers, with tax calculations ranging from \$34,240 to \$68,912.⁴⁷

Economic Planning Difficulty

Tax complexity impedes efficient decisionmaking and results in families and businesses missing opportunities and making poor economic judgments. This decision-making impediment of the tax system has been called "transactional complexity."⁴⁸ For example, the growing number of saving vehicles under the income tax, including numerous individual retirement accounts (IRAs), confuses family financial planning. The wrong saving choice may mean lower returns, less liquidity, and payment of penalties if money needs to be withdrawn. Other examples of transactional complexity include the difficulty in figuring out when capital gains should be realized and the complicated tax implications of choosing a business structure for a new company.

A dramatic example of how income tax complexity interferes with economic planning is the recent phenomenon of taxpayers who

exercise incentive stock options (ISOs) being unwittingly hit with large alternative minimum tax (AMT) bills.⁴⁹ Many ISO holders are middle-income families working for high-tech firms. When taxpayers exercise ISOs, the difference between the option price and the market price may trigger the AMT, even if the stock is not sold. Many taxpayers have been hit with large AMT bills without enough cash available to pay the IRS. While wealthy taxpayers might have tax advisers helping them, many middle-class families have never even heard of the AMT and yet face large tax bills they never planned for.

Uncertainty

The income tax system injects at least two main types of uncertainty into economic planning. The first is the continual change in tax rules. This complicates long-term economic decisions, such as those regarding business investment and retirement planning. Taxpayers have faced remarkable change in federal tax law in recent decades. Since 1954 more than 500 public laws have made tax code changes.⁵⁰ In the past five years alone there have been 1,916 changes to the tax code.⁵¹ This year's \$1.35 trillion tax cut law contains 85 major provisions and creates 441 separate changes to the tax code.⁵²

Each change in the law sets off changes in tax regulations, requests for IRS guidance, changes to tax forms, and higher error rates. This year's tax law adds new wrinkles in uncertainty with multiyear phase-in periods for numerous provisions. This creates the threat that rules will be nullified before they become effective.

The second way tax complexity creates uncertainty is to confuse taxpayers and the IRS regarding the effects of current laws, let alone future changes. Discussing corporate tax paperwork costs, Prof. Joel Slemrod of the University of Michigan noted that "even after all this expense, neither the company nor the IRS is completely sure what the correct tax liability really is. Audits, appeals, and litigation can drag on for years."⁵³ The GAO found that hundreds of tax disputes between

the IRS and large corporations remain unsettled for 10 years or more.⁵⁴ IRS agents have estimated that “about 86 percent of corporate tax disputes were due to different interpretations of the tax laws.”⁵⁵

In 1992 the IRS estimated that after being audited large corporations owed \$142 billion in taxes, but corporations themselves figured they owed just \$118 billion.⁵⁶ Noting this gap, the GAO found that “the difference is substantial and, in large part, attributable to ambiguity and complexity in tax law.”⁵⁷ Uncertainty about corporate tax liability has measurable economic effects. One academic study found that tax law complexity decreases the accuracy of Wall Street estimates of company tax rates, which are a key component of bottom-line returns to shareholders.⁵⁸

Noncompliance

Tax complexity leads to noncompliance with the tax system, whether caused by confusion or a desire to evade taxes. It is estimated that the government loses about 17 percent of income tax revenues to noncompliance, or about \$200 billion annually.⁵⁹

Former IRS commissioner Shirley Peterson thinks that confusion plays an important role in noncompliance: “A good part of what we call non-compliance with the tax laws is caused by taxpayers’ lack of understanding of what is required in the first place.”⁶⁰ The JCT notes that for other taxpayers, “complexity can foster multiple interpretations of the law and aggressive planning opportunities. In addition, taxpayers may consciously choose to ‘play the audit lottery’ by taking a questionable position on their tax returns, in the belief that complexity will shield them from discovery.”⁶¹

Inconsistent and ambiguous income tax rules cause the government difficulty in finding tax evasion. As a consequence, it responds with more audits, more information-reporting requirements, more enforcement activities, more court battles, and more extensive regulation writing. Aggressive tax planning and the resulting responses by the IRS are lucrative for accountants and lawyers, but

the country would be better off if tax rules were simple and transparent so that business could spend its energies making good products, not playing cat-and-mouse games with the tax authorities.⁶²

Inequity and Unfairness

Tax code complexity creates unfairness when it exacerbates “horizontal inequities,” which occur when similar families pay different tax amounts. As Congress has larded up the income tax code with special preferences, inequities have increased. For example, tax incentives for education may reward individuals who pay to take classes but not individuals who learn by themselves at home. Such inequities, and the tax complexity they create, have resulted in about 60 percent of Americans thinking that the income tax system is “unfair.”⁶³ As Bradford has noted, echoing Madison, “A law that can be understood by only a tiny priesthood of lawyers and accountants is naturally subject to popular suspicion.”⁶⁴

Causes of Income Tax Complexity

The first decision to make when designing a tax system is what base, or economic quantity, to tax. In 1909 and 1913, respectively, the federal government imposed new taxes on corporate and individual income. Initially, tax rates were low and very few people were affected, so any concerns about the simplicity or efficiency of the tax base would not have seemed important.⁶⁵ But 90 years later, the twin income taxes have morphed into giant revenue machines that together raise \$1.3 trillion annually, or 60 percent of total federal receipts. Unfortunately, the government picked an economically damaging and inherently complex tax base for the bulk of its revenue.

The income tax distorts the crucial economic tradeoff between consumption and saving. Saving is a primary source of economic growth because it provides businesses with the

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investment funds they need to increase and modernize the nation's capital stock. It is widely recognized that the income tax system is biased against saving because the returns to saving can face high tax rates, whereas current consumption does not. That bias has contributed to much of the interest in fundamental tax reform in recent years. Nearly all recent tax reform proposals would adopt a consumption base to eliminate disincentives for saving and investment, and thereby boost capital formation and economic growth.

The other major burden of the income tax is excessive complexity. The following subsections discuss why high and rising levels of complexity are inherent to the income tax.

Haig-Simons Income

The Sixteenth Amendment to the U.S. Constitution in 1913 allowed "taxes on income from whatever source derived" but failed to define how income should be measured. Statutory definitions that followed were just as vague, and there have been legal wrangling and congressional gyrations ever since about the proper base for the income tax.

Academic thought has been dominated by the measure of income named after economists Robert Haig and Henry Simons, who wrote in the 1920s and 1930s.⁶⁶ Haig-Simons income is simple to describe in theory: it equals consumption plus the rise in market value of net wealth during a year. That means that it includes all forms of labor compensation, such as wages and fringe benefits, and all sources of capital income, such as interest, dividends, and capital gains. It includes all income accrued during a year, whether or not it is received, including the paper value of net capital gains. For example, if a worker had wages of \$30,000 that was spent on consumption and had unrealized stock market gains of \$10,000, a Haig-Simons tax would have a base of \$40,000. Haig-Simons also includes items individuals would not normally think of as income, such as the implicit rent received from owning one's home or the buildup of wealth in life insurance policies.

This is a very expansive measure of

income, and our tax system has never come close to fully implementing it. While Haig-Simons income is simple in abstract theory, it is very impractical to tax in the real world. A basic impracticality stems from having to determine the market value of all assets each year to measure gains and losses. In addition, Haig-Simons would require many imputations to be made, such as taxing the phantom income from owning one's home. Under such a system, taxpayers with little cash flow could be hit with large tax bills they simply could not pay.

Despite the impracticality of Haig-Simons, it has remained a touchstone for many public finance experts and still influences current tax policy. Oddly, a Haig-Simons income tax does not have a strong economic argument in its favor. In fact, the taxation of a broadly defined income base leads to a bias against saving and investment. For example, the accrual taxation of capital gains would clearly double tax investment: A rise in an asset's projected future returns would lead to an immediate taxable capital gain; then, the return to the asset would be taxed again as it generated revenues in future years. Also, Haig-Simons fails to recognize that saving is an expense incurred to earn income, and leading theorists such as Irving Fisher have argued that it is very flawed.⁶⁷

Without a strong economic justification, the attraction of a Haig-Simons income tax base seems to stem partly from its theoretical simplicity and partly from the egalitarian impulse to impose a heavy load of taxation on those with high incomes. Since Haig-Simons fully taxes capital income, many people have claimed that it is more equitable than alternatives.⁶⁸ That claim is of course subjective, and many other people argue that consumption-based taxation is superior to income taxation on fairness grounds, but a discussion of tax fairness is beyond the scope of this paper.⁶⁹

Falling Back on ad Hoc Rules

The impracticality of taxing Haig-Simons income has forced policymakers to fall back

on an array of ad hoc rules to implement the federal income tax. 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.

Ad hoc rules have multiplied because there is no simple and efficient structure for an income tax. A key reason is the necessity of dealing with inflation, which “wreaks havoc” with income taxes, as Bradford notes.⁷⁰ Inflation distorts many key income tax items, including capital gains, depreciation, and interest.

Dealing with inflation creates a Catch-22 of efficiency and complexity problems for the income tax. If inflation is not specifically dealt with, the result will be overtaxation and distortion of tax rates across different investments. Alternately, fully adjusting the income tax for inflation would require excessive paperwork or “rule complexity.” As a result, governments usually fall back on ad hoc and approximate fixes for inflation. The problem with ad hoc fixes is that they generate inconsistencies and thus create decisionmaking difficulties or “transactional complexities.”⁷¹

A classic example is capital gains taxation. To avoid taxing purely inflationary gains, special rules are needed. A full solution would be to allow indexing of the capital gain basis, but that would involve excessive paperwork. Instead, the federal tax system has usually allowed an ad hoc adjustment for inflation in the form of an exemption or a lower tax rate. Such makeshift adjustments provide only a rough solution, and they create tension as taxpayers seek to recharacterize ordinary income as capital gains. Complexity increases as the government drafts extensive rules to prevent taxpayers from unduly taking advantage of the special capital gains rules.

The realization tax treatment of capital gains is another example of the Catch-22 complexity problem of income taxation.⁷² A Haig-Simons income tax would tax capital gains on an accrual basis, thus taxing all net

gains at the end of each year. As noted, that would be both difficult and unfair since cash-poor taxpayers could not afford to pay taxes on purely paper gains. As a result, federal taxation has fallen back on taxing capital gains upon realization, or asset sale. But that approach creates transactional complexity as taxpayers seek to optimally time realizations and offset capital gains with losses. Complexity has increased as the government has created complicated rules to limit taxpayer flexibility. For example, special rules limit the extent that ordinary income may be offset with capital losses, and “wash-sale rules” restrict the use of timing techniques to match gains with losses.

Inherent Inconsistency for Deductions

Determining which expenses may be deducted against gross income also involves inherent complexities. Under the income tax, businesses generally use accrual accounting to measure the tax base of net income or profits. The basic idea is to match revenues with expenses over time to accurately measure net income within each period.⁷³ This is far more difficult than it sounds, especially because there is no agreed-upon definition of net income.

Consider business purchases of buildings and capital equipment. Those assets generate revenues in future years, so it is thought that they should not be simply deducted in the year of purchase. Rather, they must be depreciated, or deducted against receipts, in future periods on the basis of the decline in their value. If depreciation deductions don't accurately track the decline in the asset's value, the Haig-Simons income tax base will be mismeasured. Since every asset is different, and new types of assets are being invented all the time, it is difficult to maintain accurate and simple rules for depreciation calculations.

As is the case with capital gains, inflation creates depreciation distortions for which there are no simple solutions. The current income tax allows accelerated depreciation, which may roughly compensate for inflation, but this ad hoc fix involves complicated rules

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The ad hoc and inconsistent rules of the income tax have been a major source of instability in the federal tax system.

and can lead to economic distortions.⁷⁴ Inflation also causes problems for other tax code provisions that attempt to match revenues and expenses through time, such as inventory accounting.

At a more fundamental level, the current concept of taxing income creates the intractable problem of determining which expenses should be deducted immediately and which should be capitalized. Purchases that are capitalized are deducted over future years using the special rules for depreciation, amortization, and inventory. In theory, any asset that produces benefits in future years should be capitalized, but the tax code contains no consistently followed principle of capitalization. A lack of consistency has resulted in many battles between the IRS and taxpayers.⁷⁵ The Supreme Court has noted the ambiguity: "If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period . . . in which the expenditure is made, the result will be to force the capitalization of virtually every business expense."⁷⁶ For example, business advertising costs may be immediately deducted under current rules. But most advertising produces benefits in future years and so in theory should be amortized rather than immediately deducted.

Congress has followed no consistent policy on capitalization. For example, in one attempt to properly measure Haig-Simons income, Congress burdened entrepreneurs by requiring amortization over five years of costs associated with starting a new business. It decided that start-up costs create value in future time periods and thus should not be immediately deducted. On the other hand, Congress has decided that research and development expenses may be immediately deducted, even though R&D clearly generates benefits over future years.

Inconsistency regarding deductions has also created complexity under the individual income tax. For example, the personal interest deduction was eliminated in 1986 in an effort to broaden the tax base. But because

mortgage interest remained deductible, home equity loans developed to essentially allow people who own homes to continue to deduct personal interest.

Such income tax inconsistencies create administrative and enforcement problems. The government must create complicated "anti-abuse" rules to counter the natural tendency of taxpayers to reorganize their affairs to seek out tax preferences. And there is a continual call for IRS guidance from taxpayers and tax accountants because, with no generally followed principles, it is not clear what the law requires in each specific situation.

Inconsistency Breeds Instability

The ad hoc and inconsistent rules of the income tax have been a major source of instability in the federal tax system. Policymakers have gyrated between broader and narrower tax bases, with saving and investment provisions as the main battleground. Proponents of broadening the base use Haig-Simons income as the touchstone. Others are concerned about the economic damage caused by taxing broad-based income and instead favor removing excess taxes from personal saving and business investment. Removing taxes from saving and investment moves the system toward a consumption-based tax. Table 2 gives some of the gyrations taken by Congress as it has changed policy direction on saving and investment provisions in recent decades.⁷⁷

Congress has changed the treatment of long-term capital gains 25 times since it first treated gains separately from ordinary income in 1922.⁷⁸ Another example of unstable policy is the investment tax credit (ITC), which was adopted in 1962, repealed in the late 1960s, reinstated and then increased in the 1970s, and repealed in 1986.⁷⁹ Similarly, since accelerated depreciation was introduced in 1954, depreciation rules have changed every decade or so.⁸⁰

Major tax acts have embraced opposite tax base philosophies. The tax laws of 1969 and 1976 generally moved toward a Haig-Simons income tax base but were followed by

Table 2
The Gyrating Income Tax Base: Changing Rules for Saving and Investment

Broad-Based Income Is Taxed	Exceptions Are Created	Exceptions Are Restricted	Restrictions Are Liberalized
Income tax is imposed, resulting in heavy tax burden on saving and investment.	Harm from income taxation is recognized and exceptions are made.	Exceptions are restricted in effort to "broaden the base."	Restrictions are liberalized as their disincentive effects are recognized.
<i>Personal Saving</i>			
	Capital gains treatment changed 25 times since 1922. Rate reduced in 1978 and 1981.	Capital gains rate increased in 1986	Capital gains rate reduced in 1997.
	Creation of individual and employer-based saving/pension plans.	Restrictions imposed on eligibility, contribution limits, early withdrawals, distributions, etc.	Liberalization in 1996, 1997, 2001. Creation of SIMPLE plans with fewer rules
	IRAs liberalized in 1981.	IRAs restricted in 1986.	IRAs liberalized in 1997, 2001.
<i>Business Investment</i>			
	Depreciation liberalized in 1962, 1971, 1981.	Depreciation deductions pared back in 1982, 1984, 1986.	Calls to liberalize depreciation for high-tech and other assets today.
	Investment tax credit (ITC) on and off since 1962.	ITC eliminated in 1986.	
	Business incentives in general.	Corporate AMT limits business incentives.	JCT, ABA, AICPA, and others call for AMT repeal.
	Small business incentives, such as expensing capital purchases.	Small business incentives are restricted and denied to larger firms.	Small business expensing liberalized in 1996.

Source: Author's compilation.

While TRA86 cut marginal tax rates, the broadening of the tax base toward Haig-Simons has been widely criticized for its complexity and anti-saving effects.

the 1978 tax law that moved back toward a consumption base.⁸¹ The Economic Recovery Tax Act of 1981 then moved the system much further toward a consumption base. It liberalized depreciation deductions, expanded IRAs, and lowered the capital gains tax rate. Congress changed course in 1982 and 1984, scaling back the liberalized depreciation of the 1981 law and reducing the ITC.

The wide-ranging Tax Reform Act of 1986 (TRA86) substantially expanded the tax base toward the Haig-Simons ideal. IRA provisions were cut back, the capital gains tax rate was raised, depreciation deductions were further restricted, the ITC was eliminated, and the individual and corporate AMTs were beefed up. TRA86 also created some of the most complex parts of the income tax code, including the new rules for the AMT and inventory accounting. So while TRA86 cut marginal tax rates, the broadening of the tax base toward Haig-Simons has been widely criticized for its complexity and anti-saving effects.

After TRA86, Congress realized its overreach and began slowly moving the tax system back toward a consumption base. Capital gains tax rates were lowered once again in 1997. Small business expensing for capital purchases was modestly liberalized in 1996. And rules for retirement saving plans were liberalized in 1996, 1997, and 2001.

Income Tax Damage and Band-Aid Fixes

A key cause of the gyration of the tax system is that high tax rates imposed on an income base cause substantial economic damage, particularly to saving and investment. In response to the damage, there are continuing demands for Congress to carve out exceptions. For small businesses, Congress carved out an exception to the complex and costly depreciation rules to allow immediate deduction, or “expensing,” of the first \$24,000 of capital investment.⁸²

Congress has recognized that full income taxation of individuals’ personal saving would be destructive. In response, it has carved out dozens of preferential provisions for saving, including 401(k)s, numerous

IRAs, and other vehicles. With the income tax, Congress takes as its starting position that saving should be fully taxed, but numerous and complicated exceptions to the rule should then be carved out. This is a much more complex approach than starting with the general rule that saving should not be taxed, as would be the case under a consumption-based tax system.⁸³

The current approach causes great instability, as shown in Table 2. Congress creates tax preferences and then determines that the preferences should not be used “too much” and restricts them. The negative effects of restrictions then lead to calls for liberalizing the restrictions.

For personal saving vehicles, Congress has created a complicated patchwork of rules for eligibility, contribution limits, withdrawal requirements, and “nondiscrimination” designed to broaden plan coverage. Employer-based plans are also subject to complex regulations under the Employee Retirement Income Security Act of 1974. The JCT notes that major areas of employer pension law have changed nearly every year since the early 1980s, and the changes often create such a large backlog of regulations that employers are frequently left unsure of how to comply.⁸⁴

The complexity of personal saving taxation has led to both ineffectiveness and inequitable treatment. The complex rules and limitations reduce the pro-saving benefits that saving vehicles might otherwise have, thus defeating their purpose. In addition, the results are inequitable since different individuals have access to different plans, and some purposes, such as retirement, receive favorable saving treatment while others do not.

Congress sometimes realizes that the complexity it created has gone too far. It then creates newer rules to skirt the existing complex rules. For example, as the complexity of employer-based pension plans increased, firms, particularly smaller firms, dropped pension coverage. In response, Congress created SIMPLE retirement plans with less complicated rules for firms with 100 or fewer

employees. Simplified employee pensions (SEPs) were another congressional attempt to create a simpler retirement saving vehicle.

The 1996 tax law that created SIMPLEs included 32 other law changes under the heading "Pension Simplification Provisions." The recently passed \$1.35 trillion tax cut includes 64 separate provisions changing the rules for tax-favored saving plans.⁸⁵ Wouldn't it be much better to exempt personal saving from taxation altogether? This would hugely simplify financial planning and eliminate the need for Congress to pick and choose forms of saving to favor. In fact, this would be the treatment of saving under a consumption-based tax, as discussed further below.

The Income Tax Fosters Social Engineering

In recent decades, the income tax system has become a popular tool for social engineering by the government. "Social engineering" through the tax code may be defined as using tax exemptions, deductions, credits, and other preferences to promote particular activities that policymakers believe need special treatment. For example, there are eight different education incentives under the income tax, each with separate rules and beneficiaries.⁸⁶

While individual policymakers often support particular preferences, nearly everyone agrees that the overall effect is a Swiss cheese tax code that is complex and sows taxpayer confusion. Some of the political dynamics that lead to social engineering are unavoidable in any tax system. After all, tax code preferences usually have easily identifiable beneficiaries, but the costs of complexity are more diffuse and less visible.

Nonetheless, because the federal income tax follows no consistent principles, it is ripe for loophole lobbying and special tax breaks for favored groups. Inconsistent treatment begets further inconsistent treatment. And, as noted, the economic damage caused by taxing income in the first place creates unending calls for special exceptions.

By contrast, a consumption base provides

a more consistent starting point for a tax system that could substantially reduce social engineering. Consider the complexity of personal saving provisions under the income tax. A consumption-based tax would eliminate all special rules for the taxation of personal saving and thus preempt a major channel for promoting favored activities. For example, five of the eight targeted provisions for education in this year's tax law relate to either saving or interest and would therefore be automatically nullified under a consumption tax. Certainly, Congress could continue favoring some activities under a consumption tax, but removing saving and investment would narrow the options for special tax preferences.

A major tax reform could also reduce social engineering if it reduced overall tax rates and levels. High taxes cause taxpayer pain, thus raising demands that Congress provide Band-Aids. For example, the earned income tax credit (EITC) was created and expanded to offset the heavy burden of payroll taxes that Congress imposes. The EITC is so complicated that it has a 25 percent filer error rate and requires a special \$145 million annual outlay for IRS compliance.⁸⁷ Reducing overall tax levels would reduce the demands to complicate the tax code with such special preferences.

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. In addition to the economic growth benefits of such a reform, Bradford notes that a consumption-based tax would have "vastly simpler implementation" than the income tax.⁸⁸

Dramatic simplification gains could be achieved under either a national retail sales tax or a flat tax based on the design of Robert Hall and Alvin Rabushka of the Hoover

Because the federal income tax follows no consistent principles, it is ripe for loophole lobbying and special tax breaks for favored groups.

A study by the American Institute of Certified Public Accountants found that the flat tax would be “a massive simplification that would eliminate much of the complexity that plagues the current system.”

Institution.⁸⁹ According to the Tax Foundation, replacement of the income tax with a retail sales tax would reduce compliance costs by 95 percent, and the flat tax would reduce compliance costs by 94 percent.⁹⁰ Tax compliance expert Joel Slemrod more conservatively estimates that the flat tax would cut compliance costs by 50 percent.⁹¹ A study by the American Institute of Certified Public Accountants found that the flat tax would be “a massive simplification that would eliminate much of the complexity that plagues the current system.”⁹² To simplify discussion, this section focuses primarily on the simplification advantages of the flat tax over the income tax, but many of the points could be generalized to other consumption-based tax plans.

The Flat Tax

A number of misconceptions surround the Hall-Rabushka flat tax.⁹³ First, it is often mistakenly assumed that it is the flat rate structure of the flat tax that is the source of its simplification benefits. While a flat rate structure does create some simplification, the main advantage of a flat rate is that the economic disincentive effects of the current tax system would be reduced.⁹⁴ The second misconception is that the flat tax is just a simpler version of the current income tax. In fact, the flat tax is a consumption-based tax, although it is collected like the income tax from both individuals and businesses.⁹⁵ Indeed, it is the consumption base of the flat tax that is the key to its simplification benefits.

To see why the flat tax is a consumption-based tax, note that only wages and pension benefits would be taxed at the individual level. At the business level, firms would deduct wages, pension payments, and purchases from other businesses, including capital purchases. Now modify the flat tax to an equivalent structure where there is no individual-level tax and businesses are denied deductions for wages and pensions. The resulting tax would be a “subtraction method” value-added tax (VAT). VATs have the same tax base as retail sales taxes. Hence,

the flat tax has essentially the same tax base as a retail sales tax.⁹⁶ Because of the similar bases of the flat tax and a retail sales tax, they would share many of the simplification benefits that are discussed below.

Individual and Business Taxes Simplified

The basic difference between an income tax and a consumption tax is the treatment of saving and investment. For individuals, consumption-based taxes can treat saving under rules similar either to those that govern either regular IRAs or Roth IRAs. In the first case, saving is initially deducted, and then later withdrawals are included in the tax base. In the second case, no deduction is given for saving initially, but returns are not taxed. The flat tax adopts the latter Roth IRA treatment of saving.⁹⁷ 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 greatly ease paperwork headaches for taxpayers, especially in comparison with complying with the current complicated rules for tax-favored saving vehicles. This structure would also dispense with the need for businesses and the IRS to keep track of more than half a billion Form 1099s and other information-reporting documents each year.⁹⁸

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. This would occur because consumption-based taxes use cash-flow accounting in place of accrual accounting, which is generally used under the current income tax.⁹⁹ Accrual accounting requires that firms accurately match revenues and expenses each year to measure net income and to capitalize expenses that create future benefits. Such timing of income and expense recognition under the income tax is a key source of complexity.

Because consumption taxes do not measure broad-based income, they do not require the complexities of accrual accounting. Instead, under cash-flow accounting businesses would simply deduct materials, inventories,

equipment, and structures immediately upon purchase. The purchase price of a \$1 pencil would be deducted just the same as the purchase price of a \$10 million machine. Bradford notes that “income accounting is more difficult than cash-flow accounting. That difficulty is responsible for much of the complexity in the current income tax system.”¹⁰⁰

Complexities Eliminated under a Consumption-Based Tax

A 1995 survey asked 315 corporate tax directors to rank the most complex parts of the corporate income tax.¹⁰¹ Of the 10 most complex parts, 4 dealt with “timing” issues inherent to measuring income, such as depreciation, and 4 dealt with international tax issues. The other two items were the AMT and “instability in the tax code.” Nearly all of those sources of complexity would be eliminated or greatly reduced under a consumption-based tax.¹⁰² Similarly, most complex features of the individual income tax would be eliminated under a consumption-based tax such as the flat tax.

The first column of Table 3 gives complex tax provisions that would be automatically eliminated under the flat tax and generally would also be eliminated under other consumption-based tax proposals. The major items in this part are discussed separately below. The rest of the table gives tax complexities that could remain under nearly any tax system. The second column is complexities that could be eliminated by the specific design of a tax reform plan. The third column is complexities that would remain under the flat tax or other consumption-based tax designs.

Capital Gains

Complaints about the difficulty of taxing capital gains have been voiced since the beginning of the income tax, and capital gains “are generally credited with a high proportion of the [tax] law’s bulk and complexity.”¹⁰³ There are currently 17 different tax rates that may be applied to capital gains, and the current IRS Schedule D for reporting

capital gains is 54 lines long and scheduled to grow even longer next year.¹⁰⁴

Capital gains taxation comes into play in individual stock and bond ownership, mutual fund ownership, real estate taxation, and corporate and partnership taxation. Capital gains taxpayers must deal with multiple tax rates, multiple holding periods, the timing of realizations, strategies for netting gains and losses, different ways of calculating cost basis, limitations on deducting capital losses, loss carryovers, “wash-sale rules” to prevent loss sales and repurchases, and many other issues.

Most of this complexity is unavoidable under an income tax because capital gains cannot be widely taxed on an accrual basis as suggested by Haig-Simons income theory. As a result, the government has fallen back on taxing gains when realized. Unfortunately, “elaborate rules to define and limit capital gains are inevitable in an income tax based on realization.”¹⁰⁵ Taxing gains on realization, combined with preferential capital gains rates, stimulates large tax-planning efforts, such as recharacterizing ordinary income as capital gains.

While taxpayers invest large efforts to minimize their tax bills, government busily churns out rules and regulations to prevent “abuse” of the ambiguities in the capital gains apparatus. For example, the rules that deny capital gains treatment to businesses that try to characterize regular business receipts as gains are an area of continuing complexity. It is often difficult to draw distinct lines between assets sold as a part of regular business sales, which are taxed as ordinary income, and assets sold by “investors” for “speculation,” which are taxed as capital gains.¹⁰⁶

There is no need for all this complexity. The flat tax would eliminate capital gains taxation for both individuals and businesses.¹⁰⁷ Eliminating capital gains taxation would eliminate all the special tax rates and other rules as well as extensive tax avoidance efforts.

Personal Saving

Americans interested in saving a portion of their current income to support them-

The flat tax would eliminate capital gains taxation for both individuals and businesses.

Table 3
Complexities Eliminated and Not Eliminated under a Consumption-Based Flat Tax

Complexities Eliminated Automatically	Complexities That Must Be Eliminated by Design	Complexities Not Eliminated
<p>Personal savings income: No taxation of interest, dividends, and capital gains at individual level. No need to track more than half a billion 1099s and other forms.</p>	<p>Multiple tax rates.</p>	<p>Transfer pricing issues for multinational corporations remain under flat tax.</p>
<p>Capital gains: Special treatment eliminated at business and individual levels. Gets rid of multiple tax rates and holding periods, timing of realizations, matching gains with losses, calculating basis, etc.</p>	<p>Family status adjustments, such as child tax credit.</p>	<p>Defining taxable consumption vs. nontaxable savings and investment.</p>
<p>Interest: Interest income and expense complications, such as muni-bond preference, “tracing rules,” “original issue discount,” eliminated.</p>	<p>Earned income tax credit.</p>	<p>Defining financial flows vs. nonfinancial flows.</p>
<p>Savings vehicles: Plethora of savings vehicles eliminated including 401(k)s and numerous IRAs. Most complex business pension issues disappear.</p>	<p>Charitable contribution tax preferences.</p>	<p>Defining financial services businesses vs. other businesses.</p>
<p>Depreciation: Complex and distortionary accounting rules for capital purchases eliminated.</p>	<p>Health care tax preferences.</p>	<p>Defining taxable vs. tax-exempt activities.</p>
<p>Inventory: Complex accounting rules for business inventory eliminated.</p>	<p>Home ownership tax preferences.</p>	
<p>Inflation: Measurement problems and distortions caused by inflation eliminated for depreciation, inventory, interest, capital gains, etc.</p>	<p>Education tax preferences.</p>	
<p>Other business complexities: Capitalization issues, and most issues related to timing of income and deductions, eliminated.</p>		
<p>International tax rules: Taxing businesses on a territorial basis would eliminate some of the most complex aspects of business taxation, such as the foreign tax credit and Subpart F.</p>		
<p>Business structure: Uniform business taxation would replace “C” and “S” corporations, LLCs, sole proprietorships, and partnerships. Merger and acquisition accounting greatly simplified.</p>		
<p>Social engineering of capital income: For example, 8 of 20 income tax phaseouts that relate to capital income disappear. And 5 of the 8 education preferences that relate to interest or savings disappear.</p>		

Source: Author’s compilation.

selves in later years face an enormously complex array of tax rules. Different rules come into play for ordinary income, capital gains, 401(k)s, Keoghs, SIMPLEs, SEPs, IRAs, traditional pension plans, insurance company annuities, tax-exempt bonds, and other saving vehicles. An Amazon.com search finds three books, one 258 pages long, to help families figure out how just one vehicle, the Roth IRA, works.

Each investment option has separate rules regarding eligibility, income limits, maximum contributions, required distributions, withdrawal limitations, penalties, rollovers, and other items.¹⁰⁸ Any of those rules can create confusion for individuals trying to plan for their future. For example, the American Bar Association recently noted that the “minimum distribution requirements are among the most complex in the code,” and yet Congress expects millions of families to figure them out.¹⁰⁹

Employers face heavy burdens with the administrative complexity of tax rules for pension plans. The JCT notes that “the federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex sets of rules applicable to any area of the tax law.”¹¹⁰ The proliferation of new types of plans makes it difficult for businesses to figure out which option they want for their employees.

The complexity of those saving plans is self-defeating in many ways. Individuals don’t save as much as they might because complex minimum distribution and other rules limit the attractiveness of employer-provided plans. Those plans reduce family liquidity compared with regular taxable saving because of withdrawal restrictions. High administrative expenses for those plans reduce net returns to saving. And the tax and ERISA 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. Not

only would this be massively simpler, it would free Congress from picking and choosing which forms of saving should be specially favored. Retirement and education saving are the current favorites among federal politicians, but families have other saving goals, such as saving for a new car or for possible leaner times ahead. 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.

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. This would hugely simplify family financial planning. Families could receive all the benefits of the current hodge-podge of accounts, but with none of the complexity and none of the constant rule changes. Individuals could save in whatever type of asset they saw fit, withdraw money any time they wanted for any purpose, and enjoy the full gross return to saving.

Depreciation and Amortization

Business investment in buildings and equipment generates a stream of future revenues as products produced with the assets are sold in the marketplace. The income tax is supposed to measure broad-based income in each period by matching revenues against depreciation deductions taken to recover the cost of assets. In income tax theory, depreciation deductions should come close to an asset’s actual decay or obsolescence over time.¹¹¹

In practice, the depreciation system falls far short of measuring depreciation properly. Rough approximations are used in the tax code to place assets in different classes that determine how fast they are depreciated.¹¹² The current asset classification system is very out of date and is partly based on a 1959 Treasury study.¹¹³ As a result, the treatment of new technologies, such as computers, is often wrong and results in those assets being overtaxed. But even up-to-date depreciation schedules would be wrong because inflation makes it extremely difficult to measure

Consumption taxes would exempt personal saving from taxation.

A key problem with the income tax is inherent ambiguity and inconsistency regarding the capitalization of assets.

depreciation accurately.

The depreciation system has many complex features: assets must be placed in one of eight “tax life” categories to determine the period over which deductions are taken; various mathematical formulas are used for calculating deductions; complicated rules determine when assets are considered to be placed in service; if partly depreciated assets are sold, complex “depreciation recapture” rules come into play to deny capital gains treatment for a portion of the gain; and many assets are unique and thus raise difficult questions as to appropriate treatment.

Similarly complex issues arise about intangible assets, such as patents and trademarks. When such assets are purchased, they must be amortized to recover their cost over time. Harvey Rosen, a leading public finance expert, notes that the “intractable complexities” related to intangible assets are “unavoidable if the base of the tax is income.” He discusses one real-life example from professional baseball:

If you buy a baseball team, part of what you are buying is the contracts of the players. The tax authorities have ruled that the component of the acquisition cost that is attributable to player contracts is a depreciable asset . . . on the other hand, other components of the value of the franchise, such as television contracts, are not depreciable. Predictably, club owners are locked into a perpetual battle with the IRS over the value of the player-component of acquisition costs.¹¹⁴

This example highlights a key problem with the income tax: there is inherent ambiguity and inconsistency regarding the capitalization of assets. As a result, there are frequent battles between the IRS and taxpayers over which items are capital purchases and which are regular expenses that may be deducted immediately. The JCT notes that, “despite guidance provided by the IRS and

decisions reached by courts, distinguishing a capital expenditure from a current expense continues to be uncertain and a source of significant disputes.”¹¹⁵ In fact, capitalization is one of the most litigated parts of the tax code.¹¹⁶ In recent years, the IRS has exacerbated the problem by aggressively forcing companies to capitalize all kinds of expenses that the IRS unilaterally decides yield long-term benefits.¹¹⁷

The flat tax would eliminate the complexity of depreciation and amortization and the nonstop battles over capitalization. All business purchases would be treated the same way and immediately deducted. Assets would not need to be separated into various depreciation classes, so it wouldn’t matter if Congress didn’t get around to updating them in 40 years, as is currently the case. The rules under the flat tax would be simple and durable over the long term.

Congress has already recognized the excessive complexity and inefficiency of depreciation accounting—but only for small businesses. Small businesses may deduct the first \$24,000 of capital purchases each year. The flat tax would give all businesses this huge simplicity benefit that only very small businesses enjoy today.

Inventory Accounting

Under the income tax, businesses with inventories may not simply deduct the costs of materials purchased for production or finished goods held for sale. Rather, those inventory expenses must be capitalized and deducted later when products are sold. The idea is to match revenues and expenses so as to accurately measure income in each period, the same principle behind the depreciation rules.

Like the depreciation rules, the inventory rules are complex, and they create economic distortions because of the effects of inflation. And both the tax rules for inventory and the tax rules for depreciation differ from the rules used for regular financial accounting. As a result, businesses must keep two sets of books for these and other items.

The tax rules for inventory accounting

have become more complex in recent years. In particular, the “uniform inventory capitalization” rules enacted in TRA86 are “extraordinarily complex,” according to the ABA.¹¹⁸ These rules deny deductions for a range of indirect costs, such as interest expenses, that are related to inventories. The JCT has similarly called the rules “complex and burdensome” and proposed some reforms.¹¹⁹

Under the flat tax, all materials purchased would be immediately deducted. That would put an end to the complex inventory rules under tax law and end a major source of disputes between business taxpayers and the IRS.

Alternative Minimum Taxes

The corporate and individual AMTs are complex income tax systems that operate alongside the ordinary income taxes. There is broad agreement that these ill-conceived parallel tax systems should be repealed. For example, AMT repeal has been recommended by the JCT, the ABA, and the AICPA.¹²⁰ Former IRS national taxpayer advocate Val Oveson called the AMT “absolutely, asinine stupid.”¹²¹ Under current projections, 36 million taxpayers will be subject to the “asinine” individual AMT by 2010 unless Congress acts to repeal it.¹²²

The AMTs are too extensive a topic to cover in this paper. However, of particular relevance is that the two AMTs were originally supported in an attempt to better measure “income” under the income tax. For corporations, that meant using the AMT to produce more consistent marginal tax rates across industries. For individuals, that meant using the AMT to produce more consistent tax rates across families with similar incomes.

Consumption-based taxes easily achieve consistent and neutral tax rates across industries and across families with similar consumption levels. There would be no need for the AMTs under the flat tax, and they would be eliminated.

Taxing Multinational Corporations

Rapid integration of the United States into the world economy is raising questions about

the viability of the current “worldwide” system of federal income taxation. Under this system, the foreign earnings of U.S. businesses are subject to U.S. taxation. U.S. companies operate more than 24,000 foreign affiliates in Europe, Asia, and elsewhere.¹²³

U.S. corporations set up foreign affiliates to more easily penetrate foreign markets and to stay competitive by tapping into foreign business and technological know-how. This has been a successful strategy as about one-third of the global sales of the largest 500 U.S. corporations are from foreign affiliates.¹²⁴ Most U.S. foreign affiliates are in high-income countries, such as Germany and France, where they pay tax to foreign governments at generally high rates.

In general, the U.S. income tax is assessed on foreign business income when it is repatriated to the United States, but a tax credit is provided to roughly prevent double taxation. This is the general rule, but there is a large hodge-podge of special and often inconsistent rules for different industries and types of investments. In fact, there are at least six overlapping sets of “anti-deferral” rules that break the general rule of not taxing foreign profits until repatriated, such as the Subpart F rules.¹²⁵ This lack of consistently followed principles has led to complexity, instability, tax avoidance efforts, and loophole-closing Band-Aids applied by the government.

Many facets of the U.S. international tax system are complex: foreign income and domestic income are measured differently; foreign assets and domestic assets have different depreciation rules; detailed rules are required to convert foreign currency earnings into dollars; financial services face numerous special rules on foreign earnings; different levels of foreign affiliate ownership have different tax treatment; some foreign income is taxed when repatriated, other income is taxed when earned; different types of foreign income are placed in nine different “baskets” with separate foreign tax credit limitations; special rules allocate certain expenses between domestic and foreign-source income; and so on.

The overall result of these rules is to great-

Former IRS national taxpayer advocate Val Oveson called the AMT “absolutely, asinine stupid.”

Consumption-based taxes would eliminate most international tax rules because they are “territorial” taxes, which do not tax the foreign operations of U.S. businesses.

ly complicate business planning. And these worldwide tax rules raise little if any added revenue for the U.S. government because the government provides a credit to roughly offset foreign taxes paid. Glenn Hubbard, chairman of the Council of Economic Advisers, and James Hines have in the past concluded that “the present U.S. system of taxing multinationals’ income may be raising little U.S. tax revenue, while stimulating a host of tax-motivated financial transactions.”¹²⁶

There have been repeated calls for simplifying the international tax rules. For example, the ABA has called for reform, noting, “These rules may never be truly simple, but actions can be taken to temper the extraordinary complexity of the current regime.”¹²⁷ It is true that these rules may never be simple under a worldwide income tax system, but they can be greatly simplified by replacing the income tax with a consumption tax.

Consumption-based taxes, including the flat tax, would eliminate most international tax rules because they are “territorial” taxes, which do not tax the foreign operations of U.S. businesses.¹²⁸ Although all major consumption-based tax proposals are territorial, there are differences with regard to U.S. imports and exports. In particular, a national retail sales tax would tax imports and exempt exports from U.S. taxation. By contrast, the flat tax would tax firms on their export sales but allow deductions for foreign inputs to production.¹²⁹

Most economists think these differences would not be economically important, but they would create different issues with regard to tax administration. In particular, under the flat tax U.S. firms would continue to have incentives to use “transfer pricing” to shift their tax base to low-tax countries, thus requiring the IRS to continue monitoring such activity.¹³⁰ These pressures also exist under the current income tax. On the other hand, the low rate of the flat tax and others of its features would increase the role of the United States as a tax haven. In a 1998 study, the U.S. International Trade Commission concluded that a consumption-based tax

would, on net, attract greater foreign investment to the United States and encourage U.S. firms to increase capital investment here rather than abroad.¹³¹

Business Structure

Under the income tax, companies may take a variety of legal forms, each with different income tax implications. These include sole proprietorship, partnership, LLC, S corporation, and C corporation. This patchwork has created tax complexity and economic inefficiency. In theory, reforms could be made within the income tax system to simplify this business framework. But the 90-year history of the income tax has shown the tendency for this web of business structures to grow more complex over time. Recent decades have witnessed the rapid growth of S corporations and LLCs in response to the tax disadvantages of regular C corporations.¹³²

The flat tax would treat all business activity equally and eliminate special forms of business organization.¹³³ Bradford notes that “uniform treatment of all businesses, whether corporate or in other form, automatically deals with a vast array of complex issues that are intractable under present law.”¹³⁴ It would also bring greater efficiency as different investments would return the same after-tax returns no matter which business structure the investment took.

A side effect of this simpler organization of business would be that it would take most complex tax planning issues out of business restructurings, such as mergers and acquisitions. According to the tax guide publisher, CCH, Inc., the income tax rules governing business reorganizations are “immensely complicated” with an “alphabet soup” of at least seven different methods of reorganization.¹³⁵ Some of the different tax implications include whether capital gains are triggered and the value of depreciation deductions available after restructuring. These “notoriously complex” tax rules for business restructuring “would become almost entirely obsolete” under the flat tax, according to the AICPA.¹³⁶

Financial Transactions

“The present law tax treatment of financial instruments is governed by a patchwork of statutory rules located throughout the Code,” notes the JCT.¹³⁷ This is no coincidence; it is inherent in the income tax because of the lack of clear and consistent principles defining the tax base.

The inconsistencies of capital gains taxation have already been noted. The taxation of interest is also complex. For example, interest expenses receive a range of different treatments under the income tax. Interest on personal consumer debt and interest on debt used to purchase tax-exempt municipal bonds is not deductible. But mortgage interest is deductible, as is investment interest and normal business interest. Under current rules, at least 10 types of interest are subject to special deduction limitations.¹³⁸ Tax accountants “have bemoaned the inordinate complexity” of interest expenses, which “have become far more complex” since TRA86.¹³⁹

Such inconsistencies lead taxpayers to arbitrage 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.¹⁴⁰ For example, because only some types of interest are deductible, “interest-tracing” rules are required to draw lines between different types of interest. These rules are “complex and subject to manipulation,” according to the JCT.¹⁴¹ A well-known example of interest arbitrage is the increase in home equity loans in recent years to get around TRA86’s disallowance of personal interest deductions. Tax rules limit the deductibility of interest on home equity loans.

Congress could try to tax financial flows on a more comprehensive and consistent Haig-Simons income basis. But as tax attorney Sheldon Pollack notes, some of the most complex parts of the tax code stem from attempts to tax on a Haig-Simons basis.¹⁴² One attempt is the original issue discount, or OID, rules for bond interest. OID rules require interest income to be imputed and

taxed when accrued, not when actually received by taxpayers. Pollack notes that these rules add an “extraordinary and unprecedented level of complexity into the tax laws,” requiring sophisticated computer software to figure out how much tax is owed. The OID regulations are 441 pages long.¹⁴³

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. Nonfinancial businesses would also not 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.

However, financial businesses, such as banks, would require special rules under a consumption-based tax and pose a challenge to any tax system.¹⁴⁴ The tax base is difficult to measure for financial businesses because the value of financial services, such as account administration costs, are often hidden in margins between borrowing and lending rates. One solution would be to exclude financial businesses from a consumption tax, as is the case under most state retail sales taxes and VATS in foreign countries.¹⁴⁵ A number of other options have been discussed for taxing financial businesses under a consumption tax entailing varying levels of complexity.¹⁴⁶

Complexities Not Eliminated

While a consumption base is a much simpler starting point for a tax system, some areas of complexity would remain. And, no doubt, under a new tax system various loopholes would arise that would need to be plugged with additional rules. However, many of the areas in which a consumption tax would need special rules are already problem areas under the income tax (see Table 3).

Under a consumption tax, as under an income tax, there are problems of accurately defining taxable “consumption” versus deductible “investment.” A good example is

Many of the areas in which a consumption tax would need special rules are already problem areas under the income tax.

The most effective way to reduce the pressure for social engineering is to lower overall levels of taxation.

the purchase of a computer for home use. If it is mainly used for playing games it should be taxable as consumption, but if it is used for a home business it should be deductible as investment (or depreciable under the income tax).¹⁴⁷ Another example is expenditures for education, which may be viewed as either consumption or investment.

Fringe benefit issues would continue to pose challenges as they do under the income tax. Today, many fringe benefits are tax-free and efforts are expended to engineer employee compensation to fit into this tax-free window. Under the flat tax, fringes would be taxed at the business level by denying a deduction. But problems may arise regarding the valuation of fringe benefits and separating them from normal business expenses. For example, a company tennis court might be considered a taxable fringe benefit and denied a business deduction, or it might be treated as a deductible business expense.

Defining financial flows under a flat tax would require special rules. Financial flows, which are generally not in the tax base, would need to be separated from nonfinancial flows. For example, U.S. businesses selling to foreign firms would have an incentive to redefine regular sales receipts as financial income in order to escape U.S. tax.¹⁴⁸ Special rules would be required to prevent this sort of tax avoidance and evasion.

Complexities Eliminated by Design

The second and third columns of Table 3 list some areas of tax complexity that stem from policymakers' efforts to social engineer through the tax code. Any tax system may be subject to these sorts of complexities. For example, Congress would still be able to subsidize education through the tax code under a consumption-based tax: a retail sales tax could exempt tuition from taxation, and a flat tax could provide wage credits for tuition.

Tax policy should eschew these types of special provisions, and consumption tax proposals generally eliminate most of them. There would of course be political pressure

for such provisions to creep back into the tax code over time. However, a consumption-based tax would substantially narrow the scope of social engineering. In particular, capital income would become off-limits for social engineering since it would not be taxed at the individual level. This would mean, for example, that five of the eight education subsidies under the income tax would disappear since they relate to interest or saving. Similarly, 8 of the 20 income tax phaseouts in the tax code would be automatically eliminated because they deal with capital income.

Ultimately, however, the most effective way to reduce the pressure for social engineering is to lower overall levels of taxation. High tax levels create political pressure to selectively reduce the tax burden. For example, high taxes reduce family income, thus reducing every family's ability to afford education. As a result, families turn to the government for subsidies. High tax rates also increase the incentive for taxpayers to find loopholes in the tax code, which in turn causes the government to add new preventive rules. For those reasons, tax reform should be combined with lowering overall tax levels to bring about the largest reduction in federal tax complexity.

Tax Reform for the 21st Century

It was a historic mistake to impose federal taxation on a broad income base, a mistake that is becoming more important all the time. As the economy becomes more complex and dynamic, the income tax will become a greater drag on business efficiency and individual prosperity.

Most of the problems with the income tax relate to the taxation of capital income, that is, the returns to saving and investment. In recent decades, the taxation of capital income has become a key concern of middle-class families as they save for their retirement and other priorities. Today, about half of American households own mutual funds, in

either taxable or tax-favored accounts, up from just 25 percent in 1990 and from just 6 percent in 1980.¹⁴⁹ Between 1975 and 1999 the share of taxpayers with taxable dividend income rose from 11 to 25 percent, and the share with taxable capital gains rose from 10 to 22 percent.¹⁵⁰

It is not just taxpayers with currently taxable capital income who are affected by the tax system. Taxpayers who own tax-favored investments, such as 401(k)s and IRAs, are greatly affected by the complexity of the rules and restrictions on these forms of saving. For example, as the U.S. elderly population increases in coming decades, many more people will be exposed to the complex distribution rules for retirement plans. The ABA recently testified that those rules are so complicated that “all but the most sophisticated taxpayers must seek professional help to navigate the maze of complicated rules . . . an ever-growing percentage of Americans are now in or approaching their retirement years, and untold millions of IRA and 401(k) accounts (in addition to traditional pension accounts) will become subject to these rules. Simplification is badly needed.”¹⁵¹

Capital income taxation is under increasing strain as a result of huge increases in financial wealth here and abroad and rising international capital flows. Today’s complex financial instruments are making it difficult to measure “income” and to separate ordinary income from capital gains. Pollack has noted that “the Treasury Department has struggled in recent years to keep up with the creativity of Wall Street investment bankers in crafting new so-called derivative, or hybrid, financial instruments, whose treatment for federal income tax purposes is quite baffling.”¹⁵² Similarly, the JCT has noted that “economic activities such as information technology and financial services are highly mobile, and intangible in nature, which presents serious problems for existing tax rules.”¹⁵³ Those trends are putting pressure on governments to reduce reliance on capital income taxes and move toward consumption-based taxation.

For businesses, many parts of the federal income tax have not kept pace with the dynamic global economy. U.S. corporations are globalizing quickly; by 1998 U.S. firms held investments in 24,000 foreign affiliates, up 40 percent from the number of affiliates a decade earlier. The U.S. international tax rules are being strained trying to keep up with all this foreign activity. The ABA notes that global economic changes are making it more difficult to comply with the foreign tax credit rules, and the 40-year-old Subpart F rules “sorely need to be updated to deal with today’s global environment.”¹⁵⁴ Some business trends that are straining the international tax system are the increases in financial services activities, electronic commerce, and foreign contract manufacturing.¹⁵⁵

There are increasing concerns that U.S. international tax rules are putting U.S.-headquartered multinationals at a competitive disadvantage.¹⁵⁶ The vice president for taxes at Intel Corporation testified before Congress that, “if I had known at Intel’s founding what I know today about the international tax rules, I would have advised that the parent company be established outside of the U.S.”¹⁵⁷ He went on to note that “the degree to which our tax code intrudes upon business decision-making is unparalleled in the world . . . other countries do not have such complex rules.”¹⁵⁸

U.S. income tax rules for depreciation are also much out of date in our fast-moving, high-tech economy. The Tax Executives Institute recently concluded that the depreciation system is “hopelessly outdated and needlessly complex.”¹⁵⁹ In a recent study, two Ernst and Young economists conclude that “the problem of classifying new assets does not have a simple solution within the existing tax depreciation framework . . . there is currently no workable procedure to address the rapidly changing nature of the U.S. economy with development of entirely new assets, rapid technological advancements in existing assets, and the deregulation and globalization of many industries.”¹⁶⁰ Ultimately, the only “workable procedure” is to move the

For businesses, many parts of the federal income tax have not kept pace with the dynamic global economy.

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business tax system toward a consumption-based tax by allowing immediate expensing of capital purchases.

Conclusion

Consumption-based tax plans, including the flat tax and the national retail sales tax, have gained widespread support because they would reduce the tax burden on saving and investment and spur greater economic growth. In addition, those tax proposals hold great promise for vastly simplifying the increasingly complicated federal tax system.

Income taxes cannot be implemented in a simple way, especially in today's complex economy. The inherent inconsistencies of income taxation, and the distortions caused by inflation, breed complexity as policymakers fall back on ad hoc rules. And because the income tax does not follow consistent principles, change is continual as Congress gyrates between different treatments for income and deduction items in the tax base.

Consumption-based taxes offer a simpler and more efficient solution. One of the leading experts on tax reform, David Bradford, concludes that “an income-based tax is inevitably plagued with inconsistencies that can be averted in a consumption-based tax.”¹⁶¹ Complexity is averted and uncertainty reduced because tax base measurement would not rely on estimations and jury-rigged rules, as is the case for depreciation and capital gains. In addition, complex and out-of-date parts of the tax code, including most international tax rules, would be eliminated. That would allow businesses to operate more efficiently in the dynamic global economy.

Tax simplification would improve business planning, thus increasing economic growth and raising incomes. At the individual level, the exemption of saving from personal taxation would vastly simplify personal financial planning. Families could save as much as they needed with ease, withdraw their savings as required, and use their savings for priorities of their own choice—not

for preferences dictated by Washington.

It is true that political pressures operate to increase complexity under any tax system. But the basic starting point of a consumption-based tax is simpler than that of an income tax, and the logical consistency would be more resistant to added complexity. In addition, a consumption-based tax does not harm saving and investment and so would not require the Band-Aids needed under the income tax to alleviate this damage. Overall tax reductions would also promote simplification by reducing pressures to create special preferences.

Given the nine-decade reign of the income tax, it is surprising what a weak case there is for it compared with the case for a consumption-based tax. The chairman of the Council of Economic Advisers, Glenn Hubbard, has called the income tax “fundamentally flawed” because of its inefficiency, complexity, and unfairness.¹⁶² 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.

Notes

1. CCH, Inc., *Standard Federal Tax Reporter*, 2001, <http://www.cch.com>.
2. The number of hours is the total burden imposed by the Department of the Treasury. See Office of Management and Budget (OMB), “Information Collection Budget of the U.S. Government, Fiscal Year 1999,” <http://www.whitehouse.gov/omb/inforeg>.
3. Time/CNN poll reported in Congressional Research Service, “Tax Issues: National Public Opinion,” CRS 98-552, May 28, 1998.
4. “O’Neill Lays Out Vision for Tax,” *Financial Times*, May 18, 2001.
5. “Transcript of Jimmy Carter’s Speech at Democratic National Convention,” *New York Times*, July 16, 1976, p. A10.
6. CCH, Inc., *Standard Federal Tax Reporter*.
7. David Bradford, “An Uncluttered Income Tax: The Next Reform Agenda,” John M. Olin Program Discussion Paper no. 20, Princeton University, July

1988. In his position at the Treasury from 1975 to 1976, Bradford directed the publication of the Treasury's *Blueprints for Tax Reform*, which was one of the most influential studies supporting major tax reform in the past two decades.

8. *Wall Street Journal*, "Tax Report," May 30, 2001, p. 1. Based on information from CCH, Inc.

9. *Ibid.*

10. Joint Committee on Taxation (JCT), *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, JCS-3-01 (Washington: Government Printing Office, April 2001), <http://www.house.gov/jct>. This study was mandated by the IRS Restructuring and Reform Act of 1998.

11. The study provided more than 100 proposals for reform, but most would be quite narrow in impact, as the JCT did not seek to change the underlying policies articulated by Congress in legislation.

12. The leading "flat tax" proposal, based on the design of Robert Hall and Alvin Rabushka of the Hoover Institution, is House Majority Leader Dick Armey's (R-Tex.) H.R. 1040. Leading retail sales tax proposals include Rep. Billy Tauzin's (R-La.) H.R. 2001, which would replace income taxes and the estate tax with a 15 percent retail sales tax, and Rep. John Linder's (R-Ga.) H.R. 2525, which would replace these taxes and federal payroll taxes with a 23 percent sales tax called the "FairTax." Rep. Phil English (R-Pa.) has introduced H.R. 86, which is a simplified "USA Tax" based on the consumed-income tax approach. The Institute for Research on the Economics of Taxation (IRET) also has a consumed-income tax proposal; see IRET, "The Inflow-Outflow Tax—A Savings-Deferred Neutral Tax System," <http://www.iret.org>.

13. CCH, Inc., News release, January 14, 2000, <http://www.cch.com>. See also House Committee on Ways and Means, *Overview of the Federal Tax System*, 103rd Cong., 1st sess., June 14, 1993, Committee Print 103-17. Note that the first U.S. income tax was enacted during the Civil War but eliminated in 1872. Another income tax was enacted in 1894 but struck down by the Supreme Court. In 1913 the Sixteenth Amendment to the Constitution paved the way for the modern income tax.

14. Michael Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go from Here* (New York: W.W. Norton, 1999), p. 87.

15. CCH, Inc., News release; and May 2001 e-mail

from CCH to author. While fairly comprehensive, the CCH *Standard Federal Tax Reporter* does not contain the full text of IRS rulings and Tax Court cases.

16. JCT, *Study of the Overall State of the Federal Tax System*, vol. 1, p. C-6. JCT's estimate of 1.4 million words is conservative as it does not include notes, cross-references, and other items often included in published volumes of the tax code. This author's more inclusive counts of the 2000 tax codes published by the Research Institute of America and the West Group both indicate a length of about 2.8 million words. Chris Edwards, "Tax Complexity Factbook," Joint Economic Committee, April 2000. The increase since 1985 is based on Scott Moody, "The Cost of Complying with the U.S. Federal Income Tax," Tax Foundation, November 2000.

17. Telephone conversations with John Harris and Rosalie LaPlant, Internal Revenue Service (IRS), Forms and Publications Division, March 28, 2000, and June 15, 2001.

18. JCT, *Study of the Overall State of the Federal Tax System*, vol. 1, pp. 105, 108.

19. IRS Web site hits from *Budget of the United States Government, Fiscal Year 2002—Appendix* (Washington: Government Printing Office, 2001), p. 861.

20. IRS, *1998 Data Book* (Washington: IRS, 1999), Table 27.

21. Includes workers in the Bureau of Alcohol, Tobacco and Firearms, the Customs Service, the Department of Justice, Congress, the Tax Court, and other agencies. See Art Hall, "Growth of Federal Government Tax Industry Parallels Growth of Federal Tax Code," Tax Foundation, September 1994.

22. "IRS Help Wrong 47% of Time," *Washington Post*, April 4, 2001. In 1999 and 2000 the IRS was able to answer phone inquiries correctly only 74 and 72 percent of the time, respectively. See General Accounting Office (GAO), "Tax Administration: IRS' 2000 Tax Filing Season," GAO-01-158, December 22, 2000, <http://www.gao.gov>.

23. This is the author's rough estimate, as there are no accurate counts available of the number of U.S. tax accountants. However, note that 29 percent of revenues of the top 100 accounting firms are tax fees according to Public Accounting Report, *Ranking of America's 100 Largest Public Accounting Firms* (Atlanta: Strafford Publications, 2001). Total number of U.S. accountants from U.S. Department of Labor, Bureau of Labor Statistics, *Employment*

and *Earnings*, January 2001.

24. This is the author's rough estimate, as there are no accurate counts available of the number of U.S. tax lawyers. Total number of U.S. lawyers from American Bar Foundation, *Lawyer Statistical Report*, 2001, <http://www.abf-sociolegal.org>. Alternately, data from U.S. Department of Labor, *Employment and Earnings*, January 2001, indicate that there are 881,000 lawyers in the country.

25. Gregory Steinbis, National Association of Enrolled Agents, Testimony before the Senate Finance Committee, 106th Cong., 1st sess., April 15, 1999.

26. The U.S. Bureau of the Census reports that state and local employees employed in "Financial Administration" number 363,000. U.S. Bureau of the Census, *Government Finances*, 1998, <http://www.census.gov/govs/www>.

27. Richard Vedder also estimated that tax workers number more than 1 million. See Joint Economic Committee, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," December 1995, <http://www.house.gov/jec>. Considering that annual tax compliance time is more than 3 million person-years, tax industry employment of more than 1 million seems to be a reasonable estimate.

28. There are about 985,000 workers in the motor vehicles and parts industry in the United States. See U.S. Department of Labor, *Employment and Earnings*, June 2001.

29. IRS, "Taxpayer Usage Study," 2001, http://www.irs.ustreas.gov/tax_stats. Includes returns filed between January 2 and May 4, 2001. Data for 1960 are from Graetz, p. 81.

30. This is H&R Block's average fee. See H&R Block, Press release, May 3, 2001, http://www.hrblock.com/press_relations.

31. H&R Block, *Annual Report 2000*, <http://www.hrblock.com/about>.

32. Ibid. See also H&R Block, Press release, May 3, 2001.

33. Phone conversation with Frank Zaffino, IRS Office of Planning and Finance, April 5, 2000. It is not known how many of the preparers were paid preparers.

34. Author's calculations based on data from Public Accounting Report's annual survey of top public accounting firms. Figures for the top 8 firms are for 1996–2001; figures for the top 100

are for 1993–2000.

35. The IRS estimates are summarized in OMB, "Information Collection Budget of the U.S. Government, Fiscal Year 1999." This estimate is the total Treasury Department burden. The IRS is currently updating its methodology for calculating taxpayer compliance burdens with the help of PricewaterhouseCoopers.

36. OMB roughly estimated time costs at \$26.50 per hour in 1996, which, adjusted for inflation, is \$30 per hour today. See OMB, "Report to Congress on the Costs and Benefits of Federal Regulations," 1997, www.whitehouse.gov/omb/inforeg.

37. For a summary of studies, see GAO, "Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators," GAO/GCD-98-37, January 1998. Income tax compliance costs as a percentage of revenues have been estimated as 18 percent by the Tax Foundation's Art Hall, 10 percent by University of Michigan Business School professor Joel Slemrod, and 24 percent by author James L. Payne.

38. JCT, *Study of the Overall State of the Federal Tax System*, vol. 1, pp. C-3, C-5.

39. Moody. An earlier Tax Foundation study found that 67 percent of the compliance burden fell on businesses. See Art Hall, "Compliance Costs of Alternative Tax Systems II," Tax Foundation, March 1996.

40. Graetz, p. 85.

41. Harvey Rosen, *Public Finance*, 6th ed. (New York: McGraw-Hill, 2002), p. 415.

42. Hall, "Compliance Costs of Alternative Tax National Systems II." The IRS Taxpayer Advocate has found that the heavy compliance burden on small businesses is one of the most serious problems with the tax system. See IRS, National Taxpayer Advocate, "Annual Report to Congress, FY 1999," GPO publication 2104, http://www.irs.ustreas.gov/ind_info/advocate.html.

43. Daniel J. Pilla, Testimony before the Senate Finance Committee, 105th Cong., 1st sess., September 23, 1997. See also IRS, *Data Book*, GPO publication 55b, 1997.

44. IRS, National Taxpayer Advocate.

45. Albert Crenshaw, "IRS Help Wrong 47% of Time," *Washington Post*, April 4, 2001. See also *Budget of the United States Government, Fiscal 2002—Appendix*, p. 854; and GAO, "Tax Administration:

IRS' 1999 Tax Filing Season."

46. GAO, "Tax Deductions," GAO-01-52, April 2001, <http://www.gao.gov>.

47. Joan Caplin, "6 Mistakes Even the Tax Pros Make," *Money*, March 1998.

48. David Bradford, *Untangling the Income Tax* (Cambridge, Mass.: Harvard University Press, 1999), p. 267.

49. <http://www.reformamt.org>.

50. JCT, *Study of the Overall State of the Federal Tax System*, vol. 1, p. 63.

51. *Wall Street Journal*, "Tax Report," May 30, 2001.

52. CCH, Inc., as reported in *ibid*.

53. Joel Slemrod, quoted in *Tax Notes*, February 27, 1995.

54. GAO, "Reducing the Tax Gap," GAO/GGD-95-157, June 2, 1995, p. 4, <http://www.gao.gov>.

55. See GAO, "Tax Administration: Factors Affecting Results from Audits of Large Corporations," GAO/GGD-97-62, April 1997, p. 7, <http://www.gao.gov>.

56. GAO, "Reducing the Tax Gap," p. 4.

57. *Ibid*.

58. Marlene Plumlee, University of Utah, "The Effect of Information Complexity on Information Use by Analysts," Paper presented at American Accounting Association Annual Meeting, New Orleans, August 19, 1998.

59. GAO, "Reducing the Tax Gap," p. 2.

60. Quoted in Daniel Pilla, "Why You Can't Trust the IRS," Cato Institute Policy Analysis no. 222, April 15, 1995.

61. JCT, *Study of the Overall State of the Federal Tax System*, vol. 1, p. 102.

62. Janet Novack, "Are You a Chump?" *Forbes*, March 5, 2001.

63. Graetz, p. 24.

64. Bradford, *Untangling the Income Tax*, p. 266.

65. The income tax affected just 1 percent of the population in 1913 and 5 percent by 1939. See Sheldon Pollack, "Tax Complexity, Reform, and the Illusions of Tax Simplification," *Tax Notes*, December 20, 1994.

66. For further discussion, see Art Hall, "The Concept of Income Revisited: An Investigation into the Double Taxation of Saving," Tax Foundation, February 1997.

67. Irving Fisher, "A Fundamental Reason for Not Taxing Saving," *Taxes*, January 1941. See also Steve Entin, "Fixing the Saving Problem," IRET Policy Bulletin no. 85, July 2001.

68. Appeals are often made to the principle of "vertical equity" to justify an income tax with a steeply graduated rate structure, yet such appeals are inherently subjective and political. See Sheldon Pollack, *The Failure of U.S. Tax Policy* (University Park, Pa.: Penn State University Press, 1996), pp. 234, 235.

69. As Bradford notes in support of a consumption-based tax, "It seems to me that two taxpayers who are alike in all respects except the timing of their consumption should also bear the same tax burden." By contrast, an income tax penalizes the taxpayer who saves now to consume later. Bradford, "An Uncluttered Income Tax," p. 9.

70. *Ibid.*, pp. 10, 17.

71. Bradford, *Untangling the Income Tax*, p. 267.

72. *Ibid.*, pp. 273, 287, 313.

73. Tax accounting is similar in concept to accrual financial accounting, but there are large differences for items such as depreciation and inventory measurement. Note that some small businesses may use a cash method for tax accounting rather than an accrual method.

74. Bradford notes the Catch-22 problem of depreciation with the accelerated depreciation provisions of the 1981 tax law that reduced the "rule" complexity of depreciation but increased "transactional" complexity because it increased taxpayer efforts to develop complex tax minimization strategies. Bradford, *Untangling the Income Tax*, p. 273.

75. American Bar Association (ABA), "Tax Simplification Recommendations," February 2001, <http://www.abanet.org/tax/pubpolicy/2001/01simple/home.html>, noted that "whether a particular expense may be deducted or must be capitalized has become a particularly troublesome issue for businesses. The National Taxpayer Advocate has confirmed that capitalization issues are a major cause of controversy for business taxpayers, identifying them as the most litigated issue." See also Richard Lipton, ABA, Testimony before the Senate Committee on Finance, 107th Cong., 1st sess., April 26, 2001.

76. *Encyclopedia Britannica v. Commissioner of Internal Revenue*, 685 F.2d 212, 217 (1982), quoted in JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, p. 324.
77. As noted in Laurence Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Cato Institute Policy Analysis no. 193, April 15, 1993, p. 8.
78. Author's count based on Leonard Burman, *The Labyrinth of Capital Gains Tax Policy* (Washington: Brookings Institution Press, 1999), p. 26.
79. Donald Kiefer, "Tax Policy: What Happened? What Next?" *Tax Notes*, June 22, 1992.
80. Jane Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge, Mass.: MIT Press, 1994), has a useful summary of historical changes in savings and investment policies in Appendix A.
81. These laws are the Tax Reform Act of 1969, the Tax Reform Act of 1976, and the Revenue Act of 1978. See David Bradford, *Taxation, Wealth, and Saving* (Cambridge, Mass.: MIT Press, 2000), p. 143.
82. The expensing limit will rise to \$25,000 in 2003 under the Small Business Job Protection Act of 1996.
83. The Hall-Rabushka flat tax and retail sales taxes do not tax the returns to savings at the personal level. A consumed-income-style consumption-based tax would instead provide a deduction for saving up front and then tax returns to saving later when consumed.
84. JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, p. 150.
85. Author's count.
86. Pamela Pecarich, American Institute of Certified Public Accountants (AICPA), Testimony before the Senate Committee on Finance, 107th Cong., 1st sess., April 26, 2001.
87. *Budget of the United States Government, Fiscal Year 2002—Appendix*, p. 864.
88. Bradford, "An Uncluttered Income Tax," p. 9.
89. Another potential simplification option would be a consumed-income tax that eliminated business-level taxation. The "USA tax," introduced by Senator Domenici and former senator Nunn, uses this approach at the individual level but retains business-level taxation. The USA tax would be more complex than the flat tax. Nonetheless, when Senator Domenici introduced his USA tax legislation, he estimated that it would eliminate 75 percent of current tax code sections.
90. Hall, "Compliance Costs of Alternative Tax Systems II."
91. Joel Slemrod, "Which Is the Simplest Tax System of Them All?" Paper presented at Brookings Institution Conference on Fundamental Tax Reform, Washington, February 15–16, 1996. See also Joel Slemrod, "The Simplification Potential of Alternatives to the Income Tax," *Tax Notes*, February 27, 1995. Slemrod thinks that compared to income tax compliance costs of about 10 percent of tax revenue, current state retail sales tax compliance costs are about 2 to 4 percent of revenue, and the Armey flat tax would cost about half of current income tax compliance costs, or about 5 percent of revenues.
92. AICPA, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: AICPA, December 1995), p. 103.
93. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2d ed. (Stanford, Calif.: Hoover Institution Press, 1995). Other flat tax proposals in recent years, including House Majority Leader Dick Armey's, are based on the Hall-Rabushka design.
94. Disincentives to work and invest cause "dead-weight losses" to the economy as taxpayers alter their behavior. Those losses rise more than proportionally as tax rates rise. See Chris Edwards, "Economic Benefits of Personal Income Tax Rate Reductions," Joint Economic Committee, April 2001, <http://www.house.gov/jec>. A flat rate would remove incentives to shuffle assets between low- and high-rate taxpayers or to move income to years when one has a lower tax rate.
95. James Bickley, "Flat Tax: An Overview of the Hall-Rabushka Proposal," CRS 98-529, February 10, 2000. Note that the flat tax could be turned into a flat income tax by requiring businesses to depreciate assets rather than "expense," or immediately deduct, them. Similarly, value-added taxes (VATs) may be either income based or consumption based depending on whether assets are depreciated or expensed. Nearly all VATs in existence are consumption based.
96. A few differences between the bases of the flat tax and a retail sales tax include provisions to reduce taxation of low-income families and the treatment of exports and imports.
97. With the exception that, under the flat tax, employer-provided pensions are given regular IRA treatment since businesses would deduct pension contributions and individuals would include pension benefits in income when withdrawn.
98. This includes 1099INT, 1099DIV, 1099B, and 1098 forms. See GAO, "Tax Administration:

Potential Impact of Alternative Taxes on Taxpayers and Administrators," p. 37.

99. Accrual accounting is also the general approach used for financial accounting. There are, however substantial differences between tax accounting and financial accounting. Note also that some small businesses may use a cash method of accounting under current tax law.

100. David Bradford, *Fundamental Issues in Consumption Taxation* (Washington: American Enterprise Institute, 1996), p. 17.

101. Art Hall, "The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws," Tax Foundation, January 1995.

102. One of the international tax areas cited, transfer pricing, would continue to be a significant complexity problem under a flat tax.

103. Bradford, *Untangling the Income Tax*, p. 273. See also JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, pp. 36-38.

104. *Ibid.*, pp. 97-102.

105. Bradford, *Untangling the Income Tax*, p. 48.

106. JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, p. 37.

107. However, the Hall-Rabushka flat tax would retain capital gains taxation for rental property.

108. Eugene Steuerle of the Urban Institute has a useful table showing the complexity of the rules. Eugene Steuerle, Testimony before the House Committee on Ways and Means, 106th Cong., 1st sess., May 25, 1999.

109. ABA. See also JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, p. 196.

110. *Ibid.*, pp. 149, 150, 197, 198.

111. For a discussion of the economics of depreciation vs. expensing, see James Kee, "Introductory Discussion of the Basic Concepts of Depreciation and Expensing," IRET, March 10, 1999.

112. Under the Tax Reform Act of 1986, businesses depreciate tangible property under the Modified Accelerated Cost Recovery System, sec. 168 of the tax code, which determines recovery periods, placed-in-service rules, and depreciation methods.

113. Tom Neubig and Stephen Rhody, "21st Century Distortions from 1950s Depreciation Class Lives," *Tax Notes*, May 29, 2000. They note that

the current classification system is partly based on guidelines from a 1959 Treasury study.

114. Rosen, p. 402.

115. JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, p. 324. The JCT also notes that "whether an expenditure is deductible or required to be capitalized has been a source of litigation between taxpayers and the IRS for many years."

116. The ABA recently noted, "Whether a particular expense may be deducted or must be capitalized has become a particularly troublesome issue for businesses. The National Taxpayer Advocate has confirmed that capitalization issues are a major cause of controversy for business taxpayers, identifying them as the most litigated issue." ABA.

117. "How to Fight the IRS," *Forbes*, January 22, 1996. The IRS's aggressive position grew out of the 1992 INDOPCO court case. See also Lawrence Lokken, "Capitalization: Complexity in Simplicity," *Tax Notes*, May 28, 2001.

118. Lipton. For a brief description of these rules, see Ernst & Young, *Tax Saver's Guide* (New York: John Wiley & Sons, 2001).

119. JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, pp. 329, 432.

120. *Ibid.*, p. 15.

121. Quoted in "Oveson Speaks Out on Tax Code Complexity," *Tax Notes*, September 4, 2000, p. 1199.

122. JCT, "Estimated Budget Effects of Conference Agreement for H.R. 1836," JCX-51-01, May 26, 2001.

123. Ray Mataloni, Bureau of Economic Analysis, U.S. Department of Commerce, e-mail to author, June 22, 2001.

124. National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century* (Washington: NFTC, March 29, 1999), p. 5-3.

125. JCT, "Impact on International Competitiveness of Replacing the Federal Income Tax," JCS-5-96, July 17, 1996, <http://www.house.gov/jct>.

126. R. Glenn Hubbard and James Hines, "Coming Home to America: Dividend Repatriations by U.S. Multinationals," National Bureau of Economic Research Working Paper 2931, September 1990, <http://papers.nber.org>.

127. ABA. This comment referred to the foreign

tax credit rules in particular.

128. Note that there is no need for an income tax to have a worldwide base either, and numerous countries have income tax systems that are generally territorial.

129. A retail sales tax is a "destination-based" consumption tax, whereas the flat tax is an "origin-based" consumption tax. Note that royalty and leasing receipts received from abroad are U.S. exports and would continue to be taxed under a flat tax. For a full discussion of these complex issues, see Harry Grubert and Scott Newlon, *Taxing Consumption in a Global Economy* (Washington: American Enterprise Institute Press, 1997).

130. There would, however, be a new incentive, arising from the flat tax's exempting interest income from taxation, to shift interest income into the United States. See *ibid.*, p. 22.

131. U.S. International Trade Commission, "Implications for U.S. Trade and Competitiveness of a Broad-Based Consumption Tax," Publication 3110, June 1998, <http://www.usitc.gov>.

132. See Pollack, "Tax Complexity, Reform, and the Illusions of Tax Simplification."

133. With the possible exception of financial services businesses.

134. Bradford, "An Uncluttered Income Tax," p. 17.

135. Gary Maydew, *Small Business Taxation*, 2d ed. (Chicago: CCH Inc., 1997).

136. AICPA, *Flat Taxes and Consumption Taxes*, pp. 7, 99. Note, however, that with the expensing of investment under the flat tax, numerous firms could have tax losses that might provide incentives for mergers to offset other firms' positive tax liability. However, this effect would be mitigated with a full loss carry-back and carry-forward provision with interest, as under Armey's flat tax proposal.

137. JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, p. 336.

138. Martin McMahon, "Simplifying the Interest Deduction for Individual Taxpayers," *Tax Notes*, May 28, 2001

139. *Ibid.*

140. Tax avoidance activities regarding financial transactions were highlighted in two *Wall Street Journal* stories on the same day recently. *Wall Street Journal*, "Tax Report," June 20, 2001, p. 1. One story reported on special investments called "exchange funds," which effectively allow wealthy investors to

swap blocks of stocks to avoid capital gains taxes. "Congress has acted several times to curb these funds, only to see them restructured in different forms," notes the story. The other story notes: "The IRS loses a battle in its long-running assault on corporate tax shelters." This story involves trading in foreign shares listed on U.S. exchanges to generate capital losses and foreign tax credits. The message of both stories is that these problems are insoluble under the income tax.

141. JCT, *Study of the Overall State of the Federal Tax System*, vol. 2, pp. 40, 41.

142. Pollack, *The Failure of U.S. Tax Policy*, pp. 209, 211.

143. Bradford, "An Uncluttered Income Tax," p. 11.

144. House Majority Leader Dick Armey's flat tax legislation, H.R. 1040, recognizes the need for special rules for "financial intermediation services" but does not specify the details of such rules.

145. See Harry Grubert and James Mackie, "An Unnecessary Complication: Must Financial Services Be Taxed under a Consumption Tax?" U.S. Department of the Treasury, January 30, 1996. Note that countries with VATs often impose a separate type of tax on financial institutions.

146. See Peter Merrill and Chris Edwards, "Cash-Flow Taxation of Financial Services," *National Tax Journal*, September 1996. See also Peter Merrill and Harold Adrion, "Treatment of Financial Services under Consumption-Based Tax Systems," *Tax Notes*, September 18, 1995.

147. AICPA, *Flat Taxes and Consumption Taxes*, pp. 8, 111.

148. GAO, "Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators," p. 170. See also Charles McLure and George Zodrow, "A Hybrid Approach to the Direct Taxation of Consumption," *Tax Notes*, October 9, 1995.

149. Investment Company Institute, *Mutual Fund Factbook*, 2001, <http://www.ici.org>.

150. IRS, *Statistics of Income Bulletin* (Spring 2001).

151. ABA.

152. Pollack, *The Failure of U.S. Tax Policy*, p. 203.

153. JCT, *Study of the Overall State of the Federal Tax System*, vol. 1, p. 73.

154. ABA.

155. As noted in a recent Treasury study on the

- Subpart F tax rules. See *Tax Notes*, January 1, 2001. 107th Cong., 1st sess., April 26, 2001.
156. For background on international business taxation, see National Foreign Trade Council. 160. Neubig and Rhody.
157. Bob Perlman, Testimony before the Senate Finance Committee, 106th Cong., 1st sess., March 11, 1999. 161. Bradford, *Taxation, Wealth, and Saving*, p. xii.
158. *Ibid.* 162. Glenn Hubbard, Testimony before the House Committee on Ways and Means, 104th Cong., 2d sess., March 27, 1996. Hubbard noted that "I believe that the current federal income tax is fundamentally flawed, generating adverse consequences for economic efficiency, costly complexity, and significant violations of conventional norms of fairness" (p. 1).
159. Betty Wilson, Tax Executives Institute, Testimony before the Senate Finance Committee,

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