

Michael J. Graetz

100 Million
Unnecessary Returns:

A Fresh Start for the U.S. Tax System



Dozens of people showed up at the IRS Midtown office in New York City as they faced the deadline on the last day of tax filing season. The IRS had set up a desk outside of its offices where agents answered last-minute questions and processed extensions.

“The vast majority of American families should not have to file tax returns or deal with the IRS at all.”

During the past twenty-five years, the income tax has fallen into disrepute. From the period immediately following World War II until 1972, the American people viewed the income tax as the fairest tax in the nation. Since 1980, they have consistently viewed it as the least fair. A poll in 1999 revealed that nearly half of the American people favor changing to a “completely different” tax system.

They have a point. Substantively, the income tax is a mess. Taxpayers at every income level confront extraordinary complexity. In 1940, the instructions to the Form 1040 were about four pages long. By 1976, they had expanded to forty-eight pages. For the tax year 2001, the instruction booklet alone was 122 pages. Form 1040 for the year 2001 had eleven schedules and twenty additional worksheets.

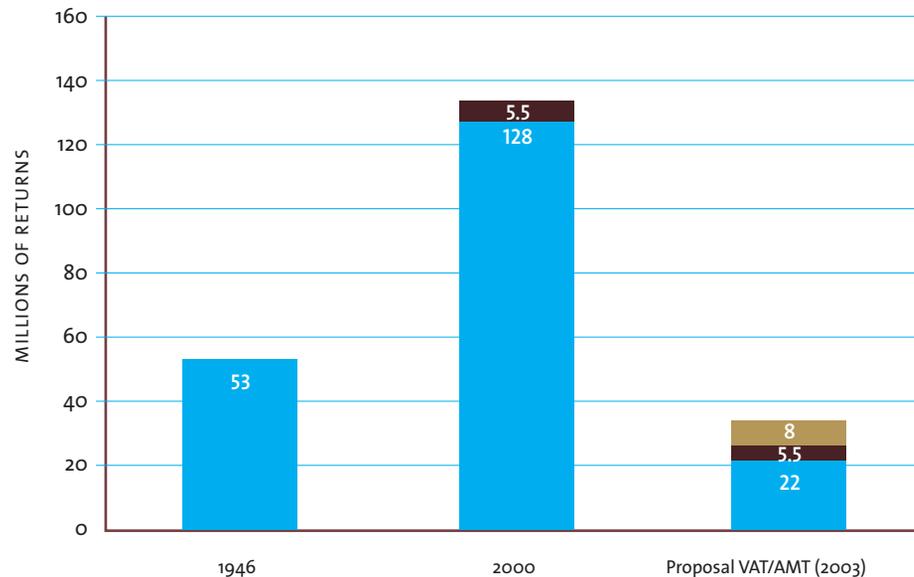
In 1998, Congress enacted the Internal Revenue Service Restructuring and Reform Act, changing the governance and many of the operations of the IRS. While I am a great fan of IRS Commissioner Charles Rossotti and his efforts to reorganize the IRS, to think that the IRS can become a

modern financial services institution without a major overhaul of the tax law it administers is to believe that you can turn the Winnebago around without taking it out of the garage.

The fundamental problem is that the IRS is being asked to do too much. A major simplification of the nation’s tax law is necessary. In order to achieve that, we need a fundamental overhaul of our nation’s tax system. The vast majority of American families should not have to file tax returns or deal with the IRS at all.

We can achieve low tax rates and a reasonably simple tax system by replacing most of the income tax with a “value-added tax” (VAT), a consumption tax that is a revenue-producing mainstay in more than 120 countries on five continents. A VAT operates much like a national sales tax, but is collected at all stages of production rather than just from retailers. At the same time, we should return the income tax to its pre-World War II status—a low-rate tax on a relatively thin slice of higher-income Americans. Our income tax would be lower than that of most other nations, and our taxes on consumption would be comparable to those imposed elsewhere.

TAX RETURNS FILED



A VAT imposed at a 10 to 15 percent rate could finance an exemption from income tax for families with \$100,000 of income or less and would allow a vastly simpler income tax at a 25 percent rate to be applied to incomes over \$100,000. In combination, these two taxes would produce revenues roughly equivalent to the current income tax, and would not dramatically shift the tax burden away from high-income families to middle- and lower-income families.

People freed from income taxation would pay their federal taxes when they purchase goods and services, as they now do with state sales taxes. They would not be required to file any tax returns. They would have no dealings at all with the IRS. The income tax that would remain for high-income taxpayers would be shrunken and simplified substantially. A low, flat rate of tax would be imposed on the taxable income of high-income individuals and corporations. Most of the special income tax credits and allowances that now crowd the tax code and complicate tax forms would be repealed. Most families would be able to save free of tax, and the tax burden on savings would be reduced for everyone.

This is a realistic and feasible plan for restructuring the tax system of the United States. It would be both much simpler and more conducive to economic growth than our current tax system.

The New Consumption Tax

A new federal consumption tax, imposed at a rate of 10 to 15 percent, would finance the costs of eliminating more than 100 million American families—almost 90 percent of all filers—from the income tax rolls. With a family allowance level of \$100,000 and individual and corporate income tax rates of 25 percent, a 14 or 15 percent consumption tax would be necessary to raise revenues roughly equal to those of current law. Given existing state sales taxes, if the U.S. were to add a federal VAT of this rate, the total U.S. tax rate on consumption would approximately equal the average VAT rates in Europe.

In order to keep the tax rate as low as possible, the VAT tax base should be broad, covering virtually all goods and services. The VAT should, however, contain an exemption for small businesses. If all businesses were required to collect VAT and file returns, about 25 million businesses would be required to file, but almost half that number would be eliminated if small businesses with less than \$25,000 of annual gross receipts were exempt from tax. An exemption for businesses with gross receipts of \$100,000 or less would reduce the number of VAT returns to about 5.5 million. And the value-added tax would be imposed only on consumption in the United States; it therefore would exempt exports from tax but would tax imports.

In 1940, the instructions to the Form 1040 were about four pages long. By 1976, they had expanded to forty-eight pages. For the tax year 2001, the instruction booklet alone was 122 pages.

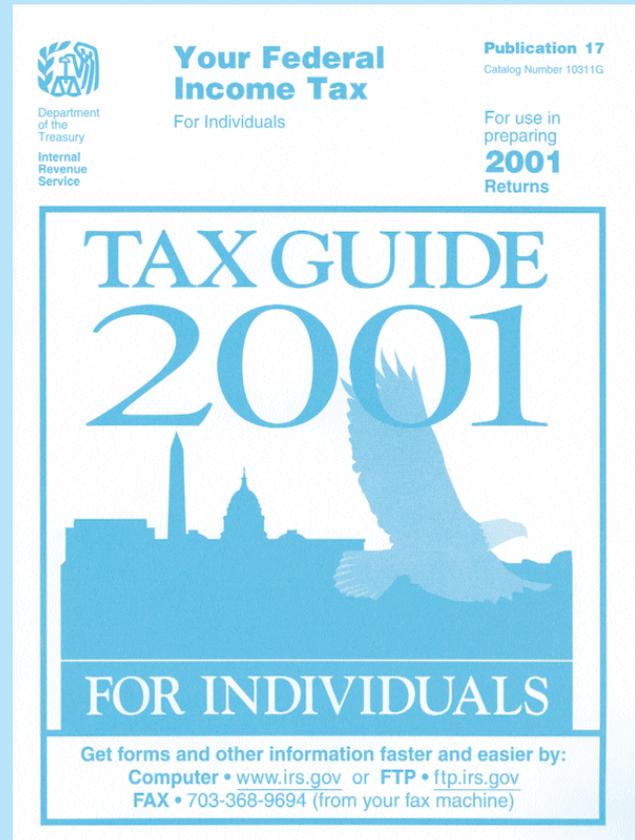
There are a variety of methods for imposing and collecting such a consumption tax. The best alternative is a so-called credit- or invoice-method VAT of the sort used predominantly throughout OECD nations. While I favor the credit method of collecting consumption tax, principally for its compliance advantages, the form of consumption tax is not critical. The key points are these: The consumption tax should be collected only from businesses, and the tax should be imposed at a level sufficient to free the vast majority of Americans both from any income tax liability and from any requirement to file tax returns.

Tax Relief for Low-Income Workers and Retirees

The United States delivers substantial tax relief and, in some instances a direct wage subsidy, to low-wage workers through the current income tax in the form of earned income tax credits (EITC). EITC supplies indispensable wage subsidies to low-income workers and their children, but it is not working well. The IRS estimated in 2002 that almost one-half of these credits are being claimed by people not entitled to them, at a cost of \$11 billion a year. Moreover, the vast majority of workers entitled to the EITC receive their credit as a lump-sum refund after they file their tax returns. Thus, workers typically cannot use the EITC to fund their monthly expenditures.

Under the proposed tax system, income tax withholding from wages would be eliminated for all low- and middle-income workers. But Social Security payroll taxes would still be withheld from all employees—and wages reported to the Social Security Administration in full—making possible new tax offsets that could both replace the EITC and, at the same time, protect low-wage workers from any tax increase that might otherwise result from the new VAT without affecting workers' future Social Security benefits. These payroll tax offsets would put money in low-income workers' pockets when their paychecks are earned and would not require workers to file any year-end tax return.

For retirees, any impact from the new VAT on their cost of living would be largely offset by automatic cost-of-living increases in their monthly Social Security benefits. In addition, retirees with less than \$100,000 of income



would receive Social Security benefits, private pension, and IRA distributions free from the income taxes they now pay.

Bringing the States Along

Nearly all states impose an income tax, and bringing the states into conformity with the new federal system is a major goal and would be a genuine challenge. Simply eliminating the federal income tax for most Americans would create substantial political pressures for the states to do the same, however. States might mimic the federal changes by financing their own \$100,000 income tax exemption through an increase in sales or excise tax rates or through other sources. The federal government should give the states additional incentives to make such a change. For example, the federal government might speed the process of state conformity to the federal system by agreeing to collect and remit the states' remaining income taxes if they conform to the federal system.

Harmonizing states' retail sales taxes and the federal consumption tax is far less important. State sales taxes and a federal value-added tax could readily coexist. But conformity, or at least coordination, of these taxes would greatly ease the burdens of compliance for businesses and reduce administrative costs for tax collectors. Even with such state conformity, the combined federal and state consumption tax rates would be no greater than value-added tax rates in Europe.

The Individual Income Tax

The federal income tax enacted in October 1913 contained an exemption level that limited its application to a relatively small group of the nation's highest-income taxpayers. The tax was originally imposed at low rates and applied to fewer than two percent of American households. The income tax did not become a tax on the masses until the federal government needed substantial new revenues to finance World War II. Now more than 176 million people file more than 125 million tax returns annually. The plan I am proposing would eliminate 100 million of these returns and restore the income tax to its pre-World War II status.

A new "family allowance" of \$100,000 per family (\$50,000 for unmarried taxpayers) would replace the current law's standard deductions, personal exemptions, and

most personal tax credits, including child tax credits, education tax credits, and dependent care tax credits. This means that only about 25 million income tax returns would be filed each year. The IRS's workload would be substantially reduced, and individuals' costs of tax compliance would be reduced dramatically. The family allowance would increase annually with inflation so that its value would remain stable when prices increase. Itemized deductions for charitable contributions, home mortgage interest, and medical expenses would be retained. Employees would be allowed to deduct their business expenses, but all other itemized deductions would be repealed.

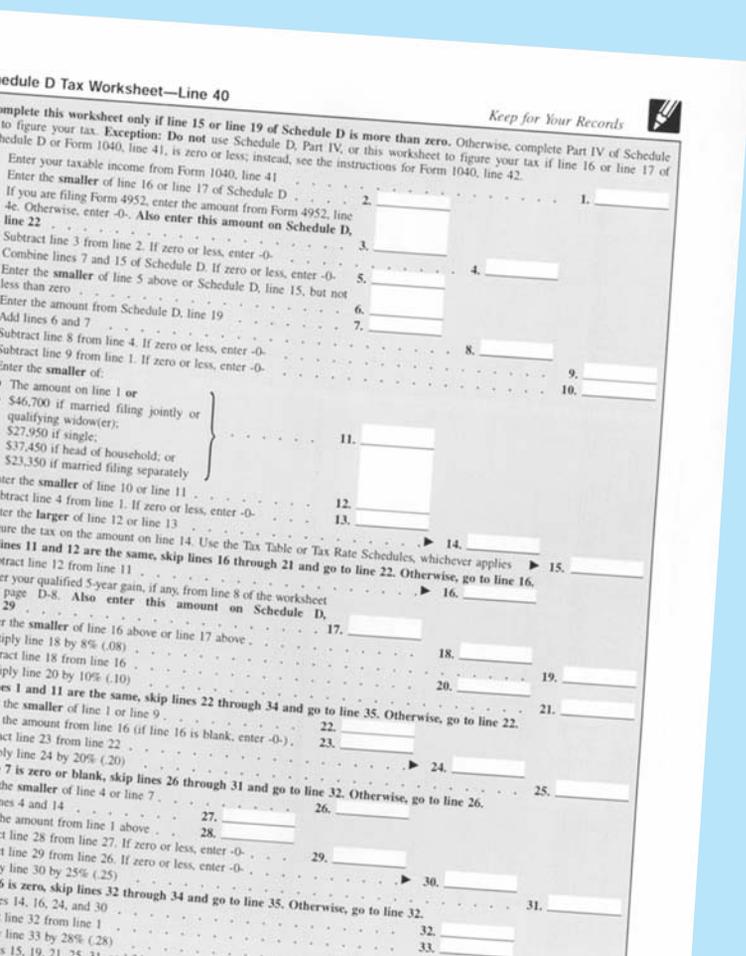
The Corporate Income Tax

The corporate income tax rate would also be reduced to 25 percent. The computation of corporate income tax would thus be simplified substantially. By adopting identical tax rates (and depreciation allowances) under the individual and corporate income taxes, the income of small corporations could be taxed on a flow-through basis, thereby eliminating the separate corporate tax for many small businesses and taxing their income directly to their owners. This would allow small-business income to qualify for the \$100,000 income tax family allowance and the corporate income tax to apply only to large publicly held companies.

In addition, the corporate income tax should require much greater conformity of tax and financial accounting rules for publicly traded corporations than the current income tax law. This convergence of tax and book accounting would greatly simplify corporate tax computations. Moreover, it offers real hope of a solution to the growing problem of corporate tax shelters, since it would make it impossible to concoct tax-reducing transactions without also reducing the company's earnings for financial reporting purposes.

A Tax on Transfers of Large Amounts of Wealth

Much of the progressivity of the nation's tax system currently supplied by the estate tax could be maintained by treating large gifts and bequests as income to those families whose \$100,000 family allowance does not exempt them from income tax. A flat tax of 25 percent would then apply to taxable transfers of large amounts of wealth. The size of gifts or bequests required to be included in the recipient's income should be set at a level that maintains at least half the revenue that the estate tax would have produced. Restructuring the nation's tax system as I have described here would not entail any substantial shift in the distribution of tax burdens among American families at



different income levels. Nor would this plan reduce overall federal revenues. Estimates suggest that the individual income tax relief described above would reduce revenues by about \$600 billion; that the adjustment for low- and moderate-income workers could cost roughly another \$100 billion; and that, depending on how depreciation allowances are determined, reducing the corporate tax rate might reduce corporate tax revenues anywhere from zero to more than \$100 billion. At a 14 percent rate, the new consumption tax is projected to increase revenues by the approximately \$800 billion needed to fund these changes. My plan would eliminate more than 80 percent of the income tax returns that currently are filed each year and would allow substantial simplification of the limited income tax that would remain.

The IRS should then be fully capable of administering the nation's tax system, a task that it is unable to fulfill under the current tax law. For the more than 150 million people from whom no income tax would be required, April 15th would be just another spring day.

Revamping the nation's tax system should also produce positive economic benefits. The new tax system would be friendlier to savings and investment than the existing tax law. The tax burden on savings would be reduced for everyone, and people subject only to the new consumption tax would have no tax burden on their savings whatsoever. The corporate income tax would be reduced to a twenty-five percent rate, making the United States an extremely attractive nation for corporate investments for both U.S. citizens and foreigners. This tax system should stimulate economic growth and create additional jobs for American workers, producing substantial long-term benefits for the American economy.

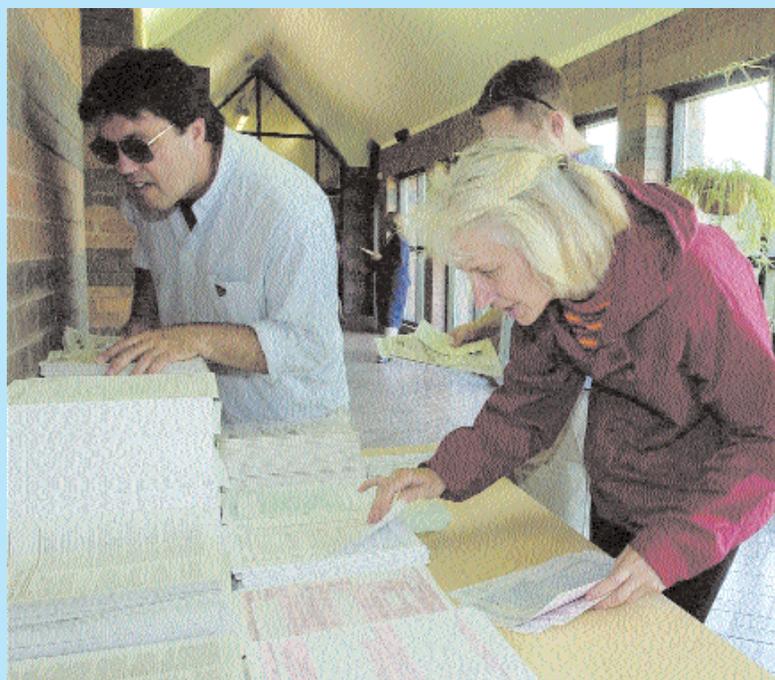
When it first takes effect, the consumption tax might produce consumer price increases equal to the amount of the tax, but the Congressional Budget Office has predicted that no inflation should occur beyond that initial price jump. For most families, the price increase could be offset by the increase in their weekly paychecks due to the elimination of the income tax. Low- and moderate-income workers would be protected through payroll tax withholding reductions, and the elderly by increased Social Security benefits and the elimination of income taxes on their retirement income. Thus, for most Americans, this one-time price adjustment should have little adverse impact.

Moreover, there are substantive advantages to using two

low-rate taxes on both consumption and income rather than relying solely on the income tax. Economic distortions should be smaller. Tax avoidance would be more difficult; those who are able to conceal their income would be taxed when they spend. Aggressive tax planning would reap smaller benefits. The system I advocate here should be more efficient, more equitable, and much simpler than the present income tax.

The income tax did not become a tax on the masses until the federal government needed substantial new revenues to finance World War II. Now more than 176 million people file more than 125 million tax returns annually.

To be sure, today's political climate makes it difficult to see how we might muster the necessary bipartisan majority to achieve such a fundamental restructuring of the nation's tax law. It is difficult to be optimistic that we will move forward intelligently when, in our political discourse, ideology trumps ideas and demagoguery drowns out debate. But continuing with the current tax law portends ever greater complexity, rising dissatisfaction with the tax system, and a decreasing willingness of Americans to comply with tax requirements they cannot comprehend. ▀



Last-minute filers look over tax return papers at the Princeton post office in West Windsor, N.J., on April 15, 2002.