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Funding Leviathan, Part 1

by Laurence M. Vance

The federal leviathan is fed by taxes. According to the Congressional Budget Office, during the federal government's most recent fiscal year (FY 2006), which ended on September 30, 2006, total revenues were approximately $2.403 trillion. Most of this revenue was, of course, raised as a result of taxes confiscated from the American people. These taxes are, broadly and in descending order of their magnitude: individual income taxes, social insurance taxes, corporate income taxes, excise taxes, and estate and gift taxes. Customs duties and miscellaneous receipts account for only a small percentage of the federal government's total revenue.

Individual income taxes — which swelled government coffers by roughly $1.059 trillion during FY 2006 — are the most onerous. Income taxes discourage the creation of wealth, they punish success, they violate financial privacy, they are the fuel of wealth distribution and social engineering, they are the backbone of the interventionist-welfare state. And because the tax code is so complicated and intrusive, additional resources are wasted in compliance and enforcement costs. Acceptance of income taxes as legitimate is predicated on the belief that the government has a right to a portion of each person's income.

Government tax reform

By Executive Order 13369, President Bush created, in January 2005, the President's Advisory Panel on Federal Tax Reform. This advisory panel was composed of nine members appointed by the president, and chaired by the former senator from Florida Connie Mack. The purpose of the panel was to submit to the secretary of the Treasury a report with options for reforming the Internal Revenue Code. Although this report was supposed to be submitted no later than July 31, 2005, the deadline was extended twice, first to September 30, and then to November 1.

After holding 12 public meetings in five states and Washington, D.C., hearing from almost 100 witnesses, and receiving thousands of written comments, the panel released its 272-page report on November 1, 2005, along with an introduction containing a letter to John Snow, the

secretary of the Treasury. The panel unanimously recommended two tax-reform options: the Simplified Income Tax Plan and the Growth and Investment Tax Plan. Although the two plans differ in the taxation of businesses and capital income, they are both said to reduce complexity, improve fairness, and promote economic growth.

The Simplified Income Tax Plan would create four tax brackets of 15, 25, 30, and 33 percent, with a rate of 31.5 percent for corporations. According to the letter to Secretary Snow, this plan dramatically simplifies the tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps such as the Alternative Minimum Tax. It preserves and simplifies major features of the current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans. It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

This plan would exclude from taxation 100 percent of dividends received and 75 percent of corporate-stock capital gains received, but would still tax interest received at regular income-tax rates.

The Growth and Investment Tax Plan would create three tax brackets of 15, 25, and 30 percent, with a 30 percent rate for corporations. According to the letter to Secretary Snow, this plan builds on the Simplified Income Tax Plan and adds a major new feature: moving the tax code closer to a system that would not tax families or businesses on their savings or investments. It would allow businesses to expense or write-off their investments immediately. It would lower tax rates, and impose a single, low tax rate on dividends, interest, and capital gains.

This plan would tax dividends, capital gains, and interest received at a rate of 15 percent.

In addition to using a simplified 1040 tax form, both plans would replace the personal exemption, standard deduction, and child tax credit with a family credit. The earned-income tax credit would be replaced with a work credit that builds on the family credit. Deductions for charitable giving would be available to all taxpayers, not just to those who itemize their deductions. The home-mortgage interest deduction would be replaced with a home credit equal to 15 percent of mortgage interest paid. Although the home credit would not be limited just to itemizers, it would be limited to mortgages less than $412,000, down from the current $1.1 million. Completely eliminated would be the deduction for state and local taxes paid. Social Security benefits would not be taxed for those married couples making less than $44,000 ($22,000 for singles).

One underlying problem with both of these plans is that they are revenue-neutral; that is, the federal leviathan and all of its agencies and programs would be funded at the same obscene levels that they are under the current tax system. But since these are government tax-reform proposals, as a practical matter it could not be any other way. The president’s executive order that

set up his Advisory Panel on Federal Tax Reform stated that it wanted "revenue neutral policy options for reforming the Federal Internal Revenue Code." The letter to Secretary Snow from the panel even mentions this mandate:

> As directed by the President, our recommendations have been designed to raise approximately the same amount of money as the current tax system. The issue of whether the tax code should raise more or less revenue was outside of our mandate. Regardless of how one feels about the amount of revenue required to fund our government, all should agree that the tax system needs a solid and rational foundation.

A tax-reform plan based on the principle of revenue-neutrality is one that all advocates of liberty and limited government should be suspicious of.

The flat rate

A proposed alternative to our current income-tax system with six brackets (10, 15, 25, 28, 33, and 35 percent) is an income tax with one flat rate. It was first proposed by economist Milton Friedman in his 1962 book, *Capitalism and Freedom.* Hoover Institution economists Robert Hall and Alvin Rabushka, the "intellectual godfathers" of the flat-tax movement, drew attention to the idea in a 1981 *Wall Street Journal* article. This grew into the 1985 book, *The Flat Tax* (2nd ed., 1995). House Majority Leader Dick Armey (R-Texas) supported a flat tax in Congress, as did the former California governor Jerry Brown in his failed bid for the 1992 Democratic presidential nomination.

The most recent flat-tax plan is that of the former presidential candidate Steve Forbes, the head of the Forbes publishing empire. Forbes, who sits on the board of the National Taxpayers Union, is the author of *Flat Tax Revolution* (Regnery, 2005), which is subtitled *Using a Postcard to Abolish the IRS.* He describes the federal tax code as "a multi-headed hydra of countless brackets, deductions, and exemptions." In exchange for the current system, Forbes calls for "a new tax system that is simple, honest, and fair" — a flat tax of 17 percent "with generous exemptions for adults and children" that can be filed on a twelve-line, postcard-sized form. Corporations too would have a similar plan, and their profits would be taxed at the same rate.

Under Forbes's proposed flat-tax scheme there would no longer be any taxes on capital gains, Social Security benefits, interest earned, or dividends received. Additionally, the estate tax and the Alternative Minimum Tax would be done away with. Individuals would have "generous exemptions for adults and children," such as deductions of $13,200 for adults and $4,000 for dependents. Corporations could expense all investments (depreciation schedules would be used only for accounting purposes), and would be taxed only on what they made in the United States.

However, because the flat tax is just a replacement for the federal income tax, it will not eliminate Social Security taxes, Medicare taxes, or federal excise taxes. And neither will it have any effect on state and local taxes. Nevertheless, Forbes believes that his flat tax would make us more prosperous, invigorate the economy, and make us more competitive overseas.

But is the Forbes plan a solution to the horrendous, convoluted, wealth-destroying federal income-tax code or does it merely mask the real problem? Although the Forbes plan is a solution if the problem is how to shorten and simplify the tax code so people will feel better about paying their taxes, it is no solution at all if it perpetuates the federal leviathan. It has some other problems as well.

The first problem with Forbes's flat tax is that it is not a flat tax. It is a highly progressive tax that shifts the tax burden to the "rich" — the middle class and upper middle class that earn wages and salaries. The flat tax has tax brackets just like the current system. There is the single bracket, the single-mother bracket, and a series of married-with-children brackets. The flat tax would enable "a family of four to pay no federal income tax on its first $46,165 of income." A family of six "would owe no income tax until its earnings exceeded $65,930." These families would not pay any income tax because not only does the Forbes plan include deductions for each adult and child in a family, it also includes a refundable tax credit of $1,000 per child "as under the current system." Thus, the flat tax continues a welfare scheme, since the refund comes out of other taxpayers' money. If you want an example of a real flat tax then look at the Medicare tax. The rate is 2.9 percent for everyone no matter how much or how little one makes. What Forbes calls the flat tax may be a lower tax and a simpler tax than the system we have now, but it is not a flat tax.

The second problem with Forbes's plan is that it includes that fraudulent welfare tax-credit scheme known as the Earned Income Tax Credit. He claims that the EITC is "a back-door way of effectively refunding" the Social Security and Medicare taxes paid by "low-income families with children." But why is Forbes so concerned about "low-income families" paying half of their Social Security and Medicare taxes, but not at all concerned about the self-employed small business owner who struggles with the whole amount? And like the child tax credit, the EITC is refundable.

The third problem with Forbes's flat tax is that it is still an income tax. Forbes calls for "a new tax system that is simple, honest, and fair." But what is so fair about a tax on income? And what is so fair about the government's confiscating 17 percent of our income, even after "generous exemptions for adults and children"? "The flat-tax movement," as explained by the economist Murray Rothbard (1926–1995), "is part of a process by which the government and its allies have been able to split and deflect the tax protest movement from trying to lower the taxes of everyone, into trying to force everyone into paying some arbitrarily defined 'fair share.'"

Although proponents of other plans to change the U.S. tax system usually talk about how their tax will be revenue-neutral, Forbes does them one better: he claims that his flat-tax plan will generate increased government revenue. And what will the government do with this extra revenue? Forbes wants it to "fund programs like Social Security and Medicare" and "help us wage a successful war against Islamic terrorism"; that is, he wants to increase the funding of the welfare/warfare state.

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